

**OECD/G20 Base Erosion and Profit Shifting
Project**



Aligning Transfer Pricing Outcomes with Value Creation

ACTIONS 8-10: 2015 Final Reports



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Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports

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Foreword

International tax issues have never been as high on the political agenda as they are today. The integration of national economies and markets has increased substantially in recent years, putting a strain on the international tax rules, which were designed more than a century ago. Weaknesses in the current rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created.

Following the release of the report *Addressing Base Erosion and Profit Shifting* in February 2013, OECD and G20 countries adopted a 15-point Action Plan to address BEPS in September 2013. The Action Plan identified 15 actions along three key pillars: introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards, and improving transparency as well as certainty.

Since then, all G20 and OECD countries have worked on an equal footing and the European Commission also provided its views throughout the BEPS project. Developing countries have been engaged extensively via a number of different mechanisms, including direct participation in the Committee on Fiscal Affairs. In addition, regional tax organisations such as the African Tax Administration Forum, the *Centre de rencontre des administrations fiscales* and the *Centro Interamericano de Administraciones Tributarias*, joined international organisations such as the International Monetary Fund, the World Bank and the United Nations, in contributing to the work. Stakeholders have been consulted at length: in total, the BEPS project received more than 1 400 submissions from industry, advisers, NGOs and academics. Fourteen public consultations were held, streamed live on line, as were webcasts where the OECD Secretariat periodically updated the public and answered questions.

After two years of work, the 15 actions have now been completed. All the different outputs, including those delivered in an interim form in 2014, have been consolidated into a comprehensive package. The BEPS package of measures represents the first substantial renovation of the international tax rules in almost a century. Once the new measures become applicable, it is expected that profits will be reported where the economic activities that generate them are carried out and where value is created. BEPS planning strategies that rely on outdated rules or on poorly co-ordinated domestic measures will be rendered ineffective.

Implementation therefore becomes key at this stage. The BEPS package is designed to be implemented via changes in domestic law and practices, and via treaty provisions, with negotiations for a multilateral instrument under way and expected to be finalised in 2016. OECD and G20 countries have also agreed to continue to work together to ensure a consistent and co-ordinated implementation of the BEPS recommendations. Globalisation requires that global solutions and a global dialogue be established which go beyond OECD and G20 countries. To further this objective, in 2016 OECD and G20 countries will conceive an inclusive framework for monitoring, with all interested countries participating on an equal footing.

A better understanding of how the BEPS recommendations are implemented in practice could reduce misunderstandings and disputes between governments. Greater focus on implementation and tax administration should therefore be mutually beneficial to governments and business. Proposed improvements to data and analysis will help support ongoing evaluation of the quantitative impact of BEPS, as well as evaluating the impact of the countermeasures developed under the BEPS Project.

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Abbreviations and acronyms

BEPS	Base erosion and profit shifting
CCA	Cost contribution arrangement
CFC	Controlled foreign company
CRO	Contract research organisation
CUP	Comparable uncontrolled price
G20	Group of twenty
HTVI	Hard-to-value intangibles
IT	Information technology
MAP	Mutual agreement procedure
MNE	Multinational enterprise
OECD	Organisation for Economic Co-operation and Development
R&D	Research and development
TNMM	Transactional net margin method
UN	United Nations
VAT	Value added tax
WACC	Weighted average cost of capital
WP6	Working party No.6 on the Taxation of Multinational Enterprises

Executive summary

Over several decades and in step with the globalisation of the economy, world-wide intra-group trade has grown exponentially. Transfer pricing rules, which are used for tax purposes, are concerned with determining the conditions, including the price, for transactions within an MNE group resulting in the allocation of profits to group companies in different countries. The impact of these rules has become more significant for business and tax administrations with the growth in the volume and value of intra-group trade. As the *Action Plan on Base Erosion and Profit Shifting* (BEPS Action Plan, OECD, 2013) identified, the existing international standards for transfer pricing rules can be misapplied so that they result in outcomes in which the allocation of profits is not aligned with the economic activity that produced the profits. The work under Actions 8-10 of the BEPS Action Plan has targeted this issue, to ensure that transfer pricing outcomes are aligned with value creation.

The arm's length principle is used by countries as the cornerstone of transfer pricing rules. It is embedded in treaties and appears as Article 9(1) of the OECD and UN Model Tax Conventions. A shared interpretation of the principle by many of those countries is set out in the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter: "Transfer Pricing Guidelines") first published as the Report on Transfer Pricing and Multinational Enterprises in 1979, revised and published as Guidelines in 1995, with a further update in 2010. The principle requires that transactions between associated enterprises are priced as if the enterprises were independent, operating at arm's length and engaging in comparable transactions under similar conditions and economic circumstances. Where the conditions of the transaction are different to those between third parties in comparable circumstances, adjustments to the profits may be needed for tax purposes. The arm's length principle has proven useful as a practical and balanced standard for tax administrations and taxpayers to evaluate transfer prices between associated enterprises, and to prevent double taxation. However, with its perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has also proven vulnerable to manipulation. This manipulation can lead to outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of an MNE group. Therefore, the BEPS Action Plan required the guidance on the arm's length principle to be clarified and strengthened and, furthermore, if transfer pricing risks remain after clarifying and strengthening the guidance, the BEPS Action Plan foresaw the possibility of introducing special measures either within or beyond the arm's length principle.

This work on transfer pricing under the BEPS Action Plan has focused on three key areas. Work under Action 8 looked at transfer pricing issues relating to transactions involving intangibles, since misallocation of the profits generated by valuable intangibles has contributed to base erosion and profit shifting. Work under Action 9 considered the contractual allocation of risks, and the resulting allocation of profits to those risks, which may not correspond with the activities actually carried out. Work under Action 9 also

addressed the level of returns to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company. Work under Action 10 focused on other high-risk areas, including the scope for addressing profit allocations resulting from transactions which are not commercially rational for the individual enterprises concerned (re-characterisation), the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, and neutralising the use of certain types of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with value creation.

This Report contains revised guidance which responds to these issues and ensures that the transfer pricing rules secure outcomes that see operational profits allocated to the economic activities which generate them. It represents an agreement of the countries participating in the OECD/G20 BEPS Project. For countries that formally subscribe to the Transfer Pricing Guidelines, the guidance in this Report takes the form of amendments to the Transfer Pricing Guidelines. Therefore this Report also reflects how the changes will be incorporated in those Guidelines.¹

To achieve this objective, the revised guidance requires careful delineation of the actual transaction between the associated enterprises by analysing the contractual relations between the parties in combination with the conduct of the parties. The conduct will supplement or replace the contractual arrangements if the contracts are incomplete or are not supported by the conduct. In combination with the proper application of pricing methods in a way that prevents the allocation of profits to locations where no contributions are made to these profits, this will lead to the allocation of profits to the enterprises that conduct the corresponding business activities. In circumstances where the transaction between associated enterprises lacks commercial rationality, the guidance continues to authorise the disregarding of the arrangement for transfer pricing purposes.

The revised guidance includes two important clarifications relating to risks and intangibles.

Risks are defined as the effect of uncertainty on the objectives of the business. In all of a company's operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed. No profit-seeking business takes on risk associated with commercial opportunities without expecting a positive return. This economic notion that higher risks warrant higher anticipated returns made MNE groups pursue tax planning strategies based on contractual re-allocations of risks, sometimes without any change in the business operations. In order to address this, the Report determines that risks contractually assumed by a party that cannot in fact exercise meaningful and specifically defined control over the risks, or does not have the financial capacity to assume the risks, will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks.

For intangibles, the guidance clarifies that legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible. The group companies performing important functions, controlling economically significant risks and contributing assets, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return reflecting the value of their contributions. Specific guidance will ensure that the analysis is not weakened by information asymmetries between the tax administration and the taxpayer in relation to hard-to-value intangibles, or by using special contractual relationships, such as a cost contribution arrangement.

The revised guidance also addresses the situation where a capital-rich member of the group provides funding but performs few activities. If this associated enterprise does not in fact control the financial risks associated with its funding (for example because it just provides the money when it is asked to do so, without any assessment of whether the party receiving the money is creditworthy), then it will not be allocated the profits associated with the financial risks and will be entitled to no more than a risk-free return, or less if, for example, the transaction is not commercially rational and therefore the guidance on non-recognition applies.

Finally, the guidance ensures that pricing methods will allocate profits to the most important economic activities. It will no longer be possible to allocate the synergistic benefits of operating as a group to members other than the ones contributing to such synergistic benefits. For example, discounts that are generated because of the volume of goods ordered by a combination of group companies will need to be allocated to these group companies. As part of the Report, a mandate is included for follow-up work to be done on the transactional profit split method, which will be carried out during 2016 and finalised in the first half of 2017. This work should lead to detailed guidance on the ways in which this method can usefully and appropriately be applied to align transfer pricing outcomes with value creation, including in the circumstances of integrated global value chains.

The guidance is linked in a holistic way with other Actions. As mentioned above, this guidance will ensure that capital-rich entities without any other relevant economic activities (“cash boxes”) will not be entitled to any excess profits. The profits the cash box is entitled to retain will be equivalent to no more than a risk-free return. Moreover, if this return qualifies as interest or an economically equivalent payment, then those already marginal profits will also be targeted by the interest deductibility rules of Action 4. In addition, it will become extremely difficult to structure the payments to the country where the cash box is tax-resident in a way that avoids withholding taxes, due to the guidance provided on preventing treaty abuse (Action 6). Finally, a cash box with limited or no economic activities is likely to be the target of CFC rules (Action 3). With that, the holistic approach provided by the BEPS Action Plan will secure that the role of cash boxes in BEPS strategies is seriously discouraged.

This holistic approach to tackling BEPS behaviour is supported by the transparency requirements agreed under Action 13. Transfer pricing analysis depends on access to relevant information. The access to the transfer pricing documentation provided by Action 13 will enable the guidance provided in this Report to be applied in practice, based on relevant information on global and local operations in the master file and local file. In addition, the Country-by-Country Report will enable better risk assessment practices by providing information about the global allocation of the MNE group’s revenues, profits, taxes, and economic activity.

In addition to improving access to relevant transfer pricing information through Action 13, this report also contains guidance on transactions involving commodities as well as on low value-adding intra-group services. As BEPS creates additional transfer pricing challenges for developing countries and these two areas were identified by them as being of critical importance, this guidance will be supplemented with further work mandated by the G20 Development Working Group, which will provide knowledge, best practices, and tools for developing countries to use to price commodity transactions for transfer pricing purposes and to prevent the erosion of their tax bases through common types of base-eroding payments.

Transfer pricing depends on a facts and circumstances analysis and can involve subjective interpretations of these facts and circumstances. In order to address the risk of double taxation, the work under Action 14 to improve the effectiveness of dispute resolution mechanisms includes a new minimum standard providing for access to the Mutual Agreement Procedure of Article 25 of the Model Tax Convention for all transfer pricing cases. In addition, the 20 countries which have made the commitment to mandatory binding arbitration under Action 14 have specified that they will allow access to arbitration for transfer pricing cases so that double taxation will be eliminated.

The work under Actions 8-10 of the BEPS Action Plan will ensure that transfer pricing outcomes better align with value creation of the MNE group. Moreover, the holistic nature of the BEPS Action Plan will ensure that the role of capital-rich, low-functioning entities in BEPS planning will become less relevant. As a consequence, the goals set by the BEPS Action Plan in relation to the development of transfer pricing rules have been achieved without the need to develop special measures outside the arm's length principle. Further work will be undertaken on profit splits and financial transactions. Special attention is given in the Report to the needs of developing countries. This new guidance will be supplemented with further work mandated by the G20 Development Working Group, following reports by the OECD on the impact of base erosion and profit shifting in developing countries. Finally, the interaction with Action 14 on dispute resolution will ensure that the transfer pricing measures included in this Report will not result in double taxation.

GUIDANCE FOR APPLYING THE ARM'S LENGTH PRINCIPLE

Revisions to Section D of Chapter I of the Transfer Pricing Guidelines

Summary

The guidance set out in this chapter of the Report responds to the mandate under Actions 8-10 of the BEPS Action Plan requiring the development of transfer pricing rules which create transfer pricing outcomes in line with value creation. More specifically, Actions 9 and 10 mandate the development of:

(i) “rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation.”

(ii) “rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterised.”

The guidance ensures that:

- actual business transactions undertaken by associated enterprises are identified, and transfer pricing is not based on contractual arrangements that do not reflect economic reality
- contractual allocations of risk are respected only when they are supported by actual decision-making
- capital without functionality will generate no more than a risk-free return, assuring that no premium returns will be allocated to cash boxes without relevant substance
- tax administrations may disregard transactions when the exceptional circumstances of commercial irrationality apply.

In combination, the changes make a key contribution to aligning transfer pricing outcomes with the value creating activities performed by the members of an MNE group.

These revisions will update the Transfer Pricing Guidelines so that they provide guidance for taxpayers and tax administrations to follow in performing a transfer pricing analysis. The revisions emphasise the importance of accurately delineating the actual

transaction between the associated enterprises by supplementing, where necessary, the terms of any contract with the evidence of the actual conduct of the parties. The transaction is not simply delineated by what is set out in a contract.

The assumption of risk by a party to a transaction can significantly affect the pricing of that transaction at arm's length. The revisions expand the guidance on identifying specific risks and their impact, and provide an analytical framework to determine which associated enterprise assumes risk for transfer pricing purposes. To assume a risk for transfer pricing purposes, the associated enterprise needs to control the risk and have the financial capacity to assume the risk.

Finally, the guidance helps to accurately determine the actual contributions made by an associated enterprise that solely provides capital. Where the capital provider does not exercise control over the investment risks that may give rise to premium returns, that associated enterprise should expect no more than a risk-free return.

Taken together, these aspects of the revised guidance ensure that a transfer pricing analysis is based on an accurate delineation of what the associated enterprises actually contribute in the transaction, and not on contractual terms, including contractual assumption of risk, that are not in practice performed. The guidance provides a basis for any transfer pricing analysis, but in so doing it also addresses some of the key BEPS challenges: allocating risks on paper does not in itself shift profits.

Ordinarily the actual arrangements should then be priced in accordance with guidance provided in other chapters of the Transfer Pricing Guidelines. However, the revisions in this chapter reinforce the need for tax administrations to be able to disregard transactions between associated enterprises when the exceptional circumstances of commercial irrationality apply. The guidance emphasises that the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised. Instead, the key question is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances.

In summary, the revisions respond to the mandate to prevent inappropriate returns to capital and misallocation of risk by encouraging thoroughness in determining the actual arrangements between the associated enterprises so that pricing takes into account the actual contributions of those parties, including risks actually assumed, and by authorising the non-recognition of transactions which make no commercial sense.

The current provisions of Chapter I, Section D of the Transfer Pricing Guidelines are deleted in their entirety and replaced by the following language.

D.1. Identifying the commercial or financial relations

1.33 As stated in paragraph 1.6 a “comparability analysis” is at the heart of the application of the arm’s length principle. Application of the arm’s length principle is based on a comparison of the conditions in a controlled transaction with the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances. There are two key aspects in such an analysis: the first aspect is to identify the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated; the second aspect is to compare the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and the economically relevant circumstances of comparable transactions between independent enterprises. This section of Chapter I provides guidance on identifying the commercial or financial relations between the associated enterprises and on accurately delineating the controlled transaction. This first aspect of the analysis is distinct from the second aspect of considering the pricing of that controlled transaction under the arm’s length principle. Chapters II and III provide guidance on the second aspect of the analysis. The information about the controlled transaction determined under the guidance in this section is especially relevant for steps 2 and 3 of the typical process of a comparability analysis set out in paragraph 3.4.

1.34 The typical process of identifying the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations requires a broad-based understanding of the industry sector in which the MNE group operates (e.g. mining, pharmaceutical, luxury goods) and of the factors affecting the performance of any business operating in that sector. The understanding is derived from an overview of the particular MNE group which outlines how the MNE group responds to the factors affecting performance in the sector, including its business strategies, markets, products, its supply chain, and the key functions performed, material assets used, and important risks assumed. This information is likely to be included as part of the master file as described in Chapter V in support of a taxpayer’s analysis of its transfer pricing, and provides useful context in which the commercial or financial relations between members of the MNE group can be considered.

1.35 The process then narrows to identify how each MNE within that MNE group operates, and provides an analysis of what each MNE does (e.g. a production company, a sales company) and identifies its commercial or financial relations with associated enterprises as expressed in transactions between them. The accurate delineation of the actual transaction or transactions between the associated enterprises requires analysis of the economically relevant characteristics of the transaction. These economically relevant characteristics consist of the conditions of the transaction and the economically relevant circumstances in which the transaction takes place. The application of the arm’s length principle depends on determining the conditions that independent parties would have agreed in comparable transactions in comparable circumstances. Before making comparisons with uncontrolled transactions, it is therefore vital to identify the economically relevant characteristics of the commercial or financial relations as expressed in the controlled transaction.

1.36 The economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations between the associated enterprises in order to accurately delineate the actual transaction can be broadly categorised as follows:

- The contractual terms of the transaction (D.1.1).
- 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 (D.1.2).
- The characteristics of property transferred or services provided (D.1.3).
- The economic circumstances of the parties and of the market in which the parties operate (D.1.4).
- The business strategies pursued by the parties (D.1.5).

This information about the economically relevant characteristics of the actual transaction should be included as part of the local file as described in Chapter V in support of a taxpayer's analysis of its transfer pricing.

1.37 Economically relevant characteristics or comparability factors are used in two separate but related phases in a transfer pricing analysis. The first phase relates to the process of accurately delineating the controlled transaction for the purposes of this chapter, and involves establishing the characteristics of the transaction, including its terms, the functions performed, assets used, and risks assumed by the associated enterprises, the nature of the products transferred or services provided, and the circumstances of the associated enterprises, in accordance with the categories set out in the previous paragraph. The extent to which any one of the characteristics categorised above is economically relevant in a particular transaction depends on the extent to which it would be taken into account by independent enterprises when evaluating the terms of the same transaction were it to occur between them.

1.38 Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that offers a clearly more attractive opportunity to meet their commercial objectives. In other words, independent enterprises would only enter into a transaction if it is not expected to make them worse off than their next best option. For example, one enterprise is unlikely to accept a price offered for its product by an independent commercial enterprise if it knows that other potential customers are willing to pay more under similar conditions, or are willing to pay the same under more beneficial conditions. Independent enterprises will generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk) when valuing those options. Therefore, identifying the economically relevant characteristics of the transaction is essential in accurately delineating the controlled transaction and in revealing the range of characteristics taken into account by the parties to the transaction in reaching the conclusion that the transaction adopted offers a clearly more attractive opportunity to meet commercial objectives than alternative options realistically available. In making such an assessment, it may be necessary or useful to assess the transaction in the context of a broader arrangement of transactions, since assessment of the options realistically available to third parties is not necessarily limited to the single transaction, but may take into account a broader arrangement of economically related transactions.

1.39 The second phase in which economically relevant characteristics or comparability factors are used in a transfer pricing analysis relates to the process set out in Chapter III of making comparisons between the controlled transactions and uncontrolled transactions in order to determine an arm's length price for the controlled transaction. To make such comparisons, taxpayers and tax administrations need first to have identified the economically relevant characteristics of the controlled transaction. As set out in Chapter III, differences in economically relevant characteristics between the controlled and uncontrolled arrangements need to be taken into account when establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability.

1.40 All methods that apply the arm's length principle can be tied to the concept that independent enterprises consider the options realistically available to them and in comparing one option to another they consider any differences between the options that would significantly affect their value. For instance, before purchasing a product at a given price, independent enterprises normally would be expected to consider whether they could buy an equivalent product on otherwise comparable terms and conditions but at a lower price from another party. Therefore, as discussed in Chapter II, Part II, the comparable uncontrolled price (CUP) method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative to the controlled transaction. However, the method becomes a less reliable substitute for arm's length transactions if not all the characteristics of these uncontrolled transactions that significantly affect the price charged between independent enterprises are comparable. Similarly, the resale price and cost plus methods compare the gross profit margin earned in the controlled transaction to gross profit margins earned in similar uncontrolled transactions. The comparison provides an estimate of the gross profit margin one of the parties could have earned had it performed the same functions for independent enterprises and therefore provides an estimate of the payment that party would have demanded, and the other party would have been willing to pay, at arm's length for performing those functions. Other methods, as discussed in Chapter II, Part III, are based on comparisons of net profit indicators (such as profit margins) between independent and associated enterprises as a means to estimate the profits that one or each of the associated enterprises could have earned had they dealt solely with independent enterprises, and therefore the payment those enterprises would have demanded at arm's length to compensate them for using their resources in the controlled transaction. Where there are differences between the situations being compared that could materially affect the comparison, comparability adjustments must be made, where possible, to improve the reliability of the comparison. Therefore, in no event can unadjusted industry average returns themselves establish arm's length prices.

1.41 For a discussion of the relevance of these factors for the application of particular pricing methods, see the consideration of those methods in Chapter II.

D.1.1. The contractual terms of the transaction

1.42 A transaction is the consequence or expression of the commercial or financial relations between the parties. The controlled transactions may have been formalised in written contracts which may reflect the intention of the parties at the time the contract was concluded in relation to aspects of the transaction covered by the contract, including in typical cases the division of responsibilities, obligations and rights, assumption of identified risks, and pricing arrangements. Where a transaction has been formalised by the associated enterprises through written contractual agreements, those agreements provide the starting point for delineating the transaction between them and how the responsibilities,

risks, and anticipated outcomes arising from their interaction were intended to be divided at the time of entering into the contract. The terms of a transaction may also be found in communications between the parties other than a written contract.

1.43 However, the written contracts alone are unlikely to provide all the information necessary to perform a transfer pricing analysis, or to provide information regarding the relevant contractual terms in sufficient detail. Further information will be required by taking into consideration evidence of the commercial or financial relations provided by the economically relevant characteristics in the other four categories (see paragraph 1.36): the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, together with the characteristics of property transferred or services provided, the economic circumstances of the parties and of the market in which the parties operate, and the business strategies pursued by the parties. Taken together, the analysis of economically relevant characteristics in all five categories provides evidence of the actual conduct of the associated enterprises. The evidence may clarify aspects of the written contractual arrangements by providing useful and consistent information. If the contract neither explicitly nor implicitly (taking into account applicable principles of contract interpretation) addresses characteristics of the transaction that are economically relevant, then any information provided by the contract should be supplemented for purposes of the transfer pricing analysis by the evidence provided by identifying those characteristics.

1.44 The following example illustrates the concept of clarifying and supplementing the written contractual terms based on the identification of the actual commercial or financial relations. Company P is the parent company of an MNE group situated in Country P. Company S, situated in Country S, is a wholly-owned subsidiary of Company P and acts as an agent for Company P's branded products in the Country S market. The agency contract between Company P and Company S is silent about any marketing and advertising activities in Country S that the parties should perform. Analysis of other economically relevant characteristics and in particular the functions performed, determines that Company S launched an intensive media campaign in Country S in order to develop brand awareness. This campaign represents a significant investment for Company S. Based on evidence provided by the conduct of the parties, it could be concluded that the written contract may not reflect the full extent of the commercial or financial relations between the parties. Accordingly, the analysis should not be limited by the terms recorded in the written contract, but further evidence should be sought as to the conduct of the parties, including as to the basis upon which Company S undertook the media campaign.

1.45 If the characteristics of the transaction that are economically relevant are inconsistent with the written contract between the associated enterprises, the actual transaction should generally be delineated for purposes of the transfer pricing analysis in accordance with the characteristics of the transaction reflected in the conduct of the parties.

1.46 In transactions between independent enterprises, the divergence of interests between the parties ensures (i) that contractual terms are concluded that reflect the interests of both of the parties, (ii) that the parties will ordinarily seek to hold each other to the terms of the contract, and (iii) that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties. The same divergence of interests may not exist in the case of associated enterprises or any such divergences may be managed in ways facilitated by the control relationship and not solely or mainly through contractual agreements. It is, therefore, particularly important in considering the commercial or financial relations between associated enterprises to examine whether the arrangements reflected in the actual conduct of the parties substantially conform

to the terms of any written contract, or whether the associated enterprises' actual conduct indicates that the contractual terms have not been followed, do not reflect a complete picture of the transactions, have been incorrectly characterised or labelled by the enterprises, or are a sham. Where conduct is not fully consistent with economically significant contractual terms, further analysis is required to identify the actual transaction. Where there are material differences between contractual terms and the conduct of the associated enterprises in their relations with one another, the functions they actually perform, the assets they actually use, and the risks they actually assume, considered in the context of the contractual terms, should ultimately determine the factual substance and accurately delineate the actual transaction.

1.47 Where there is doubt as to what transaction was agreed between the associated enterprises, it is necessary to take into account all the relevant evidence from the economically relevant characteristics of the transaction. In doing so one must bear in mind that the terms of the transaction between the enterprises may change over time. Where there has been a change in the terms of a transaction, the circumstances surrounding the change should be examined to determine whether the change indicates that the original transaction has been replaced through a new transaction with effect from the date of the change, or whether the change reflects the intentions of the parties in the original transaction. Particular care should be exercised where it appears that any changes may have been triggered by knowledge of emerging outcomes from the transaction. Changes made in the purported assumption of a risk when risk outcomes are known do not involve an assumption of risk since there is no longer any risk, as discussed in paragraph 1.78.

1.48 The following example illustrates the concept of differences between written contractual terms and conduct of the parties, with the result that the actual conduct of the parties delineates the transaction. Company S is a wholly-owned subsidiary of Company P. The parties have entered into a written contract pursuant to which Company P licenses intellectual property to Company S for use in Company S's business; Company S agrees to compensate Company P for the licence with a royalty. Evidence provided by other economically relevant characteristics, and in particular the functions performed, establishes that Company P performs negotiations with third-party customers to achieve sales for Company S, provides regular technical services support to Company S so that Company S can deliver contracted sales to its customers, and regularly provides staff to enable Company S to fulfil customer contracts. A majority of customers insist on including Company P as joint contracting party along with Company S, although fee income under the contract is payable to Company S. The analysis of the commercial or financial relations indicates that Company S is not capable of providing the contracted services to customers without significant support from Company P, and is not developing its own capability. Under the contract, Company P has given a licence to Company S, but in fact controls the business risk and output of Company S such that it has not transferred risk and function consistent with a licensing arrangement, and acts not as the licensor but the principal. The identification of the actual transaction between Company P and Company S should not be defined solely by the terms of the written contract. Instead, the actual transaction should be determined from the conduct of the parties, leading to the conclusion that the actual functions performed, assets used, and risks assumed by the parties are not consistent with the written licence agreement.

1.49 Where no written terms exist, the actual transaction would need to be deduced from the evidence of actual conduct provided by identifying the economically relevant characteristics of the transaction. In some circumstances the actual outcome of commercial or financial relations may not have been identified as a transaction by the MNE, but nevertheless may result in a transfer of material value, the terms of which would need to be

deduced from the conduct of the parties. For example, technical assistance may have been granted, synergies may have been created through deliberate concerted action (as discussed in section D.8), or know-how may have been provided through seconded employees or otherwise. These relations may not have been recognised by the MNE, may not be reflected in the pricing of other connected transactions, may not have been formalised in written contracts, and may not appear as entries in the accounting systems. Where the transaction has not been formalised, all aspects would need to be deduced from available evidence of the conduct of the parties, including what functions are actually performed, what assets are actually used, and what risks are actually assumed by each of the parties.

1.50 The following example illustrates the concept of determining the actual transaction where a transaction has not been identified by the MNE. In reviewing the commercial or financial relations between Company P and its subsidiary companies, it is observed that those subsidiaries receive services from an independent party engaged by Company P. Company P pays for the services, the subsidiaries do not reimburse Company P directly or indirectly through the pricing of another transaction and there is no service agreement in place between Company P and the subsidiaries. The conclusion is that, in addition to a provision of services by the independent party to the subsidiaries, there are commercial or financial relations between Company P and the subsidiaries, which transfer potential value from Company P to the subsidiaries. The analysis would need to determine the nature of those commercial or financial relations from the economically relevant characteristics in order to determine the terms and conditions of the identified transaction.

D.1.2. Functional analysis

1.51 In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in delineating the controlled transaction and determining comparability between controlled and uncontrolled transactions or entities, a functional analysis is necessary. This functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions. The analysis focuses on what the parties actually do and the capabilities they provide. Such activities and capabilities will include decision-making, including decisions about business strategy and risks. For this purpose, it may be helpful to understand the structure and organisation of the MNE group and how they influence the context in which the MNE operates. In particular, it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the associated enterprises with the rest of the group, and the contribution that the associated enterprises make to that value creation. It will also be relevant to determine the legal rights and obligations of each of the parties in performing their functions. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.

1.52 The actual contributions, capabilities, and other features of the parties can influence the options realistically available to them. For example, an associated enterprise provides logistics services to the group. The logistics company is required to operate warehouses with spare capacity and in several locations in order to be able to cope in the event that supply is disrupted at any one location. The option of greater efficiency through consolidation of locations and reduction in excess capacity is not available. Its functions and assets may, therefore, be different to those of an independent logistics company if that independent service provider did not offer the same capabilities to reduce the risk of disruption to supply.

1.53 Therefore, the process of identifying the economically relevant characteristics of the commercial or financial relations should include consideration of the capabilities of the parties, how such capabilities affect options realistically available, and whether similar capabilities are reflected in potentially comparable arm's length arrangements.

1.54 The functional analysis should consider the type of assets used, such as plant and equipment, the use of valuable intangibles, financial assets, etc., and the nature of the assets used, such as the age, market value, location, property right protections available, etc.

1.55 The functional analysis may show that the MNE group has fragmented highly integrated functions across several group companies. There may be considerable interdependencies between the fragmented activities. For example, the separation into different legal entities of logistics, warehousing, marketing, and sales functions may require considerable co-ordination in order that the separate activities interact effectively. Sales activities are likely to be highly dependent on marketing, and fulfilment of sales, including the anticipated impact of marketing activities, would require alignment with stocking processes and logistics capability. That required co-ordination may be performed by some or all of the associated enterprises performing the fragmented activities, performed through a separate co-ordination function, or performed through a combination of both. Risk may be mitigated through contributions from all the parties, or risk mitigation activities may be undertaken mainly by the co-ordination function. Therefore, when conducting a functional analysis to identify the commercial or financial relations in fragmented activities, it will be important to determine whether those activities are highly interdependent, and, if so, the nature of the interdependencies and how the commercial activity to which the associated enterprises contribute is co-ordinated.

D.1.2.1. Analysis of risks in commercial or financial relations²

1.56 A functional analysis is incomplete unless the material risks assumed by each party have been identified and considered since the actual assumption of risks would influence the prices and other conditions of transactions between the associated enterprises. Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised. The level and assumption of risk, therefore, are economically relevant characteristics that can be significant in determining the outcome of a transfer pricing analysis.

1.57 Risk is inherent in business activities. Enterprises undertake commercial activities because they seek opportunities to make profits, but those opportunities carry uncertainty that the required resources to pursue the opportunities either will be greater than expected or will not generate the expected returns. Identifying risks goes hand in hand with identifying functions and assets and is integral to the process of identifying the commercial or financial relations between the associated enterprises and of accurately delineating the transaction or transactions.

1.58 The assumption of risks associated with a commercial opportunity affects the profit potential of that opportunity in the open market, and the allocation of risks assumed between the parties to the arrangement affects how profits or losses resulting from the transaction are allocated at arm's length through the pricing of the transaction. Therefore, in making comparisons between controlled and uncontrolled transactions and between controlled and uncontrolled parties it is necessary to analyse what risks have been assumed, what functions are performed that relate to or affect the assumption or impact of these risks and which party or parties to the transaction assume these risks.

1.59 This section provides guidance on the nature and sources of risk relevant to a transfer pricing analysis in order to help identify relevant risks with specificity. In addition, this section provides guidance on risk assumption under the arm's length principle. The detailed guidance provided in this section on the analysis of risks as part of a functional analysis covering functions, assets, and risks, should not be interpreted as indicating that risks are more important than functions or assets. The relevance of functions, assets and risks in a specific transaction will need to be determined through a detailed functional analysis. The expanded guidance on risks reflects the practical difficulties presented by risks: risks in a transaction can be harder to identify than functions or assets, and determining which associated enterprise assumes a particular risk in a transaction can require careful analysis.

1.60 The steps in the process set out in the rest of this section for analysing risk in a controlled transaction, in order to accurately delineate the actual transaction in respect to that risk, can be summarised as follows:

- 1) Identify economically significant risks with specificity (see Section D.1.2.1.1).
- 2) Determine how specific, economically significant risks are contractually assumed by the associated enterprises under the terms of the transaction (see Section D.1.2.1.2).
- 3) Determine through a functional analysis how the associated enterprises that are parties to the transaction operate in relation to assumption and management of the specific, economically significant risks, and in particular which enterprise or enterprises perform control functions and risk mitigation functions, which enterprise or enterprises encounter upside or downside consequences of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk (see Section D.1.2.1.3).
- 4) Steps 2-3 will have identified information relating to the assumption and management of risks in the controlled transaction. The next step is to interpret the information and determine whether the contractual assumption of risk is consistent with the conduct of the associated enterprises and other facts of the case by analysing (i) whether the associated enterprises follow the contractual terms under the principles of Section D.1.1; and (ii) whether the party assuming risk, as analysed under (i), exercises control over the risk and has the financial capacity to assume the risk (see Section D.1.2.1.4).
- 5) Where the party assuming risk under steps 1-4(i) does not control the risk or does not have the financial capacity to assume the risk, apply the guidance on allocating risk (see Section D.1.2.1.5).
- 6) The actual transaction as accurately delineated by considering the evidence of all the economically relevant characteristics of the transaction as set out in the guidance in Section D.1, should then be priced taking into account the financial and other consequences of risk assumption, as appropriately allocated, and appropriately compensating risk management functions (see Section D.1.2.1.6).

1.61 In this section references are made to terms that require initial explanation and definition. The term "risk management" is used to refer to the function of assessing and responding to risk associated with commercial activity. Risk management comprises three elements: (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function, (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function, and

(iii) the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.

1.62 Some risk management functions can be undertaken only by the party performing functions and using assets in creating and pursuing commercial opportunities, while other risk management functions can be undertaken by a different party. Risk management should not be thought of as necessarily encompassing a separate function, requiring separate remuneration, distinct from the performance of the activities that optimise profits. For example, the development of intangibles through development activities may involve mitigating risks relating to performing the development according to specifications at the highest possible standards and on time; the particular risks might be mitigated through the performance of the development function itself. For example, if the contractual arrangement between the associated enterprises is a contract R&D arrangement that is respected under the requirements of this section, remuneration for risk mitigation functions performed through the development activity would be incorporated into the arm's length services payment. Neither the intangible risk itself, nor the residual income associated with such risk, would be allocated to the service provider. See also Example 1 in paragraph 1.83.

1.63 Risk management is not the same as assuming a risk. Risk assumption means taking on the upside and downside consequences of the risk with the result that the party assuming a risk will also bear the financial and other consequences if the risk materialises. A party performing part of the risk management functions may not assume the risk that is the subject of its management activity, but may be hired to perform risk mitigation functions under the direction of the risk-assuming party. For example, the day-to-day mitigation of product recall risk may be outsourced to a party performing monitoring of quality control over a specific manufacturing process according to the specifications of the party assuming the risk.

1.64 Financial capacity to assume risk can be defined as access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materialises. Access to funding by the party assuming the risk takes into account the available assets and the options realistically available to access additional liquidity, if needed, to cover the costs anticipated to arise should the risk materialise. This assessment should be made on the basis that the party assuming the risk is operating as an unrelated party in the same circumstances as the associated enterprise, as accurately delineated under the principles of this section. For example, exploitation of rights in an income-generating asset could open up funding possibilities for that party. Where a party assuming risk receives intra-group funding to meet the funding demands in relation to the risk, the party providing the funding may assume financial risk but does not, merely as a consequence of providing funding, assume the specific risk that gives rise to the need for additional funding. Where the financial capacity to assume a risk is lacking, then the allocation of risk requires further consideration under step 5.

1.65 Control over risk involves the first two elements of risk management defined in paragraph 1.61; that is (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function. It is not necessary for a party to perform the day-to-day mitigation, as described in (iii) in order to have control of the risks. Such day-to-day mitigation may be outsourced, as the example in paragraph 1.63 illustrates. However, where these day-to-day mitigation activities are outsourced, control of the risk would require capability to

determine the objectives of the outsourced activities, to decide to hire the provider of the risk mitigation functions, to assess whether the objectives are being adequately met, and, where necessary, to decide to adapt or terminate the contract with that provider, together with the performance of such assessment and decision-making. In accordance with this definition of control, a party requires both capability and functional performance as described above in order to exercise control over a risk.

1.66 The capability to perform decision-making functions and the actual performance of such decision-making functions relating to a specific risk involve an understanding of the risk based on a relevant analysis of the information required for assessing the foreseeable downside and upside risk outcomes of such a decision and the consequences for the business of the enterprise. Decision-makers should possess competence and experience in the area of the particular risk for which the decision is being made and possess an understanding of the impact of their decision on the business. They should also have access to the relevant information, either by gathering this information themselves or by exercising authority to specify and obtain the relevant information to support the decision-making process. In doing so, they require capability to determine the objectives of the gathering and analysis of the information, to hire the party gathering the information and making the analyses, to assess whether the right information is gathered and the analyses are adequately made, and, where necessary, to decide to adapt or terminate the contract with that provider, together with the performance of such assessment and decision-making. Neither a mere formalising of the outcome of decision-making in the form of, for example, meetings organised for formal approval of decisions that were made in other locations, minutes of a board meeting and signing of the documents relating to the decision, nor the setting of the policy environment relevant for the risk (see paragraph 1.76), qualifies as the exercise of a decision-making function sufficient to demonstrate control over a risk.

1.67 References to control over risk should not necessarily be taken to mean that the risk itself can be influenced or that the uncertainty can be nullified. Some risks cannot be influenced, and are a general condition of commercial activity affecting all businesses undertaking that activity. For example, risks associated with general economic conditions or commodity price cycles are typically beyond the scope of an MNE group to influence. Instead control over risk should be understood as the capability and authority to decide to take on the risk, and to decide whether and how to respond to the risk, for example through the timing of investments, the nature of development programmes, the design of marketing strategies, or the setting of production levels.

1.68 Risk mitigation refers to measures taken that are expected to affect risk outcomes. Such measures may include measures that reduce the uncertainty or measures that reduce the consequences in the event that the downside impact of risk occurs. Control should not be interpreted as requiring risk mitigation measures to be adopted, since in assessing risks businesses may decide that the uncertainty associated with some risks, including risks that may be fundamental to their core business operations, after being evaluated, should be taken on and faced in order to create and maximise opportunities.

1.69 The concept of control may be illustrated by the following examples. Company A appoints a specialist manufacturer, Company B to manufacture products on its behalf. The contractual arrangements indicate that Company B undertakes to perform manufacturing services, but that the product specifications and designs are provided by Company A, and that Company A determines production scheduling, including the volumes and timing of product delivery. The contractual relations imply that Company A bears the inventory risk and the product recall risk. Company A hires Company C to perform regular quality

controls of the production process. Company A specifies the objectives of the quality control audits and the information that Company C should gather on its behalf. Company C reports directly to Company A. Analysis of the economically relevant characteristics shows that Company A controls its product recall and inventory risks by exercising its capability and authority to make a number of relevant decisions about whether and how to take on risk and how to respond to the risks. Besides that Company A has the capability to assess and take decisions relating to the risk mitigation functions and actually performs these functions. These include determining the objectives of the outsourced activities, the decision to hire the particular manufacturer and the party performing the quality checks, the assessment of whether the objectives are adequately met, and, where necessary, to decide to adapt or terminate the contracts.

1.70 Assume that an investor hires a fund manager to invest funds on its account.³ Depending on the agreement between the investor and the fund manager, the latter may be given the authority to make portfolio investments on behalf of the investor on a day-to-day basis in a way that reflects the risk preferences of the investor, although the risk of loss in value of the investment would be borne by the investor. In such an example, the investor is controlling its risks through four relevant decisions: the decision about its risk preference and therefore about the required diversification of the risks attached to the different investments that are part of the portfolio, the decision to hire (or terminate the contract with) that particular fund manager, the decision of the extent of the authority it gives to the fund manager and objectives it assigns to the latter, and the decision of the amount of the investment that it asks this fund manager to manage. Moreover, the fund manager would generally be required to report back to the investor on a regular basis as the investor would want to assess the outcome of the fund manager's activities. In such a case, the fund manager is providing a service and managing his business risk from his own perspective (e.g. to protect his credibility). The fund manager's operational risk, including the possibility of losing a client, is distinct from his client's investment risk. This illustrates the fact that an investor who gives to another person the authority to perform risk mitigation activities such as those performed by the fund manager does not necessarily transfer control of the investment risk to the person making these day-to-day decisions.

D.1.2.1.1. Step 1: Identify economically significant risks with specificity

1.71 There are many definitions of risk, but in a transfer pricing context it is appropriate to consider risk as the effect of uncertainty on the objectives of the business. In all of a company's operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed. A company is likely to direct much attention to identifying uncertainties it encounters, in evaluating whether and how business opportunities should be pursued in view of their inherent risks, and in developing appropriate risk mitigation strategies which are important to shareholders seeking their required rate of return. Risk is associated with opportunities, and does not have downside connotations alone; it is inherent in commercial activity, and companies choose which risks they wish to assume in order to have the opportunity to generate profits. No profit-seeking business takes on risk associated with commercial opportunities without expecting a positive return. Downside impact of risk occurs when the anticipated favourable outcomes fail to materialise. For example, a product may fail to attract as much consumer demand as projected. However, such an event is the downside manifestation of uncertainty associated with commercial opportunities. Companies are likely to devote considerable attention to identifying and managing economically significant risks in order to maximise the positive returns from having pursued the opportunity in the face of

risk. Such attention may include activities around determining the product strategy, how the product is differentiated, how to identify changing market trends, how to anticipate political and social changes, and how to create demand. The significance of a risk depends on the likelihood and size of the potential profits or losses arising from the risk. For example, a different flavour of ice-cream may not be the company's sole product, the costs of developing, introducing, and marketing the product may have been marginal, the success or failure of the product may not create significant reputational risks so long as business management protocols are followed, and decision-making may have been effected by delegation to local or regional management who can provide knowledge of local tastes. However, ground-breaking technology or an innovative healthcare treatment may represent the sole or major product, involve significant strategic decisions at different stages, require substantial investment costs, create significant opportunities to make or break reputation, and require centralised management that would be of keen interest to shareholders and other stakeholders.

1.72 Risks can be categorised in various ways, but a relevant framework in a transfer pricing analysis is to consider the sources of uncertainty which give rise to risk. The following non-exclusive list of sources of risk is not intended to suggest a hierarchy of risk. Neither is it intended to provide rigid categories of risk, since there is overlap between the categories. Instead, it is intended to provide a framework that may assist in ensuring that a transfer pricing analysis considers the range of risks likely to arise from the commercial or financial relations of the associated enterprises, and from the context in which those relations take place. Reference is made to risks that are externally driven and those that are internally driven in order to help clarify sources of uncertainty. However, there should be no inference that externally driven risks are less relevant because they are not generated directly by activities. On the contrary, the ability of a company to face, respond to and mitigate externally driven risks is likely to be a necessary condition for a business to remain competitive. Importantly, guidance on the possible range of risk should assist in identifying material risks with specificity. Risks which are vaguely described or undifferentiated will not serve the purposes of a transfer pricing analysis seeking to delineate the actual transaction and the actual allocation of risk between the parties.

- a) Strategic risks or marketplace risks. These are largely external risks caused by the economic environment, political and regulatory events, competition, technological advance, or social and environmental changes. The assessment of such uncertainties may define the products and markets the company decides to target, and the capabilities it requires, including investment in intangibles and tangible assets, as well as in the talent of its human capital. There is considerable potential downside, but the upside is also considerable if the company identifies correctly the impact of external risks, and differentiates its products and secures and continues to protect competitive advantage. Examples of such risks may include marketplace trends, new geographical markets, and concentration of development investment.
- b) Infrastructure or operational risks. These are likely to include the uncertainties associated with the company's business execution and may include the effectiveness of processes and operations. The impact of such risks is highly dependent on the nature of the activities and the uncertainties the company chooses to assume. In some circumstances breakdowns can have a crippling effect on the company's operations or reputation and threaten its existence; whereas successful management of such risks can enhance reputation. In other circumstances, the failure to bring a product to market on time, to meet demand, to meet specifications, or to produce to high standards, can affect competitive and reputational position, and give advantage

to companies which bring competing products to market more quickly, better exploit periods of market protection provided by, for example, patents, better manage supply chain risks and quality control. Some infrastructure risks are externally driven and may involve transport links, political and social situations, laws and regulations, whereas others are internally driven and may involve capability and availability of assets, employee capability, process design and execution, outsourcing arrangements, and IT systems.

- c) Financial risks. All risks are likely to affect a company's financial performance, but there are specific financial risks related to the company's ability to manage liquidity and cash flow, financial capacity, and creditworthiness. The uncertainty can be externally driven, for example by economic shock or credit crisis, but can also be internally driven through controls, investment decisions, credit terms, and through outcomes of infrastructure or operational risks.
- d) Transactional risks. These are likely to include pricing and payment terms in a commercial transaction for the supply of goods, property, or services.
- e) Hazard risks. These are likely to include adverse external events that may cause damages or losses, including accidents and natural disasters. Such risks can often be mitigated through insurance, but insurance may not cover all the potential loss, particularly where there are significant impacts on operations or reputation.

1.73 Determining the economic significance of risk and how risk may affect the pricing of a transaction between associated enterprises is part of the broader functional analysis of how value is created by the MNE group, the activities that allow the MNE group to sustain profits, and the economically relevant characteristics of the transaction. The analysis of risk also helps to determine comparability under the guidance in Chapter III. Where potential comparables are identified, it is relevant to determine whether they include the same level of risks and management of risks. The economic significance of risk may be illustrated by the following two situations.

1.74 In the first situation the MNE group distributes heating oil to consumers. Analysis of the economically relevant characteristics establishes that the product is undifferentiated, the market is competitive, the market size is predictable, and players are price-takers. In such circumstances, the ability to influence margins may be limited. The credit terms achieved from managing the relationship with the oil suppliers fund working capital and are crucial to the distributor's margin. The impact of the risk on cost of capital is, therefore, significant in the context of how value is created for the distribution function.

1.75 In the second situation, a multinational toy retailer buys a wide range of products from a number of third-party manufacturers. Most of its sales are concentrated in the last two months of the calendar year, and a significant risk relates to the strategic direction of the buying function, and in making the right bets on trends and determining the products that will sell and in what volumes. Trends and the demand for products can vary across markets, and so expertise is needed to evaluate the right bets in the local market. The effect of the buying risk can be magnified if the retailer negotiates a period of exclusivity for a particular product with the third-party manufacturer.

1.76 Control over a specific risk in a transaction focusses on the decision-making of the parties to the transaction in relation to the specific risk arising from the transaction. This is not to say, however, that in an MNE group other parties may not be involved in setting general policies that are relevant for the assumption and control of the specific risks identified in a transaction, without such policy-setting itself representing decision making.

The board and executive committees of the group, for example, may set the level of risk the group as a whole is prepared to accept in order to achieve commercial objectives, and to establish the control framework for managing and reporting risk in its operations. Line management in business segments, operational entities, and functional departments may identify and assess risk against the commercial opportunities, and put in place appropriate controls and processes to address risk and influence the risk outcomes arising from day-to-day operations. The opportunities pursued by operational entities require the ongoing management of the risk that the resources allocated to the opportunity will deliver the anticipated return. For example, finished product inventory risk in a supply transaction between two associated enterprises may be controlled by the party with the capability to determine the production volumes together with the performance of that decision-making. The way that inventory risk in the transaction between two associated enterprises is addressed may be subject to policy-setting elsewhere in the MNE group about overall levels of working capital tied up in inventory, or co-ordination of appropriate minimum stocking levels across markets to meet strategic objectives. This wider policy-setting however cannot be regarded as decisions to take on, lay off, decline, or mitigate the specific inventory risk in the example of the product supply transaction in this paragraph.

D.1.2.1.2. Step 2: Contractual assumption of risk

1.77 The identity of the party or parties assuming risks may be set out in written contracts between the parties to a transaction involving these risks. A written contract typically sets out an intended assumption of risk by the parties. Some risks may be explicitly assumed in the contractual arrangements. For example, a distributor might contractually assume accounts receivable risk, inventory risk, and credit risks associated with the distributor's sales to unrelated customers. Other risks might be implicitly assumed. For example, contractual arrangements that provide non-contingent remuneration for one of the parties implicitly allocate the outcome of some risks, including unanticipated profits or losses, to the other party.

1.78 A contractual assumption of risk constitutes an *ex ante* agreement to bear some or all of the potential costs associated with the *ex post* materialisation of downside outcomes of risk in return for some or all of the potential benefit associated with the *ex post* materialisation of positive outcomes. Importantly, *ex ante* contractual assumption of risk should provide clear evidence of a commitment to assume risk prior to the materialisation of risk outcomes. Such evidence is a very important part of the tax administration's transfer pricing analysis of risks in commercial or financial relations, since, in practice, an audit performed by the tax administration may occur years after the making of such up-front decisions by the associated enterprises and when outcomes are known. The purported assumption of risk by associated enterprises when risk outcomes are certain is by definition not an assumption of risk, since there is no longer any risk. Similarly, *ex post* reallocations of risk by a tax administration when risk outcomes are certain may, unless based on the guidance elsewhere in these Guidelines and in particular Section D.1.2.1, be inappropriate.

1.79 It is economically neutral to take on (or lay off) risk in return for higher (or lower) anticipated nominal income as long as the net present value of both options are equal. Between unrelated parties, for example, the sale of a risky income-producing asset may reflect in part a preference of the seller to accept a lower but more certain amount of nominal income and to forego the possibility of higher anticipated nominal income it might earn if it instead retained and exploited the asset. In a without-recourse debt factoring arrangement between independent enterprises, for example, the seller discounts the face value of its receivables in return for a fixed payment, and so accepts a lower return but has

reduced its volatility and laid off risk. The factor will often be a specialised organisation which has the capability to decide to take on risk and to decide on how to respond to the risk, including by diversifying the risk and having the functional capabilities to mitigate the risk and generate a return from the opportunity. Neither party will expect to be worse off as a result of entering into the arrangement, essentially because they have different risk preferences resulting from their capabilities in relation to the specific risk. The factor is more capable of managing the risk than the seller and terms acceptable to both parties can be agreed.

1.80 However, it does not follow that every contractual exchange of potentially higher but riskier income for lower but less risky income between associated enterprises is automatically arm's length. The rest of the steps set out in this section describe the information required to determine how the associated enterprises operate in relation to the assumption and management of risk leading to the accurate delineation of the actual transaction in relation to risk.

1.81 The assumption of risk has a significant effect on determining arm's length pricing between associated enterprises, and it should not be concluded that the pricing arrangements adopted in the contractual arrangements alone determine which party assumes risk. Therefore, one may not infer from the fact that the price paid between associated enterprises for goods or services is set at a particular level, or by reference to a particular margin, that risks are borne by those associated enterprises in a particular manner. For example, a manufacturer may claim to be protected from the risk of price fluctuation of raw material as a consequence of its being remunerated by another group company on a basis that takes account of its actual costs. The implication of the claim is that the other group company bears the risk. The form of remuneration cannot dictate inappropriate risk allocations. It is the determination of how the parties actually manage and control risks, as set out in the remaining steps of the process of analysing risk, which will determine the assumption of risks by the parties, and consequently dictate the selection of the most appropriate transfer pricing method.

D.1.2.1.3. Step 3: Functional analysis in relation to risk

1.82 In this step the functions in relation to risk of the associated enterprises that are parties to the transaction are analysed. The analysis provides information about how the associated enterprises operate in relation to the assumption and management of the specific, economically significant risks, and in particular about which enterprise or enterprises perform control functions and risk mitigation functions, which enterprise or enterprises encounter upside or downside consequences of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk. This step is illustrated by the following examples and conclusions are drawn from these examples in subsequent paragraphs of Section D.1.2.

Example 1

1.83 Company A seeks to pursue a development opportunity and hires a specialist company, Company B, to perform part of the research on its behalf. Under step 1 development risk has been identified as economically significant in this transaction, and under step 2 it has been established that under the contract Company A assumes development risk. The functional analysis under step 3 shows that Company A controls its development risk through exercising its capability and authority in making a number of relevant decisions about whether and how to take on the development risk. These include the decision to perform part of the development

work itself, the decision to seek specialist input, the decision to hire the particular researcher, the decision of the type of research that should be carried out and objectives assigned to it, and the decision of the budget allocated to Company B. Company A has mitigated its risk by taking measures to outsource development activities to Company B which assumes the day-to-day responsibility for carrying out the research under the control of Company A. Company B reports back to Company A at predetermined milestones, and Company A assesses the progress of the development and whether its ongoing objectives are being met, and decides whether continuing investments in the project are warranted in the light of that assessment. Company A has the financial capacity to assume the risk. Company B has no capability to evaluate the development risk and does not make decisions about Company A's activities. Company B's risk is mainly to ensure it performs the research activities competently and it exercises its capability and authority to control that risk through making decisions about the processes, expertise, and assets it needs. The risk Company B assumes is distinct from the development risk assumed by Company A under the contract, and which is controlled by Company A based on the evidence of the functional analysis.

Example 2

1.84 Company B manufactures products for Company A. Under step 1 capacity utilisation risk and supply chain risk have been identified as economically significant in this transaction, and under step 2 it has been established that under the contract Company A assumes these risks. The functional analysis under step 3 provides evidence that Company B built and equipped its plant to Company A's specifications, that products are manufactured to technical requirements and designs provided by Company A, that volume levels are determined by Company A, and that Company A runs the supply chain, including the procurement of components and raw materials. Company A also performs regular quality checks of the manufacturing process. Company B builds the plant, employs and trains competent manufacturing personnel, and determines production scheduling based on volume levels determined by Company A. Although Company B has incurred fixed costs, it has no ability to manage the risk associated with the recovery of those costs through determining the production units over which the fixed costs are spread, since Company A determines volumes. Company A also determines significant costs relating to components and raw materials and the security of supply. The evaluation of the evidence concludes that Company B performs manufacturing services. Significant risks associated with generating a return from the manufacturing activities are controlled by Company A. Company B controls the risk that it fails to competently deliver services. Each company has the financial capacity to assume its respective risks.

Example 3

1.85 Company A has acquired ownership of a tangible asset and enters into contracts for the use of the asset with unrelated customers. Under step 1 utilisation of the tangible asset, that is the risk that there will be insufficient demand for the asset to cover the costs Company A has incurred, has been identified as an economically significant risk. Under step 2 it is established that Company A has a contract for the provision of services with another group company, Company C; the contract does not address the assumption of utilisation risk by the owner of the tangible asset, Company A. The functional analysis under step 3 provides evidence that another group company, Company B, decides that investment in the asset is appropriate in light of anticipated commercial opportunities identified and evaluated by Company B and its assessment of the asset's anticipated useful life; Company B provides specifications for the asset and the unique features required to

respond to the commercial opportunities, and arranges for the asset to be constructed in accordance with its specifications, and for Company A to acquire the asset. Company C decides how to utilise the asset, markets the asset's capabilities to third-party customers, negotiates the contracts with these third party customers, assures that the asset is delivered to the third parties and installed appropriately. Although it is the legal owner of the asset, Company A does not exercise control over the investment risk in the tangible asset, since it lacks any capability to decide on whether to invest in the particular asset, and whether and how to protect its investment including whether to dispose of the asset. Although it is the owner of the asset, Company A does not exercise control over the utilisation risk, since it lacks any capability to decide whether and how to exploit the asset. It does not have the capability to assess and make decisions relating to the risk mitigation activities performed by other group companies. Instead, risks associated with investing in and exploiting the asset, enhancing upside risk and mitigating downside risk, are controlled by the other group companies. Company A does not have control over the economically significant risks associated with the investment in and exploitation of the asset. The functional contribution of the legal owner of the asset is limited to providing financing for an amount equating to the cost of the asset. However, the functional analysis also provides evidence that Company A has no capability and authority to control the risk of investing in a financial asset. Company A does not have the capability to make decisions to take on or decline the financing opportunity, or the capability to make decisions on whether and how to respond to the risks associated with the financing opportunity. Company A does not perform functions to evaluate the financing opportunity, does not consider the appropriate risk premium and other issues to determine the appropriate pricing of the financing opportunity, and does not evaluate the appropriate protection of its financial investment. Companies A, B and C all have financial capacity to assume their respective risks.

D.1.2.1.4. Step 4: Interpreting steps 1-3

1.86 Carrying out steps 1-3 involves the gathering of information relating to the assumption and management of risks in the controlled transaction. The next step is to interpret the information resulting from steps 1-3 and to determine whether the contractual assumption of risk is consistent with the conduct of the parties and the other facts of the case by analysing (i) whether the associated enterprises follow the contractual terms under the principles of Section D.1.1; and (ii) whether the party assuming risk, as analysed under (i), exercises control over the risk and has the financial capacity to assume risk.

1.87 The significance of step 4 will depend on the findings. In the circumstances of Examples 1 and 2 above, the step may be straightforward. Where a party contractually assuming a risk applies that contractual assumption of risk in its conduct, and also both exercises control over the risk and has the financial capacity to assume the risk, then there is no further analysis required beyond step 4(i) and (ii) to determine risk assumption. Companies A and B in both examples fulfil the obligations reflected in the contracts and exercise control over the risks that they assume in the transaction, supported by financial capacity. As a result step 4(ii) is satisfied, there is no need to consider step 5, and the next step to consider is step 6.

1.88 In line with the discussion in relation to contractual terms (see Section D.1.1), it should be considered under step 4(i) whether the parties' conduct conforms to the assumption of risk contained in written contracts, or whether the contractual terms have not been followed or are incomplete. Where differences exist between contractual terms related to risk and the conduct of the parties which are economically significant and would be taken into account by third parties in pricing the transaction between them, the parties'

conduct in the context of the consistent contractual terms should generally be taken as the best evidence concerning the intention of the parties in relation to the assumption of risk.

1.89 Consider for example, a manufacturer, whose functional currency is US dollars, that sells goods to an associated distributor in another country, whose functional currency is euros, and the written contract states that the distributor assumes all exchange rate risks in relation to this controlled transaction. If, however, the price for the goods is charged by the manufacturer to the distributor over an extended period of time in euros, the currency of the distributor, then aspects of the written contractual terms do not reflect the actual commercial or financial relations between the parties. The assumption of risk in the transaction should be determined by the actual conduct of the parties in the context of the contractual terms, rather than by aspects of written contractual terms which are not in practice applied. The principle can be further illustrated by Example 7 in the annex to Chapter VI, where there is an inconsistency between the contractual assumption of risk and the conduct of the parties as evidenced by the bearing of costs relating to the downside outcome of that risk.

1.90 Under step 4(ii) it should be determined whether the party assuming the risk under the contract, taking into account whether the contractual terms have been applied in the conduct of the parties under step 4(i), controls the risk and has the financial capacity to assume the risk. If all the circumstances set out in Example 1 remain the same except for the fact that the contract between Company A and Company B allocates development risk to Company B, and if there is no evidence from the conduct of the parties under step 4(i) to suggest that the contractual allocation of risk is not being followed, then Company B contractually assumes development risk but the facts remain that Company B has no capability to evaluate the development risk and does not make decisions about Company A's activities. Company B has no decision-making function which allows it to control the development risk by taking decisions that affect the outcomes of that risk. Based on the information provided in Example 1, the development risk is controlled by Company A. The determination that the party assuming a risk is not the party controlling that risk means that further consideration is required under step 5.

1.91 If the circumstances of Example 2 remain the same except for the fact that, while the contract specifies that Company A assumes supply chain risks, Company B is not reimbursed by Company A when there was a failure to secure key components on time, the analysis under step 4(i) would show that contractual assumption of risk has not been followed in practice in regard to that supply chain risk, such that Company B in fact assumes the downside consequences of that risk. Based on the information provided in Example 2, Company B does not have any control over the supply chain risk, whereas Company A does exercise control. Therefore, the party assuming risk as analysed under step 4(i), does not under step 4(ii) exercise control over that risk, and further consideration is required under step 5.

1.92 In the circumstances of Example 3, analysis under step 4(i) shows that the assumption of utilisation risk by Company A is consistent with its contractual arrangements with Company C, but under step 4(ii) it is determined that Company A does not control risks that it assumes associated with the investment in and exploitation of the asset. Company A has no decision-making function which allows it to control its risks by taking decisions that affect the outcomes of the risks. Under step 4(ii) the party assuming risk does not control that risk, and further consideration is required under step 5.

1.93 In some cases, the analysis under step 3 may indicate that there is more than one MNE that is capable of exercising control over a risk. However, control requires both capability and

functional performance in order to exercise control over a risk. Therefore, if more than one party is capable of exercising control, but the entity contractually assuming risk (as analysed under step 4(i)) is the only party that actually exercises control through capability and functional performance, then the party contractually assuming the risk also controls the risk.

1.94 Furthermore, in some cases, there may be more than one party to the transaction exercising control over a specific risk. Where the associated enterprise assuming risk (as analysed under step 4(i)) controls that risk in accordance with the requirements set out in paragraphs 1.65-1.66, all that remains under step 4(ii) is to consider whether the enterprise has the financial capacity to assume the risk. If so, the fact that other associated enterprises also exercise control over the same risk does not affect the assumption of that risk by the first-mentioned enterprise, and step 5 need not be considered.

1.95 Where two or more parties to the transaction assume a specific risk (as analysed under step 4(i)), and in addition they together control the specific risk and each has the financial capacity to assume their share of the risk, then that assumption of risk should be respected. Examples may include the contractual assumption of development risk under a transaction in which the enterprises agree jointly to bear the costs of creating a new product.

1.96 If it is established that the associated enterprise assuming the risk as analysed under step 4(i) either does not control the risk or does not have the financial capacity to assume the risk, then the analysis described under step 5 needs to be performed.

1.97 In light of the potential complexity that may arise in some circumstances when determining whether an associated enterprise assuming a risk controls that risk, the test of control should be regarded as being met where comparable risk assumptions can be identified in a comparable uncontrolled transaction. To be comparable those risk assumptions require that the economically relevant characteristics of the transactions are comparable. If such a comparison is made, it is particularly relevant to establish that the enterprise assuming comparable risk in the uncontrolled transaction performs comparable risk management functions relating to control of that risk to those performed by the associated enterprise assuming risk in the controlled transaction. The purpose of the comparison is to establish that an independent party assuming a comparable risk to that assumed by the associated enterprise also performs comparable risk management functions to those performed by the associated enterprise.

D.1.2.1.5. Step 5: Allocation of risk

1.98 If it is established in step 4(ii) that the associated enterprise assuming the risk based on steps 1 – 4(i) does not exercise control over the risk or does not have the financial capacity to assume the risk, then the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk. If multiple associated enterprises are identified that both exercise control and have the financial capacity to assume the risk, then the risk should be allocated to the associated enterprise or group of associated enterprises exercising the most control. The other parties performing control activities should be remunerated appropriately, taking into account the importance of the control activities performed.

1.99 In exceptional circumstances, it may be the case that no associated enterprise can be identified that both exercises control over the risk and has the financial capacity to assume the risk. As such a situation is not likely to occur in transactions between third parties, a rigorous analysis of the facts and circumstances of the case will need to be performed, in

order to identify the underlying reasons and actions that led to this situation. Based on that assessment, the tax administrations will determine what adjustments to the transaction are needed for the transaction to result in an arm's length outcome. An assessment of the commercial rationality of the transaction based on Section D.2 may be necessary.

D.1.2.1.6. Step 6: Pricing of the transaction, taking account of the consequences of risk allocation

1.100 Following the guidance in this section, the accurately delineated transaction should then be priced in accordance with the tools and methods available to taxpayers and tax administrations set out in the following chapters of these Guidelines and taking into account the financial and other consequences of risk-assumption, and the remuneration for risk management. The assumption of a risk should be compensated with an appropriate anticipated return, and risk mitigation should be appropriately remunerated. Thus, a taxpayer that both assumes and mitigates a risk will be entitled to greater anticipated remuneration than a taxpayer that only assumes a risk, or only mitigates, but does not do both.

1.101 In the circumstances of Example 1 in paragraph 1.83, Company A assumes and controls the development risk and should bear the financial consequences of failure and enjoy the financial consequences of success. Company B should be appropriately rewarded for the carrying out of its development services, incorporating the risk that it fails to do so competently.

1.102 In the circumstances of Example 2 in paragraph 1.84, the significant risks associated with generating a return from the manufacturing activities are controlled by Company A, and the upside and downside consequences of those risks should therefore be allocated to Company A. Company B controls the risk that it fails to competently deliver services, and its remuneration should take into account that risk, as well as its funding costs for the acquisition of the manufacturing plant. Since the risks in relation to the capacity utilisation of the asset are controlled by Company A, Company A should be allocated the risk of under-utilisation. This means that the financial consequences related to the materialisation of that risk including failure to cover fixed costs, write-downs, or closure costs should be allocated to Company A.

1.103 The consequences of risk allocation in Example 3 in paragraph 1.85 depend on analysis of functions under step 3. Company A does not have control over the economically significant risks associated with the investment in and exploitation of the asset, and those risks should be aligned with control of those risks by Companies B and C. The functional contribution of Company A is limited to providing financing for an amount equating to the cost of the asset that enables the asset to be created and exploited by Companies B and C. However, the functional analysis also provides evidence that Company A has no capability and authority to control the risk of investing in a financial asset. Company A does not have the capability to make decisions to take on or decline the financing opportunity, or the capability to make decisions on whether and how to respond to the risks associated with the financing opportunity. Company A does not perform functions to evaluate the financing opportunity, does not consider the appropriate risk premium and other issues to determine the appropriate pricing of the financing opportunity, and does not evaluate the appropriate protection of its financial investment. In the circumstances of Example 3, Company A would not be entitled to any more than a risk-free return⁴ as an appropriate measure of the profits it is entitled to retain, since it lacks the capability to control the risk associated with investing in a riskier financial asset. The risk will be allocated to the enterprise which has control and the financial capacity to assume the risk associated with the financial asset. In the circumstances of example, this would be Company B. Company A does not control the

investment risk that carries a potential risk premium. An assessment may be necessary of the commercial rationality of the transaction based on the guidance in Section D.2 taking into account the full facts and circumstances of the transaction.

1.104 Guidance on the relationship between risk assumption in relation to the provision of funding and the operational activities for which the funds are used is given in paragraphs 6.60-6.64. The concepts reflected in these paragraphs are equally applicable to investments in assets other than intangibles.

1.105 A party should always be appropriately compensated for its control functions in relation to risk. Usually, the compensation will derive from the consequences of being allocated risk, and therefore that party will be entitled to receive the upside benefits and to incur the downside costs. In circumstances where a party contributes to the control of risk, but does not assume the risk, compensation which takes the form of a sharing in the potential upside and downside, commensurate with that contribution to control, may be appropriate.

1.106 The difference between *ex ante* and *ex post* returns discussed in particular in Section D of Chapter VI arises in large part from risks associated with the uncertainty of future business outcomes. As discussed in paragraph 1.78 the *ex ante* contractual assumption of risk should provide clear evidence of a commitment to assume risk prior to the materialisation of risk outcomes. Following the steps in this section, the transfer pricing analysis will determine the accurate delineation of the transaction with respect to risk, including the risk associated with unanticipated returns. A party which, under these steps, does not assume the risk, nor contributes to the control of that risk, will not be entitled to unanticipated profits (or required to bear unanticipated losses) arising from that risk. In the circumstances of Example 3 (see paragraph 1.85), this would mean that neither unanticipated profits nor unanticipated losses will be allocated to Company A. Accordingly, if the asset in Example 3 were unexpectedly destroyed, resulting in an unanticipated loss, that loss would be allocated for transfer pricing purposes to the company or companies that control the investment risk, contribute to the control of that risk and have the financial capacity to assume that risk, and that would be entitled to unanticipated profits or losses with respect to the asset. That company or companies would be required to compensate Company A for the return to which it is entitled as described in paragraph 1.103.

D.1.3. Characteristics of property or services

1.107 Differences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market. Therefore, comparisons of these features may be useful in delineating the transaction and in determining the comparability of controlled and uncontrolled transactions. Characteristics that may be important to consider include the following: in the case of transfers of tangible property, the physical features of the property, its quality and reliability, and the availability and volume of supply; in the case of the provision of services, the nature and extent of the services; and in the case of intangible property, the form of transaction (e.g. licensing or sale), the type of property (e.g. patent, trademark, or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property. For further discussion of some of the specific features of intangibles that may prove important in a comparability analysis involving transfers of intangibles or rights in intangibles, see Section D.2.1 of Chapter VI.

1.108 Depending on the transfer pricing method, this factor must be given more or less weight. Among the methods described at Chapter II of these Guidelines, the requirement for comparability of property or services is the strictest for the comparable uncontrolled price method. Under the comparable uncontrolled price method, any material difference

in the characteristics of property or services can have an effect on the price and would require an appropriate adjustment to be considered (see in particular paragraph 2.15). Under the resale price method and cost plus method, some differences in the characteristics of property or services are less likely to have a material effect on the gross profit margin or mark-up on costs (see in particular paragraphs 2.23 and 2.41). Differences in the characteristics of property or services are also less sensitive in the case of the transactional profit methods than in the case of traditional transaction methods (see in particular paragraph 2.69). This however does not mean that the question of comparability in characteristics of property or services can be ignored when applying transactional profit methods, because it may be that product differences entail or reflect different functions performed, assets used and/or risks assumed by the tested party. See paragraphs 3.18-3.19 for a discussion of the notion of tested party.

1.109 In practice, it has been observed that comparability analyses for methods based on gross or net profit indicators often put more emphasis on functional similarities than on product similarities. Depending on the facts and circumstances of the case, it may be acceptable to broaden the scope of the comparability analysis to include uncontrolled transactions involving products that are different, but where similar functions are undertaken. However, the acceptance of such an approach depends on the effects that the product differences have on the reliability of the comparison and on whether or not more reliable data are available. Before broadening the search to include a larger number of potentially comparable uncontrolled transactions based on similar functions being undertaken, thought should be given to whether such transactions are likely to offer reliable comparables for the controlled transaction.

D.1.4. Economic circumstances

1.110 Arm's length prices may vary across different markets even for transactions involving the same property or services; therefore, to achieve comparability requires that the markets in which the independent and associated enterprises operate do not have differences that have a material effect on price or that appropriate adjustments can be made. As a first step, it is essential to identify the relevant market or markets taking account of available substitute goods or services. Economic circumstances that may be relevant to determining market comparability include the geographic location; the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers; the availability (risk thereof) of substitute goods and services; the levels of supply and demand in the market as a whole and in particular regions, if relevant; consumer purchasing power; the nature and extent of government regulation of the market; costs of production, including the costs of land, labour, and capital; transport costs; the level of the market (e.g. retail or wholesale); the date and time of transactions; and so forth. The facts and circumstances of the particular case will determine whether differences in economic circumstances have a material effect on price and whether reasonably accurate adjustments can be made to eliminate the effects of such differences. More detailed guidance on the importance in a comparability analysis of the features of local markets, especially local market features that give rise to location savings, is provided in Section D.6 of this chapter.

1.111 The existence of a cycle (e.g. economic, business, or product cycle) is one of the economic circumstances that should be identified. See paragraph 3.77 in relation to the use of multiple year data where there are cycles.

1.112 The geographic market is another economic circumstance that should be identified. The identification of the relevant market is a factual question. For a number of industries,

large regional markets encompassing more than one country may prove to be reasonably homogeneous, while for others, differences among domestic markets (or even within domestic markets) are very significant.

1.113 In cases where similar controlled transactions are carried out by an MNE group in several countries and where the economic circumstances in these countries are in effect reasonably homogeneous, it may be appropriate for this MNE group to rely on a multiple-country comparability analysis to support its transfer pricing policy towards this group of countries. But there are also numerous situations where an MNE group offers significantly different ranges of products or services in each country, and/or performs significantly different functions in each of these countries (using significantly different assets and assuming significantly different risks), and/or where its business strategies and/or economic circumstances are found to be significantly different. In these latter situations, the recourse to a multiple-country approach may reduce reliability.

D.1.5. Business strategies

1.114 Business strategies must also be examined in delineating the transaction and in determining comparability for transfer pricing purposes. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws, duration of arrangements, and other factors bearing upon the daily conduct of business. Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions and enterprises.

1.115 Business strategies also could include market penetration schemes. A taxpayer seeking to penetrate a market or to increase its market share might temporarily charge a price for its product that is lower than the price charged for otherwise comparable products in the same market. Furthermore, a taxpayer seeking to enter a new market or expand (or defend) its market share might temporarily incur higher costs (e.g. due to start-up costs or increased marketing efforts) and hence achieve lower profit levels than other taxpayers operating in the same market.

1.116 Timing issues can pose particular problems for tax administrations when evaluating whether a taxpayer is following a business strategy that distinguishes it from potential comparables. Some business strategies, such as those involving market penetration or expansion of market share, involve reductions in the taxpayer's current profits in anticipation of increased future profits. If in the future those increased profits fail to materialise because the purported business strategy was not actually followed by the taxpayer, the appropriate transfer pricing outcome would likely require a transfer pricing adjustment. However legal constraints may prevent re-examination of earlier tax years by the tax administrations. At least in part for this reason, tax administrations may wish to subject the issue of business strategies to particular scrutiny.

1.117 When evaluating whether a taxpayer was following a business strategy that temporarily decreased profits in return for higher long-run profits, several factors should be considered. Tax administrations should examine the conduct of the parties to determine if it is consistent with the purported business strategy. For example, if a manufacturer charges its associated distributor a below-market price as part of a market penetration strategy, the cost savings to the distributor may be reflected in the price charged to the distributor's customers or in greater market penetration expenses incurred by the distributor. A market penetration strategy of an MNE group could be put in place either by the manufacturer or by the distributor acting separately from the manufacturer (and the resulting cost borne

by either of them), or by both of them acting in a co-ordinated manner. Furthermore, unusually intensive marketing and advertising efforts would often accompany a market penetration or market share expansion strategy. Another factor to consider is whether the nature of the relationship between the parties to the controlled transaction would be consistent with the taxpayer bearing the costs of the business strategy. For example, in arm's length transactions a company acting solely as a sales agent with little or no responsibility for long-term market development would generally not bear the costs of a market penetration strategy. Where a company has undertaken market development activities at its own risk and enhances the value of a product through a trademark or trade name or increases goodwill associated with the product, this situation should be reflected in the analysis of functions for the purposes of establishing comparability.

1.118 An additional consideration is whether there is a plausible expectation that following the business strategy will produce a return sufficient to justify its costs within a period of time that would be acceptable in an arm's length arrangement. It is recognised that a business strategy such as market penetration may fail, and the failure does not of itself allow the strategy to be ignored for transfer pricing purposes. However, if such an expected outcome was implausible at the time of the transaction, or if the business strategy is unsuccessful but nonetheless is continued beyond what an independent enterprise would accept, the arm's length nature of the business strategy may be doubtful and may warrant a transfer pricing adjustment. In determining what period of time an independent enterprise would accept, tax administrations may wish to consider evidence of the commercial strategies evident in the country in which the business strategy is being pursued. In the end, however, the most important consideration is whether the strategy in question could plausibly be expected to prove profitable within the foreseeable future (while recognising that the strategy might fail), and that a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions.

D.2. Recognition of the accurately delineated transaction

1.119 Following the guidance in the previous section, the transfer pricing analysis will have identified the substance of the commercial or financial relations between the parties, and will have accurately delineated the actual transaction by analysing the economically relevant characteristics.

1.120 In performing the analysis, the actual transaction between the parties will have been deduced from written contracts and the conduct of the parties. Formal conditions recognised in contracts will have been clarified and supplemented by analysis of the conduct of the parties and the other economically relevant characteristics of the transaction (see Section D.1.1). Where the characteristics of the transaction that are economically significant are inconsistent with the written contract, then the actual transaction will have been delineated in accordance with the characteristics of the transaction reflected in the conduct of the parties. Contractual risk assumption and actual conduct with respect to risk assumption will have been examined taking into account control over the risk (as defined in paragraphs 1.65-1.68) and the financial capacity to assume risk (as defined in paragraph 1.64), and consequently, risks assumed under the contract may have been allocated in accordance with the conduct of the parties and the other facts on the basis of steps 4 and 5 of the process for analysing risk in a controlled transaction as reflected in Sections D.1.2.1.4 and D.1.2.1.5. Therefore, the analysis will have set out the factual substance of the commercial or financial relations between the parties and accurately delineated the actual transaction.

1.121 Every effort should be made to determine pricing for the actual transaction as accurately delineated under the arm's length principle. The various tools and methods available to tax administrations and taxpayers to do so are set out in the following chapters of these Guidelines. A tax administration should not disregard the actual transaction or substitute other transactions for it unless the exceptional circumstances described in the following paragraphs 1.122-1.125 apply.

1.122 This section sets out circumstances in which the transaction between the parties as accurately delineated can be disregarded for transfer pricing purposes. Because non-recognition can be contentious and a source of double taxation, every effort should be made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and to ensure that non-recognition is not used simply because determining an arm's length price is difficult. Where the same transaction can be seen between independent parties in comparable circumstances (i.e. where all economically relevant characteristics are the same as those under which the tested transaction occurs other than that the parties are associated enterprises) non-recognition would not apply. Importantly, the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised. Associated enterprises may have the ability to enter into a much greater variety of arrangements than can independent enterprises, and may conclude transactions of a specific nature that are not encountered, or are only very rarely encountered, between independent parties, and may do so for sound business reasons. The transaction as accurately delineated may be disregarded, and if appropriate, replaced by an alternative transaction, where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to each of them at the time of entering into the transaction. It is also a relevant pointer to consider whether the MNE group as a whole is left worse off on a pre-tax basis since this may be an indicator that the transaction viewed in its entirety lacks the commercial rationality of arrangements between unrelated parties.

1.123 The key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties. The non-recognition of a transaction that possesses the commercial rationality of an arm's length arrangement is not an appropriate application of the arm's length principle. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured. It should again be noted that the mere fact that the transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm's length arrangement.

1.124 The structure that for transfer pricing purposes, replaces that actually adopted by the taxpayers should comport as closely as possible with the facts of the actual transaction undertaken whilst achieving a commercially rational expected result that would have enabled the parties to come to a price acceptable to both of them at the time the arrangement was entered into.

1.125 The criterion for non-recognition may be illustrated by the following examples.

Example 1

1.126 Company S1 carries on a manufacturing business that involves holding substantial inventory and a significant investment in plant and machinery. It owns commercial property situated in an area prone to increasingly frequent flooding in recent years. Third-party insurers experience significant uncertainty over the exposure to large claims, with the result that there is no active market for the insurance of properties in the area. Company S2, an associated enterprise, provides insurance to Company S1, and an annual premium representing 80% of the value of the inventory, property and contents is paid by Company S1. In this example S1 has entered into a commercially irrational transaction since there is no market for insurance given the likelihood of significant claims, and either relocation or not insuring may be more attractive realistic alternatives. Since the transaction is commercially irrational, there is not a price that is acceptable to both S1 and S2 from their individual perspectives.

1.127 Under the guidance in this section, the transaction should not be recognised. S1 is treated as not purchasing insurance and its profits are not reduced by the payment to S2; S2 is treated as not issuing insurance and therefore not being liable for any claim.

Example 2

1.128 Company S1 conducts research activities to develop intangibles that it uses to create new products that it can produce and sell. It agrees to transfer to an associated company, Company S2, unlimited rights to all future intangibles which may arise from its future work over a period of twenty years for a lump sum payment. The arrangement is commercially irrational for both parties since neither Company S1 nor Company S2 has any reliable means to determine whether the payment reflects an appropriate valuation, both because it is uncertain what range of development activities Company S1 might conduct over the period and also because valuing the potential outcomes would be entirely speculative. Under the guidance in this section, the structure of the arrangement adopted by the taxpayer, including the form of payment, should be modified for the purposes of the transfer pricing analysis. The replacement structure should be guided by the economically relevant characteristics, including the functions performed, assets used, and risks assumed, of the commercial or financial relations of the associated enterprises. Those facts would narrow the range of potential replacement structures to the structure most consistent with the facts of the case (for example, depending on those facts the arrangement could be recast as the provision of financing by Company S2, or as the provision of research services by Company S1, or, if specific intangibles can be identified, as a licence with contingent payments terms for the development of those specific intangibles, taking into account the guidance on hard-to-value intangibles as appropriate).

D.3. Losses

1.129 When an associated enterprise consistently realizes losses while the MNE group as a whole is profitable, the facts could trigger some special scrutiny of transfer pricing issues. Of course, associated enterprises, like independent enterprises, can sustain genuine losses, whether due to heavy start-up costs, unfavourable economic conditions, inefficiencies, or other legitimate business reasons. However, an independent enterprise would not be prepared to tolerate losses that continue indefinitely. An independent enterprise that experiences recurring losses will eventually cease to undertake business on such terms. In contrast, an associated enterprise that realizes losses may remain in business if the business is beneficial to the MNE group as a whole.

1.130 The fact that there is an enterprise making losses that is doing business with profitable members of its MNE group may suggest to the taxpayers or tax administrations that the transfer pricing should be examined. The loss enterprise may not be receiving adequate compensation from the MNE group of which it is a part in relation to the benefits derived from its activities. For example, an MNE group may need to produce a full range of products and/or services in order to remain competitive and realize an overall profit, but some of the individual product lines may regularly lose revenue. One member of the MNE group might realize consistent losses because it produces all the loss-making products while other members produce the profit-making products. An independent enterprise would perform such a service only if it were compensated by an adequate service charge. Therefore, one way to approach this type of transfer pricing problem would be to deem the loss enterprise to receive the same type of service charge that an independent enterprise would receive under the arm's length principle.

1.131 A factor to consider in analysing losses is that business strategies may differ from MNE group to MNE group due to a variety of historic, economic, and cultural reasons. Recurring losses for a reasonable period may be justified in some cases by a business strategy to set especially low prices to achieve market penetration. For example, a producer may lower the prices of its goods, even to the extent of temporarily incurring losses, in order to enter new markets, to increase its share of an existing market, to introduce new products or services, or to discourage potential competitors. However, especially low prices should be expected for a limited period only, with the specific object of improving profits in the longer term. If the pricing strategy continues beyond a reasonable period, a transfer pricing adjustment may be appropriate, particularly where comparable data over several years show that the losses have been incurred for a period longer than that affecting comparable independent enterprises. Further, tax administrations should not accept especially low prices (e.g. pricing at marginal cost in a situation of underemployed production capacities) as arm's length prices unless independent enterprises could be expected to have determined prices in a comparable manner.

D.4. The effect of government policies

1.132 There are some circumstances in which a taxpayer will consider that an arm's length price must be adjusted to account for government interventions such as price controls (even price cuts), interest rate controls, controls over payments for services or management fees, controls over the payment of royalties, subsidies to particular sectors, exchange control, anti-dumping duties, or exchange rate policy. As a general rule, these government interventions should be treated as conditions of the market in the particular country, and in the ordinary course they should be taken into account in evaluating the taxpayer's transfer price in that market. The question then presented is whether in light of these conditions the transactions undertaken by the controlled parties are consistent with transactions between independent enterprises.

1.133 One issue that arises is determining the stage at which a price control affects the price of a product or service. Often the direct impact will be on the final price to the consumer, but there may nonetheless be an impact on prices paid at prior stages in the supply of goods to the market. MNEs in practice may make no adjustment in their transfer prices to take account of such controls, leaving the final seller to suffer any limitation on profit that may occur, or they may charge prices that share the burden in some way between the final seller and the intermediate supplier. It should be considered whether or not an independent supplier would share in the costs of the price controls and whether an

independent enterprise would seek alternative product lines and business opportunities. In this regard, it is unlikely that an independent enterprise would be prepared to produce, distribute, or otherwise provide products or services on terms that allowed it no profit. Nevertheless, it is quite obvious that a country with price controls must take into account that those price controls will affect the profits that can be realised by enterprises selling goods subject to those controls.

1.134 A special problem arises when a country prevents or “blocks” the payment of an amount which is owed by one associated enterprise to another or which in an arm’s length arrangement would be charged by one associated enterprise to another. For example, exchange controls may effectively prevent an associated enterprise from transferring interest payments abroad on a loan made by another associated enterprise located in a different country. This circumstance may be treated differently by the two countries involved: the country of the borrower may or may not regard the untransferred interest as having been paid, and the country of the lender may or may not treat the lender as having received the interest. As a general rule, where the government intervention applies equally to transactions between associated enterprises and transactions between independent enterprises (both in law and in fact), the approach to this problem where it occurs between associated enterprises should be the same for tax purposes as that adopted for transactions between independent enterprises. Where the government intervention applies only to transactions between associated enterprises, there is no simple solution to the problem. Perhaps one way to deal with the issue is to apply the arm’s length principle viewing the intervention as a condition affecting the terms of the transaction. Treaties may specifically address the approaches available to the treaty partners where such circumstances exist.

1.135 A difficulty with this analysis is that often independent enterprises simply would not enter into a transaction in which payments were blocked. An independent enterprise might find itself in such an arrangement from time to time, most likely because the government interventions were imposed subsequent to the time that the arrangement began. But it seems unlikely that an independent enterprise would willingly subject itself to a substantial risk of non-payment for products or services rendered by entering into an arrangement when severe government interventions already existed unless the profit projections or anticipated return from the independent enterprise’s proposed business strategy are sufficient to yield it an acceptable rate of return notwithstanding the existence of the government intervention that may affect payment.

1.136 Because independent enterprises might not engage in a transaction subject to government interventions, it is unclear how the arm’s length principle should apply. One possibility is to treat the payment as having been made between the associated enterprises, on the assumption that an independent enterprise in a similar circumstance would have insisted on payment by some other means. This approach would treat the party to whom the blocked payment is owed as performing a service for the MNE group. An alternative approach that may be available in some countries would be to defer both the income and the relevant expenses of the taxpayer. In other words, the party to whom this blocked payment was due would not be allowed to deduct expenses, such as additional financing costs, until the blocked payment was made. The concern of tax administrations in these situations is mainly their respective tax bases. If an associated enterprise claims a deduction in its tax computations for a blocked payment, then there should be corresponding income to the other party. In any case, a taxpayer should not be permitted to treat blocked payments due from an associated enterprise differently from blocked payments due from an independent enterprise.

D.5. Use of customs valuations

1.137 The arm's length principle is applied, broadly speaking, by many customs administrations as a principle of comparison between the value attributable to goods imported by associated enterprises, which may be affected by the special relationship between them, and the value for similar goods imported by independent enterprises. Valuation methods for customs purposes however may not be aligned with the OECD's recognised transfer pricing methods. That being said, customs valuations may be useful to tax administrations in evaluating the arm's length character of a controlled transaction transfer price and vice versa. In particular, customs officials may have contemporaneous information regarding the transaction that could be relevant for transfer pricing purposes, especially if prepared by the taxpayer, while tax authorities may have transfer pricing documentation which provides detailed information on the circumstances of the transaction.

1.138 Taxpayers may have competing incentives in setting values for customs and tax purposes. In general, a taxpayer importing goods may be interested in setting a low price for the transaction for customs purposes so that the customs duty imposed will be low. (There could be similar considerations arising with respect to value added taxes, sales taxes, and excise taxes.) For tax purposes, however, a higher price paid for those same goods would increase the deductible costs in the importing country (although this would also increase the sales revenue of the seller in the country of export). Cooperation between income tax and customs administrations within a country in evaluating transfer prices is becoming more common and this should help to reduce the number of cases where customs valuations are found unacceptable for tax purposes or vice versa. Greater cooperation in the area of exchange of information would be particularly useful, and should not be difficult to achieve in countries that already have integrated administrations for income taxes and customs duties. Countries that have separate administrations may wish to consider modifying the exchange of information rules so that the information can flow more easily between the different administrations.

D.6. Location savings and other local market features

1.139 Paragraphs 1.110, 1.112 and 6.120 indicate that features of the geographic market in which business operations occur can affect comparability and arm's length prices. Difficult issues can arise in evaluating differences between geographic markets and in determining appropriate comparability adjustments. Such issues may arise in connection with the consideration of cost savings attributable to operating in a particular market. Such savings are sometimes referred to as location savings. In other situations comparability issues can arise in connection with the consideration of local market advantages or disadvantages that may not be directly related to location savings.

D.6.1. Location savings

1.140 Paragraphs 9.148 – 9.153 discuss the treatment of location savings in the context of a business restructuring. The principles described in those paragraphs apply generally to all situations where location savings are present, not just in the case of a business restructuring.

1.141 Pursuant to the guidance in paragraphs 9.148 – 9.153, in determining how location savings are to be shared between two or more associated enterprises, it is necessary to consider (i) whether location savings exist; (ii) the amount of any location savings; (iii) the

extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and (iv) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings.

1.142 Where the functional analysis shows that location savings exist that are not passed on to customers or suppliers, and where comparable entities and transactions in the local market can be identified, those local market comparables will provide the most reliable indication regarding how the net location savings should be allocated amongst two or more associated enterprises. Thus, where reliable local market comparables are available and can be used to identify arm's length prices, specific comparability adjustments for location savings should not be required.

1.143 When reliable local market comparables are not present, determinations regarding the existence and allocation of location savings among members of an MNE group, and any comparability adjustments required to take into account location savings, should be based on an analysis of all of the relevant facts and circumstances, including the functions performed, risks assumed, and assets used of the relevant associated enterprises, in the manner described in paragraphs 9.148 – 9.153.

D.6.2. Other local market features

1.144 Features of the local market in which business operations occur may affect the arm's length price with respect to transactions between associated enterprises. While some such features may give rise to location savings, others may give rise to comparability concerns not directly related to such savings. For example, the comparability and functional analysis conducted in connection with a particular matter may suggest that the relevant characteristics of the geographic market in which products are manufactured or sold, the purchasing power and product preferences of households in that market, whether the market is expanding or contracting, the degree of competition in the market and other similar factors affect prices and margins that can be realised in the market. Similarly, the comparability and functional analysis conducted in connection with a particular matter may suggest that the relative availability of local country infrastructure, the relative availability of a pool of trained or educated workers, proximity to profitable markets, and similar features in a geographic market where business operations occur create market advantages or disadvantages that should be taken into account. Appropriate comparability adjustments should be made to account for such factors where reliable adjustments that will improve comparability can be identified.

1.145 In assessing whether comparability adjustments for such local market features are required, the most reliable approach will be to refer to data regarding comparable uncontrolled transactions in that geographic market between independent enterprises performing similar functions, assuming similar risks, and using similar assets. Such transactions are carried out under the same market conditions as the controlled transaction, and, accordingly, where comparable transactions in the local market can be identified, specific adjustments for features of the local market should not be required.

1.146 In situations where reasonably reliable local market comparables cannot be identified, the determination of appropriate comparability adjustments for features of the local market should consider all of the relevant facts and circumstances. As with location savings, in each case where reliable local market comparables cannot be identified, it is necessary to consider (i) whether a market advantage or disadvantage exists, (ii) the amount of any increase or

decrease in revenues, costs or profits, *vis-à-vis* those of identified comparables from other markets, that are attributable to the local market advantage or disadvantage, (iii) the degree to which benefits or burdens of local market features are passed on to independent customers or suppliers, and (iv) where benefits or burdens attributable to local market features exist and are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate such net benefits or burdens between them.

1.147 The need for comparability adjustments related to features of the local market in cases where reasonably reliable local market comparables cannot be identified may arise in several different contexts. In some circumstances, market advantages or disadvantages may affect arm's length prices of goods transferred or services provided between associated enterprises.

1.148 In other circumstances, a business restructuring or the transfer of intangibles between associated enterprises may make it possible for one party to the transaction to gain the benefit of local market advantages or require that party to assume the burden of local market disadvantages in a manner that would not have been possible in the absence of the business restructuring or transfer of the intangibles. In such circumstances, the anticipated existence of local market advantages and disadvantages may affect the arm's length price paid in connection with the business restructuring or intangible transfer.

1.149 In conducting a transfer pricing analysis it is important to distinguish between features of the local market, which are not intangibles, and any contractual rights, government licences, or know-how necessary to exploit that market, which may be intangibles. Depending on the circumstances, these types of intangibles may have substantial value that should be taken into account in a transfer pricing analysis in the manner described in Chapter VI, including the guidance on rewarding entities for functions, assets and risks associated with the development of intangibles contained in Section B of Chapter VI. In some circumstances, contractual rights and government licences may limit access of competitors to a particular market and may therefore affect the manner in which the economic consequences of local market features are shared between parties to a particular transaction. In other circumstances, contractual rights or government licences to access a market may be available to many or all potential market entrants with little restriction.

1.150 For example, a country may require a regulatory licence to be issued as a pre-condition for conducting an investment management business in the country and may restrict the number of foreign-owned firms to which such licences are granted. The comparability and functional analysis may indicate that qualifying for such a licence requires demonstrating to appropriate government authorities that the service provider has appropriate levels of experience and capital to conduct such a business in a reputable fashion. The market to which such a licence relates may also be one with unique features. It may, for example be a market where the structure of pension and insurance arrangements gives rise to large cash pools, a need to diversify investments internationally, and a resulting high demand for quality investment management services and knowledge of foreign financial markets that can make the provision of such services highly lucrative. The comparability analysis may further suggest that those features of the local market may affect the price that can be charged for certain types of investment management services and the profit margins that may be earned from providing such services. Under these circumstances, the intangible in question (i.e. the regulatory licence to provide investment management services) may allow the party or parties holding the licence to extract a greater share of the benefits of operating in the local market, including the

benefits provided by unique features of that market, than would be the case in the absence of the licensing requirement. However, in assessing the impact of the regulatory licence, it may be important in a particular case to consider the contributions of both the local group member in the local market and other group members outside the local market in supplying the capabilities necessary to obtain the licence, as described in Section B of Chapter VI.

1.151 In a different circumstance, the comparability and functional analysis may suggest that a government issued business licence is necessary as a pre-condition for providing a particular service in a geographic market. However, it may be the case that such licences are readily available to any qualified applicant and do not have the effect of restricting the number of competitors in the market. Under such circumstances, the licence requirement may not present a material barrier to entry, and possession of such a licence may not have any discernible impact on the manner in which the benefits of operating in the local market are shared between independent enterprises.

D.7. Assembled workforce

1.152 Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group may affect the arm's length price for services provided by the employee group or the efficiency with which services are provided or goods produced by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis. Where it is possible to determine the benefits or detriments of a unique assembled workforce *vis-à-vis* the workforce of enterprises engaging in potentially comparable transactions, comparability adjustments may be made to reflect the impact of the assembled workforce on arm's length prices for goods or services.

1.153 In some business restructuring and similar transactions, it may be the case that an assembled workforce is transferred from one associated enterprise to another as part of the transaction. In such circumstances, it may well be that the transfer of the assembled workforce along with other transferred assets of the business will save the transferee the time and expense of hiring and training a new workforce. Depending on the transfer pricing methods used to evaluate the overall transaction, it may be appropriate in such cases to reflect such time and expense savings in the form of comparability adjustments to the arm's length price otherwise charged with respect to the transferred assets. In other situations, the transfer of the assembled workforce may result in limitations on the transferee's flexibility in structuring business operations and create potential liabilities if workers are terminated. In such cases it may be appropriate for the compensation paid in connection with the restructuring to reflect the potential future liabilities and limitations.

1.154 The foregoing paragraph is not intended to suggest that transfers or secondments of individual employees between members of an MNE group should be separately compensated as a general matter. In many instances the transfer of individual employees between associated enterprises will not give rise to a need for compensation. Where employees are seconded (i.e. they remain on the transferor's payroll but work for the transferee), in many cases the appropriate arm's length compensation for the services of the seconded employees in question will be the only payment required.

1.155 It should be noted, however, that in some situations, the transfer or secondment of one or more employees may, depending on the facts and circumstances, result in the transfer of valuable know-how or other intangibles from one associated enterprise to another. For example, an employee of Company A seconded to Company B may have knowledge of a secret

formula owned by Company A and may make that secret formula available to Company B for use in its commercial operations. Similarly, employees of Company A seconded to Company B to assist with a factory start-up may make Company A manufacturing know-how available to Company B for use in its commercial operations. Where such a provision of know-how or other intangibles results from the transfer or secondment of employees, it should be separately analysed under the provisions of Chapter VI and an appropriate price should be paid for the right to use the intangibles.

1.156 Moreover, it should also be noted that access to an assembled workforce with particular skills and experience may, in some circumstances, enhance the value of transferred intangibles or other assets, even where the employees making up the workforce are not transferred. Example 23 in the annex to Chapter VI illustrates one fact pattern where the interaction between intangibles and access to an assembled workforce may be important in a transfer pricing analysis.

D.8. MNE group synergies

1.157 Comparability issues, and the need for comparability adjustments, can also arise because of the existence of MNE group synergies. In some circumstances, MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies amongst group members that would not generally be available to similarly situated independent enterprises. Such group synergies can arise, for example, as a result of combined purchasing power or economies of scale, combined and integrated computer and communication systems, integrated management, elimination of duplication, increased borrowing capacity, and numerous similar factors. Such group synergies are often favourable to the group as a whole and therefore may heighten the aggregate profits earned by group members, depending on whether expected cost savings are, in fact, realised, and on competitive conditions. In other circumstances such synergies may be negative, as when the size and scope of corporate operations create bureaucratic barriers not faced by smaller and more nimble enterprises, or when one portion of the business is forced to work with computer or communication systems that are not the most efficient for its business because of group wide standards established by the MNE group.

1.158 Paragraph 7.13 of these Guidelines suggests that an associated enterprise should not be considered to receive an intra-group service or be required to make any payment when it obtains incidental benefits attributable solely to its being part of a larger MNE group. In this context, the term incidental refers to benefits arising solely by virtue of group affiliation and in the absence of deliberate concerted actions or transactions leading to that benefit. The term incidental does not refer to the quantum of such benefits or suggest that such benefits must be small or relatively insignificant. Consistent with this general view of benefits incidental to group membership, when synergistic benefits or burdens of group membership arise purely as a result of membership in an MNE group and without the deliberate concerted action of group members or the performance of any service or other function by group members, such synergistic benefits of group membership need not be separately compensated or specifically allocated among members of the MNE group.

1.159 In some circumstances, however, synergistic benefits and burdens of group membership may arise because of deliberate concerted group actions and may give an MNE group a material, clearly identifiable structural advantage or disadvantage in the marketplace over market participants that are not part of an MNE group and that are involved in comparable transactions. Whether such a structural advantage or disadvantage exists, what the nature and source of the synergistic benefit or burden may be, and whether

the synergistic benefit or burden arises through deliberate concerted group actions can only be determined through a thorough functional and comparability analysis.⁵

1.160 For example, if a group takes affirmative steps to centralise purchasing in a single group company to take advantage of volume discounts, and that group company resells the items it purchases to other group members, a deliberate concerted group action occurs to take advantage of group purchasing power. Similarly, if a central purchasing manager at the parent company or regional management centre performs a service by negotiating a group wide discount with a supplier on the condition of achieving minimum group wide purchasing levels, and group members then purchase from that supplier and obtain the discount, deliberate concerted group action has occurred notwithstanding the absence of specific purchase and sale transactions among group members. Where a supplier unilaterally offers one member of a group a favourable price in the hope of attracting business from other group members, however, no deliberate concerted group action would have occurred.

1.161 Where corporate synergies arising from deliberate concerted group actions do provide a member of an MNE group with material advantages or burdens not typical of comparable independent companies, it is necessary to determine (i) the nature of the advantage or disadvantage, (ii) the amount of the benefit or detriment provided, and (iii) how that benefit or detriment should be divided among members of the MNE group.

1.162 If important group synergies exist and can be attributed to deliberate concerted group actions, the benefits of such synergies should generally be shared by members of the group in proportion to their contribution to the creation of the synergy. For example, where members of the group take deliberate concerted actions to consolidate purchasing activities to take advantage of economies of scale resulting from high volume purchasing, the benefits of those large scale purchasing synergies, if any exist after an appropriate reward to the party co-ordinating the purchasing activities, should typically be shared by the members of the group in proportion to their purchase volumes.

1.163 Comparability adjustments may be warranted to account for group synergies.

Example 1

1.164 P is the parent company of an MNE group engaging in a financial services business. The strength of the group's consolidated balance sheet makes it possible for P to maintain an AAA credit rating on a consistent basis. S is a member of the MNE group engaged in providing the same type of financial services as other group members and does so on a large scale in an important market. On a stand-alone basis, however, the strength of S's balance sheet would support a credit rating of only Baa. Nevertheless, because of S's membership in the P group, large independent lenders are willing to lend to it at interest rates that would be charged to independent borrowers with an A rating, i.e. a lower interest rate than would be charged if S were an independent entity with its same balance sheet, but a higher interest rate than would be available to the parent company of the MNE group.

1.165 Assume that S borrows EUR 50 million from an independent lender at the market rate of interest for borrowers with an A credit rating. Assume further that S simultaneously borrows EUR 50 million from T, another subsidiary of P, with similar characteristics as the independent lender, on the same terms and conditions and at the same interest rate charged by the independent lender (i.e. an interest rate premised on the existence of an A credit rating). Assume further that the independent lender, in setting its terms and conditions, was aware of S's other borrowings including the simultaneous loan to S from T.

1.166 Under these circumstances the interest rate charged on the loan by T to S is an arm's length interest rate because (i) it is the same rate charged to S by an independent lender in a comparable transaction; and (ii) no payment or comparability adjustment is required for the group synergy benefit that gives rise to the ability of S to borrow from independent enterprises at an interest rate lower than it could were it not a member of the group because the synergistic benefit of being able to borrow arises from S's group membership alone and not from any deliberate concerted action of members of the MNE group.

Example 2⁶

1.167 The facts relating to S's credit standing and borrowing power are identical to those in the preceding example. S borrows EUR 50 million from Bank A. The functional analysis suggests that Bank A would lend to S at an interest rate applicable to A rated borrowers without any formal guarantee. However, P agrees to guarantee the loan from Bank A in order to induce Bank A to lend at the interest rate that would be available to AAA rated borrowers. Under these circumstances, S should be required to pay a guarantee fee to P for providing the express guarantee. In calculating an arm's length guarantee fee, the fee should reflect the benefit of raising S's credit standing from A to AAA, not the benefit of raising S's credit standing from Baa to AAA. The enhancement of S's credit standing from Baa to A is attributable to the group synergy derived purely from passive association in the group which need not be compensated under the provisions of this section. The enhancement of S's credit standing from A to AAA is attributable to a deliberate concerted action, namely the provision of the guarantee by P, and should therefore give rise to compensation.

Example 3

1.168 Assume that Company A is assigned the role of central purchasing manager on behalf of the entire group. It purchases from independent suppliers and resells to associated enterprises. Company A, based solely on the negotiating leverage provided by the purchasing power of the entire group is able to negotiate with a supplier to reduce the price of widgets from USD 200 to USD 110. Under these circumstances, the arm's length price for the resale of widgets by Company A to other members of the group would not be at or near USD 200. Instead, the arm's length price would remunerate Company A for its services of coordinating purchasing activity. If the comparability and functional analysis suggests in this case that in comparable uncontrolled transactions involving a comparable volume of purchases, comparable coordination services resulted in a service fee based on Company A's costs incurred plus a mark-up equating to a total service fee of USD 6 per widget, then the intercompany price for the resale of the widgets by Company A would be approximately USD 116. Under these circumstances, each member of the group would derive benefits attributable to the group purchasing power of approximately USD 84 per widget. In addition, Company A would earn USD 6 per widget purchased by members of the group for its service functions.

Example 4

1.169 Assume facts similar to those in Example 3, except that instead of actually purchasing and reselling the widgets, Company A negotiates the discount on behalf of the group and group members subsequently purchase the widgets directly from the independent supplier. Under these circumstances, assume that the comparability analysis suggests that Company A would be entitled to a service fee of USD 5 per widget for the coordinating services that it

performed on behalf of other group members. (The lower assumed service fee in Example 4 as compared to Example 3 may reflect a lower level of risk in the service provider following from the fact that it does not take title to the widgets or hold any inventory.) Group members purchasing widgets would retain the benefit of the group purchasing discount attributable to their individual purchases after payment of the service fee.

Example 5

1.170 Assume a multinational group based in Country A, has manufacturing subsidiaries in Country B and Country C. Country B has a tax rate of 30% and Country C has a tax rate of 10%. The group also maintains a shared services centre in Country D. Assume that the manufacturing subsidiaries in Country B and Country C each have need of 5 000 widgets produced by an independent supplier as an input to their manufacturing processes. Assume further that the Country D shared services company is consistently compensated for its aggregate activities by other group members, including the Country B and Country C manufacturing affiliates, on a cost plus basis, which, for purposes of this example, is assumed to be arm's length compensation for the level and nature of services it provides.

1.171 The independent supplier sells widgets for USD 10 apiece and follows a policy of providing a 5% price discount for bulk purchases of widgets in excess of 7 500 units. A purchasing employee in the Country D shared services centre approaches the independent supplier and confirms that if the Country B and Country C manufacturing affiliates simultaneously purchase 5 000 widgets each, a total group purchase of 10 000 widgets, the purchase discount will be available with respect to all of the group purchases. The independent supplier confirms that it will sell an aggregate of 10 000 widgets to the MNE group at a total price of USD 95 000, a discount of 5% from the price at which either of the two manufacturing affiliates could purchase independently from the supplier.

1.172 The purchasing employee at the shared services centre then places orders for the required widgets and requests that the supplier invoice the Country B manufacturing affiliate for 5 000 widgets at a total price of USD 50 000 and invoice the Country C manufacturing affiliate for 5 000 widgets at a total price of USD 45 000. The supplier complies with this request as it will result in the supplier being paid the agreed price of USD 95 000 for the total of the 10 000 widgets supplied.

1.173 Under these circumstances, Country B would be entitled to make a transfer pricing adjustment reducing the expenses of the Country B manufacturing affiliate by USD 2 500. The transfer pricing adjustment is appropriate because the pricing arrangements misallocate the benefit of the group synergy associated with volume purchasing of the widgets. The adjustment is appropriate notwithstanding the fact that the Country B manufacturing affiliate acting alone could not purchase widgets for a price less than the USD 50 000 it paid. The deliberate concerted group action in arranging the purchase discount provides a basis for the allocation of part of the discount to the Country B manufacturing affiliate notwithstanding the fact that there is no explicit transaction between the Country B and Country C manufacturing affiliates.

COMMODITY TRANSACTIONS

Additions to Chapter II of the Transfer Pricing Guidelines

Summary

This chapter of the Report contains new guidance in respect of commodity transactions, to be inserted immediately following paragraph 2.16 of the 2010 Transfer Pricing Guidelines.

Action 10 of the BEPS Action Plan instructs the G20 and the OECD countries to develop transfer pricing rules to provide protection against common types of base eroding payments. Under this mandate, the G20 and OECD countries have examined the transfer pricing aspects of cross-border commodity transactions between associated enterprises (“commodity transactions”). The outcome of this work is an improved framework for the analysis of commodity transactions from a transfer pricing perspective which should lead to greater consistency in the way that tax administrations and taxpayers determine the arm’s length price for commodity transactions and should ensure that pricing reflects value creation.

Chapter II of the Transfer Pricing Guidelines has been amended to include new guidance especially applicable to commodity transactions. These provisions draw from experiences of countries that have introduced domestic rules aimed at pricing commodity transactions. The new guidance includes:

- Clarification of the existing guidance on the application of the comparable uncontrolled price (CUP) method to commodity transactions. The new guidance states that (i) the CUP method would generally be an appropriate transfer pricing method for commodity transactions between associated enterprises; (ii) quoted prices can be used under the CUP method, subject to a number of considerations, as a reference to determine the arm’s length price for the controlled commodity transaction; and (iii) reasonably accurate comparability adjustments should be made, when needed, to ensure that the economically relevant characteristics of the controlled and uncontrolled transactions are sufficiently comparable.
- A new provision on the determination of the pricing date for commodity transactions. This provision should prevent taxpayers from using pricing dates in contracts that enable the adoption of the most advantageous quoted price. It allows tax authorities to impute, under certain conditions, the shipment date (or any other date for which evidence is available) as the pricing date for the commodity transaction.

The guidance developed under other BEPS actions is also relevant in dealing with issues relating to commodity transactions. In particular, the revised standards for transfer pricing documentation (Action 13 of the BEPS Action Plan) and the guidance in the chapter “Guidance for Applying the Arm’s length Principle” (Action 9 of the BEPS Action Plan).

This new guidance will be supplemented with further work mandated by the G20 Development Working Group, following reports by the OECD on the impact of base erosion and profit shifting (BEPS) in developing countries.⁷ The outcome of this work will provide knowledge, best practices and tools for commodity-rich countries in pricing commodity transactions for transfer pricing purposes.

The following paragraphs are added to Chapter II of the Transfer Pricing Guidelines, immediately following paragraph 2.16.

2.16A Subject to the guidance in paragraph 2.2 for selecting the most appropriate transfer pricing method in the circumstances of a particular case, the CUP method would generally be an appropriate transfer pricing method for establishing the arm's length price for the transfer of commodities between associated enterprises. The reference to "commodities" shall be understood to encompass physical products for which a quoted price is used as a reference by independent parties in the industry to set prices in uncontrolled transactions. The term "quoted price" refers to the price of the commodity in the relevant period obtained in an international or domestic commodity exchange market. In this context, a quoted price also includes prices obtained from recognised and transparent price reporting or statistical agencies, or from governmental price-setting agencies, where such indexes are used as a reference by unrelated parties to determine prices in transactions between them.

2.16B Under the CUP method, the arm's length price for commodity transactions may be determined by reference to comparable uncontrolled transactions and by reference to comparable uncontrolled arrangements represented by the quoted price. Quoted commodity prices generally reflect the agreement between independent buyers and sellers in the market on the price for a specific type and amount of commodity, traded under specific conditions at a certain point in time. A relevant factor in determining the appropriateness of using the quoted price for a specific commodity is the extent to which the quoted price is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled transactions comparable to the controlled transaction. Accordingly, depending on the facts and circumstances of each case, quoted prices can be considered as a reference for pricing commodity transactions between associated enterprises. Taxpayers and tax administrations should be consistent in their application of the appropriately selected quoted price.

2.16C For the CUP method to be reliably applied to commodity transactions, the economically relevant characteristics of the controlled transaction and the uncontrolled transactions or the uncontrolled arrangements represented by the quoted price need to be comparable. For commodities, the economically relevant characteristics include, among others, the physical features and quality of the commodity; the contractual terms of the controlled transaction, such as volumes traded, period of the arrangements, the timing and terms of delivery, transportation, insurance, and foreign currency terms. For some commodities, certain economically relevant characteristics (e.g. prompt delivery) may lead to a premium or a discount. If the quoted price is used as a reference for determining the arm's length price or price range, the standardised contracts which stipulate specifications on the basis of which commodities are traded on the exchange and which result in a quoted price for the commodity may be relevant. Where there are differences between the conditions of the controlled transaction and the conditions of the uncontrolled transactions or the conditions determining the quoted price for the commodity that materially affect the price of the commodity transactions being examined, reasonably accurate adjustments should be made to ensure that the economically relevant characteristics of the transactions are comparable. Contributions made in the form of functions performed, assets used and risks assumed by other entities in the supply chain should be compensated in accordance with the guidance provided in these Guidelines.

2.16D In order to assist tax administrations in conducting an informed examination of the taxpayer's transfer pricing practices, taxpayers should provide reliable evidence

and document, as part of their transfer pricing documentation, the price-setting policy for commodity transactions, the information needed to justify price adjustments based on the comparable uncontrolled transactions or comparable uncontrolled arrangements represented by the quoted price and any other relevant information, such as pricing formulas used, third party end-customer agreements, premia or discounts applied, pricing date, supply chain information, and information prepared for non-tax purposes.

2.16E A particularly relevant factor for commodity transactions determined by reference to the quoted price is the pricing date, which refers to the specific time, date or time period (e.g. a specified range of dates over which an average price is determined) selected by the parties to determine the price for commodity transactions. Where the taxpayer can provide reliable evidence of the pricing date agreed by the associated enterprises in the controlled commodity transaction at the time the transaction was entered into (e.g. proposals and acceptances, contracts or registered contracts, or other documents setting out the terms of the arrangements may constitute reliable evidence) and this is consistent with the actual conduct of the parties or with other facts of the case, in accordance with the guidance in Section D of Chapter I on accurately delineating the actual transaction, tax administrations should determine the price for the commodity transaction by reference to the pricing date agreed by the associated enterprises. If the pricing date specified in any written agreement between the associated enterprises is inconsistent with the actual conduct of the parties or with other facts of the case, tax administrations may determine a different pricing date consistent with those other facts of the case and what independent enterprises would have agreed in comparable circumstances (taking into considerations industry practices). When the taxpayer does not provide reliable evidence of the pricing date agreed by the associated enterprises in the controlled transaction and the tax administration cannot otherwise determine a different pricing date under the guidance in Section D of Chapter I, tax administrations may deem the pricing date for the commodity transaction on the basis of the evidence available to the tax administration; this may be the date of shipment as evidenced by the bill of lading or equivalent document depending on the means of transport. This would mean that the price for the commodities being transacted would be determined by reference to the average quoted price on the shipment date, subject to any appropriate comparability adjustments based on the information available to the tax administration. It would be important to permit resolution of cases of double taxation arising from application of the deemed pricing date through access to the mutual agreement procedure under the applicable Treaty.

SCOPE OF WORK FOR GUIDANCE ON THE TRANSACTIONAL PROFIT SPLIT METHOD

Summary

Action 10 of the BEPS Action Plan invites clarification of the application of transfer pricing methods, in particular the transactional profit split method, in the context of global value chains.

In order to determine the matters relating to the application of the transactional profit split method for which clarification would be useful, the OECD released a discussion draft on 16 December 2014, which raised a number of questions based on scenarios developed from the use of profit splits encountered in practice by some delegates to Working Party No. 6. That discussion draft did not include revised guidance. Comments on the discussion draft from interested parties extended to around 500 pages, and a public consultation on 19-20 March 2015 attracted considerable interest.

Some of the key themes emerging from the consultation process and subsequent discussion within WP6 included the need to reflect on clarifying, improving, and strengthening the guidance on when it is appropriate to apply a transactional profit split method and how to do so, since experiences indicate that this method may not be straightforward for taxpayers to apply, and may not be straightforward for tax administrations to evaluate. Nevertheless, the consultation process confirmed that transactional profit splits can offer a useful method which has the potential when properly applied, to align profits with value creation in accordance with the arm's length principle and the most appropriate method, particularly in situations where the features of the transaction makes the application of other transfer pricing methodologies problematic.

Improved guidance needs to clarify the circumstances in which transactional profit splits are the most appropriate method for a particular case and to describe what approaches can be taken to split profits in a reliable way. The guidance on transactional profit splits also needs to take into account changes to the transfer pricing guidance in pursuit of other BEPS actions, including changes in relation to the guidance on applying the arm's length principle in the section on performing a robust functional analysis and identifying and allocating risks, in the section on synergies; and to the guidance on intangibles. The guidance should take into account the conclusions of the Report on *Addressing the Tax Challenges of the Digital Economy* (OECD, 2015), developed in relation to BEPS Action 1, which noted that attention should be paid to the consequences of greater integration of business models as a result of the digitised economy, and the potential role for profit splits to account for such integration.⁸ In addition, the guidance should reflect further work being undertaken to develop approaches to transfer pricing in situations where the availability of comparables is limited, for example due to the specific features of the controlled transaction; and clarify how in such cases, the most appropriate method should be selected. This concerns work mandated by the G20 Development Working Group, following reports

by the OECD on the impact of BEPS in developing countries,⁹ including the development of a toolkit for low income countries to address challenges these countries face due to the lack of comparables.

The clarification and strengthening of the guidance on transactional profit splits, set out in this Report, together with the development of useful illustrations of the situations in which transactional profits splits can reliably be applied and how they can be applied to produce arm's length outcomes, requires proper consideration of the matters raised during the initial consultation and further consultation on draft guidance. This paper sets out the proposed scope of that work.

This Report will form the basis for draft guidance to be developed by WP6 during 2016 and expected to be finalised in the first half of 2017. A discussion draft of guidance will be released for public comments and a public consultation will be held in May 2016.

Part I: Current guidance on transactional profit split method and public consultation

Current guidance

1. The current guidance on the application of the transactional profit split method in Chapter II, Part III, Section C of the Transfer Pricing Guidelines indicates that the main strength of the method is that it can provide solutions for highly integrated operations for which a one-sided method would not be appropriate, such as global trading of financial instruments. The current guidance also states that transactional profit split methods may be found to be the most appropriate method in situations where both parties to the transaction make unique and valuable contributions, for example in the form of unique intangibles (see paragraph 2.109).
2. The guidance makes the point that where each party makes unique and valuable contributions, reliable comparables information may be insufficient to apply another method. The guidance stresses that the selection of a transactional profit split method should be determined in accordance with the overall guidance for method selection at paragraph 2.2 of the Guidelines (see paragraphs 2.109 and 3.39).
3. While the guidance on splitting profits provides a number of examples of potential allocation keys, it focusses on asset-based and cost-based allocation keys (see paragraphs 2.134-139). There is tentative mention of an approach which splits profits so that each party achieves the same return on capital (paragraph 2.145).
4. Chapter VI of the Transfer Pricing Guidelines, Special Considerations for Intangibles, makes a number of references to the transactional profit split method and to situations where the current guidance on its application may need to be clarified. For example, the guidance suggests:
 - In some cases profit splits or valuation techniques may be useful for evaluating arm's length allocations of profit in situations involving the outsourcing of important functions where information on comparable uncontrolled transactions is unavailable.¹⁰
 - Where no information on comparable uncontrolled transactions is available, a transactional profit split method is a method that may be useful in situations involving the pricing of transfers of intangibles.¹¹ This may include the transfer of partially developed intangibles; or the transfer of all, or limited rights in a fully developed intangible.
5. Furthermore, aspects of Chapter I of the Transfer Pricing Guidelines may prompt consideration of transactional profit splits, but specific guidance has not yet been provided. Areas of particular interest in this regard include situations where multiple parties exercise control over a risk such that a sharing in the potential upside and downside of the risk may be appropriate, and the sharing of group synergies arising from deliberate concerted group action.

Scope of revised guidance

6. The revised guidance should follow the current structure in Chapter II of the Transfer Pricing Guidelines, but should clarify and supplement the following matters. Practical application should be illustrated through examples.

Most appropriate method

7. The December 2014 discussion draft on the use of transactional profit splits stated that the consideration of transactional profit splits did not imply any changes to the guidance for selecting the most appropriate method set out in paragraph 2.2 of the Guidelines. Nevertheless, comments on the discussion draft pointed to significant concerns at the potential for transactional profit split methods to be misused, particularly in cases where the nature of the transaction itself, based on the functional analysis of the parties, suggests that a sharing of combined profits would not be expected at arm's length. Concerns were expressed that the profit split method would be used in the absence of reliable comparables, without considering whether the profit split method was itself appropriate.

Highly integrated business operations

8. While the current Guidelines state that transactional profit split methods may be found to be the most appropriate method where business operations are highly integrated, integration alone may be insufficient to warrant the use of such a method. All MNE groups are integrated to a greater or lesser degree, and so it is unclear how the criterion of integration should be applied.

Unique and valuable contributions

9. The existing guidance on the application of transactional profit split methods notes that such methods may be the most appropriate method in situations where both parties to the transaction make unique and valuable contributions. However, there is little further guidance in the current Guidelines about what constitutes a “unique and valuable contribution” aside from an example where intangibles are contributed by both parties to the transaction.

10. Some commentators on the December discussion draft suggested that “unique” contributions could be defined as those which cannot be benchmarked by reference to uncontrolled transactions, and “valuable” contributions could be defined as those which are expected to yield future economic benefits. Others went further and proposed that “valuable” contributions could be those which contribute to a key source of competitive advantage. A number of commentators on the December discussion draft supported the notion that the sharing of significant risks could constitute a “unique and valuable contribution” and hence may result in the conclusion that a transactional profit split method is the most appropriate to the circumstances.

Synergistic benefits

11. The December discussion draft included a scenario describing a multisided digital economy business model. A number of commentators and Working Party No. 6 delegates consider that the scenario, rather than illustrating a specific feature of the digital economy, instead simply demonstrates the effect of synergistic benefits. In such cases, both parts of the business may make significant contributions towards the key value driver(s) of

the MNE group. The guidance on group synergies provides that, where the synergistic benefits arise as a result of deliberate concerted action, such benefits must be shared by group members in proportion to their contribution to the creation of the synergy.¹² While it may, in some circumstances be possible to benchmark the contributions of each part of the business, such a process may not be able to account for the potentially significant integration benefits which are achieved by the two parts acting in concert.

Profit splitting factors

12. The over-arching objective of the BEPS Actions 8-10 is to ensure that transfer pricing outcomes are in line with economic value creation. Such an objective is achieved by accurately delineating the actual transaction and pricing it in accordance with the most appropriate method. The December discussion draft noted that transactional profit split methods could make a contribution to achieving this aim and asked about experiences in using various approaches to splitting profits that might indicate ways of ensuring both greater objectivity and alignment with value creation in circumstances where application of the transactional profit split method is appropriate.

13. While there is general agreement that the splitting of profits should be based on a functional analysis of the parties' contributions, the mechanism by which the value of those contributions is quantified is not always clear. Possible mechanisms that are used in practice to various extents include invested capital, costs, surveys of functional contributions, weighting of factors, as well as equalised expected rates of return. Commentators observed advantages and disadvantages in these mechanisms, based on issues such as availability of information, measurability, subjectivity, and practicality, and the observations emphasise the current lack of guidance on what is a key aspect of applying a profit split – how the profits should reliably be split.

Use of profit split to determine TNMM range, or converting to a royalty

14. The December discussion draft raised questions about the use of profit splits to vary the range of results derived from a TNMM analysis by reference to increase or decrease in consolidated profits achieved by the parties to the transaction. The draft also raised a question about using a profit split to determine the expected share of profits, and then converting the analysis to a running royalty. Some commentators also felt that these were useful suggestions.

Part II: Scope of revisions of the guidance on the transactional profit split method

Most appropriate method

- The guidance on transactional profit splits and selecting the most appropriate method should emphasise the point made at paragraph 2.2 of the current Guidelines that the nature of the transaction, determined in accordance with the guidance in Section D of Chapter I, is a vital consideration for the selection of the most appropriate transfer pricing method even in the absence of information on reliable, comparable uncontrolled transactions. The sharing of profits or losses under a profit split may in some circumstances reflect a fundamentally different commercial relationship between the parties, in particular concerning risk allocation, to the paying of a fee for goods or services. In cases where the delineation of the actual transaction is such that a share of profits would be unlikely to represent an arm's length outcome, the revised

guidance will emphasise the need to use and adjust the best available comparables rather than selecting a profit split method. An appropriate method using inexact comparables is likely to be more reliable in such cases than an inappropriate use of the transactional profit split method. As such, the guidance on how the most appropriate method standard should be applied in such difficult cases will be expanded. Selecting the most appropriate method is particularly acute where there is a lack of reliable comparables data, as is very often the case in developing countries, and is relevant to the work mandated by the G20 Development Working Group on the development of toolkits to help low income countries address the challenge of the lack of comparables.

Highly integrated business operations

- Additional guidance will be provided on when significant integration of business operations may lead to the conclusion that a transactional profit split is the most appropriate method. To this end, the guidance should refer to the relevance of a value chain analysis in understanding the context of the controlled transaction(s). As part of this analysis, it may be helpful to distinguish between sequential integration of a global value chain (which may involve the parties performing different activities linked through transactions between them in a coherent value chain, and which may not warrant the use of a profit split without taking into account further features of the arrangements) and parallel integration, which may involve the parties performing similar activities relating to the same revenues, costs, assets, or risks, within the value chain or at a stage in the value chain. The reference to global trading of financial instruments in the current Guidelines, which may involve parallel activities on the same asset, revenue stream, and risks, suggests that the current Guidelines envisaged that splitting the combined profits arising from this type of parallel integration may be appropriate.

Unique and valuable contributions

- Additional guidance and examples will be provided to clarify what is meant by “unique and valuable” contributions in order to distinguish those circumstances when transactional profit split methods are likely to be the most appropriate method. Additional guidance on unique and valuable contributions other than in the form of intangibles will be provided.
- Taking into account revisions to the guidance on intangibles, guidance will be provided to clarify the selection of a transactional profit split as the most appropriate method in cases involving the performance of important functions relating to the development, enhancement, maintenance, protection or exploitation of intangibles, i.e. when do such functions constitute “unique and valuable contributions” for the purposes of identifying the most appropriate transfer pricing method.
- In developing this guidance due regard should be given to situations where independent enterprises make use of profit split models in comparable transactions.

Synergistic benefits

- Additional guidance will be provided on the circumstances to take into account in determining whether a transactional profit split method could be the most appropriate method for dealing with scenarios with significant group synergies, and how such profit split methods could be applied.

Profit splitting factors

- Additional guidance will be provided that explains how to fulfil the need for a strong correlation between profit allocation factors and the creation of value in order to ensure an outcome that is consistent with the arm's length principle. Various mechanisms should be explained in detail, with examples of their application. In addition, the sensitivities and practical application of the various mechanisms, including the capability independently to verify the underlying data, should be compared, in order that guidance is provided about the appropriate application of the mechanisms.

Use of profit split to determine TNMM range, royalty rates and other payment forms

- Additional guidance will be provided on the circumstances to take into account in evaluating whether a transactional profit split method can be used to support results under a TNMM, or to determine royalty rates, or in other ways that are practical, respect the form of the contractual arrangements, and help simplify pricing outcomes.

INTANGIBLES

Revisions to Chapter VI of the Transfer Pricing Guidelines

Summary

This chapter of the Report provides guidance specially tailored to determining arm's length conditions for transactions that involve the use or transfer of intangibles under Article 9 of the OECD Model Tax Convention. In doing so, the guidance contained in this chapter addresses the opportunities for base erosion and profit shifting resulting from the transfer of intangibles among members of an MNE group. Under this guidance, members of the MNE group are to be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles. Tax administrations are given new tools to tackle the problem of information asymmetry to assist in determining the appropriate pricing arrangements for intangibles, and valuation techniques are recognised as useful tools when pricing transactions involving intangibles.

The guidance was developed under Action 8 of the OECD/G20 BEPS Project, which requested the development of rules to prevent BEPS by moving intangibles among group members by “(i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles.”

This chapter places the guidance on intangibles within the wider context of the guidance on accurately delineating the transaction and the analysis of risks contained in the first chapter of this Report relating to “Guidance on Applying the Arm's Length Principle”, which is relevant in dealing with the difference between anticipated and actual returns to intangibles.

The framework for analysing risks contained in the chapter “Guidance on Applying the Arm's Length Principle” depends on a very specific and meaningful control requirement, which takes into account both the capability to perform relevant decision-making functions together with the actual performance of such functions. If an associated enterprise contractually assuming a specific risk does not exercise control over that risk nor has the financial capacity to assume the risk, then the framework contained in the chapter “Guidance on Applying the Arm's Length Principle” determines that the risk will be allocated to another member of the MNE group that does exercise such control and has the financial capacity to assume the risk. This control requirement is used in this chapter

to determine which parties assume risks in relation to intangibles, but also for assessing which member of the MNE group in fact controls the performance of outsourced functions in relation to the development, enhancement, maintenance, protection and exploitation of the intangible.

The guidance refers to the treatment of the return to funding contained in the chapter “Guidance on Applying the Arm’s Length Principle”, and ensures that funding of the development, enhancement, maintenance, protection or exploitation of an intangible by an entity that does not perform any of the important functions in relation to the intangible and does not exercise control over the financial risk will generate no more than a risk-free return.

In relation to arm’s length pricing when valuation is highly uncertain at the time of the transaction, the guidance recognises that third parties may adopt different approaches for taking account of uncertainties that are relevant for the value of an intangible, including to conclude a contract based on contingent payments dependent on the actual results achieved. The guidance also takes into account that, because of information asymmetries, it proves difficult for a tax administration to evaluate the reliability of the information on which the taxpayer priced the transaction, especially in relation to intangibles with a highly uncertain value at the time of the transfer. To address these challenges, an approach to pricing hard-to-value intangibles has been developed which allows the taxpayer to demonstrate that its pricing is based on a thorough transfer pricing analysis and leads to an arm’s length outcome, while the approach at the same time protects the tax administrations from the negative effects of information asymmetry. It does so by ensuring that tax administrations can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements, and the taxpayer cannot demonstrate that the uncertainty has been appropriately taken into account in the pricing methodology adopted. Guidance on the implementation of this approach will be provided during 2016, and the practical application of the exemptions, including the measurement of materiality and time periods contained in the current exemptions, will be reviewed by 2020 in the light of further experience.

In summary, the guidance contained in this chapter ensures that:

- Legal ownership of intangibles by an associated enterprise alone does not determine entitlement to returns from the exploitation of intangibles;
- Associated enterprises performing important value-creating functions related to the development, maintenance, enhancement, protection and exploitation of the intangibles can expect appropriate remuneration;
- An associated enterprise assuming risk in relation to the development, maintenance, enhancement, protection and exploitation of the intangibles must exercise control over the risks and have the financial capacity to assume the risks, in accordance with the guidance on risks in Section D.1.2 of the chapter “Guidance on Applying the Arm’s Length Principle”, including the very specific and meaningful control requirement;
- Entitlement of any member of the MNE group to profit or loss relating to differences between actual and expected profits will depend on which entity or entities assume(s) the risks that caused these differences and whether the entity or entities are performing the important functions in relation to the development, enhancement, maintenance, protection or exploitation of the intangibles or contributing to the control over the economically significant risks and it is determined that arm’s length remuneration of these functions would include a profit sharing element;

- An associated enterprise providing funding and assuming the related financial risks, but not performing any functions relating to the intangible, could generally only expect a risk-adjusted return on its funding;
- If the associated enterprise providing funding does not exercise control over the financial risks associated with the funding, then it is entitled to no more than a risk-free return;
- The guidance on the situations in which valuation techniques can appropriately be used is expanded;
- A rigorous transfer pricing analysis by taxpayers is required to ensure that transfers of hard-to-value intangibles are priced at arm's length.

The current provisions of Chapter VI of the Transfer Pricing Guidelines are deleted in their entirety and are replaced by the following language.

6.1 Under Article 9 of the OECD Model Tax Convention, where the conditions made or imposed in the use or transfer of intangibles between two associated enterprises differ from those that would be made between independent enterprises, then any profits that 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.

6.2 The purpose of this Chapter VI is to provide guidance specially tailored to determining arm's length conditions for transactions that involve the use or transfer of intangibles. Article 9 of the OECD Model Tax Convention is concerned with the conditions of transactions between associated enterprises, not with assigning particular labels to such transactions. Consequently, the key consideration is whether a transaction conveys economic value from one associated enterprise to another, whether that benefit derives from tangible property, intangibles, services or other items or activities. An item or activity can convey economic value notwithstanding the fact that it may not be specifically addressed in Chapter VI. To the extent that an item or activity conveys economic value, it should be taken into account in the determination of arm's length prices whether or not it constitutes an intangible within the meaning of paragraph 6.6.

6.3 The principles of Chapters I–III of these Guidelines apply equally to transactions involving intangibles and those transactions which do not. Under those principles, as is the case with other transfer pricing matters, the analysis of cases involving the use or transfer of intangibles should begin with a thorough identification of the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the actual transaction involving the use or transfer of intangibles is accurately delineated. The functional analysis should identify the functions performed, assets used, and risks assumed¹³ by each relevant member of the MNE group. In cases involving the use or transfer of intangibles, it is especially important to ground the functional analysis on an understanding of the MNE's global business and the manner in which intangibles are used by the MNE to add or create value across the entire supply chain. Where necessary, the analysis should consider, within the framework of Section D.2 of Chapter I, whether independent parties would have entered into the arrangement and if so, the conditions that would have been agreed.

6.4 In order to determine arm's length conditions for the use or transfer of intangibles it is important to perform a functional and comparability analysis in accordance with Section D.1 of Chapter I, based on identifying the intangibles and associated risks in contractual arrangements and then supplementing the analysis through examination of the actual conduct of the parties based on the functions performed, assets used, and risks assumed, including control of important functions and economically significant risks. Accordingly the next section, Section A, provides guidance on identifying intangibles. Section B examines legal ownership and other contractual terms, together with guidance on the evaluation of the conduct of the parties based on functions, assets and risks. Section C outlines some typical scenarios involving intangibles, and Section D provides guidance on determining arm's length conditions including the application of pricing methods and valuation techniques, and provides an approach to determining arm's length conditions for a specific category of hard-to-value intangibles. Examples illustrating the guidance are contained in the annex to this chapter.

A. Identifying intangibles

A.1. In general

6.5 Difficulties can arise in a transfer pricing analysis as a result of definitions of the term intangible that are either too narrow or too broad. If an overly narrow definition of the term intangible is applied, either taxpayers or governments may argue that certain items fall outside the definition and may therefore be transferred or used without separate compensation, even though such use or transfer would give rise to compensation in transactions between independent enterprises. If too broad a definition is applied, either taxpayers or governments may argue that the use or transfer of an item in transactions between associated enterprises should require compensation in circumstances where no such compensation would be provided in transactions between independent enterprises.

6.6 In these Guidelines, therefore, the word “intangible” is intended to address something which is not a physical asset or a financial asset,¹⁴ which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.

6.7 Intangibles that are important to consider for transfer pricing purposes are not always recognised as intangible assets for accounting purposes. For example, costs associated with developing intangibles internally through expenditures such as research and development and advertising are sometimes expensed rather than capitalised for accounting purposes and the intangibles resulting from such expenditures therefore are not always reflected on the balance sheet. Such intangibles may nevertheless be used to generate significant economic value and may need to be considered for transfer pricing purposes. Furthermore, the enhancement to value that may arise from the complementary nature of a collection of intangibles when exploited together is not always reflected on the balance sheet. Accordingly, whether an item should be considered to be an intangible for transfer pricing purposes under Article 9 of the OECD Model Tax Convention can be informed by its characterisation for accounting purposes, but will not be determined by such characterisation only. Furthermore, the determination that an item should be regarded as an intangible for transfer pricing purposes does not determine or follow from its characterisation for general tax purposes, as, for example, an expense or an amortisable asset.

6.8 The availability and extent of legal, contractual, or other forms of protection may affect the value of an item and the returns that should be attributed to it. The existence of such protection is not, however, a necessary condition for an item to be characterised as an intangible for transfer pricing purposes. Similarly, while some intangibles may be identified separately and transferred on a segregated basis, other intangibles may be transferred only in combination with other business assets. Therefore, separate transferability is not a necessary condition for an item to be characterised as an intangible for transfer pricing purposes.

6.9 It is important to distinguish intangibles from market conditions or local market circumstances. Features of a local market, such as the level of disposable income of households in that market or the size or relative competitiveness of the market are not capable of being owned or controlled. While in some circumstances they may affect the determination of an arm’s length price for a particular transaction and should be taken into account in a comparability analysis, they are not intangibles for the purposes of Chapter VI. See Section D.6 of Chapter I.

6.10 The identification of an item as an intangible is separate and distinct from the process for determining the price for the use or transfer of the item under the facts and circumstances of a given case. Depending on the industry sector and other facts specific to a particular case, exploitation of intangibles can account for either a large or small part of the MNE's value creation. It should be emphasised that not all intangibles deserve compensation separate from the required payment for goods or services in all circumstances, and not all intangibles give rise to premium returns in all circumstances. For example, consider a situation in which an enterprise performs a service using non-unique know-how, where other comparable service providers have comparable know-how. In that case, even though know-how constitutes an intangible, it may be determined under the facts and circumstances that the know-how does not justify allocating a premium return to the enterprise, over and above normal returns earned by comparable independent providers of similar services that use comparable non-unique know-how. See Section D.1.3 of Chapter I. See also paragraph 6.17 for a definition of "unique" intangibles.

6.11 Care should be taken in determining whether or when an intangible exists and whether an intangible has been used or transferred. For example, not all research and development expenditures produce or enhance an intangible, and not all marketing activities result in the creation or enhancement of an intangible.

6.12 In a transfer pricing analysis of a matter involving intangibles, it is important to identify the relevant intangibles with specificity. The functional analysis should identify the relevant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, the important functions performed and specific risks assumed in connection with the development, enhancement, maintenance, protection and exploitation of the intangibles and the manner in which they interact with other intangibles, with tangible assets and with business operations to create value. While it may be appropriate to aggregate intangibles for the purpose of determining arm's length conditions for the use or transfer of the intangibles in certain cases, it is not sufficient to suggest that vaguely specified or undifferentiated intangibles have an effect on arm's length prices or other conditions. A thorough functional analysis, including an analysis of the importance of identified relevant intangibles in the MNE's global business, should support the determination of arm's length conditions.

A.2. Relevance of this chapter for other tax purposes

6.13 The guidance contained in this chapter is intended to address transfer pricing matters exclusively. It is not intended to have relevance for other tax purposes. For example, the Commentary on Article 12 of the OECD Model Tax Convention contains a detailed discussion of the definition of royalties under that Article (paragraphs 8 to 19). The Article 12 definition of "royalties" is not intended to provide any guidance on whether, and if so at what price, the use or transfer of intangibles would be remunerated between independent parties. It is therefore not relevant for transfer pricing purposes. Moreover, the manner in which a transaction is characterised for transfer pricing purposes has no relevance to the question of whether a particular payment constitutes a royalty or may be subjected to withholding tax under Article 12. The concept of intangibles for transfer pricing purposes and the definition of royalties for purposes of Article 12 of the OECD Model Tax Convention are two different notions that do not need to be aligned. It may occur that a payment made between associated enterprises may be regarded as not constituting a royalty for purposes of Article 12, and nevertheless be treated for transfer pricing purposes as a payment to which the principles of this chapter may apply. Examples could include certain payments related to goodwill or ongoing concern value. It may also

occur that a payment properly treated as a royalty under Article 12 of a relevant Treaty may not be made in remuneration for intangibles for purposes of this chapter. Examples could include certain payments for technical services. Similarly, the guidance in this chapter is not intended to have relevance for customs purposes.

6.14 The guidance in this chapter is also not relevant to recognition of income, capitalisation of intangible development costs, amortisation, or similar matters. Thus, for example, a country may choose not to impose tax on the transfer of particular types of intangibles under specified circumstances. Similarly, a country may not permit amortisation of the cost of certain acquired items that would be considered intangibles under the definitions in this chapter and whose transfer may be subjected to tax at the time of the transfer in the transferor's country. It is recognised that inconsistencies between individual country laws regarding such matters can sometimes give rise to either double taxation or double non-taxation.

A.3. Categories of intangibles

6.15 In discussions of transfer pricing issues related to intangibles, it is sometimes the case that various categories of intangibles are described and labels applied. Distinctions are sometimes made between trade intangibles and marketing intangibles, between “soft” intangibles and “hard” intangibles, between routine and non-routine intangibles, and between other classes and categories of intangibles. The approach contained in this chapter for determining arm's length prices in cases involving intangibles does not turn on these categorisations. Accordingly, no attempt is made in these Guidelines to delineate with precision various classes or categories of intangibles or to prescribe outcomes that turn on such categories.

6.16 Certain categories of intangibles are, however, commonly referred to in discussions of transfer pricing matters. To facilitate discussions, definitions of two such commonly used terms, “marketing intangibles” and “trade intangibles” are contained in the Glossary and referred to from time to time in the discussion in these Guidelines. It should be emphasised that generic references to marketing or trade intangibles do not relieve taxpayers or tax administrations from their obligation in a transfer pricing analysis to identify relevant intangibles with specificity, nor does the use of those terms suggest that a different approach should be applied in determining arm's length conditions for transactions that involve either marketing intangibles or trade intangibles.

The Glossary of these Guidelines is amended by deleting the definition of the term “marketing intangible” and replacing that definition with the following language:

“Marketing intangible”

“An intangible (within the meaning of paragraph 6.6) that relates to marketing activities, aids in the commercial exploitation of a product or service, and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers.”

6.17 In certain instances these Guidelines refer to “unique and valuable” intangibles. “Unique and valuable” intangibles are those intangibles (i) that are not comparable to intangibles used by or available to parties to potentially comparable transactions, and (ii) whose use in business operations (e.g. manufacturing, provision of services, marketing, sales or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible.

A.4. Illustrations

6.18 This section provides illustrations of items often considered in transfer pricing analyses involving intangibles. The illustrations are intended to clarify the provisions of Section A.1., but this listing should not be used as a substitute for a detailed analysis. The illustrations are not intended to be comprehensive or to provide a complete listing of items that may or may not constitute intangibles. Numerous items not included in this listing of illustrations may be intangibles for transfer pricing purposes. The illustrations in this section should be adapted to the specific legal and regulatory environment that prevails in each country. Furthermore, the illustrations in this section should be considered and evaluated in the context of the comparability analysis (including the functional analysis) of the controlled transaction with the objective of better understanding how specific intangibles and items not treated as intangibles contribute to the creation of value in the context of the MNE’s global business. It should be emphasised that a generic reference to an item included in the list of illustrations does not relieve taxpayers or tax administrations from their obligation in a transfer pricing analysis to identify relevant intangibles with specificity based on the guidance of Section A.1.

A.4.1. Patents

6.19 A patent is a legal instrument that grants an exclusive right to its owner to use a given invention for a limited period of time within a specific geography. A patent may relate to a physical object or to a process. Patentable inventions are often developed through risky and costly research and development activities. In some circumstances, however, small research and development expenditures can lead to highly valuable patentable inventions. The developer of a patent may try to recover its development costs (and earn a return) through the sale of products covered by the patent, by licensing others to use the patented invention, or by an outright sale of the patent. The exclusivity granted by a patent may, under some circumstances, allow the patent owner to earn premium returns from the use of its invention. In other cases, a patented invention may provide cost advantages to the owner that are not available to competitors. In still other situations, patents may not provide a significant commercial advantage. Patents are intangibles within the meaning of Section A.1.

A.4.2. Know-how and trade secrets

6.20 Know-how and trade secrets are proprietary information or knowledge that assist or improve a commercial activity, but that are not registered for protection in the manner of a patent or trademark. Know-how and trade secrets generally consist of undisclosed information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise. Know-how and trade secrets may relate to manufacturing, marketing, research and development, or any other commercial activity. The value of know-how and trade secrets is often dependent on the ability of the enterprise to preserve the confidentiality of the know-how or trade

secret. In certain industries the disclosure of information necessary to obtain patent protection could assist competitors in developing alternative solutions. Accordingly, an enterprise may, for sound business reasons, choose not to register patentable know-how, which may nonetheless contribute substantially to the success of the enterprise. The confidential nature of know-how and trade secrets may be protected to some degree by (i) unfair competition or similar laws, (ii) employment contracts, and (iii) economic and technological barriers to competition. Know-how and trade secrets are intangibles within the meaning of Section A.1.

A.4.3. Trademarks, trade names and brands

6.21 A trademark is a unique name, symbol, logo or picture that the owner may use to distinguish its products and services from those of other entities. Proprietary rights in trademarks are often confirmed through a registration system. The registered owner of a trademark may exclude others from using the trademark in a manner that would create confusion in the marketplace. A trademark registration may continue indefinitely if the trademark is continuously used and the registration appropriately renewed. Trademarks may be established for goods or services, and may apply to a single product or service, or to a line of products or services. Trademarks are perhaps most familiar at the consumer market level, but they are likely to be encountered at all market levels. Trademarks are intangibles within the meaning of Section A.1.

6.22 A trade name (often but not always the name of an enterprise) may have the same force of market penetration as a trademark and may indeed be registered in some specific form as a trademark. The trade names of certain MNEs may be readily recognised, and may be used in marketing a variety of goods and services. Trade names are intangibles within the meaning of Section A.1.

6.23 The term “brand” is sometimes used interchangeably with the terms “trademark” and “trade name.” In other contexts a brand is thought of as a trademark or trade name imbued with social and commercial significance. A brand may, in fact, represent a combination of intangibles and/or other items, including among others, trademarks, trade names, customer relationships, reputational characteristics, and goodwill. It may sometimes be difficult or impossible to segregate or separately transfer the various items contributing to brand value. A brand may consist of a single intangible, or a collection of intangibles, within the meaning of Section A.1.

A.4.4. Rights under contracts and government licences

6.24 Government licences and concessions may be important to a particular business and can cover a wide range of business relationships. They may include, among others, a government grant of rights to exploit specific natural resources or public goods (e.g. a licence of bandwidth spectrum), or to carry on a specific business activity. Government licences and concessions are intangibles within the meaning of Section A.1. However, government licences and concessions should be distinguished from company registration obligations that are preconditions for doing business in a particular jurisdiction. Such obligations are not intangibles within the meaning of Section A.1.

6.25 Rights under contracts may also be important to a particular business and can cover a wide range of business relationships. They may include, among others, contracts with suppliers and key customers, and agreements to make available the services of one or more employees. Rights under contracts are intangibles within the meaning of Section A.1.

A.4.5. Licences and similar limited rights in intangibles

6.26 Limited rights in intangibles are commonly transferred by means of a licence or other similar contractual arrangement, whether written, oral or implied. Such licensed rights may be limited as to field of use, term of use, geography or in other ways. Such limited rights in intangibles are themselves intangibles within the meaning of Section A.1.

A.4.6. Goodwill and ongoing concern value

6.27 Depending on the context, the term goodwill can be used to refer to a number of different concepts. In some accounting and business valuation contexts, goodwill reflects the difference between the aggregate value of an operating business and the sum of the values of all separately identifiable tangible and intangible assets. Alternatively, goodwill is sometimes described as a representation of the future economic benefits associated with business assets that are not individually identified and separately recognised. In still other contexts goodwill is referred to as the expectation of future trade from existing customers. The term ongoing concern value is sometimes referred to as the value of the assembled assets of an operating business over and above the sum of the separate values of the individual assets. It is generally recognised that goodwill and ongoing concern value cannot be segregated or transferred separately from other business assets. See paragraphs 9.93 to 9.95 for a discussion of the related notion of a transfer of all of the elements of an ongoing concern in connection with a business restructuring.

6.28 It is not necessary for purposes of this chapter to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes or to define when goodwill or ongoing concern value may or may not constitute an intangible. It is important to recognise, however, that an important and monetarily significant part of the compensation paid between independent enterprises when some or all of the assets of an operating business are transferred may represent compensation for something referred to in one or another of the alternative descriptions of goodwill or ongoing concern value. When similar transactions occur between associated enterprises, such value should be taken into account in determining an arm's length price for the transaction. When the reputational value sometimes referred to by the term goodwill is transferred to or shared with an associated enterprise in connection with a transfer or licence of a trademark or other intangible that reputational value should be taken into account in determining appropriate compensation. If features of a business such as a reputation for producing high quality products or providing high quality service allow that business to charge higher prices for goods or services than an entity lacking such reputation, and such features might be characterised as goodwill or ongoing concern value under one or another definition of such terms, such features should be taken into account in establishing arm's length prices for sales of goods or the provision of services between associated enterprises whether or not they are characterised as goodwill. In other words, labelling a contribution of value from one party to another as goodwill or ongoing concern value does not render such contribution non-compensable. See paragraph 6.2.

6.29 The requirement that goodwill and ongoing concern value be taken into account in pricing transactions in no way implies that the residual measures of goodwill derived for some specific accounting or business valuation purposes are necessarily appropriate measures of the price that would be paid for the transferred business or licence rights, together with their associated goodwill and ongoing concern value, by independent parties. Accounting and business valuation measures of goodwill and ongoing concern value do not, as a general rule, correspond to the arm's length price of transferred

goodwill or ongoing concern value in a transfer pricing analysis. Depending on the facts and circumstances, however, accounting valuations and the information supporting such valuations can provide a useful starting point in conducting a transfer pricing analysis. The absence of a single precise definition of goodwill makes it essential for taxpayers and tax administrations to describe specifically relevant intangibles in connection with a transfer pricing analysis, and to consider whether independent enterprises would provide compensation for such intangibles in comparable circumstances.

A.4.7. Group synergies

6.30 In some circumstances group synergies contribute to the level of income earned by an MNE group. Such group synergies can take many different forms including streamlined management, elimination of costly duplication of effort, integrated systems, purchasing or borrowing power, etc. Such features may have an effect on the determination of arm's length conditions for controlled transactions and should be addressed for transfer pricing purposes as comparability factors. As they are not owned or controlled by an enterprise, they are not intangibles within the meaning of Section A.1. See Section D.8 of Chapter I for a discussion of the transfer pricing treatment of group synergies.

A.4.8. Market specific characteristics

6.31 Specific characteristics of a given market may affect the arm's length conditions of transactions in that market. For example, the high purchasing power of households in a particular market may affect the prices paid for certain luxury consumer goods. Similarly, low prevailing labour costs, proximity to markets, favourable weather conditions and the like may affect the prices paid for specific goods and services in a particular market. Such market specific characteristics are not capable, however, of being owned or controlled, and are therefore not intangibles within the meaning of Section A.1., and should be taken into account in a transfer pricing analysis through the required comparability analysis. See Section D.6 of Chapter I for guidance regarding the transfer pricing treatment of market specific characteristics.

B. Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles

6.32 In transfer pricing cases involving intangibles, the determination of the entity or entities within an MNE group which are ultimately entitled to share in the returns derived by the group from exploiting intangibles is crucial.¹⁵ A related issue is which entity or entities within the group should ultimately bear the costs, investments and other burdens associated with the development, enhancement, maintenance, protection and exploitation of intangibles. Although the legal owner of an intangible may receive the proceeds from exploitation of the intangible, other members of the legal owner's MNE group may have performed functions, used assets,¹⁶ or assumed risks that are expected to contribute to the value of the intangible. Members of the MNE group performing such functions, using such assets, and assuming such risks must be compensated for their contributions under the arm's length principle. This Section B confirms that the ultimate allocation of the returns derived by the MNE group from the exploitation of intangibles, and the ultimate allocation of costs and other burdens related to intangibles among members of the MNE group, is accomplished by compensating members of the MNE group for functions performed,

assets used, and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles according to the principles described in Chapters I–III.

6.33 Applying the provisions of Chapters I–III to address these questions can be highly challenging for a number of reasons. Depending on the facts of any given case involving intangibles the following factors, among others, can create challenges:

- i) A lack of comparability between the intangible related transactions undertaken between associated enterprises and those transactions that can be identified between independent enterprises;
- ii) A lack of comparability between the intangibles in question;
- iii) The ownership and/or use of different intangibles by different associated enterprises within the MNE group;
- iv) The difficulty of isolating the impact of any particular intangible on the MNE group's income;
- v) The fact that various members of an MNE group may perform activities relating to the development, enhancement, maintenance, protection and exploitation of an intangible, often in a way and with a level of integration that is not observed between independent enterprises;
- vi) The fact that contributions of various members of the MNE group to intangible value may take place in years different than the years in which any associated returns are realised; and
- vii) The fact that taxpayer structures may be based on contractual terms between associated enterprises that separate ownership, the assumption of risk, and/or funding of investments in intangibles from performance of important functions, control over risk, and decisions related to investment in ways that are not observed in transactions between independent enterprises and that may contribute to base erosion and profit shifting.

Notwithstanding these potential challenges, applying the arm's length principle and the provisions of Chapters I–III within an established framework can, in most cases, yield an appropriate allocation of the returns derived by the MNE group from the exploitation of intangibles.

6.34 The framework for analysing transactions involving intangibles between associated enterprises requires taking the following steps, consistent with the guidance for identifying the commercial or financial relations provided in Section D.1 of Chapter I:

- i) Identify the intangibles used or transferred in the transaction with specificity and the specific, economically significant risks associated with the development, enhancement, maintenance, protection, and exploitation of the intangibles;
- ii) Identify the full contractual arrangements, with special emphasis on determining legal ownership of intangibles based on the terms and conditions of legal arrangements, including relevant registrations, licence agreements, other relevant contracts, and other indicia of legal ownership, and the contractual rights and obligations, including contractual assumption of risks in the relations between the associated enterprises;
- iii) Identify the parties performing functions (including specifically the important functions described in paragraph 6.56), using assets, and managing risks related to developing, enhancing, maintaining, protecting, and exploiting the intangibles

by means of the functional analysis, and in particular which parties control any outsourced functions, and control specific, economically significant risks;

- iv) Confirm the consistency between the terms of the relevant contractual arrangements and the conduct of the parties, and determine whether the party assuming economically significant risks under step 4 (i) of paragraph 1.60, controls the risks and has the financial capacity to assume the risks relating to the development, enhancement, maintenance, protection, and exploitation of the intangibles;
- v) Delineate the actual controlled transactions related to the development, enhancement, maintenance, protection, and exploitation of intangibles in light of the legal ownership of the intangibles, the other relevant contractual relations under relevant registrations and contracts, and the conduct of the parties, including their relevant contributions of functions, assets and risks, taking into account the framework for analysing and allocating risk under Section D.1.2.1 of Chapter I;
- vi) Where possible, determine arm's length prices for these transactions consistent with each party's contributions of functions performed, assets used, and risks assumed, unless the guidance in Section D.2 of Chapter I applies.

B.1. Intangible ownership and contractual terms relating to intangibles

6.35 Legal rights and contractual arrangements form the starting point for any transfer pricing analysis of transactions involving intangibles. The terms of a transaction may be found in written contracts, public records such as patent or trademark registrations, or in correspondence and/or other communications among the parties. Contracts may describe the roles, responsibilities and rights of associated enterprises with respect to intangibles. They may describe which entity or entities provide funding, undertake research and development, maintain and protect intangibles, and perform functions necessary to exploit the intangibles, such as manufacturing, marketing and distribution. They may describe how receipts and expenses of the MNE associated with intangibles are to be allocated and may specify the form and amount of payment to all members of the group for their contributions. The prices and other conditions contained in such contracts may or may not be consistent with the arm's length principle.

6.36 Where no written terms exist, or where the facts of the case, including the conduct of the parties, differ from the written terms of any agreement between them or supplement these written terms, the actual transaction must be deduced from the facts as established, including the conduct of the parties (see Section D.1.1 of Chapter I). It is, therefore, good practice for associated enterprises to document their decisions and intentions regarding the allocation of significant rights in intangibles. Documentation of such decisions and intentions, including written agreements, should generally be in place at or before the time that associated enterprises enter into transactions leading to the development, enhancement, maintenance, protection, or exploitation of intangibles.

6.37 The right to use some types of intangibles may be protected under specific intellectual property laws and registration systems. Patents, trademarks and copyrights are examples of such intangibles. Generally, the registered legal owner of such intangibles has the exclusive legal and commercial right to use the intangible, as well as the right to prevent others from using or otherwise infringing the intangible. These rights may be granted for a specific geographic area and/or for a specific period of time.

6.38 There are also intangibles that are not protectable under specific intellectual property registration systems, but that are protected against unauthorised appropriation

or imitation under unfair competition legislation or other enforceable laws, or by contract. Trade dress, trade secrets, and know-how may fall under this category of intangibles.

6.39 The extent and nature of the available protection under applicable law may vary from country to country, as may the conditions on which such protection is provided. Such differences can arise either from differences in substantive intellectual property law between countries, or from practical differences in local enforcement of such laws. For example, the availability of legal protection for some intangibles may be subject to conditions such as continued commercial use of the intangible or timely renewal of registrations. This means that in some circumstances or jurisdictions, the degree of protection for an intangible may be extremely limited either legally or in practice.

6.40 The legal owner will be considered to be the owner of the intangible for transfer pricing purposes. If no legal owner of the intangible is identified under applicable law or governing contracts, then the member of the MNE group that, based on the facts and circumstances, controls decisions concerning the exploitation of the intangible and has the practical capacity to restrict others from using the intangible will be considered the legal owner of the intangible for transfer pricing purposes.

6.41 In identifying the legal owner of intangibles, an intangible and any licence relating to that intangible are considered to be different intangibles for transfer pricing purposes, each having a different owner. See paragraph 6.26. For example, Company A, the legal owner of a trademark, may provide an exclusive licence to Company B to manufacture, market, and sell goods using the trademark. One intangible, the trademark, is legally owned by Company A. Another intangible, the licence to use the trademark in connection with manufacturing, marketing and distribution of trademarked products, is legally owned by Company B. Depending on the facts and circumstances, marketing activities undertaken by Company B pursuant to its licence may potentially affect the value of the underlying intangible legally owned by Company A, the value of Company B's licence, or both.

6.42 While determining legal ownership and contractual arrangements is an important first step in the analysis, these determinations are separate and distinct from the question of remuneration under the arm's length principle. For transfer pricing purposes, legal ownership of intangibles, by itself, does not confer any right ultimately to retain returns derived by the MNE group from exploiting the intangible, even though such returns may initially accrue to the legal owner as a result of its legal or contractual right to exploit the intangible. The return ultimately retained by or attributed to the legal owner depends upon the functions it performs, the assets it uses, and the risks it assumes, and upon the contributions made by other MNE group members through their functions performed, assets used, and risks assumed. For example, in the case of an internally developed intangible, if the legal owner performs no relevant functions, uses no relevant assets, and assumes no relevant risks, but acts solely as a title holding entity, the legal owner will not ultimately be entitled to any portion of the return derived by the MNE group from the exploitation of the intangible other than arm's length compensation, if any, for holding title.

6.43 Legal ownership and contractual relationships serve simply as reference points for identifying and analysing controlled transactions relating to the intangible and for determining the appropriate remuneration to members of a controlled group with respect to those transactions. Identification of legal ownership, combined with the identification and compensation of relevant functions performed, assets used, and risks assumed by all contributing members, provides the analytical framework for identifying arm's length prices and other conditions for transactions involving intangibles. As with any other type of transaction, the analysis must take into account all of the relevant facts and circumstances

present in a particular case and price determinations must reflect the realistic alternatives of the relevant group members. The principles of this paragraph are illustrated by Examples 1 to 6 in the annex to Chapter VI.

6.44 Because the actual outcomes and manner in which risks associated with the development or acquisition of an intangible will play out over time are not known with certainty at the time members of the MNE group make decisions regarding intangibles, it is important to distinguish between (a) anticipated (or *ex ante*) remuneration, which refers to the future income expected to be derived by a member of the MNE group at the time of a transaction; and (b) actual (or *ex post*) remuneration, which refers to the income actually earned by a member of the group through the exploitation of the intangible.

6.45 The terms of the compensation that must be paid to members of the MNE group that contribute to the development, enhancement, maintenance, protection and exploitation of intangibles is generally determined on an *ex ante* basis. That is, it is determined at the time transactions are entered into and before risks associated with the intangible play out. The form of such compensation may be fixed or contingent. The actual (*ex post*) profit or loss of the business after compensating other members of the MNE group may differ from these anticipated profits depending on how the risks associated with the intangible or the other relevant risks related to the transaction or arrangement actually play out. The accurately delineated transaction, as determined under Section D.1 of Chapter I, will determine which associated entity assumes such risks and accordingly will bear the consequences (costs or additional returns) when the risks materialise in a different manner to what was anticipated (see paragraphs Section B.2.4).

6.46 An important question is how to determine the appropriate arm's length remuneration to members of a group for their functions, assets, and risks within the framework established by the taxpayer's contractual arrangements, the legal ownership of intangibles, and the conduct of the parties. Section B.2 discusses the application of the arm's length principle to situations involving intangibles. It focuses on the functions, assets and risks related to the intangibles. Unless stated otherwise, references to arm's length returns and arm's length remuneration in Section B.2 refer to anticipated (*ex ante*) returns and remuneration.

B.2. Functions, assets, and risks related to intangibles

6.47 As stated above, a determination that a particular group member is the legal owner of intangibles does not, in and of itself, necessarily imply that the legal owner is entitled to any income generated by the business after compensating other members of the MNE group for their contributions in the form of functions performed, assets used, and risks assumed.

6.48 In identifying arm's length prices for transactions among associated enterprises, the contributions of members of the group related to the creation of intangible value should be considered and appropriately rewarded. The arm's length principle and the principles of Chapters I–III require that all members of the group receive appropriate compensation for any functions they perform, assets they use, and risks they assume in connection with the development, enhancement, maintenance, protection, and exploitation of intangibles. It is therefore necessary to determine, by means of a functional analysis, which member(s) perform and exercise control over development, enhancement, maintenance, protection, and exploitation functions, which member(s) provide funding and other assets, and which member(s) assume the various risks associated with the intangible. Of course, in each of these areas, this may or may not be the legal owner of the intangible. As noted in paragraph 6.133, it is also important in determining arm's length compensation for functions

performed, assets used, and risks assumed to consider comparability factors that may contribute to the creation of value or the generation of returns derived by the MNE group from the exploitation of intangibles in determining prices for relevant transactions.

6.49 The relative importance of contributions to the creation of intangible value by members of the group in the form of functions performed, assets used and risks assumed will vary depending on the circumstances. For example, assume that a fully developed and currently exploitable intangible is purchased from a third party by a member of a group and exploited through manufacturing and distribution functions performed by other group members while being actively managed and controlled by the entity purchasing the intangible. It is assumed that this intangible would require no development, may require little or no maintenance or protection, and may have limited usefulness outside the area of exploitation intended at the time of the acquisition. There would be no development risk associated with the intangible, although there are risks associated with acquiring and exploiting the intangible. The key functions performed by the purchaser are those necessary to select the most appropriate intangible on the market, to analyse its potential benefits if used by the MNE group, and the decision to take on the risk-bearing opportunity through purchasing the intangible. The key asset used is the funding required to purchase the intangible. If the purchaser has the capacity and actually performs all the key functions described, including control of the risks associated with acquiring and exploiting the intangible, it may be reasonable to conclude that, after making arm's length payment for the manufacturing and distribution functions of other associated enterprises, the owner would be entitled to retain or have attributed to it any income or loss derived from the post-acquisition exploitation of the intangible. While the application of Chapters I–III may be fairly straightforward in such a simple fact pattern, the analysis may be more difficult in situations in which:

- i) Intangibles are self-developed by a multinational group, especially when such intangibles are transferred between associated enterprises while still under development;
- ii) Acquired or self-developed intangibles serve as a platform for further development; or
- iii) Other aspects, such as marketing or manufacturing are particularly important to value creation.

The generally applicable guidance below is particularly relevant for, and is primarily concerned with, these more difficult cases.

B.2.1. Performance and Control of Functions

6.50 Under the principles of Chapters I–III, each member of the MNE group should receive arm's length compensation for the functions it performs. In cases involving intangibles, this includes functions related to the development, enhancement, maintenance, protection, and exploitation of intangibles. The identity of the member or members of the group performing functions related to the development, enhancement, maintenance, protection, and exploitation of intangibles, therefore, is one of the key considerations in determining arm's length conditions for controlled transactions.

6.51 The need to ensure that all members of the MNE group are appropriately compensated for the functions they perform, the assets they contribute and the risks they assume implies that if the legal owner of intangibles is to be entitled ultimately to retain all of the returns derived from exploitation of the intangibles it must perform all of the functions, contribute all assets used and assume all risks related to the development,

enhancement, maintenance, protection and exploitation of the intangible. This does not imply, however, that the associated enterprises constituting an MNE group must structure their operations regarding the development, enhancement, maintenance, protection or exploitation of intangibles in any particular way. It is not essential that the legal owner physically performs all of the functions related to the development, enhancement, maintenance, protection and exploitation of an intangible through its own personnel in order to be entitled ultimately to retain or be attributed a portion of the return derived by the MNE group from exploitation of the intangibles. In transactions between independent enterprises, certain functions are sometimes outsourced to other entities. A member of an MNE group that is the legal owner of intangibles could similarly outsource functions related to the development, enhancement, maintenance, protection or exploitation of intangibles to either independent enterprises or associated enterprises.

6.52 Where associated enterprises other than the legal owner perform relevant functions that are anticipated to contribute to the value of the intangibles, they should be compensated on an arm's length basis for the functions they perform under the principles set out in Chapters I–III. The determination of arm's length compensation for functional contributions should consider the availability of comparable uncontrolled transactions, the importance of the functions performed to the creation of intangible value, and the realistically available options of the parties. The specific considerations described in paragraphs 6.53 to 6.58 should also be taken into account.

6.53 In outsourcing transactions between independent enterprises, it is usually the case that an entity performing functions on behalf of the legal owner of the intangible that relate to the development, enhancement, maintenance, protection, and exploitation of the intangible will operate under the control of such legal owner (as discussed in paragraph 1.65). Because of the nature of the relationships between associated enterprises that are members of an MNE group, however, it may be the case that outsourced functions performed by associated enterprises will be controlled by an entity other than the legal owner of the intangibles. In such cases, the legal owner of the intangible should also compensate the entity performing control functions related to the development, enhancement, maintenance, protection, and exploitation of intangibles on an arm's length basis. In assessing what member of the MNE group in fact controls the performance of the relevant functions, principles apply analogous to those for determining control over risk in Section D.1.2.1 of Chapter I. Assessing the capacity of a particular entity to exert control and the actual performance of such control functions will be an important part of the analysis.

6.54 If the legal owner neither controls nor performs the functions related to the development, enhancement, maintenance, protection or exploitation of the intangible, the legal owner would not be entitled to any ongoing benefit attributable to the outsourced functions. Depending on the facts, the arm's length compensation required to be provided by the legal owner to other associated enterprises performing or controlling functions related to the development, enhancement, maintenance, protection, or exploitation of intangibles may comprise any share of the total return derived from exploitation of the intangibles. A legal owner not performing any relevant function relating to the development, enhancement, maintenance, protection or exploitation of the intangible will therefore not be entitled to any portion of such returns related to the performance or control of functions relating to the development, enhancement, maintenance, protection or exploitation of the intangible. It is entitled to an arm's length compensation for any functions it actually performs, any assets it actually uses and risks it actually assumes. See Sections B.2.2 to B.2.3. In determining the functions it actually performs, assets it actually uses and the risks it actually assumes the guidance in Section D.1.2 of Chapter I is especially relevant.

6.55 The relative value of contributions to development, enhancement, maintenance, protection, and exploitation of intangibles varies depending on the particular facts of the case. The MNE group member(s) making the more significant contributions in a particular case should receive relatively greater remuneration. For example, a company that merely funds research and development should have a lower anticipated return than if it both funds and controls research and development. Other things being equal, a still higher anticipated return should be provided if the entity funds, controls, and physically performs the research and development. See also the discussion of funding in Section B.2.2.

6.56 In considering the arm's length compensation for functional contributions of various members of the MNE group, certain important functions will have special significance. The nature of these important functions in any specific case will depend on the facts and circumstances. For self-developed intangibles, or for self-developed or acquired intangibles that serve as a platform for further development activities, these more important functions may include, among others, design and control of research and marketing programmes, direction of and establishing priorities for creative undertakings including determining the course of “blue-sky” research, control over strategic decisions regarding intangible development programmes, and management and control of budgets. For any intangible (i.e. for either self-developed or acquired intangibles) other important functions may also include important decisions regarding defence and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible. Those important functions usually make a significant contribution to intangible value and, if those important functions are outsourced by the legal owner in transactions between associated enterprises, the performance of those functions should be compensated with an appropriate share of the returns derived by the MNE group from the exploitation of intangibles.

6.57 Because it may be difficult to find comparable transactions involving the outsourcing of such important functions, it may be necessary to utilise transfer pricing methods not directly based on comparables, including transactional profit split methods and *ex ante* valuation techniques, to appropriately reward the performance of those important functions. Where the legal owner outsources most or all of such important functions to other group members, attribution to the legal owner of any material portion of the return derived from the exploitation of the intangibles after compensating other group members for their functions should be carefully considered taking into account the functions it actually performs, the assets it actually uses and the risks it actually assumes under the guidance in Section D.1.2 of Chapter I. Examples 16 and 17 in the annex to Chapter VI illustrate the principles contained in this paragraph.

6.58 Because the important functions described in paragraph 6.56 are often instrumental in managing the different functions performed, assets used, and risks assumed that are key to the successful development, enhancement, maintenance, protection, or exploitation of intangibles, and are therefore essential to the creation of intangible value, it is necessary to carefully evaluate transactions between parties performing these important functions and other associated enterprises. In particular, the reliability of a one-sided transfer pricing method will be substantially reduced if the party or parties performing significant portions of the important functions are treated as the tested party or parties. See Example 6.

B.2.2. Use of Assets

6.59 Group members that use assets in the development, enhancement, maintenance, protection, and exploitation of an intangible should receive appropriate compensation for doing so. Such assets may include, without limitation, intangibles used in research, development or marketing (e.g. know-how, customer relationships, etc.), physical assets, or funding. One member of an MNE group may fund some or all of the development, enhancement, maintenance, and protection of an intangible, while one or more other members perform all of the relevant functions. When assessing the appropriate anticipated return to funding in such circumstances, it should be recognised that in arm's length transactions, a party that provides funding, but does not control the risks or perform other functions associated with the funded activity or asset, generally does not receive anticipated returns equivalent to those received by an otherwise similarly-situated investor who also performs and controls important functions and controls important risks associated with the funded activity. The nature and amount of compensation attributable to an entity that bears intangible-related costs, without more, must be determined on the basis of all the relevant facts, and should be consistent with similar funding arrangements among independent entities where such arrangements can be identified. See the guidance in Chapter I, Section D.1.2.1.6, and in particular Example 3 in paragraphs 1.85 and 1.103, which illustrate a situation where the party providing funding does not control the financial risk associated with the funding.

6.60 Funding and risk-taking are integrally related in the sense that funding often coincides with the taking of certain risks (e.g. the funding party contractually assuming the risk of loss of its funds). The nature and extent of the risk assumed, however, will vary depending on the economically relevant characteristics of the transaction. The risk will, for example, be lower when the party to which the funding is provided has a high creditworthiness, or when assets are pledged, or when the investment funded is low risk, compared with the risk where the creditworthiness is lower, or the funding is unsecured, or the investment being funded is high risk. Moreover, the larger the amount of the funds provided, the larger the potential impact of the risk on the provider of the funding.

6.61 Under the principles of Section D.1.2 of Chapter I, the first step in a transfer pricing analysis in relation to risks is to identify the economically significant risks with specificity. When identifying risks in relation to an investment with specificity, it is important to distinguish between the financial risks that are linked to the funding provided for the investments and the operational risks that are linked to the operational activities for which the funding is used, such as for example the development risk when the funding is used for developing a new intangible. Where a party providing funding exercises control over the financial risk associated with the provision of funding, without the assumption of, including the control over, any other specific risk, it could generally only expect a risk-adjusted return on its funding.

6.62 The contractual arrangements will generally determine the terms of the funding transaction, as clarified or supplemented by the economic characteristics of the transaction as reflected in the conduct of the parties.¹⁷ The return that would generally be expected by the funder should equal an appropriate risk-adjusted return. Such return can be determined, for example, based on the cost of capital or the return of a realistic alternative investment with comparable economic characteristics. In determining an appropriate return for the funding activities, it is important to consider the financing options realistically available to the party receiving the funds. There may be a difference between the return expected by the funder on an *ex ante* basis and the actual return received on an *ex post* basis. For example, when the funder provides a loan for a fixed amount at a fixed interest rate, the

difference between the actual and expected returns will reflect the risk playing out that the borrower cannot make some or all of the payments due.

6.63 The extent and form of the activities that will be necessary to exercise control over the financial risk attached to the provision of funding will depend on the riskiness of the investment for the funder, taking into account the amount of money at stake and the investment for which these funds are used. In accordance with the definition of control as reflected in paragraphs 1.65 and 1.66 of these Guidelines, exercising control over a specific financial risk requires the capability to make the relevant decisions related to the risk bearing opportunity, in this case the provision of the funding, together with the actual performance of these decision making functions. In addition, the party exercising control over the financial risk must perform the activities as indicated in paragraph 1.65 and 1.66 in relation to the day-to-day risk mitigation activities related to these risks when these are outsourced and related to any preparatory work necessary to facilitate its decision making, if it does not perform these activities itself.

6.64 When funding is provided to a party for the development of an intangible, the relevant decisions relating to taking on, laying off or declining a risk bearing opportunity and the decisions on whether and how to respond to the risks associated with the opportunity, are the decisions related to the provision of funding and the conditions of the transaction. Depending on the facts and circumstances, such decisions may depend on an assessment of the creditworthiness of the party receiving the funds and an assessment of how the risks related to the development project may impact the expectations in relation to the returns on funding provided or additional funding required. The conditions underlying the provision of the funding may include the possibility to link funding decisions to key development decisions which will impact the funding return. For example, decisions may have to be made on whether to take the project to the next stage or to allow the investments in costly assets. The higher the development risk and the closer the financial risk is related to the development risk, the more the funder will need to have the capability to assess the progress of the development of the intangible and the consequences of this progress for achieving its expected funding return, and the more closely the funder may link the continued provision of funding to key operational developments that may impact its financial risk. The funder will need to have the capability to make the assessments regarding the continued provision of funding, and will need to actually make such assessments, which will then need to be taken into account by the funder in actually making the relevant decisions on the provision of funding.

B.2.3. Assumption of Risks

6.65 Particular types of risk that may have importance in a functional analysis relating to transactions involving intangibles include (i) risks related to development of intangibles, including the risk that costly research and development or marketing activities will prove to be unsuccessful, and taking into account the timing of the investment (for example, whether the investment is made at an early stage, mid-way through the development process, or at a late stage will impact the level of the underlying investment risk); (ii) the risk of product obsolescence, including the possibility that technological advances of competitors will adversely affect the value of the intangibles; (iii) infringement risk, including the risk that defence of intangible rights or defence against other persons' claims of infringement may prove to be time consuming, costly and/or unavailing; (iv) product liability and similar risks related to products and services based on the intangibles; and (v) exploitation risks, uncertainties in relation to the returns to be generated by the intangible. The existence and

level of such risks will depend on the facts and circumstances of each individual case and the nature of the intangible in question.

6.66 The identity of the member or members of the group assuming risks related to the development, enhancement, maintenance, protection, and exploitation of intangibles is an important consideration in determining prices for controlled transactions. The assumption of risk will determine which entity or entities will be responsible for the consequences if the risk materialises. The accurate delineation of the controlled transaction, based on the guidance in Section D.1 of Chapter I, may determine that the legal owner assumes risks or that, instead, other members of the group are assuming risks, and such members must be compensated for their contributions in that regard.

6.67 In determining which member or members of the group assume risks related to intangibles, the principles of Section D.1.2 of Chapter I apply. In particular, steps 1 to 5 of the process to analyse risk in a controlled transaction as laid out in paragraph 1.60 should be followed in determining which party assumes risks related to the development, enhancement, maintenance, protection, and exploitation of intangibles.

6.68 It is especially important to ensure that the group member(s) asserting entitlement to returns from assuming risk actually bear responsibility for the actions that need to be taken and the costs that may be incurred if the relevant risk materialises. If costs are borne or actions are undertaken by an associated enterprise other than the associated enterprise assuming the risk as determined under the framework for analysing risk reflected in paragraph 1.60 of these guidelines, then a transfer pricing adjustment should be made so that the costs are allocated to the party assuming the risk and the other associated enterprise is appropriately remunerated for any activities undertaken in connection with the materialisation of the risk. Example 7 in the annex to Chapter VI illustrates this principle.

B.2.4. Actual, ex post returns

6.69 It is quite common that actual (*ex post*) profitability is different than anticipated (*ex ante*) profitability. This may result from risks materialising in a different way to what was anticipated through the occurrence of unforeseeable developments. For example, it may happen that a competitive product is removed from the market, a natural disaster takes place in a key market, a key asset malfunctions for unforeseeable reasons, or that a breakthrough technological development by a competitor will have the effect of making products based on the intangible in question obsolete or less desirable. It may also happen that the financial projections, on which calculations of *ex ante* returns and compensation arrangements are based, properly took into account risks and the probability of reasonably foreseeable events occurring and that the differences between actual and anticipated profitability reflects the playing out of those risks. Finally, it may happen that financial projections, on which calculations of *ex ante* returns and compensation arrangements are based, did not adequately take into account the risks of different outcomes occurring and therefore led to an overestimation or an underestimation of the anticipated profits. The question arises in such circumstances whether, and if so, how the profits or losses should be shared among members of an MNE group that have contributed to the development, enhancement, maintenance, protection, and exploitation of the intangible in question.

6.70 Resolution of this question requires a careful analysis of which entity or entities in the MNE group in fact assume the economically significant risks as identified when delineating the actual transaction (see Section D.1 of Chapter I). As this analytical framework indicates, the party actually assuming the economically significant risks may or may not be the associated enterprise contractually assuming these risks, such as the

legal owner of the intangible, or may or may not be the funder of the investment. A party which is not allocated the risks that give rise to the deviation between the anticipated and actual outcomes under the principles of Sections D.1.2.1.4 to D.1.2.1.6 of Chapter I will not be entitled to the differences between actual and anticipated profits or required to bear losses that are caused by these differences if such risk materialises, unless these parties are performing the important functions as reflected in paragraph 6.56 or contributing to the control over the economically significant risks as established in paragraph 1.105, and it is determined that an arm's length remuneration of these functions would include a profit sharing element. In addition, consideration must be given to whether the *ex ante* remuneration paid to members of the MNE group for their functions performed, assets used, and risks assumed is, in fact, consistent with the arm's length principle. Care should be taken to ascertain, for example, whether the group in fact underestimated or overestimated anticipated profits, thereby giving rise to underpayments or overpayments (determined on an *ex ante* basis) to some group members for their contributions. Transactions for which valuation is highly uncertain at the time of the transaction are particularly susceptible to such under or overestimations of value. This is further discussed in Section D.4.

B.2.5. Some implications from applying Sections B.1 and B.2

6.71 If the legal owner of an intangible in substance:

- performs and controls all of the functions (including the important functions described in paragraph 6.56) related to the development, enhancement, maintenance, protection and exploitation of the intangible;
- provides all assets, including funding, necessary to the development, enhancement, maintenance, protection, and exploitation of the intangibles; and
- assumes all of the risks related to the development, enhancement, maintenance, protection, and exploitation of the intangible,

then it will be entitled to all of the anticipated, *ex ante*, returns derived from the MNE group's exploitation of the intangible. To the extent that one or more members of the MNE group other than the legal owner performs functions, uses assets, or assumes risks related to the development, enhancement, maintenance, protection, and exploitation of the intangible, such associated enterprises must be compensated on an arm's length basis for their contributions. This compensation may, depending on the facts and circumstances, constitute all or a substantial part of the return anticipated to be derived from the exploitation of the intangible.

6.72 The entitlement of any member of the MNE group to profit or loss relating to differences between actual (*ex post*) and a proper estimation of anticipated (*ex ante*) profitability will depend on which entity or entities in the MNE group in fact assumes the risks as identified when delineating the actual transaction (see Section D.1 of Chapter I). It will also depend on the entity or entities which are performing the important functions as reflected in paragraph 6.56 or contributing to the control over the economically significant risks as established in paragraph 1.105, and for which it is determined that an arm's length remuneration of these functions would include a profit sharing element.

B.3. Identifying and determining the prices and other conditions for the controlled transactions

6.73 Undertaking the analysis described in Section D.1 of Chapter I, as supplemented by this Chapter, should facilitate a clear assessment of legal ownership, functions, assets and risks associated with intangibles, and an accurate identification of the transactions whose prices and other conditions require determination. In general, the transactions identified by the MNE group in the relevant registrations and contracts are those whose prices and other conditions are to be determined under the arm's length principle. However, the analysis may reveal that transactions in addition to, or different from, the transactions described in the registrations and contracts actually occurred. Consistent with Section D.1 of Chapter I, the transactions (and the true terms thereof) to be analysed are those determined to have occurred consistent with the actual conduct of the parties and other relevant facts.

6.74 Arm's length prices and other conditions for transactions should be determined according to the guidance in Chapters I–III, taking into account the contributions to anticipated intangible value of functions performed, assets used, and risks assumed at the time such functions are performed, assets are used, or risks are assumed as discussed in this Section B of this chapter. Section D of this chapter provides supplemental guidance on transfer pricing methods and other matters applicable in determining arm's length prices and other conditions for transactions involving intangibles.

B.4. Application of the foregoing principles in specific fact patterns

6.75 The principles set out in this Section B must be applied in a variety of situations involving the development, enhancement, maintenance, protection, and exploitation of intangibles. A key consideration in each case is that associated enterprises that contribute to the development, enhancement, maintenance, protection, or exploitation of intangibles legally owned by another member of the group must receive arm's length compensation for the functions they perform, the risks they assume, and the assets they use. In evaluating whether associated enterprises that perform functions or assume risks related to the development, enhancement, maintenance, protection, and exploitation of intangibles have been compensated on an arm's length basis, it is necessary to consider (i) the level and nature of the activity undertaken; and (ii) the amount and form of compensation paid. In assessing whether the compensation provided in the controlled transaction is consistent with the arm's length principle, reference should be made to the level and nature of activity of comparable uncontrolled entities performing similar functions, the compensation received by comparable uncontrolled entities performing similar functions, and the anticipated creation of intangible value by comparable uncontrolled entities performing similar functions. This section describes the application of these principles in commonly occurring fact patterns.

B.4.1. Development and enhancement of marketing intangibles

6.76 A common situation where these principles must be applied arises when an enterprise associated with the legal owner of trademarks performs marketing or sales functions that benefit the legal owner of the trademark, for example through a marketing arrangement or through a distribution/marketing arrangement. In such cases, it is necessary to determine how the marketer or distributor should be compensated for its activities. One important issue is whether the marketer/distributor should be compensated only for providing promotion and distribution services, or whether the marketer/distributor should also be compensated for enhancing the value of the trademarks and other marketing intangibles by virtue of its functions performed, assets used, and risks assumed.

6.77 The analysis of this issue requires an assessment of (i) the obligations and rights implied by the legal registrations and agreements between the parties; (ii) the functions performed, the assets used, and the risks assumed by the parties; (iii) the intangible value anticipated to be created through the marketer/distributor's activities; and (iv) the compensation provided for the functions performed by the marketer/distributor (taking account of the assets used and risks assumed). One relatively clear case is where a distributor acts merely as an agent, being reimbursed for its promotional expenditures and being directed and controlled in its activities by the owner of the trademarks and other marketing intangibles. In that case, the distributor ordinarily would be entitled to compensation appropriate to its agency activities alone. It does not assume the risks associated with the further development of the trademark and other marketing intangibles, and would therefore not be entitled to additional remuneration in that regard.

6.78 When the distributor actually bears the cost of its marketing activities (for example, when there is no arrangement for the legal owner to reimburse the expenditures), the analysis should focus on the extent to which the distributor is able to share in the potential benefits deriving from its functions performed, assets used, and risks assumed currently or in the future. In general, in arm's length transactions the ability of a party that is not the legal owner of trademarks and other marketing intangibles to obtain the benefits of marketing activities that enhance the value of those intangibles will depend principally on the substance of the rights of that party. For example, a distributor may have the ability to obtain benefits from its functions performed, assets used, and risks assumed in developing the value of a trademark and other marketing intangibles from its turnover and market share when it has a long-term contract providing for sole distribution rights for the trademarked product. In such a situation the distributor's efforts may have enhanced the value of its own intangibles, namely its distribution rights. In such cases, the distributor's share of benefits should be determined based on what an independent distributor would receive in comparable circumstances. In some cases, a distributor may perform functions, use assets or assume risks that exceed those an independent distributor with similar rights might incur or perform for the benefit of its own distribution activities and that create value beyond that created by other similarly situated marketers/distributors. An independent distributor in such a case would typically require additional remuneration from the owner of the trademark or other intangibles. Such remuneration could take the form of higher distribution profits (resulting from a decrease in the purchase price of the product), a reduction in royalty rate, or a share of the profits associated with the enhanced value of the trademark or other marketing intangibles, in order to compensate the distributor for its functions, assets, risks, and anticipated value creation. Examples 8 to 13 in the annex to Chapter VI illustrate in greater detail the application of this Section B in the context of marketing and distribution arrangements.

B.4.2. Research, development and process improvement arrangements

6.79 The principles set out in the foregoing paragraphs also apply in situations involving the performance of research and development functions by a member of an MNE group under a contractual arrangement with an associated enterprise that is the legal owner of any resulting intangibles. Appropriate compensation for research services will depend on all the facts and circumstances, such as whether the research team possesses unique skills and experience relevant to the research, assumes risks (e.g. where "blue sky" research is undertaken), uses its own intangibles, or is controlled and managed by another party. Compensation based on a reimbursement of costs plus a modest mark-up will not reflect the anticipated value of, or the arm's length price for, the contributions of the research team in all cases.

6.80 The principles set out in this section similarly apply in situations where a member of an MNE group provides manufacturing services that may lead to process or product improvements on behalf of an associated enterprise that will assume legal ownership of such process or product improvements. Examples 14 to 17 in the annex to Chapter VI illustrate in greater detail the application of this Section B in the context of research and development arrangements.

B.4.3. Payments for use of the company name

6.81 Questions often arise regarding the arm's length compensation for the use of group names, trade names and similar intangibles. Resolution of such questions should be based on the principles of this Section B and on the commercial and legal factors involved. As a general rule, no payment should be recognised for transfer pricing purposes for simple recognition of group membership or the use of the group name merely to reflect the fact of group membership. See paragraph 7.12

6.82 Where one member of the group is the owner of a trademark or other intangible for the group name, and where use of the name provides a financial benefit to members of the group other than the member legally owning such intangible, it is reasonable to conclude that a payment for use would have been made in arm's length transactions. Similarly, such payments may be appropriate where a group member owns goodwill in respect of the business represented by an unregistered trademark, use of that trademark by another party would constitute misrepresentation, and the use of the trademark provides a clear financial benefit to a group member other than that owning the goodwill and unregistered trademark.

6.83 In determining the amount of payment with respect to a group name, it is important to consider the amount of the financial benefit to the user of the name attributable to use of that name, the costs and benefits associated with other alternatives, and the relative contributions to the value of the name made by the legal owner, and the entity using the name in the form of functions performed, assets used and risks assumed. Careful consideration should be given to the functions performed, assets used, and risks assumed by the user of the name in creating or enhancing the value of the name in its jurisdiction. Factors that would be important in a licence of the name to an independent enterprise under comparable circumstances applying the principles of Chapters I–III should be taken into account.

6.84 Where an existing successful business is acquired by another successful business and the acquired business begins to use a name, trademark or other branding indicative of the acquiring business, there should be no automatic assumption that a payment should be made in respect of such use. If there is a reasonable expectation of financial benefit to the acquired company from using the acquiring company's branding, then the amount of any payment should be informed by the level of that anticipated benefit.

6.85 It may also be the case that the acquiring business will leverage the existing position of the acquired business to expand the business of the acquirer in the territory of operation of the acquired business by causing the acquired business to use the acquirer's branding. In that case, consideration should be given to whether the acquirer should make a payment to or otherwise compensate the acquired business for the functions performed, risks assumed, and assets used (including its market position) in connection with expanded use of the acquirer's name.

C. Transactions involving the use or transfer of intangibles

6.86 In addition to identifying with specificity the intangibles involved in a particular transfer pricing issue, and identifying the owner of such intangibles, it is necessary to identify and properly characterise, at the beginning of any transfer pricing analysis involving intangibles, the specific controlled transactions involving intangibles. The principles of Chapter I apply in identifying and accurately delineating transactions involving the use or transfer of intangibles. In addition to the guidance on identifying the actual transaction (Section D.1 of Chapter I) and on business restructurings (Chapter IX, especially Part II), Section C of this chapter outlines some typical scenarios that may be useful in ascertaining whether intangibles or rights in intangibles are involved in a transaction. See Example 19. The characterisation of a transaction for transfer pricing purposes has no relevance for determinations under Article 12 of the OECD Model Tax Convention. See, e.g. paragraphs 8 to 19 of the Commentary to Article 12 of the OECD Model Tax Convention.

6.87 There are two general types of transactions where the identification and examination of intangibles will be relevant for transfer pricing purposes. These are: (i) transactions involving transfers of intangibles or rights in intangibles; and (ii) transactions involving the use of intangibles in connection with the sale of goods or the provision of services.

C.1. Transactions involving transfers of intangibles or rights in intangibles

C.1.1. Transfers of intangibles or rights in intangibles

6.88 Rights in intangibles themselves may be transferred in controlled transactions. Such transactions may involve a transfer of all rights in the intangibles in question (e.g. a sale of the intangible or a perpetual, exclusive licence of the intangible) or only limited rights (e.g. a licence or similar transfer of limited rights to use an intangible which may be subject to geographical restrictions, limited duration, or restrictions with respect to the right to use, exploit, reproduce, further transfer, or further develop). The principles of Chapters I–III apply to transactions involving the transfer of intangibles or rights in intangibles. Supplemental guidance regarding the determination of arm's length conditions for such transactions is also contained in Sections D.1, D.2 and D.3 of this chapter.

6.89 In transactions involving the transfer of intangibles or rights in intangibles, it is essential to identify with specificity the nature of the intangibles and rights in intangibles that are transferred between associated enterprises. Where limitations are imposed on the rights transferred, it is also essential to identify the nature of such limitations and the full extent of the rights transferred. It should be noted in this regard that the labels applied to transactions do not control the transfer pricing analysis. For example, in the case of a transfer of the exclusive right to exploit a patent in Country X, the taxpayer's decision to characterise the transaction either as a sale of all of the Country X patent rights, or as a perpetual exclusive licence of a portion of the worldwide patent rights, does not affect the determination of the arm's length price if, in either case, the transaction being priced is a transfer of exclusive rights to exploit the patent in Country X over its remaining useful life. Thus, the functional analysis should identify the nature of the transferred rights in intangibles with specificity.

6.90 Restrictions imposed in licence and similar agreements on the use of an intangible in the further development of new intangibles or new products using the intangibles are often of significant importance in a transfer pricing analysis. It is therefore important in identifying the nature of a transfer of rights in intangibles to consider whether the

transferee receives the right to use the transferred intangible for the purpose of further research and development. In transactions between independent enterprises, arrangements are observed where the transferor/licensor retains the full right to any enhancements of the licensed intangible that may be developed during the term of the licence. Transactions between independent enterprises are also observed where the transferee/licensee retains the right to any enhancements it may develop, either for the term of its licence or in perpetuity. The nature of any limitations on further development of transferred intangibles, or on the ability of the transferee and the transferor to derive an economic benefit from such enhancements, can affect the value of the rights transferred and the comparability of two transactions involving otherwise identical or closely comparable intangibles. Such limitations must be evaluated in light of both the written terms of agreements and the actual conduct of the affected parties.

6.91 The provisions of Section D.1.1 of Chapter I apply in identifying the specific nature of a transaction involving a transfer of intangibles or rights in intangibles, in identifying the nature of any intangibles transferred, and in identifying any limitations imposed by the terms of the transfer on the use of those intangibles. For example, a written specification that a licence is non-exclusive or of limited duration need not be respected by the tax administration if such specification is not consistent with the conduct of the parties. Example 18 in the annex to Chapter VI illustrates the provisions of this paragraph.

C.1.2. Transfers of combinations of intangibles

6.92 Intangibles (including limited rights in intangibles) may be transferred individually or in combination with other intangibles. In considering transactions involving transfers of combinations of intangibles, two related issues often arise.

6.93 The first of these involves the nature and economic consequences of interactions between different intangibles. It may be the case that some intangibles are more valuable in combination with other intangibles than would be the case if the intangibles were considered separately. It is therefore important to identify the nature of the legal and economic interactions between intangibles that are transferred in combination.

6.94 For example, a pharmaceutical product will often have associated with it three or more types of intangibles. The active pharmaceutical ingredient may be protected by one or more patents. The product will also have been through a testing process and a government regulatory authority may have issued an approval to market the product in a given geographic market and for specific approved indications based on that testing. The product may be marketed under a particular trademark. In combination these intangibles may be extremely valuable. In isolation, one or more of them may have much less value. For example, the trademark without the patent and regulatory marketing approval may have limited value since the product could not be sold without the marketing approval and generic competitors could not be excluded from the market without the patent. Similarly, the value of the patent may be much greater once regulatory marketing approval has been obtained than would be the case in the absence of the marketing approval. The interactions between each of these classes of intangibles, as well as which parties performed functions, bore the risks and incurred the costs associated with securing the intangibles, are therefore very important in performing a transfer pricing analysis with regard to a transfer of the intangibles. It is important to consider the relative contribution to value creation where different associated enterprises hold rights in the intangibles used.

6.95 A second and related issue involves the importance of ensuring that all intangibles transferred in a particular transaction have been identified. It may be the case, for

example, that intangibles are so intertwined that it is not possible, as a substantive matter, to transfer one without transferring the other. Indeed, it will often be the case that a transfer of one intangible will necessarily imply the transfer of other intangibles. In such cases it is important to identify all of the intangibles made available to the transferee as a consequence of an intangibles transfer, applying the principles of Section D.1 of Chapter I. For example, the transfer of rights to use a trademark under a licence agreement will usually also imply the licensing of the reputational value, sometimes referred to as goodwill, associated with that trademark, where it is the licensor who has built up such goodwill. Any licence fee required should consider both the trademark and the associated reputational value. Example 20 in the annex to Chapter VI illustrates the principles of this paragraph.

6.96 It is important to identify situations where taxpayers or tax administrations may seek to artificially separate intangibles that, as a matter of substance, independent parties would not separate in comparable circumstances. For example, attempts to artificially separate trademarks or trade names from the goodwill or reputational value that is factually associated with the trademark or trade name should be identified and critically analysed. Example 21 in the annex to Chapter VI illustrates the principles of this paragraph.

6.97 It should be recognised that the process of identifying all of the intangibles transferred in a particular transaction is an exercise of identifying, by reference to written agreements and the actual conduct of the parties, the actual transactions that have been undertaken, applying the principles of Section D.1 of Chapter I.

C.1.3. Transfers of intangibles or rights in intangibles in combination with other business transactions

6.98 In some situations intangibles or rights in intangibles may be transferred in combination with tangible business assets, or in combination with services. It is important in such a situation to determine whether intangibles have in fact been transferred in connection with the transaction. It is also important that all of the intangibles transferred in connection with a particular transaction be identified and taken into account in the transfer pricing analysis. Examples 23 to 25 in the annex to Chapter VI illustrate the principles of this paragraph.

6.99 In some situations it may be both possible and appropriate to separate transactions in tangible goods or services from transfers of intangibles or rights in intangibles for purposes of conducting a transfer pricing analysis. In these situations, the price of a package contract should be disaggregated in order to confirm that each element of the transaction is consistent with the arm's length principle. In other situations transactions may be so closely related that it will be difficult to segregate tangible goods or service transactions from transfers of intangibles or rights in intangibles. Reliability of available comparables will be an important factor in considering whether transactions should be combined or segregated. In particular, it is important to consider whether available comparables permit accurate evaluation of interactions between transactions.

6.100 One situation where transactions involving transfers of intangibles or rights in intangibles may be combined with other transactions involves a business franchise arrangement. Under such an arrangement, one member of an MNE group may agree to provide a combination of services and intangibles to an associated enterprise in exchange for a single fee. If the services and intangibles made available under such an arrangement are sufficiently unique that reliable comparables cannot be identified for the entire service/intangible package, it may be necessary to segregate the various parts of the package of

services and intangibles for separate transfer pricing consideration. It should be kept in mind, however, that the interactions between various intangibles and services may enhance the value of both.

6.101 In other situations, the provision of a service and the transfer of one or more intangibles may be so closely intertwined that it is difficult to separate the transactions for purposes of a transfer pricing analysis. For example, some transfers of rights in software may be combined with an undertaking by the transferor to provide ongoing software maintenance services, which may include periodic updates to the software. In situations where services and transfers of intangibles are intertwined, determining arm's length prices on an aggregate basis may be necessary.

6.102 It should be emphasised that delineating the transaction as the provision of products or services or the transfer of intangibles or a combination of both does not necessarily dictate the use of a particular transfer pricing method. For example, a cost plus approach will not be appropriate for all service transactions, and not all intangibles transactions require complex valuations or the application of profit split methods. The facts of each specific situation, and the results of the required functional analysis, will guide the manner in which transactions are combined, delineated and analysed for transfer pricing purposes, as well as the selection of the most appropriate transfer pricing method in a particular case. The ultimate objective is to identify the prices and other relevant conditions that would be established between independent enterprises in comparable transactions.

6.103 Moreover, it should also be emphasised that determinations as to whether transactions should be aggregated or segregated for analysis usually involve the delineation of the actual transaction undertaken, by reference to written agreements and the actual conduct of the parties. Determinations regarding the actual transaction undertaken constitute one necessary element in determining the most appropriate transfer pricing method in the particular case.

C.2. Transactions involving the use of intangibles in connection with sales of goods or performance of services

6.104 Intangibles may be used in connection with controlled transactions in situations where there is no transfer of the intangible or of rights in the intangible. For example, intangibles may be used by one or both parties to a controlled transaction in connection with the manufacture of goods sold to an associated enterprise, in connection with the marketing of goods purchased from an associated enterprise, or in connection with the performance of services on behalf of an associated enterprise. The nature of such a transaction should be clearly specified, and any relevant intangibles used by either of the parties in connection with such a controlled transaction should be identified and taken into account in the comparability analysis, in the selection and application of the most appropriate transfer pricing method for that transaction, and in the choice of the tested party. Supplemental guidance regarding the determination of arm's length conditions for transactions involving the use of intangibles in connection with the sale of goods or the provision of services is contained in Sections D.1 and D.4 of this chapter.

6.105 The need to consider the use of intangibles by a party to a controlled transaction involving a sale of goods can be illustrated as follows. Assume that a car manufacturer uses valuable proprietary patents to manufacture the cars that it then sells to associated distributors. Assume that the patents significantly contribute to the value of the cars. The patents and the value they contribute should be identified and taken into account in the comparability analysis of the transaction consisting in the sales of cars by the car manufacturer to its associated distributors, in selecting the most appropriate transfer

pricing method for the transactions, and in selecting the tested party. The associated distributors purchasing the cars do not, however, acquire any right in the manufacturer's patents. In such a case, the patents are used in the manufacturing and may affect the value of the cars, but the patents themselves are not transferred.

6.106 As another example of the use of intangibles in connection with a controlled transaction, assume that an exploration company has acquired or developed valuable geological data and analysis, and sophisticated exploratory software and know-how. Assume further that it uses those intangibles in providing exploration services to an associated enterprise. Those intangibles should be identified and taken into account in the comparability analysis of the service transactions between the exploration company and the associated enterprise, in selecting the most appropriate transfer pricing method for the transaction, and in selecting the tested party. Assuming that the associated enterprise of the exploration company does not acquire any rights in the exploration company's intangibles, the intangibles are used in the performance of the services and may affect the value of services, but are not transferred.

D. Supplemental guidance for determining arm's length conditions in cases involving intangibles

6.107 After identifying the relevant transactions involving intangibles, specifically identifying the intangibles involved in those transactions, identifying which entity or entities legally own the intangibles as well as those that contribute to the value of the intangibles, it should be possible to identify arm's length conditions for the relevant transactions. The principles set out in Chapters I–III of these Guidelines should be applied in determining arm's length conditions for transactions involving intangibles. In particular, the recommended nine-step process set out in paragraph 3.4 can be helpful in identifying arm's length conditions for transactions involving intangibles. As an essential part of applying the principles of Chapter III to conduct a comparability analysis under the process described in paragraph 3.4, the principles contained in Sections A, B, and C of this Chapter VI should be considered.

6.108 However, the principles of Chapters I–III can sometimes be difficult to apply to controlled transactions involving intangibles. Intangibles may have special characteristics that complicate the search for comparables, and in some cases make pricing difficult to determine at the time of the transaction. Further, for wholly legitimate business reasons, due to the relationship between them, associated enterprises might sometimes structure a transaction involving intangibles in a manner that independent enterprises would not contemplate. See paragraph 1.11. The use or transfer of intangibles may raise challenging issues regarding comparability, selection of transfer pricing methods, and determination of arm's length conditions for transactions. This Section D provides supplemental guidance for use in applying the principles of Chapters I–III to determine arm's length conditions for controlled transactions involving intangibles.

6.109 Section D.1 provides general supplemental guidance related to all transactions involving intangibles. Section D.2 provides supplemental guidance specifically related to transactions involving the transfer of intangibles or rights in intangibles. Section D.3 provides supplemental guidance regarding transfers of intangibles or rights in intangibles whose value is highly uncertain at the time of the transfer. Section D.4 provides an approach to pricing hard-to-value intangibles. Section D.5 provides supplemental guidance applicable to transactions involving the use of intangibles in connection with the sale of goods or the provision of services in situations where there is no transfer of rights in the intangibles.

D.1. General principles applicable in transactions involving intangibles

6.110 Section D of Chapter I and Chapter III contain principles to be considered and a recommended process to be followed in conducting a comparability analysis. The principles described in those sections of the Guidelines apply to all controlled transactions involving intangibles.

6.111 In applying the principles of the Guidelines related to the content and process of a comparability analysis to a transaction involving intangibles, a transfer pricing analysis must consider the options realistically available to each of the parties to the transaction.

6.112 In considering the options realistically available to the parties, the perspectives of each of the parties to the transaction must be considered. A comparability analysis focusing only on one side of a transaction generally does not provide a sufficient basis for evaluating a transaction involving intangibles (including in those situations for which a one-sided transfer pricing method is ultimately determined).

6.113 While it is important to consider the perspectives of both parties to the transaction in conducting a comparability analysis, the specific business circumstances of one of the parties should not be used to dictate an outcome contrary to the realistically available options of the other party. For example, a transferor would not be expected to accept a price for the transfer of either all or part of its rights in an intangible that is less advantageous to the transferor than its other realistically available options (including making no transfer at all), merely because a particular associated enterprise transferee lacks the resources to effectively exploit the transferred rights in the intangible. Similarly, a transferee should not be expected to accept a price for a transfer of rights in one or more intangibles that would make it impossible for the transferee to anticipate earning a profit using the acquired rights in the intangible in its business. Such an outcome would be less favourable to the transferee than its realistically available option of not engaging in the transfer at all.

6.114 It will often be the case that a price for a transaction involving intangibles can be identified that is consistent with the realistically available options of each of the parties. The existence of such prices is consistent with the assumption that MNE groups seek to optimise resource allocations. If situations arise in which the minimum price acceptable to the transferor, based on its realistically available options, exceeds the maximum price acceptable to the transferee, based on its realistically available options, it may be necessary to consider whether the actual transaction should be disregarded under the criterion for non-recognition set out in Section D.2 of Chapter I, or whether the conditions of the transaction should otherwise be adjusted. Similarly, if situations arise in which there are assertions that either the current use of an intangible, or a proposed realistically available option (i.e. an alternative use of the intangible), does not optimise resource allocations, it may be necessary to consider whether such assertions are consistent with the true facts and circumstances of the case. This discussion highlights the importance of taking all relevant facts and circumstances into account in accurately delineating the actual transaction involving intangibles.

D.2. Supplemental guidance regarding transfers of intangibles or rights in intangibles

6.115 This section provides supplemental guidance regarding specific issues arising in connection with the transfer between associated enterprises of intangibles or rights in intangibles. Such transactions may include sales of intangibles as well as transactions that are economically equivalent to sales. Such transactions could also include a licence of rights in one or more intangibles or a similar transaction. This section is not intended

to provide comprehensive guidance with regard to the transfer pricing treatment of such intangibles transfers. Rather, it supplements the otherwise applicable provisions of Chapters I–III, and the guidance in Sections A, B, C, and D.1 of this chapter, in the context of transfers of intangibles or rights in intangibles, by providing guidance with regard to certain specific topics commonly arising in connection with such transfers.

D.2.1. Comparability of intangibles or rights in intangibles

6.116 In applying the provisions of Chapters I–III to transactions involving the transfer of intangibles or rights in intangibles, it should be borne in mind that intangibles often have unique characteristics, and as a result have the potential for generating returns and creating future benefits that could differ widely. In conducting a comparability analysis with regard to a transfer of intangibles, it is therefore essential to consider the unique features of the intangibles. This is particularly important where the CUP method is considered to be the most appropriate transfer pricing method, but also has importance in applying other methods that rely on comparables. In the case of a transfer of an intangible or rights in an intangible that provides the enterprise with a unique competitive advantage in the market, purportedly comparable intangibles or transactions should be carefully scrutinised. It is critical to assess whether potential comparables in fact exhibit similar profit potential.

6.117 Set out below is a description of some of the specific features of intangibles that may prove important in a comparability analysis involving transfers of intangibles or rights in intangibles. The following list is not exhaustive and in a specific case consideration of additional or different factors may be an essential part of a comparability analysis.

D.2.1.1. Exclusivity

6.118 Whether the rights in intangibles relevant to a particular transaction involving the transfer of intangibles or rights in intangibles are exclusive or non-exclusive can be an important comparability consideration. Some intangibles allow the legal owner of the intangible to exclude others from using the intangible. A patent, for example, grants an exclusive right to use the invention covered by the patent for a period of years. If the party controlling intangible rights can exclude other enterprises from the market, or exclude them from using intangibles that provide a market advantage, that party may enjoy a high degree of market power or market influence. A party with non-exclusive rights to intangibles will not be able to exclude all competitors and will generally not have the same degree of market power or influence. Accordingly, the exclusive or non-exclusive nature of intangibles or rights in intangibles should be considered in connection with the comparability analysis.

D.2.1.2. Extent and duration of legal protection

6.119 The extent and duration of legal protection of the intangibles relevant to a particular transfer can be an important comparability consideration. Legal protections associated with some intangibles can prevent competitors from entering a particular market. For other intangibles, such as know-how or trade secrets, available legal protections may have a different nature and not be as strong or last as long. For intangibles with limited useful lives, the duration of legal protections can be important since the duration of the intangible rights will affect the expectation of the parties to a transaction with regard to the future benefits from the exploitation of the intangible. For example, two otherwise comparable patents will not have equivalent value if one expires at the end of one year while the other expires only after ten years.

D.2.1.3. Geographic scope

6.120 The geographic scope of the intangibles or rights in intangibles will be an important comparability consideration. A global grant of rights to intangibles may be more valuable than a grant limited to one or a few countries, depending on the nature of the product, the nature of the intangible, and the nature of the markets in question.

D.2.1.4. Useful life

6.121 Many intangibles have a limited useful life. The useful life of a particular intangible can be affected by the nature and duration of the legal protections afforded to the intangible, as noted above. The useful life of some intangibles can also be affected by the rate of technological change in an industry and by the development of new and potentially improved products. It may also be the case that the useful life of particular intangibles can be extended.

6.122 In conducting a comparability analysis, it will therefore be important to consider the expected useful life of the intangibles in question. In general, intangibles expected to provide market advantages for a longer period of time will be more valuable than similar intangibles providing such advantages for a shorter period of time, other things being equal. In evaluating the useful life of intangibles it is also important to consider the use being made of the intangible. The useful life of an intangible that forms a base for ongoing research and development may extend beyond the commercial life of the current generation product line based on that intangible.

D.2.1.5. Stage of development

6.123 In conducting a comparability analysis, it may be important to consider the stage of development of particular intangibles. It is often the case that an intangible is transferred in a controlled transaction at a point in time before it has been fully demonstrated that the intangible will support commercially viable products. A common example arises in the pharmaceutical industry, where chemical compounds may be patented, and the patents (or rights to use the patents) transferred in controlled transactions, well in advance of the time when further research, development and testing demonstrates that the compound constitutes a safe and effective treatment for a particular medical condition.

6.124 As a general rule, intangibles relating to products with established commercial viability will be more valuable than otherwise comparable intangibles relating to products whose commercial viability is yet to be established. In conducting a comparability analysis involving partially developed intangibles, it is important to evaluate the likelihood that further development will lead to commercially significant future benefits. In certain circumstances, industry data regarding the risks associated with further development can be helpful to such evaluations. However, the specific circumstances of any individual situation should always be considered.

D.2.1.6. Rights to enhancements, revisions, and updates

6.125 Often, an important consideration in a comparability analysis involving intangibles relates to the rights of the parties with regard to future enhancements, revisions and updates of the intangibles. In some industries, products protected by intangibles can become obsolete or uncompetitive in a relatively short period of time in the absence of continuing development and enhancement of the intangibles. As a result, having access to updates

and enhancements can be the difference between deriving a short term advantage from the intangibles and deriving a longer term advantage. It is therefore necessary to consider for comparability purposes whether or not a particular grant of rights in intangibles includes access to enhancements, revisions, and updates of the intangibles.

6.126 A very similar question, often important in a comparability analysis, involves whether the transferee of intangibles obtains the right to use the intangibles in connection with research directed to developing new and enhanced intangibles. For example, the right to use an existing software platform as a basis for developing new software products can shorten development times and can make the difference between being the first to market with a new product or application, or being forced to enter a market already occupied by established competitive products. A comparability analysis with regard to intangibles should, therefore, consider the rights of the parties regarding the use of the intangibles in developing new and enhanced versions of products.

D.2.1.7. Expectation of future benefit

6.127 Each of the foregoing comparability considerations has a consequence with regard to the expectation of the parties to a transaction regarding the future benefits to be derived from the use of the intangibles in question. If for any reason there is a significant discrepancy between the anticipated future benefit of using one intangible as opposed to another, it is difficult to consider the intangibles as being sufficiently comparable to support a comparables-based transfer pricing analysis in the absence of reliable comparability adjustments. Specifically, it is important to consider the actual and potential profitability of products or potential products that are based on the intangible. Intangibles that provide a basis for high profit products or services are not likely to be comparable to intangibles that support products or services with only industry average profits. Any factor materially affecting the expectation of the parties to a controlled transaction of obtaining future benefits from the intangible should be taken into account in conducting the comparability analysis.

D.2.2. Comparison of risk in cases involving transfers of intangibles or rights in intangibles

6.128 In conducting a comparability analysis involving the transfer of intangibles or rights in intangibles, the existence of risks related to the likelihood of obtaining future economic benefits from the transferred intangibles must be considered, including the allocation of risk between the parties which should be analysed within the framework set out in Section D.1.2 of Chapter I. The following types of risks, among others, should be considered in evaluating whether transfers of intangibles or combinations of intangibles are comparable, and in evaluating whether the intangibles themselves are comparable.

- Risks related to the future development of the intangibles. This includes an evaluation of whether the intangibles relate to commercially viable products, whether the intangibles may support commercially viable products in the future, the expected cost of required future development and testing, the likelihood that such development and testing will prove successful and similar considerations. The consideration of development risk is particularly important in situations involving transfers of partially developed intangibles.
- Risks related to product obsolescence and depreciation in the value of the intangibles. This includes an evaluation of the likelihood that competitors will introduce products

or services in the future that would materially erode the market for products dependent on the intangibles being analysed.

- Risks related to infringement of the intangible rights. This includes an evaluation of the likelihood that others might successfully claim that products based on the intangibles infringe their own intangible rights and an evaluation of the likely costs of defending against such claims. It also includes an evaluation of the likelihood that the holder of intangible rights could successfully prevent others from infringing the intangibles, the risk that counterfeit products could erode the profitability of relevant markets, and the likelihood that substantial damages could be collected in the event of infringement.
- Product liability and similar risks related to the future use of the intangibles.

D.2.3. Comparability adjustments with regard to transfers of intangibles or rights in intangibles

6.129 The principles of paragraphs 3.47 to 3.54 relating to comparability adjustments apply with respect to transactions involving the transfer of intangibles or rights in intangibles. It is important to note that differences between intangibles can have significant economic consequences that may be difficult to adjust for in a reliable manner. Particularly in situations where amounts attributable to comparability adjustments represent a large percentage of the compensation for the intangible, there may be reason to believe, depending on the specific facts, that the computation of the adjustment is not reliable and that the intangibles being compared are in fact not sufficiently comparable to support a valid transfer pricing analysis. If reliable comparability adjustments are not possible, it may be necessary to select a transfer pricing method that is less dependent on the identification of comparable intangibles or comparable transactions.

D.2.4. Use of comparables drawn from databases

6.130 Comparability, and the possibility of making comparability adjustments, is especially important in considering potentially comparable intangibles and related royalty rates drawn from commercial databases or proprietary compilations of publicly available licence or similar agreements. The principles of Section A.4.3.1 of Chapter III apply fully in assessing the usefulness of transactions drawn from such sources. In particular, it is important to assess whether publicly available data drawn from commercial databases and proprietary compilations is sufficiently detailed to permit an evaluation of the specific features of intangibles that may be important in conducting a comparability analysis. In evaluating comparable licence arrangements identified from databases, the specific facts of the case, including the methodology being applied, should be considered in the context of the provisions of paragraph 3.38.

D.2.5. Selecting the most appropriate transfer pricing method in a matter involving the transfer of intangibles or rights in intangibles

6.131 The principles of these Guidelines related to the selection of the most appropriate transfer pricing method to the circumstances of the case are described in paragraphs 2.1 to 2.11. Those principles apply fully to cases involving the transfer of intangibles or rights in intangibles. In selecting the most appropriate transfer pricing method in a case involving a transfer of intangibles or rights in intangibles, attention should be given to (i) the nature of the relevant intangibles, (ii) the difficulty of identifying comparable uncontrolled

transactions and intangibles in many, if not most, cases, and (iii) the difficulty of applying certain of the transfer pricing methods described in Chapter II in cases involving the transfer of intangibles. The issues discussed below are particularly important in the selection of transfer pricing methods under the Guidelines.

6.132 In applying the principles of paragraphs 2.1 to 2.11 to matters involving the transfer of intangibles or rights in intangibles, it is important to recognise that transactions structured in different ways may have similar economic consequences. For example, the performance of a service using intangibles may have very similar economic consequences to a transaction involving the transfer of an intangible (or the transfer of rights in the intangible), as either may convey the value of the intangible to the transferee. Accordingly, in selecting the most appropriate transfer pricing method in connection with a transaction involving the transfer of intangibles or rights in intangibles, it is important to consider the economic consequences of the transaction, rather than proceeding on the basis of an arbitrary label.

6.133 This chapter makes it clear that in matters involving the transfer of intangibles or rights in intangibles it is important not to simply assume that all residual profit, after a limited return to those providing functions, should necessarily be allocated to the owner of intangibles. The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE's global business processes and how the transferred intangibles interact with other functions, assets and risks that comprise the global business. The functional analysis should identify all factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies among others. The transfer pricing method selected, and any adjustments incorporated in that method based on the comparability analysis, should take into account all of the relevant factors materially contributing to the creation of value, not only intangibles and routine functions.

6.134 The principles set out in paragraphs 2.11, 3.58 and 3.59 regarding the use of more than one transfer pricing method apply to matters involving the transfer of intangibles or rights in intangibles.

6.135 Paragraphs 3.9 to 3.12 and paragraph 3.37 provide guidance regarding the aggregation of separate transactions for purposes of transfer pricing analysis. Those principles apply fully to cases involving the transfer of intangibles or rights in intangibles and are supplemented by the guidance in Section C of this chapter. Indeed, it is often the case that intangibles may be transferred in combination with other intangibles, or in combination with transactions involving the sale of goods or the performance of services. In such situations it may well be that the most reliable transfer pricing analysis will consider the interrelated transactions in the aggregate as necessary to improve the reliability of the analysis.

D.2.6. Supplemental guidance on transfer pricing methods in matters involving the transfer of intangibles or rights in intangibles

6.136 Depending on the specific facts, any of the five OECD transfer pricing methods described in Chapter II might constitute the most appropriate transfer pricing method to the circumstances of the case where the transaction involves a controlled transfer of one or more intangibles. The use of other alternatives may also be appropriate.

6.137 Where the comparability analysis identifies reliable information related to comparable uncontrolled transactions, the determination of arm's length prices for a transfer of intangibles or rights in intangibles can be determined on the basis of such comparables after making any comparability adjustments that may be appropriate and reliable.

6.138 However, it will often be the case in matters involving transfers of intangibles or rights in intangibles that the comparability analysis (including the functional analysis) reveals that there are no reliable comparable uncontrolled transactions that can be used to determine the arm's length price and other conditions. This can occur if the intangibles in question have unique characteristics, or if they are of such critical importance that such intangibles are transferred only among associated enterprises. It may also result from a lack of available data regarding potentially comparable transactions or from other causes. Notwithstanding the lack of reliable comparables, it is usually possible to determine the arm's length price and other conditions for the controlled transaction.

6.139 Where information regarding reliable comparable uncontrolled transactions cannot be identified, the arm's length principle requires use of another method to determine the price that uncontrolled parties would have agreed under comparable circumstances. In making such determinations, it is important to consider:

- The functions, assets and risks of the respective parties to the transaction.
- The business reasons for engaging in the transaction.
- The perspectives of and options realistically available to each of the parties to the transaction.
- The competitive advantages conferred by the intangibles including especially the relative profitability of products and services or potential products and services related to the intangibles.
- The expected future economic benefits from the transaction.
- Other comparability factors such as features of local markets, location savings, assembled workforce, and MNE group synergies.

6.140 In identifying prices and other conditions that would have been agreed between independent enterprises under comparable circumstances, it is often essential to carefully identify idiosyncratic aspects of the controlled transaction that arise by virtue of the relationship between the parties. There is no requirement that associated enterprises structure their transactions in precisely the same manner as independent enterprises might have done. However, where transactional structures are utilised by associated enterprises that are not typical of transactions between independent parties, the effect of those structures on prices and other conditions that would have been agreed between uncontrolled parties under comparable circumstances should be taken into account in evaluating the profits that would have accrued to each of the parties at arm's length.

6.141 Care should be used, in applying certain of the OECD transfer pricing methods in a matter involving the transfer of intangibles or rights in intangibles. One sided methods, including the resale price method and the TNMM, are generally not reliable methods for directly valuing intangibles. In some circumstances such mechanisms can be utilised to indirectly value intangibles by determining values for some functions using those methods and deriving a residual value for intangibles. However, the principles of paragraph 6.133 are important when following such approaches and care should be exercised to ensure that all functions, risks, assets and other factors contributing to the generation of income are properly identified and evaluated.

6.142 The use of transfer pricing methods that seek to estimate the value of intangibles based on the cost of intangible development is generally discouraged. There rarely is any correlation between the cost of developing intangibles and their value or transfer price once developed. Hence, transfer pricing methods based on the cost of intangible development should usually be avoided.

6.143 However, in some limited circumstances, transfer pricing methods based on the estimated cost of reproducing or replacing the intangible may be utilised. Such approaches may sometimes have valid application with regard to the development of intangibles used for internal business operations (e.g. internal software systems), particularly where the intangibles in question are not unique and valuable intangibles. Where intangibles relating to products sold in the marketplace are at issue, however, replacement cost valuation methods raise serious comparability issues. Among other concerns, it is necessary to evaluate the effect of time delays associated with deferred development on the value of the intangibles. Often, there may be a significant first mover advantage in having a product on the market at an early date. As a result, an identical product (and the supporting intangibles) developed in future periods will not be as valuable as the same product (and the supporting intangibles) available currently. In such a case, the estimated replacement cost will not be a valid proxy for the value of an intangible transferred currently. Similarly, where an intangible carries legal protections or exclusivity characteristics, the value of being able to exclude competitors from using the intangible will not be reflected in an analysis based on replacement cost. Cost based valuations generally are not reliable when applied to determine the arm's length price for partially developed intangibles.

6.144 The provisions of paragraph 2.9A related to the use of rules of thumb apply to determinations of a correct transfer price in any controlled transaction, including cases involving the use or transfer of intangibles. Accordingly, a rule of thumb cannot be used to evidence that a price or apportionment of income is arm's length, including in particular an apportionment of income between a licensor and a licensee of intangibles.

6.145 The transfer pricing methods most likely to prove useful in matters involving transfers of one or more intangibles are the CUP method and the transactional profit split method. Valuation techniques can be useful tools. Supplemental guidance on the transfer pricing methods most likely to be useful in connection with transfers of intangibles is provided below.

D.2.6.1. Application of the CUP Method

6.146 Where reliable comparable uncontrolled transactions can be identified, the CUP method can be applied to determine the arm's length conditions for a transfer of intangibles or rights in intangibles. The general principles contained in paragraphs 2.13 to 2.20 apply when the CUP method is used in connection with transactions involving the transfer of intangibles. Where the CUP method is utilised in connection with the transfer of intangibles, particular consideration must be given to the comparability of the intangibles or rights in intangibles transferred in the controlled transaction and in the potential comparable uncontrolled transactions. The economically relevant characteristics or comparability factors described in Section D.1 of Chapter I should be considered. The matters described in Sections D.2.1 to D.2.4 of this chapter are of particular importance in evaluating the comparability of specific transferred intangibles and in making comparability adjustments, where possible. It should be recognised that the identification of reliable comparables in many cases involving intangibles may be difficult or impossible.

6.147 In some situations, intangibles acquired by an MNE group from independent enterprises are transferred to a member of the MNE group in a controlled transaction immediately following the acquisition. In such a case the price paid for the acquired intangibles will often (after any appropriate adjustments, including adjustments for acquired assets not re-transferred) represent a useful comparable for determining the arm's length price for the controlled transaction under a CUP method. Depending on the facts

and circumstances, the third party acquisition price in such situations will have relevance in determining arm's length prices and other conditions for the controlled transaction, even where the intangibles are acquired indirectly through an acquisition of shares or where the price paid to the third party for shares or assets exceeds the book value of the acquired assets. Examples 23 and 26 in the annex to Chapter VI illustrate the principles of this paragraph.

D.2.6.2. Application of transactional profit split methods¹⁸

6.148 In some circumstances, a transactional profit split method can be utilised to determine the arm's length conditions for a transfer of intangibles or rights in intangibles where it is not possible to identify reliable comparable uncontrolled transactions for such transfers. Section C of Chapter II contains guidance to be considered in applying transactional profit split methods. That guidance is fully applicable to matters involving the transfer of intangibles or rights in intangibles. In evaluating the reliability of transactional profit split methods, however, the availability of reliable and adequate data regarding combined profits, appropriately allocable expenses, and the reliability of factors used to divide combined income should be fully considered.

6.149 Transactional profit split methods may have application in connection with the sale of full rights in intangibles. As with other applications of the transactional profit split method, a full functional analysis that considers the functions performed, risks assumed and assets used by each of the parties is an essential element of the analysis. Where a transactional profit split analysis is based on projected revenues and expenses, the concerns with the accuracy of such projections described in Section D.2.6.4.1 should be taken into account.

6.150 It is also sometimes suggested that a profit split analysis can be applied to transfers of partially developed intangibles. In such an analysis, the relative value of contributions to the development of intangibles before and after a transfer of the intangibles in question is sometimes examined. Such an approach may include an attempt to amortise the transferor's contribution to the partially developed intangible over the asserted useful life of that contribution, assuming no further development. Such approaches are generally based on projections of cash flows and benefits expected to arise at some future date following the transfer and the assumed successful completion of further development activities.

6.151 Caution should be exercised in applying profit split approaches to determine estimates of the contributions of the parties to the creation of income in years following the transfer, or an arm's length allocation of future income, with respect to partially developed intangibles. The contribution or value of work undertaken prior to the transfer may bear no relationship to the cost of that work. For example, a chemical compound with potentially blockbuster pharmaceutical indications might be developed in the laboratory at relatively little cost. In addition, a variety of difficult to evaluate factors would need to be taken into account in such a profit split analysis. These would include the relative riskiness and value of research contributions before and after the transfer, the relative risk and its effect on value, for other development activities carried out before and after the transfer, the appropriate amortisation rate for various contributions to the intangible value, assumptions regarding the time at which any potential new products might be introduced, and the value of contributions other than intangibles to the ultimate generation of profit. Income and cash flow projections in such situations can sometimes be especially speculative. These factors can combine to call the reliability of such an application of a profit split analysis into question. See Section D.4 on hard-to-value intangibles.

6.152 Where limited rights in fully developed intangibles are transferred in a licence or similar transaction, and reliable comparable uncontrolled transactions cannot be identified, a transactional profit split method can often be utilised to evaluate the respective contributions of the parties to earning combined income. The profit contribution of the rights in intangibles made available by the licensor or other transferor would, in such a circumstance, be one of the factors contributing to the earning of income following the transfer. However, other factors would also need to be considered. In particular, functions performed and risks assumed by the licensee/transferee should specifically be taken into account in such an analysis. Other intangibles used by the licensor/transferor and by the licensee/transferee in their respective businesses should similarly be considered, as well as other relevant factors. Careful attention should be given in such an analysis to the limitations imposed by the terms of the transfer on the use of the intangibles by the licensee/transferee and on the rights of the licensee/transferee to use the intangibles for purposes of ongoing research and development. Further, assessing contributions of the licensee to enhancements in the value of licensed intangibles may be important. The allocation of income in such an analysis would depend on the findings of the functional analysis, including an analysis of the relevant risks assumed. It should not be assumed that all of the residual profit after functional returns would necessarily be allocated to the licensor/transferor in a profit split analysis related to a licensing arrangement.

D.2.6.3. Use of valuation techniques

6.153 In situations where reliable comparable uncontrolled transactions for a transfer of one or more intangibles cannot be identified, it may also be possible to use valuation techniques to estimate the arm's length price for intangibles transferred between associated enterprises. In particular, the application of income based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future income streams or cash flows derived from the exploitation of the intangible being valued, may be particularly useful when properly applied. Depending on the facts and circumstances, valuation techniques may be used by taxpayers and tax administrations as a part of one of the five OECD transfer pricing methods described in Chapter II, or as a tool that can be usefully applied in identifying an arm's length price.

6.154 Where valuation techniques are utilised in a transfer pricing analysis involving the transfer of intangibles or rights in intangibles, it is necessary to apply such techniques in a manner that is consistent with the arm's length principle and the principles of these Guidelines. In particular, due regard should be given to the principles contained in Chapters I–III. Principles related to realistically available options, economically relevant characteristics including assumption of risk (see Section D.1 of Chapter I) and aggregation of transactions (see paragraphs 3.9 to 3.12) apply fully to situations where valuation techniques are utilised in a transfer pricing analysis. Furthermore, the rules of these Guidelines on selection of transfer pricing methods apply in determining when such techniques should be used (see paragraphs 2.1 to 2.11). The principles of Sections A, B, C, and D.1 of this chapter also apply where use of valuation techniques is considered.

6.155 It is essential to consider the assumptions and other motivations that underlie particular applications of valuation techniques. For sound accounting purposes, some valuation assumptions may sometimes reflect conservative assumptions and estimates of the value of assets reflected in a company's balance sheet. This inherent conservatism can lead to definitions that are too narrow for transfer pricing purposes and valuation approaches that are not necessarily consistent with the arm's length principle. Caution should therefore be exercised in accepting valuations performed for accounting purposes

as necessarily reflecting arm's length prices or values for transfer pricing purposes without a thorough examination of the underlying assumptions. In particular, valuations of intangibles contained in purchase price allocations performed for accounting purposes are not determinative for transfer pricing purposes and should be utilised in a transfer pricing analysis with caution and careful consideration of the underlying assumptions.

6.156 It is not the intention of these Guidelines to set out a comprehensive summary of the valuation techniques utilised by valuation professionals. Similarly, it is not the intention of these Guidelines to endorse or reject one or more sets of valuation standards utilised by valuation or accounting professionals or to describe in detail or specifically endorse one or more specific valuation techniques or methods as being especially suitable for use in a transfer pricing analysis. However, where valuation techniques are applied in a manner that gives due regard to these Guidelines, to the specific facts of the case, to sound valuation principles and practices, and with appropriate consideration of the validity of the assumptions underlying the valuation and the consistency of those assumptions with the arm's length principle, such techniques can be useful tools in a transfer pricing analysis where reliable comparable uncontrolled transactions are not available. See, however, paragraphs 6.142 and 6.143 for a discussion of the reliability and application of valuation techniques based on intangible development costs.

6.157 Valuation techniques that estimate the discounted value of projected future cash flows derived from the exploitation of the transferred intangible or intangibles can be particularly useful when properly applied. There are many variations of these valuation techniques. In general terms, such techniques measure the value of an intangible by the estimated value of future cash flows it may generate over its expected remaining lifetime. The value can be calculated by discounting the expected future cash flows to present value.¹⁹ Under this approach valuation requires, among other things, defining realistic and reliable financial projections, growth rates, discount rates, the useful life of intangibles, and the tax effects of the transaction. Moreover it entails consideration of terminal values when appropriate. Depending on the facts and circumstances of the individual case, the calculation of the discounted value of projected cash flows derived from the exploitation of the intangible should be evaluated from the perspectives of both parties to the transaction in arriving at an arm's length price. The arm's length price will fall somewhere within the range of present values evaluated from the perspectives of the transferor and the transferee. Examples 27 to 29 in the annex to Chapter VI illustrate the provisions of this section.

D.2.6.4. Specific areas of concern in applying methods based on the discounted value of projected cash flows

6.158 When applying valuation techniques, including valuation techniques based on projected cash flows, it is important to recognise that the estimates of value based on such techniques can be volatile. Small changes in one or another of the assumptions underlying the valuation model or in one or more of the valuation parameters can lead to large differences in the intangible value the model produces. A small percentage change in the discount rate, a small percentage change in the growth rates assumed in producing financial projections, or a small change in the assumptions regarding the useful life of the intangible can each have a profound effect on the ultimate valuation. Moreover, this volatility is often compounded when changes are made simultaneously to two or more valuation assumptions or parameters.

6.159 The reliability of the intangible value produced using a valuation model is particularly sensitive to the reliability of the underlying assumptions and estimates on which it is

based and on the due diligence and judgment exercised in confirming assumptions and in estimating valuation parameters.

6.160 Because of the importance of the underlying assumptions and valuation parameters, taxpayers and tax administrations making use of valuation techniques in determining arm's length prices for transferred intangibles should explicitly set out each of the relevant assumptions made in creating the valuation model, should describe the basis for selecting valuation parameters, and should be prepared to defend the reasonableness of such assumptions and valuation parameters. Moreover, it is a good practice for taxpayers relying on valuation techniques to present as part of their transfer pricing documentation some sensitivity analysis reflecting the consequential change in estimated intangible value produced by the model when alternative assumptions and parameters are adopted.

6.161 It may be relevant in assessing the reliability of a valuation model to consider the purposes for which the valuation was undertaken and to examine the assumptions and valuation parameters in different valuations undertaken by the taxpayer for non-tax purposes. It would be reasonable for a tax administration to request an explanation for any inconsistencies in the assumptions made in a valuation of an intangible undertaken for transfer pricing purposes and valuations undertaken for other purposes. For example, such requests would be appropriate if high discount rates are used in a transfer pricing analysis when the company routinely uses lower discount rates in evaluating possible mergers and acquisitions. Such requests would also be appropriate if it is asserted that particular intangibles have short useful lives but the projections used in other business planning contexts demonstrate that related intangibles produce cash flows in years beyond the "useful life" that has been claimed for transfer pricing purposes. Valuations used by an MNE group in making operational business decisions may be more reliable than those prepared exclusively for purposes of a transfer pricing analysis.

6.162 The following sections identify some of the specific concerns that should be taken into account in evaluating certain important assumptions underlying calculations in a valuation model based on discounted cash flows. These concerns are important in evaluating the reliability of the particular application of a valuation technique. Notwithstanding the various concerns expressed above and outlined in detail in the following paragraphs, depending on the circumstances, application of such a valuation technique, either as part of one of the five OECD transfer pricing methods or as a useful tool, may prove to be more reliable than application of any other transfer pricing method, particularly where reliable comparable uncontrolled transactions do not exist.

D.2.6.4.1. Accuracy of financial projections

6.163 The reliability of a valuation of a transferred intangible using discounted cash flow valuation techniques is dependent on the accuracy of the projections of future cash flows or income on which the valuation is based. However, because the accuracy of financial projections is contingent on developments in the marketplace that are both unknown and unknowable at the time the valuation is undertaken, and to this extent such projections are speculative, it is essential for taxpayers and tax administrations to examine carefully the assumptions underlying the projections of both future revenue and future expense.

6.164 In evaluating financial projections, the source and purpose of the projections can be particularly important. In some cases, taxpayers will regularly prepare financial projections for business planning purposes. It can be that such analyses are used by management of the business in making business and investment decisions. It is usually the case that projections prepared for non-tax business planning purposes are more reliable than projections

prepared exclusively for tax purposes, or exclusively for purposes of a transfer pricing analysis.

6.165 The length of time covered by the projections should also be considered in evaluating the reliability of the projections. The further into the future the intangible in question can be expected to produce positive cash flows, the less reliable projections of income and expense are likely to be.

6.166 A further consideration in evaluating the reliability of projections involves whether the intangibles and the products or services to which they relate have an established track record of financial performance. Caution should always be used in assuming that past performance is a reliable guide to the future, as many factors are subject to change. However, past operating results can provide some useful guidance as to likely future performance of products or services that rely on intangibles. Projections with respect to products or services that have not been introduced to the market or that are still in development are inherently less reliable than those with some track record.

6.167 When deciding whether to include development costs in the cash flow projections it is important to consider the nature of the transferred intangible. Some intangibles may have indefinite useful lives and may be continually developed. In these situations it is appropriate to include future development costs in the cash flow forecasts. Others, for example a specific patent, may already be fully developed and, in addition not provide a platform for the development of other intangibles. In these situations no development costs should be included in the cash flow forecasts for the transferred intangible.

6.168 Where, for the foregoing reasons, or any other reason, there is a basis to believe that the projections behind the valuation are unreliable or speculative, attention should be given to the guidance in Section D.3 and D.4.

D.2.6.4.2. Assumptions regarding growth rates

6.169 A key element of some cash flow projections that should be carefully examined is the projected growth rate. Often projections of future cash flows are based on current cash flows (or assumed initial cash flows after product introduction in the case of partially developed intangibles) expanded by reference to a percentage growth rate. Where that is the case, the basis for the assumed growth rate should be considered. In particular, it is unusual for revenues derived from a particular product to grow at a steady rate over a long period of time. Caution should therefore be exercised in too readily accepting simple models containing linear growth rates not justified on the basis of either experience with similar products and markets or a reasonable evaluation of likely future market conditions. It would generally be expected that a reliable application of a valuation technique based on projected future cash flows would examine the likely pattern of revenue and expense growth based on industry and company experience with similar products.

D.2.6.4.3. Discount rates

6.170 The discount rate or rates used in converting a stream of projected cash flows into a present value is a critical element of a valuation model. The discount rate takes into account the time value of money and the risk or uncertainty of the anticipated cash flows. As small variations in selected discount rates can generate large variations in the calculated value of intangibles using these techniques, it is essential for taxpayers and tax administrations to give close attention to the analysis performed and the assumptions made in selecting the discount rate or rates utilised in the valuation model.

6.171 There is no single measure for a discount rate that is appropriate for transfer pricing purposes in all instances. Neither taxpayers nor tax administrations should assume that a discount rate that is based on a Weighted Average Cost of Capital (WACC) approach or any other measure should always be used in transfer pricing analyses where determination of appropriate discount rates is important. Instead the specific conditions and risks associated with the facts of a given case and the particular cash flows in question should be evaluated in determining the appropriate discount rate.

6.172 It should be recognised in determining and evaluating discount rates that in some instances, particularly those associated with the valuation of intangibles still in development, intangibles may be among the most risky components of a taxpayer's business. It should also be recognised that some businesses are inherently more risky than others and some cash flow streams are inherently more volatile than others. For example, the likelihood that a projected level of research and development expense will be incurred may be higher than the likelihood that a projected level of revenues will ultimately be generated. The discount rate or rates should reflect the level of risk in the overall business and the expected volatility of the various projected cash flows under the circumstances of each individual case.

6.173 Since certain risks can be taken into account either in arriving at financial projections or in calculating the discount rate, care should be taken to avoid double discounting for risk.

D.2.6.4.4. Useful life of intangibles and terminal values

6.174 Valuation techniques are often premised on the projection of cash flows derived from the exploitation of the intangible over the useful life of the intangible in question. In such circumstances, the determination of the actual useful life of the intangible will be one of the critical assumptions supporting the valuation model.

6.175 The projected useful life of particular intangibles is a question to be determined on the basis of all of the relevant facts and circumstances. The useful life of a particular intangible can be affected by the nature and duration of the legal protections afforded the intangible. The useful life of intangibles also may be affected by the rate of technological change in the industry, and by other factors affecting competition in the relevant economic environment. See paragraphs 6.121 and 6.122.

6.176 In some circumstances, particular intangibles may contribute to the generation of cash flow in years after the legal protections have expired or the products to which they specifically relate have ceased to be marketed. This can be the case in situations where one generation of intangibles forms the base for the development of future generations of intangibles and new products. It may well be that some portion of continuing cash flows from projected new products should properly be attributed to otherwise expired intangibles where such follow on effects exist. It should be recognised that, while some intangibles have an indeterminate useful life at the time of valuation, that fact does not imply that non-routine returns are attributable to such intangibles in perpetuity.

6.177 In this regard, where specific intangibles contribute to continuing cash flows beyond the period for which reasonable financial projections exist, it will sometimes be the case that a terminal value for the intangible related cash flows is calculated. Where terminal values are used in valuation calculations, the assumptions underlying their calculation should be clearly set out and the underlying assumptions thoroughly examined, particularly the assumed growth rates.

D.2.6.4.5. Assumptions regarding taxes

6.178 Where the purpose of the valuation technique is to isolate the projected cash flows associated with an intangible, it may be necessary to evaluate and quantify the effect of projected future income taxes on the projected cash flows. Tax effects to be considered include: (i) taxes projected to be imposed on future cash flows, (ii) tax amortisation benefits projected to be available to the transferee, if any, and (iii) taxes projected to be imposed on the transferor as a result of the transfer, if any.

D.2.7. Form of payment

6.179 Taxpayers have substantial discretion in defining the form of payment for transferred intangibles. In transactions between independent parties, it is common to observe payments for intangibles that take the form of a single lump sum. It is also common to observe payments for intangibles that take the form of periodic payments over time. Arrangements involving periodic payments can be structured either as a series of instalment payments fixed in amount, or may take the form of contingent payments where the amount of payments depends on the level of sales of products supported by the intangibles, on profitability, or on some other factor. The principles of Section D.1.1 of Chapter I should be followed in evaluating taxpayer agreements with regard to the form of payment.

6.180 In evaluating the provisions of taxpayer agreements related to the form of payment, it should be noted that some payment forms will entail greater or lesser levels of risk to one of the parties. For example, a payment form contingent on future sales or profit will normally involve greater risk to the transferor than a payment form calling for either a single lump-sum payment at the time of the transfer or a series of fixed instalment payments, because of the existence of the contingency. The chosen form of the payment must be consistent with the facts and circumstances of the case, including the written contracts, the actual conduct of the parties, and the ability of the parties to bear and manage the relevant payment risks. In particular, the amount of the specified payments should reflect the relevant time value of money and risk features of the chosen form of payment. For example, if a valuation technique is applied and results in the calculation of a lump-sum present value for the transferred intangible, and if a taxpayer applies a payment form contingent on future sales, the discount rate used in converting the lump-sum valuation to a stream of contingent payments over the useful life of the intangible should reflect the increased risk to the transferor that sales may not materialise and that payments would therefore not be forthcoming, as well as the time value of money consequences arising from the deferral of the payments to future years.

D.3. Arm's length pricing of transactions involving intangibles for which valuation is highly uncertain at the time of the transaction

6.181 Intangibles or rights in intangibles may have specific features complicating the search for comparables and in some cases making it difficult to determine the value of an intangible at the time of the transaction. When valuation of an intangible or rights in an intangible at the time of the transaction is highly uncertain, the question arises as to how arm's length pricing should be determined. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction. To this aim, the guidance and recommended process in Section D of Chapter I and the principles in Chapter III as supplemented by the guidance in this chapter for conducting a comparability analysis are relevant.

6.182 Depending on the facts and circumstances, there is a variety of mechanisms that independent enterprises might adopt to address high uncertainty in the valuation of the intangible at the time of the transaction. For example, one possibility is to use anticipated benefits (taking into account all relevant economic factors) as a means for establishing the pricing at the outset of the transaction. In determining the anticipated benefits, independent enterprises would take into account the extent to which subsequent developments are foreseeable and predictable. In some cases, independent enterprises might find that subsequent developments are sufficiently predictable and therefore the projections of anticipated benefits are sufficiently reliable to fix the pricing for the transaction at the outset on the basis of those projections.

6.183 In other cases, independent enterprises might find that pricing based on anticipated benefits alone does not provide adequate protection against the risks posed by the high uncertainty in valuing the intangible. In such cases independent enterprises might, for instance, adopt shorter-term agreements, include price adjustment clauses in the terms of the agreement, or adopt a payment structure involving contingent payments to protect against subsequent developments that might not be sufficiently predictable. For these purposes, a contingent pricing arrangement is any pricing arrangement in which the quantum or timing of payments is dependent on contingent events, including the achievement of predetermined financial thresholds such as sales or profits, or of predetermined development stages (e.g. royalty or periodic milestone payments). For example, a royalty rate could be set to increase as the sales of the licensee increase, or additional payments could be required at such time as certain development targets are successfully achieved. For a transfer of intangibles or rights in intangibles at a stage when they are not ready to be commercialised but require further development, payment terms adopted by independent parties on initial transfer might include the determination of additional contingent amounts that would become payable only on the achievement of specified milestone stages in their further development.

6.184 Also, independent enterprises may determine to assume the risk of unpredictable subsequent developments. However, the occurrence of major events or developments unforeseen by the parties at the time of the transaction or the occurrence of foreseen events or developments considered to have a low probability of occurrence which change the fundamental assumptions upon which the pricing was determined may lead to renegotiation of the pricing arrangements by agreement of the parties where it is to their mutual benefit. For example, a renegotiation might occur at arm's length if a royalty rate based on sales for a patented drug turned out to be vastly excessive due to an unexpected development of an alternative low-cost treatment. The excessive royalty might remove the incentive of the licensee to manufacture or sell the drug at all, in which case the licensee will have an interest in renegotiating the agreement. It may be the case that the licensor has an interest in keeping the drug on the market and in retaining the same licensee to manufacture or sell the drug because of the skills and expertise of the licensee or the existence of a long-standing co-operative relationship between them. Under these circumstances, the parties might prospectively renegotiate to their mutual benefit all or part of the agreement and set a lower royalty rate. In any event, whether renegotiation would take place, would depend upon all the facts and circumstances of each case.

6.185 If independent enterprises in comparable circumstances would have agreed on the inclusion of a mechanism to address high uncertainty in valuing the intangible (e.g. a price adjustment clause), the tax administration should be permitted to determine the pricing of a transaction involving an intangible or rights in an intangible on the basis of such mechanism. Similarly, if independent enterprises in comparable circumstances would have

considered subsequent events so fundamental that their occurrence would have led to a prospective renegotiation of the pricing of a transaction, such events should also lead to a modification of the pricing of the transaction between associated enterprises.

D.4. Hard-to-value intangibles (HTVI)

6.186 A tax administration may find it difficult to establish or verify what developments or events might be considered relevant for the pricing of a transaction involving the transfer of intangibles or rights in intangibles, and the extent to which the occurrence of such developments or events, or the direction they take, might have been foreseen or reasonably foreseeable at the time the transaction was entered into. The developments or events that might be of relevance for the valuation of an intangible are in most cases strongly connected to the business environment in which that intangible is developed or exploited. Therefore, the assessment of which developments or events are relevant and whether the occurrence and direction of such developments or events might have been foreseen or reasonably foreseeable requires specialised knowledge, expertise and insight into the business environment in which the intangible is developed or exploited. In addition, the assessments that are prudent to undertake when evaluating the transfer of intangibles or rights in intangibles in an uncontrolled transaction, may not be seen as necessary or useful for other than transfer pricing purposes by the MNE group when a transfer takes place within the group, with the result that those assessments may not be comprehensive. For example, an enterprise may transfer intangibles at an early stage of development to an associated enterprise, set a royalty rate that does not reflect the value of the intangible at the time of the transfer, and later take the position that it was not possible at the time of the transfer to predict the subsequent success of the product with full certainty. The difference between the *ex ante* and *ex post* value of the intangible would therefore be claimed by the taxpayer to be attributable to more favourable developments than anticipated. The general experience of tax administrations in these situations is that they may not have the specific business insights or access to the information to be able to examine the taxpayer's claim and to demonstrate that the difference between the *ex ante* and *ex post* value of the intangible is due to non-arm's length pricing assumptions made by the taxpayer. Instead, tax administrations seeking to examine the taxpayer's claim are largely dependent on the insights and information provided by that taxpayer. These situations associated with information asymmetry between taxpayers and tax administrations can give rise to transfer pricing risk. See paragraph 6.191.

6.187 In these situations involving the transfer of an intangible or rights in an intangible *ex post* outcomes can provide a pointer to tax administrations about the arm's length nature of the *ex ante* pricing arrangement agreed upon by the associated enterprises, and the existence of uncertainties at the time of the transaction. If there are differences between the *ex ante* projections and the *ex post* results which are not due to unforeseeable developments or events, the differences may give an indication that the pricing arrangement agreed upon by the associated enterprises at the time the transaction was entered into may not have adequately taken into account the relevant developments or events that might have been expected to affect the value of the intangible and the pricing arrangements adopted.

6.188 In response to the considerations discussed above, this section contains an approach consistent with the arm's length principle that tax administrations can adopt to ensure that tax administrations can determine in which situations the pricing arrangements as set by the taxpayers are at arm's length and are based on an appropriate weighting of the foreseeable developments or events that are relevant for the valuation of certain hard-to-value intangibles, and in which situations this is not the case. Under this approach, *ex post*

evidence provides presumptive evidence as to the existence of uncertainties at the time of the transaction, whether the taxpayer appropriately took into account reasonably foreseeable developments or events at the time of the transaction, and the reliability of the information used *ex ante* in determining the transfer price for the transfer of such intangibles or rights in intangibles. Such presumptive evidence may be subject to rebuttal as stated in paragraphs 6.193 and 6.194, if it can be demonstrated that it does not affect the accurate determination of the arm's length price. This situation should be distinguished from the situation in which hindsight is used by taking *ex post* results for tax assessment purposes without considering whether the information on which the *ex post* results are based could or should reasonably have been known and considered by the associated enterprises at the time the transaction was entered into.

6.189 The term hard-to-value intangibles (HTVI) covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist, and (ii) at the time the transactions was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.

6.190 Transactions involving the transfer or the use of HTVI in paragraph 6.189 may exhibit one or more of the following features:

- The intangible is only partially developed at the time of the transfer.
- The intangible is not expected to be exploited commercially until several years following the transaction.
- The intangible does not itself fall within the definition of HTVI in paragraph 6.189 but is integral to the development or enhancement of other intangibles which fall within that definition of HTVI.
- The intangible is expected to be exploited in a manner that is novel at the time of the transfer and the absence of a track record of development or exploitation of similar intangibles makes projections highly uncertain.
- The intangible, meeting the definition of HTVI under paragraph 6.189, has been transferred to an associated enterprise for a lump sum payment.
- The intangible is either used in connection with or developed under a CCA or similar arrangements.

6.191 For such intangibles, information asymmetry between taxpayer and tax administrations, including what information the taxpayer took into account in determining the pricing of the transaction, may be acute and may exacerbate the difficulty encountered by tax administrations in verifying the arm's length basis on which pricing was determined for the reasons discussed in paragraph 6.186. As a result, it will prove difficult for a tax administration to perform a risk assessment for transfer pricing purposes, to evaluate the reliability of the information on which pricing has been based by the taxpayer, or to consider whether the intangible or rights in intangibles have been transferred at undervalue or overvalue compared to the arm's length price, until *ex post* outcomes are known in years subsequent to the transfer.

6.192 In these circumstances, the tax administration can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements. However, the consideration of *ex post* evidence should be based on a determination that such evidence is necessary to be taken into account to assess the reliability of the information on which *ex ante* pricing has been based. Where the tax administration is able to confirm the

reliability of the information on which *ex ante* pricing has been based, notwithstanding the approach described in this section, then adjustments based on *ex post* profit levels should not be made. In evaluating the *ex ante* pricing arrangements, the tax administration is entitled to use the *ex post* evidence about financial outcomes to inform the determination of the arm's length pricing arrangements, including any contingent pricing arrangements, that would have been made between independent enterprises at the time of the transaction, considering the guidance in paragraph 6.185. Depending on the facts and circumstances of the case and considering the guidance in Section B.5 of Chapter III, a multi-year analysis of the information for the application of this approach may be appropriate.

6.193 This approach will not apply to transactions involving the transfer or use of HTVI falling within the scope of paragraph 6.189, when at least one of the following exemptions applies:

- i) The taxpayer provides:
 1. Details of the *ex ante* projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in calculations to determine the price (e.g. probability-weighted), and the appropriateness of its consideration of reasonably foreseeable events and other risks, and the probability of occurrence; and,
 2. Reliable evidence that any significant difference between the financial projections and actual outcomes is due to: a) unforeseeable developments or events occurring after the determination of the price that could not have been anticipated by the associated enterprises at the time of the transaction; or b) the playing out of probability of occurrence of foreseeable outcomes, and that these probabilities were not significantly overestimated or underestimated at the time of the transaction;
- ii) The transfer of the HTVI is covered by a bilateral or multilateral advance pricing arrangement in effect for the period in question between the countries of the transferee and the transferor.
- iii) Any significant difference between the financial projections and actual outcomes mentioned in i)2 above does not have the effect of reducing or increasing the compensation for the HTVI by more than 20% of the compensation determined at the time of the transaction.
- iv) A commercialisation period of five years has passed following the year in which the HTVI first generated unrelated party revenues for the transferee and in which commercialisation period any significant difference between the financial projections and actual outcomes mentioned in i)2 above was not greater than 20% of the projections for that period.²⁰

6.194 The first exemption means that, although the *ex post* evidence about financial outcomes provides relevant information for tax administrations to consider the appropriateness of the *ex ante* pricing arrangements, in circumstances where the taxpayer can satisfactorily demonstrate what was foreseeable at the time of the transaction and reflected in the pricing assumptions, and that the developments leading to the difference between projections and outcomes arose from unforeseeable events, tax administrations will not be entitled to make adjustments to the *ex ante* pricing arrangements based on *ex post* outcomes. For example, if the evidence of financial outcomes shows that sales of products exploiting the transferred intangible reached 1 000 a year, but the *ex ante* pricing arrangements were based on projections that considered sales reaching a maximum of only

100 a year, then the tax administration should consider the reasons for sales reaching such higher volumes. If the higher volumes were due to, for example, an exponentially higher demand for the products incorporating the intangible caused by a natural disaster or some other unexpected event that was clearly unforeseeable at the time of the transaction or appropriately given a very low probability of occurrence, then the *ex ante* pricing should be recognised as being at arm's length, unless there is evidence other than the *ex post* financial outcomes indicating that price setting did not take place on an arm's length basis.

6.195 It would be important to permit resolution of cases of double taxation arising from application of the approach for HTVI through access to the mutual agreement procedure under the applicable Treaty.

D.5. Supplemental guidance for transactions involving the use of intangibles in connection with the sale of goods or the provision of services

6.196 This section provides supplemental guidance for applying the rules of Chapters I–III in situations where one or both parties to a controlled transaction uses intangibles in connection with the sale of goods or the provision of services, but where no transfer of intangibles or interests in intangibles occurs. Where intangibles are present, the transfer pricing analysis must carefully consider the effect of the intangibles involved on the prices and other conditions of controlled transactions.

D.5.1. Intangibles as a comparability factor in transactions involving the use of intangibles

6.197 The general rules of Section D.1 of Chapter I and Chapter III also apply to guide the comparability analysis of transactions involving the use of intangibles in connection with a controlled transaction involving the sale of goods or the provision of services. However, the presence of intangibles may sometimes raise challenging comparability issues.

6.198 In a transfer pricing analysis where the most appropriate transfer pricing method is the resale price method, the cost-plus method, or the transactional net margin method, the less complex of the parties to the controlled transaction is often selected as the tested party. In many cases, an arm's length price or level of profit for the tested party can be determined without the need to value the intangibles used in connection with the transaction. That would generally be the case where only the non-tested party uses intangibles. In some cases, however, the tested party may in fact use intangibles notwithstanding its relatively less complex operations. Similarly, parties to potentially comparable uncontrolled transactions may use intangibles. Where either of these is the case, it becomes necessary to consider the intangibles used by the tested party and by the parties to potentially comparable uncontrolled transactions as one comparability factor in the analysis.

6.199 For example, a tested party engaged in the marketing and distribution of goods purchased in controlled transactions may have developed marketing intangibles in its geographic area of operation, including customer lists, customer relationships, and customer data. It may also have developed advantageous logistical know-how or software and other tools that it uses in conducting its distribution business. The impact of such intangibles on the profitability of the tested party should be considered in conducting a comparability analysis.

6.200 It is important to note, however, that in many cases where the tested party uses such intangibles, parties to comparable uncontrolled transactions will also have the same types of intangibles at their disposal. Thus, in the distribution company case, an

uncontrolled entity engaged in providing distribution services in the tested party's industry and market is also likely to have knowledge of and contacts with potential customers, collect customer data, have its own effective logistical systems, and in other respects have similar intangibles to the tested party. Where that is the case, the level of comparability may be sufficiently high that it is possible to rely on prices paid or margins earned by the potential comparables as an appropriate measure of arm's length compensation for both the functions performed and the intangibles owned by the tested party.

6.201 Where the tested party and the potential comparable have comparable intangibles, the intangibles will not constitute unique and valuable intangibles within the meaning of paragraph 6.17, and therefore no comparability adjustments will be required with regard to the intangibles. The potential comparable will, in these circumstances, provide the best evidence of the profit contribution of the tested party's intangibles. If, however, either the tested party or the potential comparable has and uses in its business unique and valuable intangibles, it may be necessary either to make appropriate comparability adjustments or to revert to a different transfer pricing method. The principles contained in Sections D.2.1 to D.2.4 apply in evaluating the comparability of intangibles in such situations.

6.202 It is appropriate for both taxpayers and tax administrations to exercise restraint in rejecting potential comparables based on the use of intangibles by either the parties to potentially comparable transactions or by the tested party. Potential comparables should generally not be rejected on the basis of the asserted existence of unspecified intangibles or on the basis of the asserted significance of goodwill. If identified transactions or companies are otherwise comparable, they may provide the best available indication of arm's length pricing notwithstanding the existence and use by either the tested party or the parties to the potentially comparable transactions of relatively insignificant intangibles. Potentially comparable transactions should be disregarded on the basis of the existence and use of non-comparable intangibles only where the intangibles in question can be clearly and distinctly identified and where the intangibles are manifestly unique and valuable intangibles.

D.5.2. Determining arm's length prices for transactions involving the use of intangibles in connection with the sale of goods or the performance of services

6.203 The principles of Chapters I–III apply in determining arm's length prices for transactions involving the use of intangibles in connection with sales of goods or the performance of services. Two general categories of cases can arise. In the first category of cases, the comparability analysis, including the functional analysis, will reveal the existence of sufficiently reliable comparables to permit the determination of arm's length conditions for the transaction using a transfer pricing method based on comparables. In the second category of cases, the comparability analysis, including the functional analysis, will fail to identify reliable comparable uncontrolled transactions, often as a direct result of the use by one or both parties to the transaction of unique and valuable intangibles. Transfer pricing approaches to these two categories of cases are described below.

D.5.2.1. Situations where reliable comparables exist

6.204 It will often be the case that, notwithstanding the use of intangibles by one or both parties to a controlled sale of goods or provision of services, reliable comparables can be identified. Depending on the specific facts, any of the five OECD transfer pricing methods described in Chapter II might constitute the most appropriate transfer pricing method where the transaction involves the use of intangibles in connection with a controlled sale of goods or provision of services and reliable comparables are present.

6.205 Where the tested party does not use unique and valuable intangibles, and where reliable comparables can be identified, it will often be possible to determine arm's length prices on the basis of one-sided methods including the CUP, resale price, cost plus and TNMM methods. The guidance in Chapters I–III will generally be sufficient to guide the determination of arm's length prices in such situations, without the need for a detailed analysis of the nature of the intangibles used by the other party to the transaction.

6.206 The principles described in Sections D.2.1 to D.2.4 of this chapter should be applied in determining whether the use of intangibles by the tested party will preclude reliance on identified comparable uncontrolled transactions or require comparability adjustments. Only when the intangibles used by the tested party are unique and valuable intangibles will the need arise to make comparability adjustments or to adopt a transfer pricing method less dependent on comparable uncontrolled transactions. Where intangibles used by the tested party are not unique and valuable intangibles, prices paid or received, or margins or returns earned by parties to comparable uncontrolled transactions may provide a reliable basis for determining arm's length conditions.

6.207 Where the need to make comparability adjustments arises because of differences in the intangibles used by the tested party in a controlled transaction and the intangibles used by a party to a potentially comparable uncontrolled transaction, difficult factual questions can arise in quantifying reliable comparability adjustments. These issues require thorough consideration of the relevant facts and circumstances and of the available data regarding the impact of the intangibles on prices and profits. Where the impact on price of a difference in the nature of the intangibles used is clearly material, but not subject to accurate estimation, it may be necessary to utilise a different transfer pricing method that is less dependent on identification of reliable comparables.

6.208 It should also be recognised that comparability adjustments for factors other than differences in the nature of the intangibles used may be required in matters involving the use of intangibles in connection with a controlled sale of goods or services. In particular, comparability adjustments may be required for matters such as differences in markets, locational advantages, business strategies, assembled workforce, corporate synergies and other similar factors. While such factors may not be intangibles as that term is described in Section A.1 of this chapter, they can nevertheless have important effects on arm's length prices in matters involving the use of intangibles.

D.5.2.2. Situations where reliable comparables do not exist

6.209 In some circumstances where reliable uncontrolled transactions cannot be identified, transactional profit split methods may be utilised to determine an arm's length allocation of profits for the sale of goods or the provision of services involving the use of intangibles. One circumstance in which the use of transactional profit split methods may be appropriate is where both parties to the transaction make unique and valuable contributions to the transaction.

6.210 Section C of Chapter II contains guidance to be considered in applying transactional profit split methods. That guidance is fully applicable to matters involving the use of intangibles in connection with the sale of goods or the provision of services in controlled transactions.

6.211 In applying a profit split method in a case involving the use of intangibles, care should be taken to identify the intangibles in question, to evaluate the manner in which those intangibles contribute to the creation of value, and to evaluate other income producing

functions performed, risks assumed and assets used. Vague assertions of the existence and use of unspecified intangibles will not support a reliable application of a profit split method.

6.212 In appropriate circumstances, transfer pricing methods or valuation techniques not dependent on the identification of reliable comparable uncontrolled transactions may also be utilised to determine arm's length conditions for the sale of goods or the provision of services where intangibles are used in connection with the transaction. The alternative selected should reflect the nature of the goods or services provided and the contribution of intangibles and other relevant factors to the creation of value.

**Additional Guidance in Chapter II of
the Transfer Pricing Guidelines Resulting from
the Revisions to Chapter VI**

The following language is inserted following paragraph 2.9.

2.9A The application of a general rule of thumb does not provide an adequate substitute for a complete functional and comparability analysis conducted under the principles of Chapters I–III. Accordingly, a rule of thumb cannot be used to evidence that a price or an apportionment of income is arm’s length.

The provisions of the annex to Chapter VI of the Transfer Pricing Guidelines are deleted in their entirety and are replaced by the following language.

Annex to Chapter VI – Examples to illustrate the guidance on intangibles

Example 1

1. Premiere is the parent company of an MNE group. Company S is a wholly owned subsidiary of Premiere and a member of the Premiere group. Premiere funds R&D and performs ongoing R&D functions in support of its business operations. When its R&D functions result in patentable inventions, it is the practice of the Premiere group that all rights in such inventions be assigned to Company S in order to centralise and simplify global patent administration. All patent registrations are held and maintained in the name of Company S.

2. Company S employs three lawyers to perform its patent administration work and has no other employees. Company S does not conduct or control any of the R&D activities of the Premiere group. Company S has no technical R&D personnel, nor does it incur any of the Premiere group's R&D expense. Key decisions related to defending the patents are made by Premiere management, after taking advice from employees of Company S. Premiere's management, and not the employees of Company S, controls all decisions regarding licensing of the group's patents to both independent and associated enterprises.

3. At the time of each assignment of rights from Premiere to Company S, Company S makes a nominal EUR 100 payment to Premiere in consideration of the assignment of rights to a patentable invention and, as a specific condition of the assignment, simultaneously grants to Premiere an exclusive, royalty free, patent licence, with full rights to sub-licence, for the full life of the patent to be registered. The nominal payments of Company S to Premiere are made purely to satisfy technical contract law requirements related to the assignments and, for purposes of this example, it is assumed that they do not reflect arm's length compensation for the assigned rights to patentable inventions. Premiere uses the patented inventions in manufacturing and selling its products throughout the world and from time to time sublicenses patent rights to others. Company S makes no commercial use of the patents nor is it entitled to do so under the terms of the licence agreement with Premiere.

4. Under the agreement, Premiere performs all functions related to the development, enhancement, maintenance, protection and exploitation of the intangibles except for patent administration services. Premiere contributes and uses all assets associated with the development and exploitation of the intangible, and assumes all or substantially all of the risks associated with the intangibles. Premiere should be entitled to the bulk of the returns derived from exploitation of the intangibles. Tax administrations could arrive at an appropriate transfer pricing solution by delineating the actual transaction undertaken between Premiere and Company S. Depending on the facts, it might be determined that taken together the nominal assignment of rights to Company S and the simultaneous grant of full exploitation rights back to Premiere reflect in substance a patent administration service arrangement between Premiere and Company S. An arm's length price would be determined for the patent administration services and Premiere would retain or be allocated the balance of the returns derived by the MNE group from the exploitation of the patents.

Example 2

5. The facts related to the development and control of patentable inventions are the same as in Example 1. However, instead of granting a perpetual and exclusive licence of its patents back to Premiere, Company S, acting under the direction and control of Premiere, grants licences of its patents to associated and independent enterprises throughout the world in exchange for periodic royalties. For purposes of this example, it is assumed that the royalties paid to Company S by associated enterprises are all arm's length.

6. Company S is the legal owner of the patents. However, its contributions to the development, enhancement, maintenance, protection, and exploitation of the patents are limited to the activities of its three employees in registering the patents and maintaining the patent registrations. The Company S employees do not control or participate in the licensing transactions involving the patents. Under these circumstances, Company S is only entitled to compensation for the functions it performs. Based on an analysis of the respective functions performed, assets used, and risks assumed by Premiere and Company S in developing, enhancing, maintaining, protecting, and exploiting the intangibles, Company S should not be entitled ultimately to retain or be attributed income from its licensing arrangements over and above the arm's length compensation for its patent registration functions.

7. As in Example 1 the true nature of the arrangement is a patent administration service contract. The appropriate transfer pricing outcome can be achieved by ensuring that the amount paid by Company S in exchange for the assignments of patent rights appropriately reflects the respective functions performed, assets used, and risks assumed by Premiere and by Company S. Under such an approach, the compensation due to Premiere for the patentable inventions is equal to the licensing revenue of Company S less an appropriate return to the functions Company S performs.

Example 3

8. The facts are the same as in Example 2. However, after licensing the patents to associated and independent enterprises for a few years, Company S, again acting under the direction and control of Premiere, sells the patents to an independent enterprise at a price reflecting appreciation in the value of the patents during the period that Company S was the legal owner. The functions of Company S throughout the period it was the legal owner of the patents were limited to performing the patent registration functions described in Examples 1 and 2.

9. Under these circumstances, the income of Company S should be the same as in Example 2. It should be compensated for the registration functions it performs, but should not otherwise share in the returns derived from the exploitation of the intangibles, including the returns generated from the disposition of the intangibles.

Example 4

10. The facts related to the development of the patents are the same as described in Example 3. In contrast to Example 1, Company S in this example has employees capable of making, and who actually make, the decision to take on the patent portfolio. All decisions relating to the licensing programme were taken by Company S employees, all negotiations with licensees were undertaken by Company S employees, and Company S employees monitored compliance of independent licensees with the terms of the licenses. It should be assumed for purposes of this example that the price paid by Company S in exchange for the patents was an arm's length price that reflected the parties' respective assessments of

the future licensing programme and the anticipated returns to be derived from exploitation of the patents as of the time of their assignment to Company S. For the purposes of this example, it is assumed that the approach for hard-to-value intangibles in Section D.4 does not apply.

11. Following the assignments, Company S licensed the patents to independent enterprises for a few years. Thereafter the value of the patents increases significantly because of external circumstances unforeseen at the time the patents were assigned to Company S. Company S then sells the patents to an unrelated purchaser at a price exceeding the price initially paid by Company S to Premiere for the patents. Company S employees make all decisions regarding the sale of the patents, negotiate the terms of the sale, and in all respects manage and control the disposition of the patents.

12. Under these circumstances, Company S is entitled to retain the proceeds of the sale, including amounts attributable to the appreciation in the value of the patents resulting from the unanticipated external circumstances.

Example 5

13. The facts are the same as in Example 4 except that instead of appreciating, the value of the patents decreases during the time they are owned by Company S as a result of unanticipated external circumstances. Under these circumstances, Company S is entitled to retain the proceeds of the sale, meaning that it will suffer the loss.

Example 6

14. In Year 1, a multinational group comprised of Company A (a country A corporation) and Company B (a country B corporation) decides to develop an intangible, which is anticipated to be highly profitable based on Company B's existing intangibles, its track record and its experienced research and development staff. The intangible is expected to take five years to develop before possible commercial exploitation. If successfully developed, the intangible is anticipated to have value for ten years after initial exploitation. Under the development agreement between Company A and Company B, Company B will perform and control all activities related to the development, enhancement, maintenance, protection and exploitation of the intangible. Company A will provide all funding associated with the development of the intangible (the development costs are anticipated to be USD 100 million per year for five years), and will become the legal owner of the intangible. Once developed, the intangible is anticipated to result in profits of USD 550 million per year (years 6 to 15). Company B will license the intangible from Company A and make contingent payments to Company A for the right to use the intangible, based on returns of purportedly comparable licensees. After the projected contingent payments, Company B will be left with an anticipated return of USD 200 million per year from selling products based on the intangible.

15. A functional analysis by the country B tax administration of the arrangement assesses the functions performed, assets used and contributed, and risks assumed by Company A and by Company B. The analysis through which the actual transaction is delineated concludes that although Company A is the legal owner of the intangibles, its contribution to the arrangement is solely the provision of funding for the development of an intangible. This analysis shows that Company A contractually assumes the financial risk, has the financial capacity to assume that risk, and exercises control over that risk in accordance with the principles outlined in paragraphs 6.63 and 6.64. Taking into

account Company A's contributions, as well as the realistic alternatives of Company A and Company B, it is determined that Company A's anticipated remuneration should be a risk-adjusted return on its funding commitment. Assume that this is determined to be USD 110 million per year (for Years 6 to 15), which equates to an 11% risk-adjusted anticipated financial return.²¹ Company B, accordingly, would be entitled to all remaining anticipated income after accounting for Company A's anticipated return, or USD 440 million per year (USD 550 million minus USD 110 million), rather than USD 200 million per year as claimed by the taxpayer. (Based on the detailed functional analysis and application of the most appropriate method, the taxpayer incorrectly chose Company B as the tested party rather than Company A).

Example 7

16. Primero is the parent company of an MNE group engaged in the pharmaceutical business and does business in country M. Primero develops patents and other intangibles relating to Product X and registers those patents in countries around the world.

17. Primero retains its wholly owned country N subsidiary, Company S, to distribute Product X throughout Europe and the Middle East on a limited risk basis. The distribution agreement provides that Primero, and not Company S, is to bear product recall and product liability risk, and provides further that Primero will be entitled to all profit or loss from selling Product X in the territory after providing Company S with the agreed level of compensation for its distribution functions. Operating under the contract, Company S purchases Product X from Primero and resells Product X to independent customers in countries throughout its geographical area of operation. In performing its distribution functions, Company S follows all applicable regulatory requirements.

18. In the first three years of operations, Company S earns returns from its distribution functions that are consistent with its limited risk characterisation and the terms of the distribution contract. Its returns reflect the fact that Primero, and not Company S, is entitled to retain income derived from exploitation of the intangibles with respect to Product X. After three years of operation, it becomes apparent that Product X causes serious side effects in a significant percentage of those patients that use the product and it becomes necessary to recall the product and remove it from the market. Company S incurs substantial costs in connection with the recall. Primero does not reimburse Company S for these recall related costs or for the resulting product liability claims.

19. Under these circumstances, there is an inconsistency between Primero's asserted entitlement to returns derived from exploiting the Product X intangibles and its failure to bear the costs associated with the risks supporting that assertion. A transfer pricing adjustment would be appropriate to remedy the inconsistency. In determining the appropriate adjustment, it would be necessary to determine the true transaction between the parties by applying the provisions of Section D.1 of Chapter I. In doing so, it would be appropriate to consider the risks assumed by each of the parties on the basis of the course of conduct followed by the parties over the term of the agreement, the control over risk exercised by Primero and Company S, and other relevant facts. If it is determined that the true nature of the relationship between the parties is that of a limited risk distribution arrangement, then the most appropriate adjustment would likely take the form of an allocation of the recall and product liability related costs from Company S to Primero. Alternatively, although unlikely, if it is determined on the basis of all the relevant facts that the true nature of the relationship between the parties includes the exercising control over product liability and recall risk by Company S, and if an arm's length price can be

identified on the basis of the comparability analysis, an increase in the distribution margins of Company S for all years might be made to reflect the true risk allocation between the parties.

Example 8

20. Primair, a resident of country X, manufactures watches which are marketed in many countries around the world under the R trademark and trade name. Primair is the registered owner of the R trademark and trade name. The R name is widely known in countries where the watches are sold and has obtained considerable economic value in those markets through the efforts of Primair. R watches have never been marketed in country Y, however, and the R name is not known in the country Y market.

21. In Year 1, Primair decides to enter the country Y market and incorporates a wholly owned subsidiary in country Y, Company S, to act as its distributor in country Y. At the same time, Primair enters into a long-term royalty-free marketing and distribution agreement with Company S. Under the agreement, Company S is granted the exclusive right to market and distribute watches bearing the R trademark and using the R trade name in country Y for a period of five years, with an option for a further five years. Company S obtains no other rights relating to the R trademark and trade name from Primair, and in particular is prohibited from re-exporting watches bearing the R trademark and trade name. The sole activity of Company S is marketing and distributing watches bearing the R trademark and trade name. It is assumed that the R watches are not part of a portfolio of products distributed by Company S in country Y. Company S undertakes no secondary processing, as it imports packaged watches into country Y ready for sale to the final customer.

22. Under the contract between Primair and Company S, Company S purchases the watches from Primair in country Y currency, takes title to the branded watches and performs the distribution function in country Y, incurs the associated carrying costs (e.g. inventory and receivables financing), and assumes the corresponding risks (e.g. inventory, credit and financing risks). Under the contract between Primair and Company S, Company S is required to act as a marketing agent to assist in developing the market for R watches in country Y. Company S consults with Primair in developing the country Y marketing strategy for R watches. Primair develops the overall marketing plan based largely on its experience in other countries, it develops and approves the marketing budgets, and it makes final decisions regarding advertising designs, product positioning and core advertising messages. Company S consults on local market issues related to advertising, assists in executing the marketing strategy under Primair's direction, and provides evaluations of the effectiveness of various elements of the marketing strategy. As compensation for providing these marketing support activities, Company S receives from Primair a service fee based on the level of marketing expenditure it incurs and including an appropriate profit element.

23. Assume for the purpose of this example that, based upon a thorough comparability analysis, including a detailed functional analysis, it is possible to conclude that the price Company S pays Primair for the R watches should be analysed separately from the compensation Company S receives for the marketing it undertakes on behalf of Primair. Assume further that based upon identified comparable transactions, the price paid for the watches is arm's length and that this price enables Company S to earn an arm's length level of compensation from selling the watches for the distribution function it performs, the assets it uses and the risks it assumes.

24. In Years 1 to 3, Company S embarks on a strategy that is consistent with its agreement with Primair to develop the country Y market for R watches. In the process, Company S

incurs marketing expenses. Consistent with the contract, Company S is reimbursed by Primair for the marketing expenses it incurs, and is paid a mark-up on those expenses. By the end of Year 2, the R trademark and trade name have become well established in country Y. The compensation derived by Company S for the marketing activities it performed on behalf of Primair is determined to be arm's length, based upon comparison to that paid to independent advertising and marketing agents identified and determined to be comparable as part of the comparability analysis.

25. Under these circumstances, Primair is entitled to retain any income derived from exploiting the R trademark and trade name in the country Y market that exceeds the arm's length compensation to Company S for its functions and no transfer pricing adjustment is warranted under the circumstances.

Example 9

26. The facts in this example are the same as in Example 8, except as follows:

- Under the contract between Primair and Company S, Company S is now obligated to develop and execute the marketing plan for country Y without detailed control of specific elements of the plan by Primair. Company S bears the costs and assumes certain of the risks associated with the marketing activities. The agreement between Primair and Company S does not specify the amount of marketing expenditure Company S is expected to incur, only that Company S is required to use its best efforts to market the watches. Company S receives no direct reimbursement from Primair in respect of any expenditure it incurs, nor does it receive any other indirect or implied compensation from Primair, and Company S expects to earn its reward solely from its profit from the sale of R brand watches to third party customers in the country Y market. A thorough functional analysis reveals that Primair exercises a lower level of control over the marketing activities of Company S than in Example 8 in that it does not review and approve the marketing budget or design details of the marketing plan. Company S bears different risks and is compensated differently than was the case in Example 8. The contractual arrangements between Primair and Company S are different and the risks assumed by Company S are greater in Example 9 than in Example 8. Company S does not receive direct cost reimbursements or a separate fee for marketing activities. The only controlled transaction between Primair and Company S in Example 9 is the transfer of the branded watches. As a result, Company S can obtain its reward for its marketing activities only through selling R brand watches to third party customers.
- As a result of these differences, Primair and Company S adopt a lower price for watches in Example 9 than the price for watches determined for purposes of Example 8. As a result of the differences identified in the functional analysis, different criteria are used for identifying comparables and for making comparability adjustments than was the case in Example 8. This results in Company S having a greater anticipated total profit in Example 9 than in Example 8 because of its higher level of risk and its more extensive functions.

27. Assume that in Years 1 through 3, Company S embarks on a strategy that is consistent with its agreement with Primair and, in the process, performs marketing functions and incurs marketing expenses. As a result, Company S has high operating expenditures and slim margins in Years 1 through 3. By the end of Year 2, the R trademark and trade name have become established in country Y because of Company S's efforts. Where the marketer/distributor actually bears the costs and associated risks of its marketing activities, the issue

is the extent to which the marketer/distributor can share in the potential benefits from those activities. Assume that the enquiries of the country Y tax administrations conclude, based on a review of comparable distributors, that Company S would have been expected to have performed the functions it performed and incurred its actual level of marketing expense if it were independent from Primair.

28. Given that Company S performs the functions and bears the costs and associated risks of its marketing activities under a long-term contract of exclusive distribution rights for the R watches, there is an opportunity for Company S to benefit (or suffer a loss) from the marketing and distribution activities it undertakes. Based on an analysis of reasonably reliable comparable data, it is concluded that, for purposes of this example, the benefits obtained by Company S result in profits similar to those made by independent marketers and distributors bearing the same types of risks and costs as Company S in the first few years of comparable long-term marketing and distribution agreements for similarly unknown products.

29. Based on the foregoing assumptions, Company S's return is arm's length and its marketing activities, including its marketing expenses, are not significantly different than those performed by independent marketers and distributors in comparable uncontrolled transactions. The information on comparable uncontrolled arrangements provides the best measure of the arm's length return earned by Company S for the contribution to intangible value provided by its functions, risks, and costs. That return therefore reflects arm's length compensation for Company S's contributions and accurately measures its share of the income derived from exploitation of the trademark and trade name in country Y. No separate or additional compensation is required to be provided to Company S.

Example 10

30. The facts in this example are the same as in Example 9, except that the market development functions undertaken by Company S in this Example 10 are far more extensive than those undertaken by Company S in Example 9.

31. Where the marketer/distributor actually bears the costs and assumes the risks of its marketing activities, the issue is the extent to which the marketer/distributor can share in the potential benefits from those activities. A thorough comparability analysis identifies several uncontrolled companies engaged in marketing and distribution functions under similar long-term marketing and distribution arrangements. Assume, however, that the level of marketing expense Company S incurred in Years 1 through 5 far exceeds that incurred by the identified comparable independent marketers and distributors. Assume further that the high level of expense incurred by Company S reflects its performance of additional or more intensive functions than those performed by the potential comparables and that Primair and Company S expect those additional functions to generate higher margins or increased sales volume for the products. Given the extent of the market development activities undertaken by Company S, it is evident that Company S has made a larger functional contribution to development of the market and the marketing intangibles and has assumed significantly greater costs and assumed greater risks than the identified potentially comparable independent enterprises (and substantially higher costs and risks than in Example 9). There is also evidence to support the conclusion that the profits realised by Company S are significantly lower than the profit margins of the identified potentially comparable independent marketers and distributors during the corresponding years of similar long-term marketing and distribution agreements.

32. As in Example 9, Company S bears the costs and associated risks of its marketing activities under a long-term contract of exclusive marketing and distribution rights for the R watches, and therefore expects to have an opportunity to benefit (or suffer a loss) from the marketing and distribution activities it undertakes. However, in this case Company S has performed functions and borne marketing expenditures beyond what independent enterprises in potentially comparable transactions with similar rights incur for their own benefit, resulting in significantly lower profit margins for Company S than are made by such enterprises.

33. Based on these facts, it is evident that by performing functions and incurring marketing expenditure substantially in excess of the levels of function and expenditure of independent marketer/distributors in comparable transactions, Company S has not been adequately compensated by the margins it earns on the resale of R watches. Under such circumstances it would be appropriate for the country Y tax administration to propose a transfer pricing adjustment based on compensating Company S for the marketing activities performed (taking account of the risks assumed and the expenditure incurred) on a basis that is consistent with what independent enterprises would have earned in comparable transactions. Depending on the facts and circumstances reflected in a detailed comparability analysis, such an adjustment could be based on:

- Reducing the price paid by Company S for the R brand watches purchased from Primair. Such an adjustment could be based on applying a resale price method or transactional net margin method using available data about profits made by comparable marketers and distributors with a comparable level of marketing and distribution expenditure if such comparables can be identified.
- An alternative approach might apply a residual profit split method that would split the combined profits from sales of R branded watches in country Y by first giving Company S and Primair a basic return for the functions they perform and then splitting the residual profit on a basis that takes into account the relative contributions of both Company S and Primair to the generation of income and the value of the R trademark and trade name.
- Directly compensating Company S for the excess marketing expenditure it has incurred over and above that incurred by comparable independent enterprises including an appropriate profit element for the functions and risks reflected by those expenditures.

34. In this example, the proposed adjustment is based on Company S's having performed functions, assumed risks, and incurred costs that contributed to the development of the marketing intangibles for which it was not adequately compensated under its arrangement with Primair. If the arrangements between Company S and Primair were such that Company S could expect to obtain an arm's length return on its additional investment during the remaining term of the distribution agreement, a different outcome could be appropriate.

Example 11

35. The facts in this example are the same as in Example 9, except that Company S now enters into a three-year royalty-free agreement to market and distribute the watches in the country Y market, with no option to renew. At the end of the three-year period, Company S does not enter into a new contract with Primair.

36. Assume that it is demonstrated that independent enterprises do enter into short-term distribution agreements where they incur marketing and distribution expenses, but only

where they stand to earn a reward commensurate with the functions performed, the assets used, and the risks assumed within the time period of the contract. Evidence derived from comparable independent enterprises shows that they do not invest large sums of money in developing marketing and distribution infrastructure where they obtain only a short-term marketing and distribution agreement, with the attendant risk of non-renewal without compensation. The potential short-term nature of the marketing and distribution agreement is such that Company S could not, or may not be able to, benefit from the marketing and distribution expenditure it incurs at its own risk. The same factors mean that Company S's efforts may well benefit Primair in the future.

37. The risks assumed by Company S are substantially higher than in Example 9 and Company S has not been compensated on an arm's length basis for bearing these additional risks. In this case, Company S has undertaken market development activities and borne marketing expenditures beyond what comparable independent enterprises with similar rights incur for their own benefit, resulting in significantly lower profit margins for Company S than are made by comparable enterprises. The short term nature of the contract makes it unreasonable to expect that Company S has the opportunity of obtaining appropriate benefits under the contract within the limited term of the agreement with Primair. Under these circumstances, Company S is entitled to compensation for its at risk contribution to the value of the R trademark and trade name during the term of its arrangement with Primair.

38. Such compensation could take the form of direct compensation from Primair to Company S for the anticipated value created through the marketing expenditures and market development functions it has undertaken. Alternatively, such an adjustment could take the form of a reduction in the price paid by Company S to Primair for R watches during Years 1 through 3.

Example 12

39. The facts in this example are the same as in Example 9 with the following additions:

- By the end of Year 3, the R brand is successfully established in the country Y market and Primair and Company S renegotiate their earlier agreement and enter into a new long-term licensing agreement. The new agreement, which is to commence at the beginning of Year 4, is for five years with Company S having an option for a further five years. Under this agreement, Company S agrees to pay a royalty to Primair based on the gross sales of all watches bearing the R trademark. In all other respects, the new agreement has the same terms and conditions as in the previous arrangement between the parties. There is no adjustment made to the price payable by Company S for the branded watches as a result of the introduction of the royalty.
- Company S's sales of R brand watches in Years 4 and 5 are consistent with earlier budget forecasts. However, the introduction of the royalty from the beginning of year 4 results in Company S's profit margins declining substantially.

40. Assume that there is no evidence that independent marketers/distributors of similar branded products have agreed to pay royalties under similar arrangements. Company S's level of marketing expenditure and activity, from Year 4 on, is consistent with that of independent enterprises.

41. For transfer pricing purposes, it would not generally be expected that a royalty would be paid in arm's length transactions where a marketing and distribution entity obtains no rights for transfer pricing purposes in trademarks and similar intangibles

other than the right to use such intangibles in distributing a branded product supplied by the entity entitled to the income derived from exploiting such intangibles. Furthermore, the royalty causes Company S's profit margins to be consistently lower than those of independent enterprises with comparable functions performed, assets used and risks assumed during the corresponding years of similar long-term marketing and distribution arrangements. Accordingly, a transfer pricing adjustment disallowing the royalties paid would be appropriate based on the facts of this example.

Example 13

42. The facts in this example are the same as those set out in Example 10 with the following additions:

- At the end of Year 3, Primair stops manufacturing watches and contracts with a third party to manufacture them on its behalf. As a result, Company S will import unbranded watches directly from the manufacturer and undertake secondary processing to apply the R name and logo and package the watches before sale to the final customer. It will then sell and distribute the watches in the manner described in Example 10.
- As a consequence, at the beginning of Year 4, Primair and Company S renegotiate their earlier agreement and enter into a new long term licensing agreement. The new agreement, to start at the beginning of Year 4, is for five years, with Company S having an option for a further five years.
- Under the new agreement, Company S is granted the exclusive right within country Y to process, market and distribute watches bearing the R trademark in consideration for its agreement to pay a royalty to Primair based on the gross sales of all such watches. Company S receives no compensation from Primair in respect of the renegotiation of the original marketing and distribution agreement. It is assumed for purposes of this example that the purchase price Company S pays for the watches from the beginning of Year 4 is arm's length and that no consideration with respect to the R name is embedded in that price.

43. In connection with a tax audit conducted by country Y tax administrations in Year 6, it is determined, based on a proper functional analysis, that the level of marketing expenses Company S incurred during Years 1 through 3 far exceeded those incurred by independent marketers and distributors with similar long term marketing and distribution agreements. It is also determined that the level and intensity of marketing activity undertaken by Company S exceeded that of independent marketers and distributors, and that the relatively greater activity has been successful in expanding volumes and/or increasing the Primair group's overall margins from sales in country Y. Given the extent of the market development activities undertaken by Company S, including its strategic control over such activities, it is evident from the comparability and functional analysis that Company S has assumed significantly greater costs and assumed greater risks than comparable independent enterprises. There is also evidence that the individual entity profit margins realised by Company S are significantly lower than the profit margins of comparable independent marketers and distributors during the corresponding years of similar long-term marketing and distribution arrangements.

44. The country Y audit also identifies that in Years 4 and 5, Company S bears the costs and associated risks of its marketing activities under the new long-term licensing arrangement with Primair, and because of the long-term nature of the agreement,

Company S may have an opportunity to benefit (or suffer a loss) from its activities. However, Company S has undertaken market development activities and incurred marketing expenditure far beyond what comparable independent licensees with similar long-term licensing agreements undertake and incur for their own benefit, resulting in significantly lower anticipated profit margins for Company S than those of comparable enterprises.

45. Based on these facts, Company S should be compensated with an additional return for the market development functions it performs, the assets it uses and the risks it assumes. For Years 1 through 3, the possible bases for such an adjustment would be as described in Example 10. For Years 4 and 5 the bases for an adjustment would be similar, except that the adjustment could reduce the royalty payments from Company S to Primair, rather than the purchase price of the watches. Depending on the facts and circumstances, consideration could also be given to whether Company S should have received compensation in connection with the renegotiation of the arrangement at the end of Year 3 in accordance with the guidance in Part II of Chapter IX.

Example 14

46. Shuyona is the parent company of an MNE group. Shuyona is organised in and operates in country X. The Shuyona group is involved in the production and sale of consumer goods. In order to maintain and, if possible, improve its market position, ongoing research is carried out by the Shuyona group to improve existing products and develop new products. The Shuyona group maintains two R&D centres, one operated by Shuyona in country X and the other operated by Company S, a subsidiary of Shuyona operating in country Y. The Shuyona R&D centre is responsible for the overall research programme of Shuyona group. The Shuyona R&D centre designs research programmes, develops and controls budgets, makes decisions as to where R&D activities will be conducted, monitors the progress on all R&D projects and, in general, controls the R&D function for the MNE group, operating under strategic direction of Shuyona group senior management.

47. The Company S R&D centre operates on a separate project by project basis to carry out specific projects assigned by the Shuyona R&D centre. Suggestions of Company S R&D personnel for modifications to the research programme are required to be formally approved by the Shuyona R&D centre. The Company S R&D centre reports on its progress on at least a monthly basis to supervisory personnel at the Shuyona R&D centre. If Company S exceeds budgets established by Shuyona for its work, approval of Shuyona R&D management must be sought for further expenditures. Contracts between the Shuyona R&D centre and the Company S R&D centre specify that Shuyona will bear all risks and costs related to R&D undertaken by Company S. All patents, designs and other intangibles developed by Company S research personnel are registered by Shuyona, pursuant to contracts between the two companies. Shuyona pays Company S a service fee for its research and development activities.

48. The transfer pricing analysis of these facts would begin by recognising that Shuyona is the legal owner of the intangibles. Shuyona controls and manages both its own R&D work and that of Company S. It performs the important functions related to that work such as budgeting, establishing research programmes, designing projects and funding and controlling expenditures. Under these circumstances, Shuyona is entitled to returns derived from the exploitation of the intangibles developed through the R&D efforts of Company S. Company S is entitled to compensation for its functions performed, assets used, and risks assumed. In determining the amount of compensation due Company S, the relative

skill and efficiency of the Company S R&D personnel, the nature of the research being undertaken, and other factors contributing to value should be considered as comparability factors. To the extent transfer pricing adjustments are required to reflect the amount a comparable R&D service provider would be paid for its services, such adjustments would generally relate to the year the service is provided and would not affect the entitlement of Shuyona to future returns derived from exploiting intangibles derived from the Company S R&D activities.

Example 15

49. Shuyona is the parent company of an MNE group. Shuyona is organised in and operates exclusively in country X. The Shuyona group is involved in the production and sale of consumer goods. In order to maintain and, if possible, improve its market position, ongoing research is carried out by the Shuyona group to improve existing products and develop new products. The Shuyona group maintains two R&D centres, one operated by Shuyona in country X, and the other operated by Company S, a subsidiary of Shuyona, operating in country Y.

50. The Shuyona group sells two lines of products. All R&D with respect to product line A is conducted by Shuyona. All R&D with respect to product line B is conducted by the R&D centre operated by Company S. Company S also functions as the regional headquarters of the Shuyona group in North America and has global responsibility for the operation of the business relating to product line B. However, all patents developed through Company S research efforts are registered by Shuyona. Shuyona makes no or only a nominal payment to Company S in relation to the patentable inventions developed by the Company S R&D centre.

51. The Shuyona and Company S R&D centres operate autonomously. Each bears its own operating costs. Under the general policy direction of Shuyona senior management, the Company S R&D centre develops its own research programmes, establishes its own budgets, makes determinations as to when R&D projects should be terminated or modified, and hires its own R&D staff. The Company S R&D centre reports to the product line B management team in Company S, and does not report to the Shuyona R&D centre. Joint meetings between the Shuyona and Company S R&D teams are sometimes held to discuss research methods and common issues.

52. The transfer pricing analysis of this fact pattern would begin by recognising that Shuyona is the legal owner/registrant of intangibles developed by Company S. Unlike the situation in Example 14, however, Shuyona neither performs nor exercises control over the research functions carried out by Company S, including the important functions related to management, design, budgeting and funding that research. Accordingly, Shuyona's legal ownership of the intangibles does not entitle it to retain or be attributed any income related to the product line B intangibles. Tax administrations could arrive at an appropriate transfer pricing outcome by recognising Shuyona's legal ownership of the intangibles but by noting that, because of the contributions of Company S in the form of functions, assets, and risks, appropriate compensation to Company S for its contributions could be ensured by confirming that Company S should make no royalty or other payment to Shuyona for the right to use any successfully developed Company S intangibles, so that the future income derived from the exploitation of those intangibles by Company S would be allocated to Company S and not to Shuyona.

53. If Shuyona exploits the product line B intangibles by itself, Shuyona should provide appropriate compensation to Company S for its functions performed, assets used and

risks assumed related to intangible development. In determining the appropriate level of compensation for Company S, the fact that Company S performs all of the important functions related to intangible development would likely make it inappropriate to treat Company S as the tested party in an R&D service arrangement.

Example 16

54. Shuyona is the parent company of an MNE group. Shuyona is organised in and operates exclusively in Country X. The Shuyona group is involved in the production and sale of consumer goods. In order to maintain and, if possible, improve its market position, ongoing research is carried out by the Shuyona group to improve existing products and develop new products. The Shuyona group maintains two R&D centres, one operated by Shuyona in country X, and the other operated by Company S, a subsidiary of Shuyona, operating in country Y. The relationships between the Shuyona R&D centre and the Company S R&D centre are as described in Example 14.

55. In Year 1, Shuyona sells all rights to patents and other technology related intangibles, including rights to use those intangibles in ongoing research, to a new subsidiary, Company T, organised in country Z. Company T establishes a manufacturing facility in country Z and begins to supply products to members of the Shuyona group around the world. For purposes of this example, it is assumed that the compensation paid by Company T in exchange for the transferred patents and related intangibles is based on a valuation of anticipated future cash flows generated by the transferred intangibles at the time of the transfer.

56. At the same time as the transfer of patents and other technology related intangibles, Company T enters into a contract research agreement with Shuyona and a separate contract research agreement with Company S. Pursuant to these agreements, Company T contractually agrees to bear the financial risk associated with possible failure of future R&D projects, agrees to assume the cost of all future R&D activity, and agrees to pay Shuyona and Company S a service fee based on the cost of the R&D activities undertaken plus a mark-up equivalent to the profit mark-up over cost earned by certain identified independent companies engaged in providing research services.

57. Company T has no technical personnel capable of conducting or supervising the research activities. Shuyona continues to develop and design the R&D programme related to further development of the transferred intangibles, to establish its own R&D budgets, to determine its own levels of R&D staffing, and to make decisions regarding whether to pursue or terminate particular R&D projects. Moreover, Shuyona continues to supervise and control the R&D activities in Company S in the manner described in Example 14.

58. The transfer pricing analysis begins by identifying the commercial or financial relations between the parties and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated under the principles of Chapter I, Section D.1. Key assumptions in this example are that Company T functions as a manufacturer and performs no activities in relation to the acquisition, development or exploitation of the intangibles and does not control risks in relation to the acquisition of the intangibles or to their further development. Instead, all development activities and risk management functions relating to the intangibles are performed by Shuyona and Company S, with Shuyona controlling the risk. A thorough examination of the transaction indicates that it should accurately be delineated as the provision of financing by Company T equating to the costs of the acquired intangibles and the ongoing development. A key assumption in this example is that, although Company T contractually assumes the financial risk and has the financial capacity to assume that risk,

it does not exercise control over that risk in accordance with the principles outlined in paragraphs 6.63 and 6.64. As a result, in addition to its manufacturing reward, Company T is entitled to no more than a risk-free return for its funding activities. (For further guidance see Section D.1 of Chapter I, and in particular paragraph 1.103.)

Example 17

59. Company A is a fully integrated pharmaceutical company engaged in the discovery, development, production and sale of pharmaceutical preparations. Company A conducts its operations in country X. In conducting its research activities, Company A regularly retains independent Contract Research Organisations (CROs) to perform various R&D activities, including designing and conducting clinical trials with regard to products under development by Company A. However, such CROs do not engage in the blue sky research required to identify new pharmaceutical compounds. Where Company A does retain a CRO to engage in clinical research activities, research personnel at Company A actively participate in designing the CRO's research studies, provide to the CRO results and information derived from earlier research, establish budgets and timelines for CRO projects, and conduct ongoing quality control with respect to the CRO's activities. In such arrangements, CROs are paid a negotiated fee for services and do not have an ongoing interest in the profits derived from sales of products developed through their research.

60. Company A transfers patents and related intangibles related to Product M, an early stage pharmaceutical preparation believed to have potential as a treatment for Alzheimer's disease to Company S, a subsidiary of Company A operating in country Y (the transaction relates strictly to the existing intangibles and does not include compensation for future R&D services of Company A). It is assumed for purposes of this example that the payment of Company S for the transfer of intangibles related to Product M is based on a valuation of anticipated future cash flows. Company S has no technical personnel capable of designing, conducting or supervising required ongoing research activities related to Product M. Company S therefore contracts with Company A to carry on the research programme related to Product M in the same manner as before the transfer of intangibles to Company S. Company S agrees to fund all of the ongoing Product M research, assume the financial risk of potential failure of such research, and to pay for Company A's services based on the cost plus margins earned by CROs like those with which Company A regularly transacts.

61. The transfer pricing analysis of these facts begins by recognising that, following the transfer, Company S is the legal owner of the Product M intangibles under relevant contracts and registrations. However, Company A continues to perform and control functions and to manage risks related to the intangibles owned by Company S, including the important functions described in paragraph 6.56, and is entitled to compensation for those contributions. Under these circumstances, Company A's transactions with CROs are not comparable to the arrangements between Company S and Company A related to Product M and may not be used as a benchmark for the arm's length compensation required to be provided to Company A for its ongoing R&D activity with respect to the Product M intangibles. Company S does not perform or control the same functions or control the same risks in its transactions with Company A, as does Company A in its transactions with the CROs.

62. While Company S is the legal owner of the intangibles, it should not be entitled to all of the returns derived from the exploitation of the intangibles. Because Company S lacks the capability to control research related risks, Company A should be treated as bearing a substantial portion of the relevant risk and Company A should also be compensated for

its functions, including the important functions described in paragraph 6.56. Company A should be entitled to larger returns than the CROs under these circumstances.

63. A thorough examination of the transaction in this example may show that it should accurately be delineated as the provision of financing by Company S equating to the costs of the acquired intangibles and the ongoing development. As a result, Company S is entitled to only a financing return. The level of the financing return depends on the exercising of control over the financing risk in accordance with the guidance in Section D.1 of Chapter I and the principles outlined in paragraphs 6.63 and 6.64. Company A would be entitled to retain the remaining income or losses.

Example 18

64. Primarni is organised in and conducts business in country A. Company S is an associated enterprise of Primarni. Company S is organised in and does business in country B. Primarni develops a patented invention and manufacturing know-how related to Product X. It obtains valid patents in all countries relevant to this example. Primarni and Company S enter into a written licence agreement pursuant to which Primarni grants Company S the right to use the Product X patents and know-how to manufacture and sell Product X in country B, while Primarni retains the patent and know-how rights to Product X throughout Asia, Africa, and in country A.

65. Assume Company S uses the patents and know-how to manufacture Product X in country B. It sells Product X to both independent and associated customers in country B. Additionally, it sells Product X to associated distribution entities based throughout Asia and Africa. The distribution entities resell the units of Product X to customers throughout Asia and Africa. Primarni does not exercise its retained patent rights for Asia and Africa to prevent the sale of Product X by Company S to the distribution entities operating in Asia and Africa.

66. Under these circumstances, the conduct of the parties suggests that the transaction between Primarni and Company S is actually a licence of the Product X patents and know-how for country B, plus Asia and Africa. In a transfer pricing analysis of the transactions between Company S and Primarni, Company S's licence should be treated as extending to Asia and Africa, and should not be limited to country B, based on the conduct of the parties. The royalty rate should be recalculated to take into account the total projected sales by Company S in all territories including those to the Asian and African entities.

Example 19

67. Company P, a resident of country A conducts a retailing business, operating several department stores in country A. Over the years, Company P has developed special know-how and a unique marketing concept for the operation of its department stores. It is assumed that the know-how and unique marketing concept constitute intangibles within the meaning of Section A of Chapter VI. After years of successfully conducting business in country A, Company P establishes a new subsidiary, Company S, in country B. Company S opens and operates new department stores in country B, obtaining profit margins substantially higher than those of otherwise comparable retailers in country B.

68. A detailed functional analysis reveals that Company S uses in its operations in country B, the same know-how and unique marketing concept as the ones used by Company P in its operations in country A. Under these circumstances, the conduct of the parties reveals that a transaction has taken place consisting in the transfer from Company P

to Company S of the right to use the know-how and unique marketing concept. Under comparable circumstances, independent parties would have concluded a license agreement granting Company S the right to use in country B, the know-how and unique marketing concept developed by Company P. Accordingly, one possible remedy available to the tax administration is a transfer pricing adjustment imputing a royalty payment from Company S to Company P for the use of these intangibles.

Example 20

69. Ilcha is organised in country A. The Ilcha group of companies has for many years manufactured and sold Product Q in countries B and C through a wholly owned subsidiary, Company S1, which is organised in country B. Ilcha owns patents related to the design of Product Q and has developed a unique trademark and other marketing intangibles. The patents and trademarks are registered by Ilcha in countries B and C.

70. For sound business reasons, Ilcha determines that the group's business in countries B and C would be enhanced if those businesses were operated through separate subsidiaries in each country. Ilcha therefore organises in country C a wholly owned subsidiary, Company S2. With regard to the business in country C:

- Company S1 transfers to Company S2 the tangible manufacturing and marketing assets previously used by Company S1 in country C.
- Ilcha and Company S1 agree to terminate the agreement granting Company S1 the following rights with relation to Product Q: the right to manufacture and distribute Product Q in country C; the right to use the patents and trademark in carrying out its manufacturing and distribution activities in country C; and, the right to use customer relationships, customer lists, goodwill and other items in country C (hereinafter, “the Rights”).
- Ilcha enters into new, long-term licence agreements with Company S2 granting it the Rights in country C.

The newly formed subsidiary thereafter conducts the Product Q business in country C, while Company S1 continues to conduct the Product Q business in Country B.

71. Assume that over the years of its operation, Company S1 developed substantial business value in country C and an independent enterprise would be willing to pay for that business value in an acquisition. Further assume that, for accounting and business valuation purposes, a portion of such business value would be treated as goodwill in a purchase price allocation conducted with regard to a sale of Company S1's country C business to an independent party.

72. Under the facts and circumstances of the case, there is value being transferred to Company S2 through the combination of (i) the transfer of part of Company S1's tangible business assets to Company S2 in country C, and (ii) the surrendering by Company S1 of the Rights and the subsequent granting of the Rights by Ilcha to Company S2. There are three separate transactions:

- the transfer of part of Company S1's tangible business assets to Company S2 in country C;
- the surrendering by Company S1 of its rights under the licence back to Ilcha; and
- the subsequent granting of a licence by Ilcha to Company S2.

For transfer pricing purposes, the prices paid by Ilcha and by Company S2 in connection with these transactions should reflect the value of the business which would include amounts that may be treated as the value of goodwill for accounting purposes.

Example 21

73. Första is a consumer goods company organised and operating in country A. Prior to Year 1, Första produces Product Y in country A and sells it through affiliated distribution companies in many countries around the world. Product Y is well recognised and attracts a premium compared to its competitors, to which Första is entitled as the legal owner and developer of the trademark and related goodwill giving rise to that premium.

74. In Year 2, Första organises Company S, a wholly owned subsidiary, in country B. Company S acts as a super distributor and invoicing centre. Första continues to ship Product Y directly to its distribution affiliates, but title to the products passes to Company S, which reinvoices the distribution affiliates for the products.

75. Beginning in Year 2, Company S undertakes to reimburse the distribution affiliates for a portion of their advertising costs. Prices for Product Y from Company S to the distribution affiliates are adjusted upward so that the distribution affiliate operating profit margins remain constant notwithstanding the shift of advertising cost to Company S. Assume that the operating profit margins earned by the distribution affiliates are arm's length both before and after Year 2 given the concurrent changes in product pricing and the reimbursement of advertising costs. Company S performs no functions with regard to advertising nor does it control any risk related to marketing the products.

76. In Year 3, the prices charged by Första to Company S are reduced. Första and Company S claim such a reduction in price is justified because Company S is now entitled to income related to intangibles. It asserts that such income is attributable to intangibles in respect of Product Y created through the advertising costs it has borne.

77. In substance, Company S has no claim to income derived from the exploitation of intangibles with respect to Product Y. It performs no functions, assumes no risk, and in substance bears no costs related to the development, enhancement, maintenance or protection of intangibles. Transfer pricing adjustments to increase the income of Första in Year 3 and thereafter would be appropriate.

Example 22

78. Company A owns a government licence for a mining activity and a government licence for the exploitation of a railway. The mining licence has a standalone market value of 20. The railway licence has a standalone market value of 10. Company A has no other net assets.

79. Birincil, an entity which is independent of Company A, acquires 100% of the equity interests in Company A for 100. Birincil's purchase price allocation performed for accounting purposes with respect to the acquisition attributes 20 of the purchase price to the mining licence; 10 to the railway licence; and 70 to goodwill based on the synergies created between the mining and railway licences.

80. Immediately following the acquisition, Birincil causes Company A to transfer its mining and railway licences to Company S, a subsidiary of Birincil.

81. In conducting a transfer pricing analysis of the arm's length price to be paid by Company S for the transaction with Company A, it is important to identify with specificity the intangibles transferred. As was the case with Birincil's arm's length acquisition of Company A, the goodwill associated with the licences transferred to Company S would need to be considered, as it should generally be assumed that value does not disappear, nor is it destroyed as part of an internal business restructuring.

82. As such, the arm's length price for the transaction between Companies A and S should take account of the mining licence, the railway licence, and the value ascribed to goodwill for accounting purposes. The 100 paid by Birincil for the shares of Company A represents an arm's length price for those shares and provides useful information regarding the combined value of the intangibles.

Example 23

83. Birincil acquires 100% of the equity interests in an independent enterprise, Company T for 100. Company T is a company that engages in research and development and has partially developed several promising technologies but has only minimal sales. The purchase price is justified primarily by the value of the promising, but only partly developed, technologies and by the potential of Company T personnel to develop further new technologies in the future. Birincil's purchase price allocation performed for accounting purposes with respect to the acquisition attributes 20 of the purchase price to tangible property and identified intangibles, including patents, and 80 to goodwill.

84. Immediately following the acquisition, Birincil causes Company T to transfer all of its rights in developed and partially developed technologies, including patents, trade secrets and technical know-how to Company S, a subsidiary of Birincil. Company S simultaneously enters into a contract research agreement with Company T, pursuant to which the Company T workforce will continue to work exclusively on the development of the transferred technologies and on the development of new technologies on behalf of Company S. The agreement provides that Company T will be compensated for its research services by payments equal to its cost plus a mark-up, and that all rights to intangibles developed or enhanced under the research agreement will belong to Company S. As a result, Company S will fund all future research and will assume the financial risk that some or all of the future research will not lead to the development of commercially viable products. Company S has a large research staff, including management personnel responsible for technologies of the type acquired from Company T. Following the transactions in question, the Company S research and management personnel assume full management responsibility for the direction and control of the work of the Company T research staff. Company S approves new projects, develops and plans budgets and in other respects controls the ongoing research work carried on at Company T. All company T research personnel will continue to be employees of Company T and will be devoted exclusively to providing services under the research agreement with Company S.

85. In conducting a transfer pricing analysis of the arm's length price to be paid by Company S for intangibles transferred by Company T, and of the price to be paid for ongoing R&D services to be provided by Company T, it is important to identify the specific intangibles transferred to Company S and those retained by Company T. The definitions and valuations of intangibles contained in the purchase price allocation are not determinative for transfer pricing purposes. The 100 paid by Birincil for the shares of Company T represents an arm's length price for shares of the company and provides useful information regarding the value of the business of Company T. The full value of that business should be

reflected either in the value of the tangible and intangible assets transferred to Company S or in the value of the tangible and intangible assets and workforce retained by Company T. Depending on the facts, a substantial portion of the value described in the purchase price allocation as goodwill of Company T may have been transferred to Company S together with the other Company T intangibles. Depending on the facts, some portion of the value described in the purchase price allocation as goodwill may also have been retained by Company T. Under arm's length transfer pricing principles, Company T should be entitled to compensation for such value, either as part of the price paid by Company S for the transferred rights to technology intangibles, or through the compensation Company T is paid in years following the transaction for the R&D services of its workforce. It should generally be assumed that value does not disappear, nor is it destroyed, as part of an internal business restructuring. If the transfer of intangibles to Company S had been separated in time from the acquisition, a separate inquiry would be required regarding any intervening appreciation or depreciation in the value of the transferred intangibles.

Example 24

86. Zhu is a company engaged in software development consulting. In the past Zhu has developed software supporting ATM transactions for client Bank A. In the process of doing so, Zhu created and retained an interest in proprietary copyrighted software code that is potentially suitable for use by other similarly situated banking clients, albeit with some revision and customisation.

87. Assume that Company S, an associated enterprise of Zhu, enters into a separate agreement to develop software supporting ATM operations for another bank, Bank B. Zhu agrees to support its associated enterprise by providing employees who worked on the Bank A engagement to work on Company S's Bank B engagement. Those employees have access to software designs and know-how developed in the Bank A engagement, including proprietary software code. That code and the services of the Zhu employees are utilised by Company S in executing its Bank B engagement. Ultimately, Bank B is provided by Company S with a software system for managing its ATM network, including the necessary licence to utilise the software developed in the project. Portions of the proprietary code developed by Zhu in its Bank A engagement are embedded in the software provided by Company S to Bank B. The code developed in the Bank A engagement and embedded in the Bank B software would be sufficiently extensive to justify a claim of copyright infringement if copied on an unauthorised basis by a third party.

88. A transfer pricing analysis of these transactions should recognise that Company S received two benefits from Zhu which require compensation. First, it received services from the Zhu employees that were made available to work on the Bank B engagement. Second, it received rights in Zhu's proprietary software which was utilised as the foundation for the software system delivered to Bank B. The compensation to be paid by Company S to Zhu should include compensation for both the services and the rights in the software.

Example 25

89. Prathamika is the parent company of an MNE group. Prathamika has been engaged in several large litigation matters and its internal legal department has become adept at managing large scale litigation on behalf of Prathamika. In the course of working on such litigation, Prathamika has developed proprietary document management software tools unique to its industry.

90. Company S is an associated enterprise of Prathamika. Company S becomes involved in a complex litigation similar to those with which the legal department of Prathamika has experience. Prathamika agrees to make two individuals from its legal team available to Company S to work on the Company S litigation. The individuals from Prathamika assume responsibility for managing documents related to the litigation. In undertaking this responsibility they make use of the document management software of Prathamika. They do not, however, provide Company S the right to use the document management software in other litigation matters or to make it available to Company S customers.

91. Under these circumstances, it would not be appropriate to treat Prathamika as having transferred rights in intangibles to Company S as part of the service arrangement. However, the fact that the Prathamika employees had experience and available software tools that allowed them to more effectively and efficiently perform their services should be considered in a comparability analysis related to the amount of any service fee to be charged for the services of the Prathamika employees.

Example 26

92. Osnovni is the parent company of an MNE Group engaged in the development and sale of software products. Osnovni acquires 100% of the equity interests in Company S, a publicly traded company organised in the same country as Osnovni, for a price equal to 160. At the time of the acquisition, Company S shares had an aggregate trading value of 100. Competitive bidders for the Company S business offered amounts ranging from 120 to 130 for Company S.

93. Company S had only a nominal amount of fixed assets at the time of the acquisition. Its value consisted primarily of rights in developed and partially developed intangibles related to software products and its skilled workforce. The purchase price allocation performed for accounting purposes by Osnovni allocated 10 to tangible assets, 60 to intangibles, and 90 to goodwill. Osnovni justified the 160 purchase price in presentations to its Board of Directors by reference to the complementary nature of the existing products of the Osnovni group and the products and potential products of Company S.

94. Company T is a wholly owned subsidiary of Osnovni. Osnovni has traditionally licensed exclusive rights in all of its intangibles related to the European and Asian markets to Company T. For purposes of this example it is assumed that all arrangements related to the historic licences of European and Asian rights to Company T prior to the acquisition of Company S are arm's length.

95. Immediately following the acquisition of Company S, Osnovni liquidates Company S, and thereafter grants an exclusive and perpetual licence to Company T for intangible rights related to the Company S products in European and Asian markets.

96. In determining an arm's length price for the Company S intangibles licensed to Company T under the foregoing arrangements, the premium over the original trading value of the Company S shares included in the acquisition price should be considered. To the extent that premium reflects the complementary nature of Osnovni group products with the acquired products in the European and Asian markets licensed to Company T, Company T should pay an amount for the transferred Company S intangibles and rights in intangibles that reflects an appropriate share of the purchase price premium. To the extent the purchase price premium is attributable exclusively to product complementarities outside of Company T's markets, the purchase price premium should not be taken into account in determining the arm's length price paid by Company T for Company S intangibles related

to Company T's geographic market. The value attributed to intangibles in the purchase price allocation performed for accounting purposes is not determinative for transfer pricing purposes.

Example 27

97. Company A is the Parent of an MNE group with operations in country X. Company A owns patents, trademarks and know-how with regard to several products produced and sold by the MNE group. Company B is a wholly owned subsidiary of Company A. All of Company B's operations are conducted in country Y. Company B also owns patents, trademarks and know-how related to Product M.

98. For sound business reasons related to the coordination of the group's patent protection and anti-counterfeiting activities, the MNE group decides to centralise ownership of its patents in Company A. Accordingly, Company B sells the Product M patents to Company A for a lump-sum price. Company A assumes responsibility to perform all ongoing functions and it assumes all risks related to the Product M patents following the sale. Based on a detailed comparability and functional analysis, the MNE group concludes that it is not able to identify any comparable uncontrolled transactions that can be used to determine the arm's length price. Company A and Company B reasonably conclude that the application of valuation techniques represents the most appropriate transfer pricing method to use in determining whether the agreed price is consistent with arm's length dealings.

99. Valuation personnel apply a valuation method that directly values property and patents to arrive at an after-tax net present value for the Product M patent of 80. The analysis is based on royalty rates, discount rates and useful lives typical in the industry in which Product M competes. However, there are material differences between Product M and the relevant patent rights related to Product M, and those typical in the industry. The royalty arrangements used in the analysis would therefore not satisfy the comparability standards required for a CUP method analysis. The valuation seeks to make adjustments for these differences.

100. In conducting its analysis, Company A also conducts a discounted cash flow based analysis of the Product M business in its entirety. That analysis, based on valuation parameters typically used by Company A in evaluating potential acquisitions, suggests that the entire Product M business has a net present value of 100. The 20 difference between the 100 valuation of the entire Product M business and the 80 valuation of the patent on its own appears to be inadequate to reflect the net present value of routine functional returns for functions performed by Company B and to recognise any value for the trademarks and know-how retained by Company B. Under these circumstances further review of the reliability of the 80 value ascribed to the patent would be called for.

Example 28

101. Company A is the Parent company of an MNE group with operations in country S. Company B is a member of the MNE group with operations in country T, and Company C is also a member of the MNE group with operations in country U. For valid business reasons the MNE group decides to centralise all of its intangibles related to business conducted outside of country S in a single location. Accordingly, intangibles owned by Company B are sold to Company C for a lump sum, including patents, trademarks, know-how, and customer relationships. At the same time, Company C retains Company B to act as a contract manufacturer of products previously produced and sold by Company B

on a full-risk basis. Company C has the personnel and resources required to manage the acquired lines of business, including the further development of intangibles necessary to the Company B business.

102. The MNE group is unable to identify comparable uncontrolled transactions that can be used in a transfer pricing analysis of the arm's length price to be paid by Company C to Company B. Based on a detailed comparability and functional analysis, the MNE group concludes that the most appropriate transfer pricing method involves the application of valuation techniques to determine the value of the transferred intangibles. In conducting its valuation, the MNE group is unable to reliably segregate particular cash flows associated with all of the specific intangibles.

103. Under these circumstances, in determining the arm's length compensation to be paid by Company C for the intangibles sold by Company B, it may be appropriate to value the transferred intangibles in the aggregate rather than to attempt a valuation on an asset by asset basis. This would particularly be the case if there is a significant difference between the sum of the best available estimates of the value of individually identified intangibles and other assets when valued separately and the value of the business as a whole.

Example 29

104. Pervichnyi is the parent of an MNE group organised and doing business in country X. Prior to Year 1, Pervichnyi developed patents and trademarks related to Product F. It manufactured Product F in country X and supplied the product to distribution affiliates throughout the world. For purposes of this example assume the prices charged to distribution affiliates were consistently arm's length.

105. At the beginning of Year 1, Pervichnyi organises a wholly owned subsidiary, Company S, in country Y. In order to save costs, Pervichnyi transfers all of its production of Product F to Company S. At the time of the organisation of Company S, Pervichnyi sells the patents and trademarks related to Product F to Company S for a lump sum. Under these circumstances, Pervichnyi and Company S seek to identify an arm's length price for the transferred intangibles by utilising a discounted cash flow valuation technique.

106. According to this valuation analysis, Pervichnyi could have generated after tax residual cash flows (after rewarding all functional activities of other members of the MNE group on an arm's length basis) having a present value of 600 by continuing to manufacture Product F in Country X. The valuation from the buyer's perspective shows that Company S could generate after tax residual cash flows having a present value of 1 100 if it owned the intangibles and manufactured the product in country Y. The difference in the present value of Pervichnyi's after tax residual cash flow and the present value of Company S's after tax residual cash flow is attributable to several factors.

107. Another option open to Pervichnyi would be for Pervichnyi to retain ownership of the intangible, and to retain Company S or an alternative supplier to manufacture products on its behalf in country Y. In this scenario, Pervichnyi calculates it would be able to generate after tax cash flow with a present value of 875.

108. In defining arm's length compensation for the intangibles transferred by Pervichnyi to Company S, it is important to take into account the perspectives of both parties, the options realistically available to each of them, and the particular facts and circumstances of the case. Pervichnyi would certainly not sell the intangibles at a price that would yield an after tax residual cash flow with a present value lower than 600, the residual cash flow it could generate by retaining the intangible and continuing to operate in the manner it

had done historically. Moreover there is no reason to believe Pervichnyi would sell the intangible for a price that would yield an after tax residual cash flow with a present value lower than 875. If Pervichnyi could capture the production cost savings by retaining another entity to manufacture on its behalf in a low cost environment, one realistically available option open to it would be to establish such a contract manufacturing operation. That realistically available option should be taken into account in determining the selling price of the intangible.

109. Company S would not be expected to pay a price that would, after taking into account all relevant facts and circumstances, leave it with an after tax return lower than it could achieve by not engaging in the transaction. According to the discounted cash flow valuation, the net present value of the after tax residual cash flow it could generate using the intangible in its business would be 1 100. A price might be negotiated that would give Pervichnyi a return equal to or greater than its other available options, and give Company S a positive return on its investment considering all of the relevant facts, including the manner in which the transaction itself would be taxed.

110. A transfer pricing analysis utilising a discounted cash flow approach would have to consider how independent enterprises dealing at arm's length would take into account the cost savings and projected tax effects in setting a price for the intangibles. That price should, however, fall in the range between a price that would yield Pervichnyi after tax residual cash flow equivalent to that of its other options realistically available, and a price that would yield Company S a positive return to its investments and risks, considering the manner in which the transaction itself would be taxed.

111. The facts of this example and the foregoing analysis are obviously greatly oversimplified by comparison to the analysis that would be required in an actual transaction. The analysis nevertheless reflects the importance of considering all of the relevant facts and circumstances in performing a discounted cash flow analysis, evaluating the perspectives of each of the parties in such an analysis, and taking into consideration the options realistically available to each of the parties in performing the transfer pricing analysis.

LOW VALUE-ADDING INTRA-GROUP SERVICES

Revisions to Chapter VII of the Transfer Pricing Guidelines

Summary

Action 10 of the BEPS Action Plan instructs the G20 and OECD countries to develop transfer pricing rules to provide protection against common types of base eroding payments, such as management fees and head office expenses.

This chapter of the Report introduces an elective, simplified approach for low value-adding services. Besides that, it introduces some changes and clarifications to other paragraphs of Chapter VII of the Transfer Pricing Guidelines. Sections A to C and the changes to some of the paragraphs in these sections are included in this Report to provide context to the new Section D on low value-adding intra-group services of Chapter VII of the Transfer Pricing Guidelines.²²

Section D on low value-adding intra-group services provides guidance on achieving the necessary balance between appropriately allocating to MNE group members charges for intra-group services in accordance with the arm's length principle and the need to protect the tax base of payor countries. In particular this Report proposes an elective, simplified approach which:

- Specifies a wide category of common intra-group services which command a very limited profit mark-up on costs;
- Applies a consistent allocation key for all recipients for those intra-group services; and
- Provides greater transparency through specific reporting requirements including documentation showing the determination of the specific cost pool.

The approach aims to guarantee payor countries that the system through which the costs are allocated leads to an equal treatment for all associated enterprises that are operating in similar circumstances. Moreover, the approach aims to guarantee that no overpricing takes place due to general agreement on the categories of costs included in the cost base and general agreement on the moderate mark-up of 5% that should be charged. Finally, the transparency of the approach makes clear to payor countries whether intermediary companies, that may have no or low functionality and may aim to inflate the intra-group service charges, have been interposed.

The guidance provides that, because of the construction of the elective, simplified approach, the benefits test by the payor country is simplified and moderated. If the elective, simplified approach is applied, the assumption that businesses are only willing to incur costs if there is a business reason to do so and the assurance that the approach leads to an equal treatment of these costs for MNE group members in similar circumstances, replaces the detailed testing of the benefits received that is customary for other intra-group service charges. This approach allows tax administrations to free up resources for identifying and examining transfer pricing cases where the risk of encountering BEPS issues is more substantial.

Nevertheless, a number of countries have indicated that excessive charges for intra-group management services and head office expenses constitute one of their major BEPS challenges. In order to give comfort to these countries that the elective, simplified approach will not lead to base-eroding payments, the approach indicates that countries considering implementing the approach may do so in combination with the introduction of a threshold. If the payments for low-value adding intra-group services required under the approach exceed this threshold, then the tax administrations may perform a full transfer pricing analysis that would include requiring evidence demonstrating the detailed benefits received. In combination with the G20 Development Working Group mandate given to International Organisations on the development of toolkits which can be implemented by developing countries and which will protect these countries from base-eroding payments, the objective of this measure will assist developing countries in protecting their tax base from excessive intra-group service charges.

In order for the simplified approach as discussed in this chapter of the Report to be effective it must be adopted and applied on a geographic scale that is as broad as possible and it must be respected in both intra-group service provider and intra-group service recipient countries. Acknowledging the importance of both swift and broad introduction, the countries participating in the BEPS project have agreed to a two-step approach for implementation. The first step consists of a large group of countries enabling this elective mechanism by endorsing its applicability in their countries before 2018. The second step recognises that further analysis of the design of the threshold and other implementation issues of concern to some countries would be helpful in order to achieve even more widespread adoption of the simplified approach. Therefore, follow-up work on the design of the threshold and other implementation issues will be undertaken. This work will be finalised before the end of 2016 and will allow additional countries to join the group of countries already enabling the elective mechanism. As part of the follow up work on implementation, clarity will be provided about the countries joining the safe harbour approach to low value-adding intra-group services. Currently, the significant majority of the BEPS Associate Countries have indicated that they will enable the simplified approach as soon as the introduction of such an approach is feasible in their domestic situation. The other BEPS Associate Countries have indicated that they are considering the introduction of the approach, but that for them the final decision is dependent on the outcomes of the follow up work on implementation.

The current provisions of Chapter VII of the Transfer Pricing Guidelines are deleted in their entirety and replaced by the following language.

A. Introduction

7.1 This chapter discusses issues that arise in determining whether services have been provided by one member of an MNE group to other members of that group and, if so, in establishing arm's length pricing for those intra-group services. The chapter does not address except incidentally whether services have been provided in a cost contribution arrangement, nor, in such a case, the appropriate arm's length pricing. Cost contribution arrangements are the subject of Chapter VIII.

7.2 Nearly every MNE group must arrange for a wide scope of services to be available to its members, in particular administrative, technical, financial and commercial services. Such services may include management, coordination and control functions for the whole group. The cost of providing such services may be borne initially by the parent, by one or more specially designated group members ("a group service centre"), or other group members. An independent enterprise in need of a service may acquire the services from a service provider who specialises in that type of service or may perform the service for itself (i.e. in-house). In a similar way, a member of an MNE group in need of a service may acquire it from independent enterprises, or from one or more associated enterprises in the same MNE group (i.e. intra-group), or may perform the service for itself. Intra-group services often include those that are typically available externally from independent enterprises (such as legal and accounting services), in addition to those that are ordinarily performed internally (e.g. by an enterprise for itself, such as central auditing, financing advice, or training of personnel). It is not in the interests of an MNE group to incur costs unnecessarily, and it is in the interest of an MNE group to provide intra-group services efficiently. Application of the guidance in this chapter should ensure that services are appropriately identified and associated costs appropriately allocated within the MNE group in accordance with the arm's length principle.

7.3 Intra-group arrangements for rendering services are sometimes linked to arrangements for transferring goods or intangibles (or the licensing thereof). In some cases, such as know-how contracts containing a service element, it may be very difficult to determine where the exact border lies between the transfer of intangibles or rights in intangibles and the provision of services. Ancillary services are frequently associated with the transfer of technology. It may therefore be necessary to consider the principles for aggregation and segregation of transactions in Chapter III where a mixed transfer of services and property is involved.

7.4 Intra-group services may vary considerably among MNE groups, as does the extent to which those services provide a benefit, or an expected benefit, to one or more group members. Each case is dependent upon its own facts and circumstances and the arrangements within the group. For example, in a decentralised group, the parent company may limit its intra-group activity to monitoring its investments in its subsidiaries in its capacity as a shareholder. In contrast, in a centralised or integrated group, the board of directors and senior management of the parent company may make important decisions concerning the affairs of its subsidiaries, and the parent company may support the implementation of these decisions by performing general and administrative activities for its subsidiaries as well as operational activities such as treasury management, marketing, and supply chain management.

B. Main issues

7.5 There are two issues in the analysis of transfer pricing for intra-group services. One issue is whether intra-group services have in fact been provided. The other issue is what the intra-group charge for such services for tax purposes should be in accordance with the arm's length principle. Each of these issues is discussed below.

B.1. Determining whether intra-group services have been rendered

B.1.1. Benefits test

7.6 Under the arm's length principle, the question whether an intra-group service has been rendered when an activity is performed for one or more group members by another group member should depend on whether the activity provides a respective group member with economic or commercial value to enhance or maintain its business position. This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself. If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle.

7.7 The analysis described above quite clearly depends on the actual facts and circumstances, and it is not possible in the abstract to set forth categorically the activities that do or do not constitute the rendering of intra-group services. However, some guidance may be given to elucidate how the analysis would be applied for some common types of services undertaken in MNE groups.

7.8 Some intra-group services are performed by one member of an MNE group to meet an identified need of one or more specific members of the group. In such a case, it is relatively straightforward to determine whether a service has been provided. Ordinarily an independent enterprise in comparable circumstances would have satisfied the identified need either by performing the activity in-house or by having the activity performed by a third party. Thus, in such a case, an intra-group service ordinarily would be found to exist. For example, an intra-group service would normally be found where an associated enterprise repairs equipment used in manufacturing by another member of the MNE group. It is essential, however, that reliable documentation is provided to the tax administrations to verify that the costs have been incurred by the service provider.

B.1.2. Shareholder activities

7.9 A more complex analysis is necessary where an associated enterprise undertakes activities that relate to more than one member of the group or to the group as a whole. In a narrow range of such cases, an intra-group activity may be performed relating to group members even though those group members do not need the activity (and would not be willing to pay for it were they independent enterprises). Such an activity would be one that a group member (usually the parent company or a regional holding company) performs solely because of its ownership interest in one or more other group members, i.e. in its capacity as shareholder. This type of activity would not be considered to be an intra-group service, and thus would not justify a charge to other group members. Instead, the costs associated with this type of activity should be borne and allocated at the level of the shareholder. This type of activity may be referred to as a "shareholder activity",

distinguishable from the broader term “stewardship activity” used in the 1979 Report. Stewardship activities covered a range of activities by a shareholder that may include the provision of services to other group members, for example services that would be provided by a coordinating centre. These latter types of non-shareholder activities could include detailed planning services for particular operations, emergency management or technical advice (trouble shooting), or in some cases assistance in day-to-day management.

7.10 The following are examples of costs associated with shareholder activities, under the standard set forth in paragraph 7.6:

- a) Costs relating to the juridical structure of the parent company itself, such as meetings of shareholders of the parent, issuing of shares in the parent company, stock exchange listing of the parent company and costs of the supervisory board;
- b) Costs relating to reporting requirements (including financial reporting and audit) of the parent company including the consolidation of reports, costs relating to the parent company’s audit of the subsidiary’s accounts carried out exclusively in the interest of the parent company, and costs relating to the preparation of consolidated financial statements of the MNE (however, in practice costs incurred locally by the subsidiaries may not need to be passed on to the parent or holding company where it is disproportionately onerous to identify and isolate those costs);
- c) Costs of raising funds for the acquisition of its participations and costs relating to the parent company’s investor relations such as communication strategy with shareholders of the parent company, financial analysts, funds and other stakeholders in the parent company;
- d) Costs relating to compliance of the parent company with the relevant tax laws;
- e) Costs which are ancillary to the corporate governance of the MNE as a whole.

In contrast, if for example a parent company raises funds on behalf of another group member which uses them to acquire a new company, the parent company would generally be regarded as providing a service to the group member. The 1984 Report also mentioned “costs of managerial and control (monitoring) activities related to the management and protection of the investment as such in participations”. Whether these activities fall within the definition of shareholder activities as defined in these Guidelines would be determined according to whether under comparable facts and circumstances the activity is one that an independent enterprise would have been willing to pay for or to perform for itself. Where activities such as those described above are performed by a group company other than solely because of an ownership interest in other group members, then that group company is not performing shareholder activities but should be regarded as providing a service to the parent or holding company to which the guidance in this chapter applies.

B.1.3. Duplication

7.11 In general, no intra-group service should be found for activities undertaken by one group member that merely duplicate a service that another group member is performing for itself, or that is being performed for such other group member by a third party. An exception may be where the duplication of services is only temporary, for example, where an MNE group is reorganising to centralise its management functions. Another exception would be where the duplication is undertaken to reduce the risk of a wrong business decision (e.g. by getting a second legal opinion on a subject). Any consideration of possible duplication of services needs to identify the nature of the services in detail, and the reason

why the company appears to be duplicating costs contrary to efficient practices. The fact that a company performs, for example, marketing services in-house and also is charged for marketing services from a group company does not of itself determine duplication, since marketing is a broad term covering many levels of activity. Examination of information provided by the taxpayer may determine that the intra-group services are different, additional, or complementary to the activities performed in-house. The benefits test would then apply to those non-duplicative elements of the intra-group services. Some regulated sectors require control functions to be performed locally as well as on a consolidated basis by the parent; such requirements should not lead to disallowance on grounds of duplication.

B.1.4. Incidental benefits

7.12 There are some cases where an intra-group service performed by a group member such as a shareholder or coordinating centre relates only to some group members but incidentally provides benefits to other group members. Examples could be analysing the question whether to reorganise the group, to acquire new members, or to terminate a division. These activities could constitute intra-group services to the particular group members involved, for example those members who may make the acquisition or terminate one of their divisions, but they may also produce economic benefits for other group members not directly involved in the potential decision since the analysis could provide useful information about their own business operations. The incidental benefits ordinarily would not cause these other group members to be treated as receiving an intra-group service because the activities producing the benefits would not be ones for which an independent enterprise ordinarily would be willing to pay.

7.13 Similarly, an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed. For example, no service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member, or where the enterprise benefitted from deliberate concerted action involving global marketing and public relations campaigns. In this respect, passive association should be distinguished from active promotion of the MNE group's attributes that positively enhances the profit-making potential of particular members of the group. Each case must be determined according to its own facts and circumstances. See Section D.8 of Chapter I on MNE group synergies.

B.1.5. Centralised services

7.14 Other activities that may relate to the group as a whole are those centralised in the parent company or one or more group service centres (such as a regional headquarters company) and made available to the group (or multiple members thereof). The activities that are centralised depend on the kind of business and on the organisational structure of the group, but in general they may include administrative services such as planning, coordination, budgetary control, financial advice, accounting, auditing, legal, factoring, computer services; financial services such as supervision of cash flows and solvency, capital increases, loan contracts, management of interest and exchange rate risks, and refinancing; assistance in the fields of production, buying, distribution and marketing; and services in staff matters such as recruitment and training. Group service centres also often carry out order management, customer service and call centres, research and development or administer and protect intangible property for all or part of the MNE group. These types of activities

ordinarily will be considered intra-group services because they are the type of activities that independent enterprises would have been willing to pay for or to perform for themselves.

B.1.6. Form of the remuneration

7.15 In considering whether a charge for the provision of services would be made between independent enterprises, it would also be relevant to consider the form that an arm's length consideration would take had the transaction occurred between independent enterprises dealing at arm's length. For example, in respect of financial services such as loans, foreign exchange and hedging, all of the remuneration may be built into the spread and it would not be appropriate to expect a further service fee to be charged if such were the case. Similarly, in some buying or procurement services a commission element may be incorporated in the price of the product or services procured, and a separate service fee may not be appropriate.

7.16 Another issue arises with respect to services provided "on call". The question is whether the availability of such services is itself a separate service for which an arm's length charge (in addition to any charge for services actually rendered) should be determined. A parent company or one or more group service centres may be on hand to provide services such as financial, managerial, technical, legal or tax advice and assistance to members of the group at any time. In that case, a service may be rendered to associated enterprises by having staff, equipment, etc., available. An intra-group service would exist to the extent that it would be reasonable to expect an independent enterprise in comparable circumstances to incur "standby" charges to ensure the availability of the services when the need for them arises. It is not unknown, for example, for an independent enterprise to pay an annual "retainer" fee to a firm of lawyers to ensure entitlement to legal advice and representation if litigation is brought. Another example is a service contract for priority computer network repair in the event of a breakdown.

7.17 These services may be available on call and they may vary in amount and importance from year to year. It is unlikely that an independent enterprise would incur stand-by charges where the potential need for the service was remote, where the advantage of having services on-call was negligible, or where the on-call services could be obtained promptly and readily from other sources without the need for stand-by arrangements. Thus, the benefit conferred on a group company by the on-call arrangements should be considered, perhaps by looking at the extent to which the services have been used over a period of several years rather than solely for the year in which a charge is to be made, before determining that an intra-group service is being provided.

7.18 The fact that a payment was made to an associated enterprise for purported services can be useful in determining whether services were in fact provided, but the mere description of a payment as, for example, "management fees" should not be expected to be treated as *prima facie* evidence that such services have been rendered. At the same time, the absence of payments or contractual agreements does not automatically lead to the conclusion that no intra-group services have been rendered.

B.2. Determining an arm's length charge

B.2.1. In general

7.19 Once it is determined that an intra-group service has been rendered, it is necessary, as for other types of intra-group transfers, to determine whether the amount of the charge, if any, is in accordance with the arm's length principle. This means that the charge for

intra-group services should be that which would have been made and accepted between independent enterprises in comparable circumstances. Consequently, such transactions should not be treated differently for tax purposes from comparable transactions between independent enterprises, simply because the transactions are between enterprises that happen to be associated.

B.2.2. Identifying actual arrangements for charging for intra-group services

7.20 To identify the amount, if any, that has actually been charged for services, a tax administration will need to identify what arrangements, if any, have actually been put in place between the associated enterprises to facilitate charges being made for the provision of services between them.

B.2.2.1 Direct-charge methods

7.21 In certain cases, the arrangements made for charging for intra-group services can be readily identified. These cases are where the MNE group uses a direct-charge method, i.e. where the associated enterprises are charged for specific services. In general, the direct-charge method is of great practical convenience to tax administrations because it allows the service performed and the basis for the payment to be clearly identified. Thus, the direct-charge method facilitates the determination of whether the charge is consistent with the arm's length principle.

7.22 An MNE group may be able to adopt direct charging arrangements, particularly where services similar to those rendered to associated enterprises are also rendered to independent parties. If specific services are provided not only to associated enterprises but also to independent enterprises in a comparable manner and as a significant part of its business, it could be presumed that the MNE has the ability to demonstrate a separate basis for the charge (e.g. by recording the work done, the fee basis, or costs expended in fulfilling its third party contracts). As a result, MNEs in such a case are encouraged to adopt the direct-charge method in relation to their transactions with associated enterprises. It is accepted, however, that this approach may not always be appropriate if, for example, the services to independent parties are merely occasional or marginal.

B.2.2.2 Indirect-charge methods

7.23 A direct-charge method for charging for intra-group services can be difficult to apply in practice. Consequently, some MNE groups have developed other methods for charging for services provided by parent companies or group service centres. In such cases, MNE groups may find they have few alternatives but to use cost allocation and apportionment methods which often necessitate some degree of estimation or approximation, as a basis for calculating an arm's length charge following the principles in Section B.2.3 below. Such methods are generally referred to as indirect-charge methods and should be allowable provided sufficient regard has been given to the value of the services to recipients and the extent to which comparable services are provided between independent enterprises. These methods of calculating charges would generally not be acceptable where specific services that form a main business activity of the enterprise are provided not only to associated enterprises but also to independent parties. While every attempt should be made to charge fairly for the service provided, any charging has to be supported by an identifiable and reasonably foreseeable benefit. Any indirect-charge method should be sensitive to the commercial features of the individual case (e.g. the allocation key makes

sense under the circumstances), contain safeguards against manipulation and follow sound accounting principles, and be capable of producing charges or allocations of costs that are commensurate with the actual or reasonably expected benefits to the recipient of the service.

7.24 In some cases, an indirect-charge method may be necessary due to the nature of the service being provided. One example is where the proportion of the value of the services rendered to the various relevant entities cannot be quantified except on an approximate or estimated basis. This problem may occur, for example, where sales promotion activities carried on centrally (e.g. at international fairs, in the international press, or through other centralised advertising campaigns) may affect the quantity of goods manufactured or sold by a number of affiliates. Another case is where a separate recording and analysis of the relevant services for each beneficiary would involve a burden of administrative work that would be disproportionately heavy in relation to the activities themselves. In such cases, the charge could be determined by reference to an allocation among all potential beneficiaries of the costs that cannot be allocated directly, i.e. costs that cannot be specifically assigned to the actual beneficiaries of the various services. To satisfy the arm's length principle, the allocation method chosen must lead to a result that is consistent with what comparable independent enterprises would have been prepared to accept.

7.25 The allocation should be based on an appropriate measure of the usage of the service that is also easy to verify, for example turnover, staff employed, or an activity based key such as orders processed. Whether the allocation method is appropriate may depend on the nature and usage of the service. For example, the usage or provision of payroll services may be more related to the number of staff than to turnover, while the allocation of the stand-by costs of priority computer back-up could be allocated in proportion to relative expenditure on computer equipment by the group members.

7.26 When an indirect-charge method is used, the relationship between the charge and the services provided may be obscured and it may become difficult to evaluate the benefit provided. Indeed, it may mean that the enterprise being charged for a service itself has not related the charge to the service. Consequently, there is an increased risk of double taxation because it may be more difficult to determine a deduction for costs incurred on behalf of group members if compensation cannot be readily identified, or for the recipient of the service to establish a deduction for any amount paid if it is unable to demonstrate that services have been provided.

B.2.2.3 Form of the compensation

7.27 The compensation for services rendered to an associated enterprise may be included in the price for other transfers. For instance, the price for licensing a patent or know-how may include a payment for technical assistance services or centralised services performed for the licensee or for managerial advice on the marketing of the goods produced under the licence. In such cases, the tax administration and the taxpayers would have to check that there is no additional service fee charged and that there is no double deduction.

7.28 In identifying arrangements for charging any retainer for the provision of “on call” services (as discussed in paragraphs 7.16 and 7.17), it may be necessary to examine the terms for the actual use of the services since these may include provisions that no charge is made for actual use until the level of usage exceeds a predetermined level.

B.2.3. Calculating the arm's length compensation

7.29 In trying to determine the arm's length price in relation to intra-group services, the matter should be considered both from the perspective of the service provider and from the perspective of the recipient of the service. In this respect, relevant considerations include the value of the service to the recipient and how much a comparable independent enterprise would be prepared to pay for that service in comparable circumstances, as well as the costs to the service provider.

7.30 For example, from the perspective of an independent enterprise seeking a service, the service providers in that market may or may not be willing or able to supply the service at a price that the independent enterprise is prepared to pay. If the service providers can supply the wanted service within a range of prices that the independent enterprise would be prepared to pay, then a deal will be struck. From the point of view of the service provider, a price below which it would not supply the service and the cost to it are relevant considerations to address, but they are not necessarily determinative of the outcome in every case.

B.2.3.1 Methods

7.31 The method to be used to determine arm's length transfer pricing for intra-group services should be determined according to the guidelines in Chapters I, II, and III. Often, the application of these guidelines will lead to use of the CUP or a cost-based method (cost plus method or cost-based TNMM) for pricing intra-group services. A CUP method is likely to be the most appropriate method where there is a comparable service provided between independent enterprises in the recipient's market, or by the associated enterprise providing the services to an independent enterprise in comparable circumstances. For example, this might be the case where accounting, auditing, legal, or computer services are being provided subject to the controlled and uncontrolled transactions being comparable. A cost based method would likely be the most appropriate method in the absence of a CUP where the nature of the activities involved, assets used, and risks assumed are comparable to those undertaken by independent enterprises. As indicated in Chapter II, Part II, in applying the cost plus method, there should be a consistency between the controlled and uncontrolled transactions in the categories of cost that are included. In exceptional cases, for example where it may be difficult to apply the CUP method or the cost-based methods, it may be helpful to take account of more than one method (see paragraph 2.11) in reaching a satisfactory determination of arm's length pricing.

7.32 It may be necessary to perform a functional analysis of the various members of the group to establish the relationship between the relevant services and the members' activities and performance. In addition, it may be necessary to consider not only the immediate impact of a service, but also its long-term effect, bearing in mind that some costs will never actually produce the benefits that were reasonably expected when they were incurred. For example, expenditure on preparations for a marketing operation might *prima facie* be too heavy to be borne by a member in the light of its current resources; the determination whether the charge in such a case is arm's length should consider expected benefits from the operation and the possibility that the amount and timing of the charge in some arm's length arrangements might depend on the results of the operation. The taxpayer should be prepared to demonstrate the reasonableness of its charges to associated enterprises in such cases.

7.33 Where a cost based method is determined to be the most appropriate method to the circumstances of the case, the analysis would require examining whether the costs

incurred by the group service provider need some adjustment to make the comparison of the controlled and uncontrolled transactions reliable.

7.34 When an associated enterprise is acting only as an agent or intermediary in the provision of services, it is important in applying a cost based method that the return or mark-up is appropriate for the performance of an agency function rather than for the performance of the services themselves. In such a case, it may not be appropriate to determine arm's length pricing as a mark-up on the cost of the services but rather on the costs of the agency function itself. For example, an associated enterprise may incur the costs of renting advertising space on behalf of group members, costs that the group members would have incurred directly had they been independent. In such a case, it may well be appropriate to pass on these costs to the group recipients without a mark-up, and to apply a mark-up only to the costs incurred by the intermediary in performing its agency function.

B.2.3.2 Considerations on including a profit element

7.35 Depending on the method being used to establish an arm's length charge for intra-group services, the issue may arise whether it is necessary that the charge be such that it results in a profit for the service provider. In an arm's length transaction, an independent enterprise normally would seek to charge for services in such a way as to generate profit, rather than providing the services merely at cost. The economic alternatives available to the recipient of the service also need to be taken into account in determining the arm's length charge. However, there are circumstances (e.g. as outlined in the discussion on business strategies in Chapter I) in which an independent enterprise may not realise a profit from the performance of services alone, for example where a supplier's costs (anticipated or actual) exceed market price but the supplier agrees to provide the service to increase its profitability, perhaps by complementing its range of activities. Therefore, it need not always be the case that an arm's length price will result in a profit for an associated enterprise that is performing an intra-group service.

7.36 For example, it may be the case that the market value of intra-group services is not greater than the costs incurred by the service provider. This could occur where, for example, the service is not an ordinary or recurrent activity of the service provider but is offered incidentally as a convenience to the MNE group. In determining whether the intra-group services represent the same value for money as could be obtained from an independent enterprise, a comparison of functions and expected benefits would be relevant to assessing comparability of the transactions. An MNE group may still determine to provide the service intra-group rather than using a third party for a variety of reasons, perhaps because of other intra-group benefits (for which arm's length compensation may be appropriate). It would not be appropriate in such a case to increase the price for the service above what would be established by the CUP method just to make sure the associated enterprise makes a profit. Such a result would be contrary to the arm's length principle. However, it is important to ensure that all benefits to the recipient are properly taken into account.

7.37 While as a matter of principle tax administrations and taxpayers should try to establish the proper arm's length pricing, it should not be overlooked that there may be practical reasons why a tax administration in its discretion exceptionally might be willing to forgo computing and taxing an arm's length price from the performance of services in some cases, as distinct from allowing a taxpayer in appropriate circumstances to merely allocate the costs of providing those services. For instance, a cost-benefit analysis might indicate the additional tax revenue that would be collected does not justify the costs and administrative burdens of determining what an appropriate arm's length price might be in

some cases. In such cases, charging all relevant costs rather than an arm's length price may provide a satisfactory result for MNEs and tax administrations. This concession is unlikely to be made by tax administrations where the provision of a service is a principal activity of the associated enterprise, where the profit element is relatively significant, or where direct charging is possible as a basis from which to determine the arm's length price.

C. Some examples of intra-group services

7.38 This section sets forth several examples of transfer pricing issues in the provision of intra-group services. The examples are provided for illustrative purposes only. When dealing with individual cases, it is necessary to explore the actual facts and circumstances to judge the applicability of any transfer pricing method.

7.39 One example involves debt-factoring activities, where an MNE group decides to centralise the activities for economic reasons. For example, it may be prudent to centralise the debt-factoring activities to better manage liquidity, currency and debt risks and to provide administrative efficiencies. A debt-factoring centre that takes on this responsibility is performing intra-group services for which an arm's length charge should be made. A CUP method could be appropriate in such a case.

7.40 Another example of an activity that may involve intra-group services is manufacturing or assembly operations. The activities can take a variety of forms including what is commonly referred to as contract manufacturing. In some cases of contract manufacturing the producer may operate under extensive instruction from the counterparty about what to produce, in what quantity and of what quality. In some cases, raw materials or components may be made available to the producer by the counterparty. The production company may be assured that its entire output will be purchased, assuming quality requirements are met. In such a case the production company could be considered as performing a low-risk service to the counterparty, and the cost plus method could be the most appropriate transfer pricing method, subject to the principles in Chapter II.

7.41 Research is similarly an example of an activity that may involve intra-group services. The terms of the activity can be set out in a detailed contract with the party commissioning the service, commonly known as contract research. The activity can involve highly skilled personnel and vary considerably both in its nature and in its importance to the success of the group. The actual arrangements can take a variety of forms from the undertaking of detailed programmes laid down by the principal party, extending to agreements where the research company has discretion to work within broadly defined categories. In the latter instance, the additional functions of identifying commercially valuable areas and assessing the risk of unsuccessful research can be a critical factor in the performance of the group as a whole. It is therefore crucial to undertake a detailed functional analysis and to obtain a clear understanding of the precise nature of the research, and of how the activities are being carried out by the company, prior to consideration of the appropriate transfer pricing methodology. The consideration of options realistically available to the party commissioning the research may also prove useful in selecting the most appropriate transfer pricing method. See Section B.2 of Chapter VI.

7.42 Another example of intra-group services is the administration of licences. The administration and enforcement of intangible property rights should be distinguished from the exploitation of those rights for this purpose. The protection of a licence might be handled by a group service centre responsible for monitoring possible licence infringements and for enforcing licence rights.

D. Low value-adding intra-group services

7.43 This section provides specific guidance relating to a particular category of intra-group services referred to as low value-adding intra-group services. Section D.1 contains the definition of low value-adding intra-group services. Section D.2 sets out an elective, simplified approach for the determination of arm's length charges for low value-adding intra-group services, including a simplified benefits test. Section D.3 contains guidance on documentation and reporting requirements that should be met by an MNE group electing to apply this simplified approach. Finally, Section D.4 addresses some issues with regard to the levying of withholding taxes on charges for low value-adding intra-group services. In summary, the simplified approach recognises that the arm's length price for low value-adding intra-group services is closely related to costs, allocates the costs of providing each category of such services to those group companies which benefit from using those services, and then applies the same mark-up to all categories of services. MNE groups not electing to apply the simplified approach set out in this section should address transfer pricing issues related to low-value-adding services under the provisions of Sections A and B, above.

D.1. Definition of low value-adding intra-group services

7.44 This section discusses the definitional issues related to low value-adding intra-group services for applying the elective, simplified approach discussed under Section D.2. It starts by indicating the characteristics that services must have in order to qualify as low-value-adding intra-group services for applying the elective, simplified approach. It then identifies a series of activities that do not qualify as low value-adding intra-group services for the elective, simplified approach. Finally it contains a list of examples of services that likely would have the characteristics to qualify as low value-adding intra-groups services for the application of the simplified approach.

7.45 Low value-adding intra-group services for the purposes of the simplified approach are services performed by one member or more than one member of an MNE group on behalf of one or more other group members which

- are of a supportive nature
- are not part of the core business of the MNE group (i.e. not creating the profit-earning activities or contributing to economically significant activities of the MNE group)
- do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles, and
- do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.

7.46 The guidance in this section is not applicable to services that would ordinarily qualify as low value-adding intra-group services where such services are rendered to unrelated customers of the members of the MNE group. In such cases it can be expected that reliable internal comparables exist and can be used for determining the arm's length price for the intra-group services.

7.47 The following activities would not qualify for the simplified approach outlined in this section:

- services constituting the core business of the MNE group
- research and development services (including software development unless falling within the scope of information technology services in 7.49)

- manufacturing and production services
- purchasing activities relating to raw materials or other materials that are used in the manufacturing or production process
- sales, marketing and distribution activities
- financial transactions
- extraction, exploration, or processing of natural resources
- insurance and reinsurance
- services of corporate senior management (other than management supervision of services that qualify as low value-adding intra-group services under the definition of paragraph 7.45).

7.48 The fact that an activity does not qualify for the simplified approach, as defined under paragraph 7.45, should not be interpreted to mean that that activity generates high returns. The activity could still add low value, and the determination of the arm's length charge for such activity, if any, should be determined according to the guidance set out in paragraphs 7.1 to 7.42.

7.49 The following bullet points provide examples of services that would likely meet the definition of low value-adding services provided in paragraph 7.45:

- accounting and auditing, for example gathering and reviewing information for use in financial statements, maintenance of accounting records, preparation of financial statements, preparation or assistance in operational and financial audits, verifying authenticity and reliability of accounting records, and assistance in the preparation of budgets through compilation of data and information gathering
- processing and management of accounts receivable and accounts payable, for example compilation of customer or client billing information, and credit control checking and processing
- human resources activities, such as
 - staffing and recruitment, for example hiring procedures, assistance in evaluation of applicants and selection and appointment of personnel, on-boarding new employees, performance evaluation and assistance in defining careers, assistance in procedures to dismiss personnel, assistance in programmes for redundant personnel;
 - training and employee development, for example evaluation of training needs, creation of internal training and development programmes, creation of management skills and career development programmes;
 - remuneration services, for example, providing advice and determining policies for employee compensation and benefits such as healthcare and life insurance, stock option plans, and pension schemes; verification of attendance and timekeeping, payroll services including processing and tax compliance;
 - developing and monitoring of staff health procedures, safety and environmental standards relating to employment matters;
- monitoring and compilation of data relating to health, safety, environmental and other standards regulating the business

- information technology services where they are not part of the principal activity of the group, for example installing, maintaining and updating IT systems used in the business; information system support (which may include the information system used in connection with accounting, production, client relations, human resources and payroll, and email systems); training on the use or application of information systems as well as on the associated equipment employed to collect, process and present information; developing IT guidelines, providing telecommunications services, organising an IT helpdesk, implementing and maintaining of IT security systems; supporting, maintaining and supervising of IT networks (local area network, wide area network, internet)
- internal and external communications and public relations support (but excluding specific advertising or marketing activities as well as development of underlying strategies)
- legal services, for example general legal services performed by in-house legal counsel such as drafting and reviewing contracts, agreements and other legal documents, legal consultation and opinions, representation of the company (judicial litigation, arbitration panels, administrative procedures), legal research and legal as well as administrative work for the registration and protection of intangible property
- activities with regard to tax obligations, for example information gathering and preparation of tax returns (income tax, sales tax, VAT, property tax, customs and excise), making tax payments, responding to tax administrations' audits, and giving advice on tax matters
- general services of an administrative or clerical nature

7.50 The following examples illustrate an important element of the definition of low value-adding intra-group services, namely, that they should not include services which are part of the MNE's core business. Services that may seem superficially similar in nature (in the example, credit risk analysis) may or may not be low value-adding intra-group services depending on the specific context and circumstances. The examples also illustrate the point that services may not qualify as low value-adding intra-group services because in their specific context they create significant risk or unique and valuable intangibles.

- a) Company A, situated in country A, is a shoe manufacturer and wholesale distributor of shoes in the North-West region. Its wholly-owned subsidiary B, situated in country B, is a wholesale distributor in the South-East region of the shoes manufactured by A. As part of its operations, A routinely performs a credit risk analysis on its customers on the basis of reports purchased from a credit reporting agency. A performs, on behalf of B, the same credit risk analysis with respect to B's customers, using the same methods and approaches. Under the facts and circumstances, it could be reasonably concluded that the service A performs for B is a low value-adding intra-group service.
- b) Company X is a subsidiary of a worldwide investment banking group. Company X performs credit risk analysis with respect to potential counterparties for transactions involving financial derivatives contracts and prepares credit reports for the worldwide investment banking group. The credit analyses performed by Company X are utilised by the group in establishing the prices of financial derivatives for the group's clients. The personnel of Company X have developed special expertise and make use of internally developed, confidential credit risk analysis models,

algorithms and software. Under the facts and circumstances of this case, it could not be concluded that the service Company X performs for the worldwide investment banking group is a low value-adding intra-group service.

7.51 The definition of low value-adding intra-group services refers to the supportive nature of such services, which are not part of the core business of the MNE group. The provision of low value-adding intra-group services may, in fact, be the principal business activity of the legal entity providing the service, e.g. a shared service centre, provided these services do not relate to the core business of the group. As an example, assume that an MNE is engaged in the development, production, sale and marketing of dairy products worldwide. The group established a shared services company, the only activity of which is to act as a global IT support service centre. From the perspective of the IT support service provider, the rendering of the IT services is the company's principal business activity. However, from the perspective of the service recipients, and from the perspective of the MNE group as a whole, the service is not a core business activity and may therefore qualify as a low value-adding intra-group service.

D.2. Simplified determination of arm's length charges for low value-adding intra-group services

7.52 This subsection sets out the elements of a simplified charge mechanism for low value-adding intra-group services. This simplified method is premised on the proposition that all low value-adding service costs incurred in supporting the business of MNE group members should be allocated to those members. The basic benefits of using the simplified approach include: (1) reducing the compliance effort of meeting the benefits test and in demonstrating arm's length charges; (2) providing greater certainty for MNE groups that the price charged for the qualifying activities will be accepted by the tax administrations that have adopted the simplified approach when the conditions of the simplified approach mentioned in paragraph 7.45 have been met; and (3) providing tax administrations with targeted documentation enabling efficient review of compliance risks. An MNE group electing to adopt this simplified method would as far as practicable apply it on a consistent, group wide basis in all countries in which it operates.

7.53 Where a tax administration has not adopted the simplified approach, and as a consequence the MNE group complies with the local requirements in that jurisdiction, such compliance would not disqualify the MNE group from the application of the simplified approach to other jurisdictions. In addition, not all MNE groups are vertically integrated and may instead have regional or divisional sub-groups with their own management and support structures. Therefore, MNE groups may elect to adopt the simplified method at the level of a sub-holding company and apply it on a consistent basis across all subsidiaries of that sub-holding company. When the MNE group elects for and applies the simplified approach, charges for low value-adding intra-group services that are or have been determined in conformity with the guidance in this subsection are determined to be in accordance with the arm's length principle. A possible alternative approach for dealing with the issues discussed in this subsection would be the use of Cost Contribution Arrangements, covered in Chapter VIII.

D.2.1. Application of the benefits test to low value-adding intra-group services

7.54 As discussed in paragraph 7.6, under the arm's length principle an obligation to pay for an intra-group service arises only where the benefits test is satisfied, i.e. the activity must provide the group member expected to pay for the service with economic

or commercial value to enhance or maintain its commercial position, which in turn is determined by evaluating whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself. However, because of the nature of the low value-adding intra-group services discussed in this section, such determinations may be difficult or may require greater effort than the amount of the charge warrants. Tax administrations should therefore generally refrain from reviewing or challenging the benefits test when the simplified approach has been applied under the conditions and circumstances discussed in this section and in particular in conformity with the documentation and reporting discussed in Section D.3 below.

7.55 While low value-adding intra-group services may provide benefits to all recipients of those services, questions may arise about the extent of the benefits and whether independent parties would have been willing to pay for the service or perform it themselves. Where the MNE group has followed the guidance of the simplified approach the documentation and reporting discussed in Section D.3 below, it should provide sufficient evidence that the benefits test is met given the nature of low value-adding intra-group services. In evaluating the benefits test, tax administrations should consider benefits only by categories of services and not on a specific charge basis. Thus, the taxpayer need only demonstrate that assistance was provided with, for example, payroll processing, rather than being required to specify individual acts undertaken that give rise to the costs charged. Provided such information outlined in paragraph 7.64 is made available to the tax administration, a single annual invoice describing a category of services should suffice to support the charge, and correspondence or other evidence of individual acts should not be required. With regard to low value-adding intra-group services that benefit only one recipient entity in the MNE group, it is expected that the benefits to the service recipient will be capable of separate demonstration.

D.2.2. Determination of cost pools

7.56 The initial step in applying the simplified approach to low value-adding intra-group services is for the MNE group to calculate, on an annual basis, a pool of all costs incurred by all members of the group in performing each category of low value-adding intra-group services. The costs to be pooled are the direct and indirect costs of rendering the service as well as, where relevant, the appropriate part of operating expenses (e.g. supervisory, general and administrative). The costs should be pooled according to category of services, and should identify the accounting cost centres used in creating the pool. Pass-through costs in the cost pool should be identified for the purposes of applying paragraph 7.61. The cost pool should exclude costs that are attributable to an in-house activity that benefits solely the company performing the activity (including shareholder activities performed by the shareholding company).

7.57 As a second step, the MNE group should identify and remove from the pool those costs that are attributable to services performed by one group member solely on behalf of one other group member. In creating a pool of payroll costs, for example, if group company A provides payroll services solely to group company B the relevant costs should be separately identified and omitted from the pool. However, if group company A performs payroll services for itself as well as for company B, the relevant costs should remain within the pool.

7.58 At this stage in the calculation, the MNE group has identified a pool of costs associated with categories of low value-adding services which are provided to multiple members of the MNE group.

D.2.3. Allocation of low value-adding service costs

7.59 The third step in this simplified charge method for low value-adding intra-group service costs is to allocate among members of the group the costs in the cost pool that benefit multiple members of the group. The taxpayer will select one or more allocation keys to apply for this purpose based on the following principles. The appropriate allocation key or keys will depend on the nature of the services. The same allocation key or keys must be used on a consistent basis for all allocations of costs relating to the same category of services. In accordance with the guidance in paragraph 7.24, the allocation key or keys selected with respect to costs for each relevant category of services should reasonably reflect the level of benefit expected to be received by each recipient of the particular service. As a general rule, the allocation key or keys should reflect the underlying need for the particular services. By way of examples, the allocation key for services related to people might employ each company's share of total group headcount, IT services might employ the share of total users, fleet management services might employ the share of total vehicles, accounting support services might employ the share of total relevant transactions or the share of total assets. In many cases, the share of total turnover may be a relevant key.

7.60 The examples of allocation keys provided in the previous paragraph are not intended to be an exhaustive list. Depending on the facts and circumstances more sophisticated allocation keys might be used. However, a balance should be struck between theoretical sophistication and practical administration, bearing in mind that the costs involved are not generating high value for the group. In this context, there may be no need to use multiple allocation keys if the taxpayer can explain the reasons for concluding that a single key provides a reasonable reflection of the respective benefits. For reasons of consistency, the same allocation key or keys should be applied in determining the allocation to all recipients within the group of the same type of low value-adding intra-group services, and it is expected that the same reasonable key will be used from year to year unless there is a justified reason to change. Tax administrations and taxpayers should also bear in mind that changing the reasonable allocation key can give rise to considerable complexities. It is expected that the taxpayer will describe in its documentation (see paragraph 7.64 below) the reasons for concluding that the allocation key produces outcomes which reasonably reflects the benefits likely to be derived by each service recipient.

D.2.4. Profit mark-up

7.61 In determining the arm's length charge for low value-adding intra-group services, the MNE provider of services shall apply a profit mark-up to all costs in the pool with the exception of any pass-through costs as determined under paragraphs 2.93 and 7.34. The same mark-up shall be utilised for all low value-adding services irrespective of the categories of services. The mark-up shall be equal to 5% of the relevant cost as determined in Section D.2.2. The mark-up under the simplified approach does not need to be justified by a benchmarking study. The same mark-up may be applied to low value-adding intra-group services performed by one group member solely on behalf of one other group member, the costs of which are separately identified under the guidance in paragraph 7.57. It should be noted that the low value-adding intra-group services mark-up should not, without further justification and analysis, be used as benchmark for the determination of the arm's length price for services not within the definition of low value-adding intra-group services, nor for similar services not within the elective, simplified scheme.

D.2.5. Charge for low value-adding services

7.62 Subject to the provisions of paragraph 7.55, the charge for services to any member of the electing MNE group shall be the sum of (i) the costs incurred by another group member in providing services specifically to the member under the second step as detailed in paragraph 7.57, plus the selected profit mark-up, and (ii) the share of pooled costs allocated to the member under the third step as detailed in paragraph 7.59 using the selected allocation key, plus the selected profit mark-up. The charge is payable to the group member that incurred the costs in the pool, and where there is more than one group member incurring those costs, in proportion to each member's share of the pooled costs.

D.2.6. Threshold for the application of the simplified approach

7.63 Tax administrations adopting the simplified approach to low-value-adding intra-group services set out in this section may include an appropriate threshold to enable them to review the simplified approach in cases where the threshold is exceeded. Such a threshold might, for example, be based on fixed financial ratios of the recipient party (e.g. proportion of intra-group services costs to total costs or turnover or pre-intra-group service charge profit) or be determined by reference to a group-wide ratio of total service costs to turnover of the MNE group or some other appropriate measure. Where such a threshold is adopted, the tax administration would not be obliged to accept the simplified approach if the level of low-value-adding intra-group service fees exceeds the threshold and may require a full functional analysis and comparability analysis including the application of the benefits test to specific service charges.

D.3. Documentation and reporting

7.64 An MNE group electing for application of this simplified methodology shall prepare the following information and documentation and make it available upon request to the tax administration of any entity within the group either making or receiving a payment for low value-adding intra-group services.

- A description of the categories of low value-adding intra-group services provided; the identity of the beneficiaries; the reasons justifying that each category of services constitute low value-adding intra-group services within the definition set out in Section D.1; the rationale for the provision of services within the context of the business of the MNE; a description of the benefits or expected benefits of each category of services; a description of the selected allocation keys and the reasons justifying that such allocation keys produce outcomes that reasonably reflect the benefits received, and confirmation of the mark-up applied;
- Written contracts or agreements for the provision of services and any modifications to those contracts and agreements reflecting the agreement of the various members of the group to be bound by the allocation rules of this section. Such written contracts or agreements could take the form of a contemporaneous document identifying the entities involved, the nature of the services, and the terms and conditions under which the services are provided;
- Documentation and calculations showing the determination of the cost pool as described in Section D.2.2, and of the mark-up applied thereon, in particular a detailed listing of all categories and amounts of relevant costs, including costs of any services provided solely to one group member;
- Calculations showing the application of the specified allocation keys.

D.4. Levying of withholding tax on charges for low value-adding intra-group services

7.65 The levying of withholding taxes on the provision of low value-adding intra-group services can prevent the service provider recovering the totality of the costs incurred for rendering the services. When a profit element or mark-up is included in the charge of the services, tax administrations levying withholding tax are encouraged to apply it only to the amount of that profit element or mark-up.

COST CONTRIBUTION ARRANGEMENTS

Revisions to Chapter VIII of the Transfer Pricing Guidelines

Summary

Cost Contribution Arrangements (CCAs) are special contractual arrangements among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants. If contributions to and benefits of the CCA are not valued appropriately, this will lead to profits being shifted away from the location where the value is created through the economic activities performed.

Action 8 of the BEPS Action Plan covers the transfer pricing of intangibles and requires the development of rules to prevent BEPS by moving intangibles among group members without arm's length compensation, as well as an update to the guidance on CCAs. The guidance contained in this chapter deals with that latter part of Action 8 and will replace the guidance currently in Chapter VIII of the Transfer Pricing Guidelines.

This chapter of the Report provides general guidance for determining whether the conditions established by associated enterprises for transactions covered by a CCA are consistent with the arm's length principle. In doing so, the guidance contained in this chapter addresses some of the opportunities for BEPS resulting from the use of CCAs.

Parties performing activities under arrangements with similar economic characteristics should receive similar expected returns, irrespective of whether the contractual arrangement in a particular case is termed a CCA. The guidance ensures that CCAs cannot be used to circumvent the new guidance on the application of the arm's length principle in relation to transactions involving the assumption of risks, or on intangibles. The analysis of CCAs follows the framework set out in that guidance to ensure that:

- The same analytical framework for delineating the actual transaction, including allocating risk, is applicable to CCAs as to other kinds of contractual arrangements.
- The same guidance for valuing and pricing intangibles, including hard-to-value intangibles, is applicable to CCAs as to other kinds of contractual arrangements.
- The analysis of CCAs is based on the actual arrangements undertaken by associated enterprises and not on contractual terms that do not reflect economic reality.

- An associated enterprise can only be a participant to the CCA if there is a reasonable expectation that it will benefit from the objectives of the CCA activity and it exercises control over the specific risks it assumes under the CCA and has the financial capacity to assume those risks.
- Contributions made to a CCA, with specific focus on intangibles, should not be measured at cost where this is unlikely to provide a reliable basis for determining the value of the relative contributions of participants, since this may lead to non-arm's length results.

In summary the guidance ensures that CCAs are appropriately analysed and produce outcomes that are consistent with how and where value is created.

The current provisions of Chapter VIII of the Transfer Pricing Guidelines are deleted in their entirety and replaced by the following language.

A. Introduction

8.1 This chapter discusses cost contribution arrangements (CCAs) between two or more associated enterprises. The purpose of the chapter is to provide some general guidance for determining whether the conditions established by associated enterprises for transactions covered by a CCA are consistent with the arm's length principle. The analysis of the structure of such arrangements should be informed by the provisions of this chapter and other provisions of these Guidelines and should be based on an adequate documentation of the arrangement.

8.2 Section B provides a general definition and overview of the concept of CCAs, and Section C gives guidance as to the application of the arm's length principle to CCAs. Section C includes guidance on how to measure contributions to a CCA, whether balancing payments are needed (i.e. payments between participants to adjust their proportionate shares of contributions), and guidance on how contributions and balancing payments should be treated for tax purposes. It also addresses the determination of participants in the CCA and issues related to the entry or withdrawal of participants, and the termination of CCAs. Finally, Section D discusses suggestions for structuring and documenting CCAs.

B. Concept of a CCA

B.1. In general

8.3 A CCA is a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants. A CCA is a contractual arrangement rather than necessarily a distinct juridical entity or fixed place of business of all the participants. A CCA does not require the participants to combine their operations in order, for example, to exploit any resulting intangibles jointly or to share the revenues or profits. Rather, CCA participants may exploit their interest in the outcomes of a CCA through their individual businesses. The transfer pricing issues focus on the commercial or financial relations between the participants and the contributions made by the participants that create the opportunities to achieve those outcomes.

8.4 As indicated in Section D.1 of Chapter I, the delineation of the actual transaction undertaken forms the first phase in any transfer pricing analysis. The contractual agreement provides the starting point for delineating the actual transaction. In this respect, no difference exists for a transfer pricing analysis between a CCA and any other kind of contractual arrangement where the division of responsibilities, risks, and anticipated outcomes as determined by the functional analysis of the transaction is the same. The guidance on identifying the other economically relevant characteristics is equally applicable to CCAs as to any other type of contractual arrangement, including an assessment as to whether the parties contractually assuming risks are actually assuming these risks based on the framework for analysing risk set out in paragraph 1.60 of these Guidelines. As a consequence, parties performing activities under arrangements with

similar economic characteristics should receive similar expected returns, irrespective of whether the contractual arrangement in a particular case is termed a CCA. However, there are specific characteristics of CCAs that warrant special consideration.

8.5 A key feature of a CCA is the sharing of contributions. In accordance with the arm's length principle, at the time of entering into a CCA, each participant's proportionate share of the overall contributions to a CCA must be consistent with its proportionate share of the overall expected benefits to be received under the arrangement. Further, in the case of CCAs involving the development, production or obtaining of intangibles or tangible assets, an ownership interest in any intangibles or tangible assets resulting from the activity of the CCA, or rights to use or exploit those intangibles or tangible assets, is contractually provided for each participant. For CCAs for services, each participant is contractually entitled to receive services resulting from the activity of the CCA. In either case, participants may exploit the interest, rights or entitlement without paying additional consideration (other than the contributions and balancing payments described in Sections C.4 and C.5, respectively) to any party for such interest, rights or entitlement.

8.6 Some benefits of the CCA activity can be determined in advance, whereas others will be uncertain. Some types of CCA activities will produce current benefits, while others have a longer time frame or may not be successful. Nevertheless, in a CCA there is always an expected benefit that each participant seeks from its contribution, including the attendant rights to have the CCA properly administered. Each participant's interest in the results of the CCA activity should be established from the outset, even where the interest is inter-linked with that of other participants, e.g. because legal ownership of developed intangibles or tangible assets may be vested in only one of them but all of them have certain rights to use or exploit the intangibles or tangible assets as provided in the contractual arrangements (for example, perpetual, royalty-free licences for the territory in which the individual participant operates).

8.7 In some cases CCAs can provide helpful simplification of multiple transactions (bearing in mind that the tax consequences of transactions are determined in accordance with applicable local laws). In a situation where associated enterprises both perform activities for other group members and simultaneously benefit from activities performed by other group members, a CCA can provide a mechanism for replacing a web of separate intra-group arm's length payments with a more streamlined system of netted payments, based on aggregated benefits and aggregated contributions associated with all the covered activities (see also paragraphs 3.9 to 3.17 of these Guidelines). A CCA for the sharing in the development of intangibles can eliminate the need for complex cross-licensing arrangements and associated allocation of risk, and replace them with a more streamlined sharing of contributions and risks, with ownership interests of the resulting intangible(s) shared in accordance with the terms of the CCA. However, the streamlining of flows that may result from the adoption of a CCA does not affect the appropriate valuation of the separate contributions of the parties.

8.8 As an illustration of a CCA, take the example of an MNE group which manufactures products through three enterprises which each operate a production site and have their own R&D teams engaged in various projects to improve production processes. Those three enterprises enter into a CCA aimed at generating production process improvements, and as a result pool their expertise and share the risks. Since the CCA grants each participant rights to the outcomes of the projects, the CCA replaces the cross-licensing arrangements that may have resulted in the absence of a CCA and if the enterprises had individually developed certain intangibles and granted rights to one another.

B.2. Relationship to other chapters

8.9 As indicated in paragraph 8.4, there is no difference in the analytical framework for analysing transfer prices for CCAs compared to analysing other forms of contractual relations. The guidance in Section D of Chapter I is relevant to the analysis of all transactions between associated enterprises, and applies to identify the economically relevant characteristics of the commercial or financial relations between the parties as expressed in a CCA. The contractual terms of the CCA provide the starting point for delineating the transaction between the parties and how the responsibilities, risks, and anticipated outcomes were intended to be allocated at the time of entering into the arrangements. However, as set out in that guidance, the evidence of the conduct of the parties may clarify or supplement aspects of the agreement. The framework for analysing risk in Section D.1.2.1 of Chapter I is relevant to determining whether parties assume risks under the CCA, as discussed in Section C.2 of this chapter, and the consequences for providing funding without assuming risk or performing other functions. Chapter VI provides guidance regarding the determination of arm's length conditions for transactions that involve the use or transfer of intangibles. Paragraphs 6.60 to 6.64 give relevant guidance on exercising control over the financial risk if the funding is used for investment in R&D projects. The guidance in Sections D.3 and D.4 of Chapter VI on hard-to-value intangibles is equally applicable to CCAs. Chapter VII provides guidance on issues that arise in determining for transfer pricing purposes whether services have been provided by a member of an MNE group to other members of that group and, if so, in establishing arm's length prices for those intra-group services. This chapter's objective is to provide supplementary guidance on situations where resources and skills are pooled and the consideration received is, in part or whole, the reasonable expectation of mutual benefits. Thus, the provisions of Chapters VI and VII, and indeed all the other chapters of these Guidelines, will continue to apply to the extent relevant, for instance in measuring the value of a contribution to a CCA as part of the process of determining the proportionate shares of contributions. MNEs are encouraged to observe the guidance of this chapter in order to ensure that their CCAs operate in accordance with the arm's length principle.

B.3. Types of CCAs

8.10 Two types of CCAs are commonly encountered: those established for the joint development, production or the obtaining of intangibles or tangible assets ("development CCAs"); and those for obtaining services ("services CCAs"). Although each particular CCA should be considered on its own facts and circumstances, key differences between these two types of CCAs will generally be that development CCAs are expected to create ongoing, future benefits for participants, while services CCAs will create current benefits only. Development CCAs, in particular with respect to intangibles, often involve significant risks associated with what may be uncertain and distant benefits, while services CCAs often offer more certain and less risky benefits. These distinctions are useful because the greater complexity of development CCAs may require more refined guidance, particularly on the valuation of contributions, than may be required for services CCAs, as discussed below. However, the analysis of a CCA should not be based on superficial distinctions; in some cases, a CCA for obtaining current services may also create or enhance an intangible which provides ongoing and uncertain benefits, and some intangibles developed under a CCA may provide short-term and relatively certain benefits.

8.11 Under a development CCA, each participant has an entitlement to rights in the developed intangible(s) or tangible asset(s). In relation to intangibles, such rights often take

the form of separate rights to exploit the intangible in a specific geographic location or for a particular application. The separate rights obtained may constitute actual legal ownership; alternatively, it may be that only one of the participants is the legal owner of the property but the other participants have certain rights to use or exploit the property. In cases where a participant has such rights in any property developed by the CCA, there is no need for a royalty payment or other further consideration for the use of the developed property consistent with the interest to which the participant is entitled under the CCA (however, the contributions of a participant may need to be adjusted if they are not proportionate to their expected benefits; see Section C.5).

C. Applying the arm's length principle

C.1. In general

8.12 For the conditions of a CCA to satisfy the arm's length principle, the value of participants' contributions must be consistent with what independent enterprises would have agreed to contribute under comparable circumstances given their proportionate share of the total anticipated benefits they reasonably expect to derive from the arrangement. What distinguishes contributions to a CCA from any other intra-group transfer of property or services is that part or all of the compensation intended by the participants is the expected mutual and proportionate benefit from the pooling of resources and skills. In addition, particularly for development CCAs, the participants agree to share the upside and downside consequences of risks associated with achieving the anticipated CCA outcomes. As a result, there is a distinction between, say, the intra-group licensing of an intangible where the licensor has borne the development risk on its own and expects compensation through the licensing fees it will receive once the intangible has been fully developed, and a development CCA in which all parties make contributions and share in the consequences of risks materialising in relation to the development of the intangible and decide that each of them, through those contributions, acquires a right in the intangible.

8.13 The expectation of mutual and proportionate benefit is fundamental to the acceptance by independent enterprises of an arrangement for sharing the consequences of risks materialising and pooling resources and skills. Independent enterprises would require that the value of each participant's proportionate share of the actual overall contributions to the arrangement is consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement. To apply the arm's length principle to a CCA, it is therefore a necessary precondition that all the parties to the arrangement have a reasonable expectation of benefit. The next step is to calculate the value of each participant's contribution to the joint activity, and finally to determine whether the allocation of CCA contributions (as adjusted for any balancing payments made among participants) accords with their respective share of expected benefits. It should be recognised that these determinations are likely to bear a degree of uncertainty, particularly in relation to development CCAs. The potential exists for contributions to be allocated among CCA participants so as to result in an overstatement of taxable profits in some countries and the understatement of taxable profits in others, measured against the arm's length principle. For that reason, taxpayers should be prepared to substantiate the basis of their claim with respect to the CCA (see Section E).

C.2. Determining participants

8.14 Because the concept of mutual benefit is fundamental to a CCA, it follows that a party may not be considered a participant if the party does not have a reasonable expectation that it will benefit from the objectives of the CCA activity itself (and not just from performing part or all of the subject activity), for example, from exploiting its interest or rights in the intangibles or tangible assets, or from the use of the services produced through the CCA. A participant therefore must be assigned an interest or rights in the intangibles, tangible assets or services that are the subject of the CCA, and have a reasonable expectation of being able to benefit from that interest or those rights. An enterprise that solely performs the subject activity, for example performing research functions, but does not receive an interest in the output of the CCA, would not be considered a participant in the CCA but rather a service provider to the CCA. As such, it should be compensated for the services it provides on an arm's length basis external to the CCA. See paragraph 8.18. Similarly, a party would not be a participant in a CCA if it is not capable of exploiting the output of the CCA in its own business in any manner.

8.15 A party would also not be a participant in a CCA if it does not exercise control over the specific risks it assumes under the CCA and does not have the financial capacity to assume these risks, as this party would not be entitled to a share in the output that is the objective of the CCA based on the functions it actually performs. The general principles set out in Chapter I of these guidelines on the assumption of risks apply to situations involving CCAs. Each participant makes particular contributions to the CCA objectives, and contractually assumes certain risks. Guidance under Section D.1 of Chapter I on delineating the actual transaction will apply to the transfer pricing analysis in relation to these risks. This also means that a party assuming risks under a CCA based on an analysis under step 4(i) of the framework for analysing risks in paragraph 1.60 (“assumes the risk under the CCA”) must control the specific risks it assumes under the CCA and must have the financial capacity to assume these risks. In particular, this implies that a CCA participant must have (i) the capability to make decisions to take on, lay off, or decline the risk-bearing opportunity presented by participating in the CCA, and must actually perform that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, and must actually perform that decision-making function. While it is not necessary for the party to perform day-to-day risk mitigation activities in relation to activities of the CCA, in such cases, it must have the capability to determine the objectives of those risk mitigation activities to be performed by another party, to decide to entrust that other party to provide the risk mitigation functions, to assess whether the objectives are being adequately met, and, where necessary, to decide to adapt or terminate the arrangement, and must actually perform such assessment and decision-making. In accordance with the principles of prudent business management, the extent of the risks involved in the arrangement will determine the extent of capability and control required. The guidance in paragraphs 6.60 to 6.64 is relevant for assessing whether a party providing funding has the functional capability to exercise control over the financial risk attached to its contributions to the CCA and whether it actually performs these functions. See Examples 4 and 5 in the annex to this chapter for an illustration of this principle.

8.16 To the extent that specific contributions made by participants to a CCA are different in nature, e.g. the participants perform very different types of R&D activities or one of the parties contributes property and another contributes R&D activities, the guidance in paragraph 6.64 is equally applicable. This means that the higher the development risk attached to the development activities performed by the other party and the closer the risk

assumed by the first party is related to this development risk, the more the first party will need to have the capability to assess the progress of the development of the intangible and the consequences of this progress for achieving its expected benefits, and the more closely this party may need to link its actual decision-making required in relation to its continued contributions to the CCA to key operational developments that may impact the specific risks it assumes under the CCA. A development CCA in which benefits are uncertain and distant is likely to give rise to greater risks than does a services CCA in which benefits are current.

8.17 As described in the previous paragraphs, it is not necessary for the CCA participants to perform all of the CCA activities through their own personnel. In some cases, the participants in a CCA may decide to outsource certain functions related to the subject activity to a separate entity that is not a participant under the standard of paragraph 8.14 above. In such situations, the participants to the CCA should individually meet the requirements on exercising control over the specific risks they assume under the CCA. Such requirements include exercising control over the outsourced functions by at least one of the participants to the CCA. In circumstances in which the objective of the CCA is to develop an intangible, at least one of the participants to the CCA should also exercise control over the important development, enhancement, maintenance, protection and exploitation functions that are outsourced. When the contribution of a participant to the CCA consists of activities other than controlling the outsourced functions, the guidance in paragraph 8.15 is relevant for assessing whether this party has the functional capability to exercise control over the specific risks it assumes under the CCA, in particular if these risks are closely linked to the outsourced functions.

8.18 In cases where CCA activities are outsourced, an arm's length charge would be appropriate to compensate the entity for services or other contributions being rendered to the CCA participants. Where the entity is an associated enterprise of one or more of the CCA participants, the arm's length charge would be determined under the general principles of Chapters I–III, including *inter alia* consideration of functions performed, assets used, and risks assumed, as well as the special considerations affecting an arm's length charge for services and/or in relation to any intangibles, as described in Chapter VII and Chapter VI (including the guidance on hard-to-value intangibles).

C.3. Expected benefits from the CCA

8.19 The relative shares of expected benefits might be estimated based on the anticipated additional income generated or costs saved or other benefits received by each participant as a result of the arrangement. An approach that is frequently used in practice, most typically for services CCAs, would be to reflect the participants' proportionate shares of expected benefits using a relevant allocation key. The possibilities for allocation keys include sales (turnover), profits, units used, produced, or sold; number of employees, and so forth.

8.20 To the extent that a material part or all of the benefits of a CCA activity are expected to be realised in the future and not solely in the year the costs are incurred, most typically for development CCAs, the allocation of contributions will take account of projections about the participants' shares of those benefits. The use of projections may raise problems for tax administrations in verifying the assumptions based on which projections have been made and in dealing with cases where the projections vary markedly from the actual results. These problems may be exacerbated where the CCA activity ends several years before the expected benefits actually materialise. It may be appropriate, particularly where benefits are expected to be realised in the future, for a CCA to provide

for possible adjustments of proportionate shares of contributions over the term of the CCA on a prospective basis to reflect changes in relevant circumstances resulting in changes in relative shares of benefits. In situations where the actual shares of benefits differ markedly from projections, tax administrations might be prompted to enquire whether the projections made would have been considered acceptable by independent enterprises in comparable circumstances, taking into account all the developments that were reasonably foreseeable by the participants, without using hindsight. When the expected benefits of a CCA consist of a right in an intangible that is hard to value at the start of the development project or if pre-existing intangibles that are hard to value are part of the contributions to the CCA project, the guidance in Sections D.3 and D.4 of Chapter VI on hard-to-value intangibles is applicable to value the contributions of each of the participants to the CCA.

8.21 If an arrangement covers multiple activities, it will be important to take this into account in choosing an allocation method, so that the value of contributions made by each participant is properly related to the relative benefits expected by the participants. One approach (though not the only one) is to use more than one allocation key. For example, if there are five participants in a CCA, one of which cannot benefit from certain services activities undertaken within the CCA, then in the absence of some form of set-off or reduction in contribution, the contributions associated with those activities might be allocated only to the other four participants. In this case, two allocation keys might be used to allocate the contributions. Whether any particular allocation key or keys are appropriate depends on the exact nature of the CCA activity and the relationship between the allocation key(s) and the expected benefits. The guidance in Chapter VII on the use of indirect methods of determining an arm's length charge for services (paragraphs 7.23-7.26) may be helpful in this regard. In contrast, the three enterprises operating production sites in the illustration of a CCA in paragraph 8.8 are all anticipated to benefit from the multiple projects to improve production processes, and may adopt an allocation key based on, for example, relative size of production capacity. If one of the enterprises chooses not to implement the outcome of a particular project, this should not affect the relative share of benefits or the allocation key used. However, in such circumstances careful consideration should be given to the reason the enterprise chose not to implement the outcome, whether it ever had any reasonable intention of so doing, whether the expected benefits should have been adapted as the CCA arrangement developed and when its intention changed.

8.22 Whatever the method used to evaluate participants' relative shares of expected benefits, adjustments to the measure used may be necessary to account for differences between the respective shares of expected and actual benefits received by the participants. The CCA should require periodic reassessment of contributions *vis-à-vis* the revised share of benefits to determine whether the future contributions of participants should be adjusted accordingly. Thus, the allocation key(s) most relevant to any particular CCA may change over time leading to prospective adjustments. Such adjustments may reflect either the fact that the parties will have more reliable information about foreseeable (but uncertain) events as time passes, or the occurrence of unforeseeable events.

C.4. The value of each participant's contribution

8.23 For the purpose of determining whether a CCA satisfies the arm's length principle – i.e. whether each participant's proportionate share of the overall contributions to the CCA is consistent with the participant's proportionate share of the overall expected benefits – it is necessary to measure the value of each participant's contributions to the arrangement.

8.24 Contributions to a CCA may take many forms. For services CCAs, contributions primarily consist of the performance of the services. For development CCAs, contributions typically include the performance of development activities (e.g. R&D, marketing), and often include additional contributions relevant to the development CCA such as pre-existing tangible assets or intangibles. Irrespective of the type of CCA, all contributions of current or pre-existing value must be identified and accounted for appropriately in accordance with the arm's length principle. Since the value of each participant's relative share of contributions should accord with its share of expected benefits, balancing payments may be required to ensure this consistency. The term "contributions" as used in this Chapter includes contributions of both pre-existing and current value made by participants to a CCA.

8.25 Under the arm's length principle, the value of each participant's contribution should be consistent with the value that independent enterprises in comparable circumstances would have assigned to that contribution. That is, contributions must generally be assessed based on their value at the time they are contributed, bearing in mind the mutual sharing of risks, as well as the nature and extent of the associated expected benefits to participants in the CCA, in order to be consistent with the arm's length principle. In determining the value of contributions to a CCA the guidance elsewhere in these Guidelines should be followed.

8.26 In valuing contributions, distinctions should be drawn between contributions of pre-existing value and current contributions. For example, in a CCA for the development of an intangible, the contribution of patented technology by one of the participants reflects a contribution of pre-existing value which is useful towards the development of the intangible that is the objective of the CCA. The value of that technology should be determined under the arm's length principle using the guidance in Chapter I–III and Chapter VI, including, where appropriate, the use of valuation techniques as set out in that Chapter. The current R&D activity under the development CCA performed by one or more associated enterprises would constitute a current contribution. The value of current functional contributions is not based on the potential value of the resulting further application of the technology, but on the value of the functions performed. The potential value of the resulting further application of the technology is taken into account through the value of pre-existing contributions and through the sharing of the development risk in proportion to the expected share of benefits by the CCA participants. The value of the current contributions should be determined under the guidance in Chapters I–III, VI and VII. As noted in paragraph 6.79, compensation based on a reimbursement of cost plus a modest mark-up will not reflect that anticipated value of, or the arm's length price for, the contribution of the research team in all cases.

8.27 While all contributions should be measured at value (but see paragraph 8.28 below), it may be more administrable for taxpayers to pay current contributions at cost. This may be particularly relevant for development CCAs. If this approach is adopted, the pre-existing contributions should recover the opportunity cost of the *ex ante* commitment to contribute resources to the CCA. For example, a contractual arrangement (i.e. the CCA) that commits an existing R&D workforce to undertake work for the benefit of the CCA should reflect the opportunity cost of alternative R&D endeavours (e.g. the present value of the arm's length mark-up over R&D costs) in the pre-existing contributions, while contributing current activities at cost (see Example 1A in the annex to this chapter).

8.28 Whereas it cannot be assumed that the value of pre-existing contributions corresponds to costs, it is sometimes the case that cost could be used as a practical means to measure relative value of current contributions. Where the difference between the value and costs is relatively insignificant, for practical reasons, current contributions of a similar nature

may be measured at cost in such cases for services CCAs. However, in other circumstances (for example where contributions provided by the participants vary in nature and include a mixture of service types and/or intangibles or other assets) measuring current contributions at cost is unlikely to provide a reliable basis for determining the value of the relative contributions of participants, and may lead to non-arm's length results. For development CCAs, the measurement of current contributions at cost (apart from the administrative guidance in paragraph 8.27) will generally not provide a reliable basis for the application of the arm's length principle. See Examples 1-3 in the annex to this chapter for illustration of this guidance. Where uncontrolled arrangements are claimed to be comparable to the arrangements between the associated enterprises in the CCA, and those uncontrolled arrangements provide for contributions to be made at cost, it is important to consider the comparability of all of the economically relevant characteristics of the transactions in the broader context of the arrangement, including the impact of any broader arrangement of economically related transactions which may exist between the parties to the uncontrolled transaction, and the sharing of risks. Particular attention should be paid to whether other payments are made in the uncontrolled arrangements; for example, stage payments or compensating contributions may be made in addition to the reimbursement of costs.

8.29 Since contributions are based on expected benefits, this generally implies that where a cost reimbursement basis for valuing current contributions is permitted, the analysis should initially be based on budgeted costs. This does not necessarily mean fixing the costs, since the budget framework may accommodate variability arising from factors such as varying demand levels (for instance budgeted costs may be expressed as a fixed percentage of actual sales). Additionally, there are likely to be differences between budgeted costs and actual costs during the term of the CCA. In an arm's length situation, the terms agreed between the parties are likely to set out how such differences should be treated since, as stated in paragraph 2.96, independent parties are not likely to use budgeted costs without agreeing what factors are taken into account in setting the budget and how unforeseen circumstances are to be treated. Attention should be paid to the reason for any significant differences between budgeted costs and actual costs, since the difference may point to changes in the scope of activities which may not benefit all the participants in the same way as the activities originally scoped. In general terms, however, where cost is found to be an appropriate basis for measuring current contributions, it is likely to be sufficient to use actual costs as the basis for so doing.

8.30 It is important that the evaluation process recognises all contributions made by participants to the arrangement. This includes contributions made by one or more parties at the inception of the CCA (such as contributions of pre-existing intangibles) as well as contributions made on an ongoing basis during the term of the CCA. Contributions to be considered include property or services that are used solely in the CCA activity, but also property or services (i.e. shared property or services) that are used partly in the CCA activity and also partly in the participant's separate business activities. It can be difficult to measure contributions that involve shared property or services, for example where a participant contributes the partial use of assets such as office buildings and IT systems or performs supervisory, clerical, and administrative functions for the CCA and for its own business. It will be necessary to determine the proportion of the assets used or services that relate to the CCA activity in a commercially justifiable way with regard to recognised accounting principles and the actual facts, and adjustments, if material, may be necessary to achieve consistency when different jurisdictions are involved. Once the proportion is determined, the contribution can be measured in accordance with the principles in the rest of this chapter.

8.31 For development CCAs, contributions in the form of controlling and managing the CCA, its activities and risks, are likely to be important functions, as described in paragraph 6.56, in relation to the development, production, or obtaining of the intangibles or tangible assets and should be valued in accordance with the principles set out in Chapter VI.

8.32 The following scenario illustrates the guidance on determining participants, the share of benefits, and the value of contributions.

8.33 Company A based in country A and Company B based in country B are members of an MNE group and have concluded a CCA to develop intangibles. Company B has entitlement under the CCA to exploit the intangibles in country B, and Company A has entitlement under the CCA to exploit the intangibles in the rest of the world. The parties anticipate that Company A will have 75% of total sales and Company B 25% of total sales, and that their share of expected benefits from the CCA is 75:25. Both A and B have experience of developing intangibles and have their own research and development personnel. They each control their development risk under the CCA within the terms set out in paragraphs 8.14 to 8.16. Company A contributes pre-existing intangibles to the CCA that it has recently acquired from a third-party. Company B contributes proprietary analytical techniques that it has developed to improve efficiency and speed to market. Both of these pre-existing contributions should be valued under the guidance provided in Chapters I–III and VI. Current contributions in the form of day-to-day research will be performed 80% by Company B and 20% by Company A under the guidance of a leadership team made up of personnel from both companies in the ratio 90:10 in favour of Company A. These two kinds of current contributions should separately be analysed and valued under the guidance provided in Chapters I–III and VI. When the expected benefits of a CCA consist of a right in an intangible that is hard to value at the start of the development project or if pre-existing intangibles that are hard to value are part of the contributions to the CCA project, the guidance in Sections D.3 and D.4 of Chapter VI on hard-to-value intangibles is applicable to value the contributions of each of the participants to the CCA.

C.5. Balancing payments

8.34 A CCA will be considered consistent with the arm's length principle where the value of each participant's proportionate share of the overall contributions to the arrangement (taking into account any balancing payments already made) is consistent with the participant's share of the overall expected benefits to be received under the arrangement. Where the value of a participant's share of overall contributions under a CCA at the time the contributions are made is not consistent with that participant's share of expected benefits under the CCA, the contributions made by at least one of the participants will be inadequate, and the contributions made by at least one other participant will be excessive. In such a case, the arm's length principle would generally require that an adjustment be made. This will generally take the form of an adjustment to the contribution through making or imputing a (further) balancing payment. Such balancing payments increase the value of the contributions of the payor and decrease that of the payee.

8.35 Balancing payments may be made by participants to “top up” the value of the contributions when their proportionate contributions are lower than their proportionate expected benefits. Such adjustments may be anticipated by the participants upon entering into the CCA, or may be the result of periodic re-evaluation of their share of the expected benefits and/or the value of their contributions (see paragraph 8.22).

8.36 Balancing payments may also be required by tax administrations where the value of a participant's proportionate contributions of property or services at the time the contribution

was made has been incorrectly determined, or where the participants' proportionate expected benefits have been incorrectly assessed, e.g. where the allocation key when fixed or adjusted for changed circumstances was not adequately reflective of proportionate expected benefits. Normally the adjustment would be made by a balancing payment from one or more participants to another being made or imputed for the period in question.

8.37 In the case of development CCAs, variations between a participant's proportionate share of the overall contributions and that participant's proportionate share of the overall expected benefits may occur in a particular year. If that CCA is otherwise acceptable and carried out faithfully, having regard to the recommendations of Section E, tax administrations should generally refrain from making an adjustment based on the results of a single fiscal year. Consideration should be given to whether each participant's proportionate share of the overall contributions is consistent with the participant's proportionate share of the overall expected benefits from the arrangement over a period of years (see paragraphs 3.75-3.79). Separate balancing payments might be made for pre-existing contributions and for current contributions, respectively. Alternatively, it might be more reliable or administrable to make an overall balancing payment relating to pre-existing contributions and current contributions collectively. See Example 4 in the annex to this chapter.

8.38 In the example in paragraph 8.33, the participants, Companies A and B, expect to benefit from the CCA in the ratio 75:25. In the first year the value of their pre-existing contributions is 10 million for Company A and 6 million for Company B. As a result, a net balancing payment is required to be made to Company B by Company A of 2 million (i.e. 4.5 million from Company A to Company B less 2.5 million from Company B to Company A) in order to increase Company A's contribution to 12 million (75% of the total contributions) and reducing Company B's contribution to 4 million (25% of the total).

C.6. Accurately delineating the actual transaction

8.39 As indicated in paragraph 8.9, the economically relevant characteristics of the arrangement identified under the guidance in Section D of Chapter I may indicate that the actual transaction differs from the terms of the CCA purportedly agreed by the participants. For example, one or more of the claimed participants may not have any reasonable expectation of benefit from the CCA activity. Although in principle the smallness of a participant's share of expected benefits is no bar to eligibility, if a participant that is performing all of the subject activity is expected to have only a small fraction of the overall expected benefits, it may be questioned whether the reality of the arrangements for that party is to pool resources and share risks or whether the appearance of sharing in mutual benefits has been constructed to obtain more favourable tax results. The existence of significant balancing payments arising from a material difference between the parties' proportionate shares of contributions and benefits may also give rise to questions about whether mutual benefits exist or whether the arrangements should be accurately delineated, taking into account all the economically relevant characteristics, as a funding transaction.

8.40 As indicated in paragraph 8.33, the guidance in Chapter VI on hard-to-value intangibles may equally apply in situations involving CCAs. This will be the case if the objective of the CCA is to develop a new intangible that is hard to value at the start of the development project, but also in valuing contributions involving pre-existing intangibles. Where the arrangements viewed in their totality lack commercial rationality in accordance with the criteria in Section D.2 of Chapter I, the CCA may be disregarded.

C.7. The tax treatment of contributions and balancing payments

8.41 Contributions, including any balancing payments, by a participant to a CCA should be treated for tax purposes in the same manner as would apply under the general rules of the tax system(s) applicable to that participant if the contributions were made outside a CCA, to carry on the activity that is the subject of the CCA. The character of the contribution will depend on the nature of the activity being undertaken by the CCA, and will determine how it is recognised for tax purposes.

8.42 In services CCAs, a participant's contribution to the CCA will often give rise to benefits in the form of cost savings (in which case there may not be any income generated directly by the CCA activity). In development CCAs, the expected benefits to participants may not accrue until some time after contributions are made, and therefore there will be no immediate recognition of income to the participants on their contributions at the time they are made.

8.43 Any balancing payment should be treated as an addition to the contribution of the payor and as a reduction in the contribution of the recipient. As with contributions generally, the character and tax treatment of any balancing payments will be determined in accordance with domestic laws, including applicable tax treaties.

D. CCA entry, withdrawal or termination

8.44 Changes in the membership of a CCA will generally trigger a reassessment of the proportionate shares of participants' contributions and expected benefits. An entity that becomes a participant in an already active CCA might obtain an interest in any results of prior CCA activity, such as completed or work-in-progress intangibles or tangible assets. In such cases, the previous participants effectively transfer part of their respective interests in the results of the prior CCA activity to the new entrant. Under the arm's length principle, any such transfer of intangibles or tangible assets must be compensated based on an arm's length value for the transferred interest. Such compensation is referred to in this chapter as a "buy-in payment".

8.45 The amount of a buy-in payment should be determined based upon the value (i.e. the arm's length price) of the interest in the intangibles and/or tangible assets the new entrant obtains, taking into account the new entrant's proportionate share of the overall expected benefits to be received under the CCA. There may also be cases where a new participant brings existing intangibles or tangible assets to the CCA, and that balancing payments may be appropriate from the other participants in recognition of this contribution. Any balancing payments to the new entrant could be netted against any buy-in payments required, although appropriate records must be kept of the full amounts of the separate payments for tax administration purposes.

8.46 Similar issues could arise when a participant leaves a CCA. In particular, a participant that leaves a CCA may dispose of its interest in the results, if any, of past CCA activity (including work in progress) to the other participants. Any such transfer should be compensated according to the arm's length principle. Such compensation is referred to in this chapter as a "buy-out payment".

8.47 The guidance in Chapters I–III and VI is fully applicable to determining the arm's length amount of any buy-in, buy-out or balancing payments required. There may be instances where no such payments are required under the arm's length principle. For example, a CCA for the sharing of administrative services would generally only produce benefits to participants on a current basis, rather than any valuable on-going results.

8.48 Buy-in and buy-out payments should be treated for tax purposes in the same manner as would apply under the general rules of the tax system(s) (including conventions for the avoidance of double taxation) applicable to the respective participants as if the payment were made outside a CCA as consideration for the acquisition or disposal of the interest in the results of the prior CCA activity.

8.49 When a CCA terminates, the arm's length principle requires that each participant retains an interest in the results, if any, of the CCA activity consistent with their proportionate share of contributions to the CCA throughout its term (adjusted by any balancing payments actually made, including those made as a result of the termination), or is appropriately compensated for any transfer of that interest to other participants.

E. Recommendations for structuring and documenting CCAs

8.50 Generally, a CCA between controlled parties should meet the following conditions:

- a) The participants would include only enterprises expected to derive mutual and proportionate benefits from the CCA activity itself (and not just from performing part or all of that activity). See paragraph 8.14.
- b) The arrangement would specify the nature and extent of each participant's interest in the results of the CCA activity, as well its expected respective share of benefits.
- c) No payment other than the CCA contributions, appropriate balancing payments and buy-in payments would be made for the particular interest or rights in intangibles, tangible assets or services obtained through the CCA.
- d) The value of participants' contributions would be determined in accordance with these Guidelines and, where necessary, balancing payments should be made to ensure the proportionate shares of contributions align with the proportionate shares of expected benefits from the arrangement.
- e) The arrangement may specify provision for balancing payments and/ or changes in the allocation of contributions prospectively after a reasonable period of time to reflect material changes in proportionate shares of expected benefits among the participants.
- f) Adjustments would be made as necessary (including the possibility of buy-in and buy-out payments) upon the entrance or withdrawal of a participant and upon termination of the CCA.

8.51 The transfer pricing documentation standard set out in Chapter V requires reporting under the master file of important service arrangements and important agreements related to intangibles, including CCAs. The local file requires transactional information including a description of the transactions, the amounts of payments and receipts, identification of the associated enterprises involved, copies of material intercompany agreements, and pricing information including a description of reasons for concluding that the transactions were priced on an arm's length basis. It would be expected that in order to comply with these documentation requirements, the participants in a CCA will prepare or obtain materials about the nature of the subject activity, the terms of the arrangement, and its consistency with the arm's length principle. Implicit in this is that each participant should have full access to the details of the activities to be conducted under the CCA, the identity and location of the other parties involved in the CCA, the projections on which the contributions are to be made and expected benefits determined, and budgeted and actual

expenditures for the CCA activity, at a level of detail commensurate with the complexity and importance of the CCA to the taxpayer. All this information could be relevant and useful to tax administrations in the context of a CCA and, if not included in the master file or local file, taxpayers should be prepared to provide it upon request. The information relevant to any particular CCA will depend on the facts and circumstances. It should be emphasised that the information described in this list is neither a minimum compliance standard nor an exhaustive list of the information that a tax administration may be entitled to request.

8.52 The following information would be relevant and useful concerning the initial terms of the CCA:

- a) a list of participants
- b) a list of any other associated enterprises that will be involved with the CCA activity or that are expected to exploit or use the results of the subject activity
- c) the scope of the activities and specific projects covered by the CCA, and how the CCA activities are managed and controlled
- d) the duration of the arrangement
- e) the manner in which participants' proportionate shares of expected benefits are measured, and any projections used in this determination
- f) the manner in which any future benefits (such as intangibles) are expected to be exploited
- g) the form and value of each participant's initial contributions, and a detailed description of how the value of initial and ongoing contributions is determined (including any budgeted vs actual adjustments) and how accounting principles are applied consistently to all participants in determining expenditures and the value of contributions
- h) the anticipated allocation of responsibilities and tasks, and the mechanisms for managing and controlling those responsibilities and tasks, in particular, those relating to the development, enhancement, maintenance, protection or exploitation of intangibles or tangible assets used in the CCA activity
- i) the procedures for and consequences of a participant entering or withdrawing from the CCA and the termination of the CCA
- j) any provisions for balancing payments or for adjusting the terms of the arrangement to reflect changes in economic circumstances.

8.53 Over the duration of the CCA term, the following information could be useful:

- a) any change to the arrangement (e.g. in terms, participants, subject activity), and the consequences of such change
- b) a comparison between projections used to determine the share of expected benefits from the CCA activity with the actual share of benefits (however, regard should be had to paragraph 3.74)
- c) the annual expenditure incurred in conducting the CCA activity, the form and value of each participant's contributions made during the CCA's term, and a detailed description of how the value of contributions is determined.

Annex to Chapter VIII – Examples to illustrate the guidance on cost contribution arrangements

Example 1

1. Example 1 illustrates the general principle that contributions should be assessed at value (i.e. based on arm's length prices) in order to produce results that are consistent with the arm's length principle.

2. Company A and Company B are members of an MNE group and decide to enter into a CCA. Company A performs Service 1 and Company B performs Service 2. Company A and Company B each “consume” both services (that is, Company A receives a benefit from Service 2 performed by Company B, and Company B receives a benefit from Service 1 performed by Company A).

3. Assume that the costs and value of the services are as follows:

Costs of providing Service 1 (cost incurred by Company A)	100 per unit
Value of Service 1 (i.e. the arm's length price that Company A would charge Company B for the provision of Service 1)	120 per unit
Costs of providing Service 2 (cost incurred by Company B)	100 per unit
Value of Service 2 (i.e. the arm's length price that Company B would charge Company A for the provision of Service 2)	105 per unit

4. In Year 1 and in subsequent years, Company A provides 30 units of Service 1 to the group and Company B provides 20 units of Service 2 to the group. Under the CCA, the calculation of costs and benefits are as follows:

Cost to Company A of providing services (30 units * 100 per unit)	3 000	(60% of total costs)
Cost to Company B of providing services (20 units * 100 per unit)	<u>2 000</u>	(40% of total costs)
Total cost to group	5 000	
Value of contribution made by Company A (30 units * 120 per unit)	3 600	(63% of total contributions)
Value of contribution made by Company B (20 units * 105 per unit)	<u>2 100</u>	(37% of total contributions)
Total value of contributions made under the CCA	5 700	

Company A and Company B each consume 15 units of Service 1 and 10 units of Service 2:

Benefit to Company A:		
Service 1: 15 units * 120 per unit	1 800	
Service 2: 10 units * 105 per unit	<u>1 050</u>	
Total	2 850	(50% of total value of 5 700)

Benefit to Company B		
Service 1: 15 units * 120 per unit	1 800	
Service 2: 10 units * 105 per unit	<u>1 050</u>	
Total	2 850	(50% of total value of 5 700)

5. Under the CCA, the value of Company A and Company B's contributions should each correspond to their respective proportionate shares of expected benefits, i.e. 50%.

Since the total value of contributions under the CCA is 5 700, this means each party must contribute 2 850. The value of Company A's in-kind contribution is 3 600 and the value of Company B's in-kind contribution is 2 100. Accordingly, Company B should make a balancing payment to Company A of 750. This has the effect of "topping up" Company B's contribution to 2 850; and offsets Company A's contribution to the same amount.

6. If contributions were measured at cost instead of at value, since Companies A and B each receive 50% of the total benefits, they would have been required contribute 50% of the total costs, or 2 500 each, i.e. Company B would have been required to make a 500 (instead of 750) balancing payment to A.

7. In the absence of the CCA, Company A would purchase 10 units of Service 2 for the arm's length price of 1 050 and Company B would purchase 15 units of Service 1 for the arm's length price of 1 800. The net result would be a payment of 750 from Company B to Company A. As can be shown from the above, this arm's length result is only achieved in respect of the CCA when contributions are measured at value.

Example 1A

8. The facts are the same as Example 1. In accordance with the guidance in paragraph 8.27, an alternative way to achieve the identical result under Example 1 is through the use of a two-step process as set out below.

9. Step 1 (contributions measured at cost): Company A should bear 50% of the total cost of 5 000, or 2 500. The cost of Company A's in-kind contribution is 3 000. Company B should bear 50% of the total cost, or 2 500. The cost of Company B's in-kind contribution is 2 000. Company B should thus make an additional payment to Company A of 500. This reflects a balancing payment associated with current contributions.

10. Step 2 (accounting for additional contributions of value to the CCA): Company A produces 20 of value above costs per unit. Company B produces 5 of value above costs per unit. Company A consumes 10 units of Service 2 (50 of value over cost), and Company B consumes 15 units of Service 1 (300 of value over cost). Accordingly, Company A should be compensated 250 for the additional 250 of value that it contributes to the CCA. This reflects a balancing payment associated with pre-existing contributions.

11. The two-step method provides for a sharing of costs plus a separate and additional payment to the participant that makes an additional contribution of value to the arrangement. In general, the additional contribution of value might reflect pre-existing contributions, such as intangibles owned by one of the participants, that are relevant to the purpose of the CCA. Thus, the two-step method might be most usefully applied to development CCAs.

Example 2

12. The facts are the same as Example 1, except that the per-unit value of Service 1 is 103 (that is, both Service 1 and Service 2 are low-value services). Assume, therefore, that the calculation of the costs and value of the services is as follows:

Cost to Company A of providing services (30 units * 100 per unit)	3 000	(60% of total costs)
Cost to Company B of providing services (20 units * 100 per unit)	2 000	(40% of total costs)
Total cost to group	5 000	
Value of contribution made by Company A (30 units * 103 per unit)	3 090	(59.5% of total contributions)
Value of contribution made by Company B (20 units * 105 per unit)	2 100	(40.5% of total contributions)
Total value of contributions made under the CCA	5 190	

Company A and Company B each consume 15 units of Service 1 and 10 units of Service 2:		
Benefit to Company A:		
Service 1: 15 units * 103 per unit	1 545	
Service 2: 10 units * 105 per unit	<u>1 050</u>	
Total	2 595	(50% of total value of 5 190)
Benefit to Company B		
Service 1: 15 units * 103 per unit	1 545	
Service 2: 10 units * 105 per unit	<u>1 050</u>	
Total	2 595	(50% of total value of 5 190)

13. Under the CCA, the value of Company A and Company B's contributions should each correspond to their respective proportionate shares of expected benefits, i.e. 50%. Since the total value of contributions under the CCA is 5 190, this means each party must contribute 2 595. The value of Company A's in-kind contribution is 3 090. The value of Company B's in-kind contribution is 2 100. Accordingly, Company B should make a balancing payment to Company A of 495. This has the effect of "topping up" Company B's contribution to 2 595; and offsets Company A's contribution to the same amount.

14. In this example, since all contributions to the CCA are low-value services, for practical reasons, contributions may be valued at cost since this will achieve results which are broadly consistent with the arm's length principle. Under this practical approach, the cost of Company A's in-kind contribution is 3 000; the cost of Company B's in-kind contribution is 2 000; and each participant should bear the costs associated with 50% of the total cost of contributions (2 500). Accordingly, Company B should make a balancing payment to Company A of 500.

Example 3

15. The facts are the same as Example 1, except that the per-unit value of Service 2 is 120 (that is, both Service 1 and Service 2 are equally valuable, and neither are low-value services).

Cost to Company A of providing services (30 units * 100 per unit)	3 000	(60% of total costs)
Cost to Company B of providing services (20 units * 100 per unit)	<u>2 000</u>	(40% of total costs)
Total cost to group	5 000	
Value of contribution made by Company A (30 units * 120 per unit)	3 600	(60% of total contributions)
Value of contribution made by Company B (20 units * 120 per unit)	<u>2 400</u>	(40% of total contributions)
Total value of contributions made under the CCA	6 000	
Company A and Company B each consume 15 units of Service 1 and 10 units of Service 2:		
Benefit to Company A:		
Service 1: 15 units * 120 per unit	1 800	
Service 2: 10 units * 120 per unit	<u>1 200</u>	
Total	3 000	(50% of total value of 6 000)
Benefit to Company B		
Service 1: 15 units * 120 per unit	1 800	
Service 2: 10 units * 120 per unit	<u>1 200</u>	
Total	3 000	(50% of total value of 6 000)

16. Under the CCA, the value of Company A and Company B's contributions should each correspond to their respective proportionate shares of expected benefits i.e. 50%. Since the total value of contributions under the CCA is 6 000, this means each party must contribute 3 000. The value of Company A's in-kind contribution is 3 600. The value of Company B's in-kind contribution is 2 400. Accordingly, Company B should make a balancing payment to Company A of 600. This has the effect of "topping up" Company B's contribution to 3 000; and offsets Company A's contribution to the same amount. Example 3 illustrates that, in general, assessing contributions at cost will not result in an arm's length outcome even in those situations in which the arm's length mark-up on the cost of contributions is identical.

Example 4

17. Company A and Company B are members of an MNE group and decide to undertake the development of an intangible through a CCA. The intangible is anticipated to be highly profitable based on Company B's existing intangibles, its track record and its experienced research and development staff. Company A performs, through its own personnel, all the functions expected of a participant in a development CCA obtaining an independent right to exploit the resulting intangible, including functions required to exercise control over the risks it contractually assumes in accordance with the principles outlined in paragraphs 8.14 to 8.18. The particular intangible in this example is expected to take five years to develop before possible commercial exploitation and if successful, is anticipated to have value for ten years after initial exploitation.

18. Under the CCA, Company A will contribute to funding associated with the development of the intangible (its share of the development costs are anticipated to be USD 100 million per year for five years). Company B will contribute the development rights associated with its existing intangibles, to which Company A is granted rights under the CCA irrespective of the outcome of the CCA's objectives, and will perform all activities related to the development, maintenance, and exploitation of the intangible. The value of Company B's contributions (encompassing the performance of activities as well as the use of the pre-existing intangibles) would need to be determined in accordance with the guidance in Chapter VI and would likely be based on the anticipated value of the intangible expected to be produced under the CCA, less the value of the funding contribution by Company A.

19. Once developed, the intangible is anticipated to result in global profits of USD 550 million per year (Years 6 to 15). The CCA provides that Company B will have exclusive rights to exploit the resulting intangible in country B (anticipated to result in profits of USD 220 million per year in Years 6 to 15) and Company A will have exclusive rights to exploit the intangible in the rest of the world (anticipated to result in profits of USD 330 million per year).

20. Taking into account the realistic alternatives of Company A and Company B it is determined that the value of Company A's contribution is equivalent to a risk-adjusted return on its R&D funding commitment. Assume that this is determined to be USD 110 million per year (for Years 6 to 15).²³ However, under the CCA Company A is anticipated to reap benefits amounting to USD 330 million of profits per year in Years 6 to 15 (rather than USD 110 million). This additional anticipated value in the rights Company A obtains (that is, the anticipated value above and beyond the value of Company A's funding investment) reflects the contribution of Company B's pre-existing contributions of intangibles and R&D commitment to the CCA. Company A needs to pay for this additional value it receives. Accordingly, balancing payments from Company A

to Company B to account for the difference are required. In effect, Company A would need to make a balancing payment associated with those contributions to Company B equal in present value, taking into account the risk associated with this future income, to USD 220 million per year anticipated in Years 6 to 15.

Example 5

21. The facts are the same as in Example 4 except that the functional analysis indicates Company A has no capacity to make decisions to take on or decline the risk-bearing opportunity represented by its participation in the CCA, or to make decisions on whether and how to respond to the risks associated with the opportunity. It also has no capability to mitigate the risks or to assess and make decisions relating to the risk mitigation activities of another party conducted on its behalf.

22. In accurately delineating the transactions associated with the CCA, the functional analysis therefore indicates that Company A does not control its specific risks under the CCA in accordance with the guidance in paragraph 8.15 and consequently is not entitled to a share in the output that is the objective of the CCA.

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Notes

1. Brazil provides for an approach in its domestic legislation that makes use of fixed margins derived from industry practices and considers this in line with the arm's length principle. Brazil will continue to apply this approach and will use the guidance in this report in this context. When Brazil's Tax Treaties contain Article 9, paragraph 1 of the OECD and UN Model Tax Conventions and a case of double taxation arises that is captured by this Treaty provision, Brazil will provide access to MAP in line with the minimum standard of Action 14.
2. The guidance in this chapter, and in this section on risk in particular, is not specific to any particular industry sector. While the basic concept that a party bearing risks must have the ability to effectively deal with those risks applies to insurance, banking, and other financial services businesses, these regulated sectors are required to follow rules prescribing arrangements for risks, and how risks are recognised, measured, and disclosed. The regulatory approach to risk allocation for regulated entities should be taken into account and reference made as appropriate to the transfer pricing guidance specific to financial services businesses in the *Report on the Attribution of Profits to Permanent Establishments* (OECD, 2010).
3. Further guidance will be provided on the economically relevant characteristics for determining the arm's length conditions for financial transactions. This work will be undertaken in 2016 and 2017.
4. Company A could potentially be entitled to less than a risk-free return if, for example, the transaction is disregarded under Section D.2.
5. In light of differences in local law, some countries consider a deliberate concerted action to always constitute a transaction, while others do not. However, the consensus view is that, in either scenario, a deliberate concerted action involves one associated enterprise performing functions, using assets, or assuming risks for the benefit of one or more other associated enterprises, such that arm's length compensation is required. See, e.g. Example 5 at paragraphs 1.170-1.173.
6. Example 2 should not be viewed as providing comprehensive transfer pricing guidance on guarantee fees in respect of financial transactions. Further guidance will be provided on transfer pricing for financial transactions including identifying the economically relevant characteristics for determining arm's length conditions. This work will be undertaken in 2016 and 2017.
7. OECD (2014), *Reports to G20 Development Working Group on the Impact of BEPS in Low Income Countries*, OECD, Paris, www.oecd.org/tax/tax-global/report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf.
8. OECD (2015), *Addressing the Tax Challenges of the Digital Economy*, Chapter 6, paragraph 231.
9. See note 7.
10. See the section on Intangibles in this Report, paragraph 6.57.
11. Ibid, Section D.2.6.2 of Chapter VI.
12. See Section D.8 of Chapter I under Guidance for Applying the Arm's Length Principle in this Report.
13. The assumption of risks refers to the outcome of the determination of which associated enterprise assumes a specific risk under the guidance provided in Section D.1.2.1 of Chapter I,

- taking into account control over risk and financial capacity to assume the risk. Contractual assumption of risk refers to the allocation of risk in contracts between the parties.
14. As used in this paragraph, a financial asset is any asset that is cash, an equity instrument, a contractual right or obligation to receive cash or another financial asset or to exchange financial assets or liabilities, or a derivative. Examples include bonds, bank deposits, stocks, shares, forward contracts, futures contracts, and swaps.
 15. As used herein, exploitation of an intangible includes both the transfer of the intangible or rights in the intangible and the use of the intangible in commercial operations.
 16. As used in this Section B, the use of assets includes the contribution of funding and/or capital to the development, enhancement, maintenance, protection or exploitation of intangibles. See paragraph 6.59.
 17. Further guidance will be provided on the economically relevant characteristics for determining the arm's length conditions for financial transactions, including when the funding is used for project finance, in particular investments in the development of intangibles. This work will be undertaken in 2016 and 2017.
 18. Section D.2.6.2 of Chapter VI is likely to be revised to reflect the outcome of the work on the application of transactional profit split methods, mandated by Action 10 of the BEPS Action Plan. This work will be undertaken in 2016 and 2017.
 19. In the case of a financial valuation based on projections, the analysis will often be based on projections of cash flows. Accrual based measures of income, such as those determined for accounting or tax purposes, may not properly reflect the timing of cash flows which can create a difference in outcome between an income and a cash flow based approach. However, in light of a number of considerations, the use of income projections rather than cash flow projections may, in some cases, yield a more reliable result in a transfer pricing context as a practical matter. Care must be taken, however, to assure that either income or cash flow measures are applied in a consistent manner and in appropriate circumstances. References to cash flow in this document should therefore be read broadly to include both cash flow and income measures, appropriately applied.
 20. In some business sectors it is not unusual for an intangible to be transferred with a contingent clause relating to a second, or further, use. In respect of the type of intangibles where this occurs, the time period begins again with the new commercialisation.
 21. For purposes of this example, it is not necessary to derive these results. The example assumes that making a funding "investment" of USD 100 million per year for five years in a project with this level of risk should earn at arm's length anticipated profits of USD 110 million per year for the following ten years. This corresponds to an 11% return on funding.
 22. Section D is the sole part of the guidance reflected in this chapter that should be considered part of the transfer pricing outcomes following from Actions 8-10 of the BEPS Action Plan as endorsed by all BEPS Associate Countries.
 23. For purposes of this example, it is not necessary to derive these results. The example assumes that making a funding "investment" of USD 100 million per year for five years in a project with this level of risk should earn at arm's length anticipated profits of USD 110 million per year for the following ten years. The results used herein are included for the purposes of demonstrating the principles illustrated in this example only and no guidance as to the level of arm's length returns to participants in CCAs should be inferred.

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Aligning Transfer Pricing Outcomes with Value Creation

Addressing base erosion and profit shifting is a key priority of governments around the globe. In 2013, OECD and G20 countries, working together on an equal footing, adopted a 15-point Action Plan to address BEPS. This report is an output of Actions 8-10.

Beyond securing revenues by realigning taxation with economic activities and value creation, the OECD/G20 BEPS Project aims to create a single set of consensus-based international tax rules to address BEPS, and hence to protect tax bases while offering increased certainty and predictability to taxpayers. A key focus of this work is to eliminate double non-taxation. However in doing so, new rules should not result in double taxation, unwarranted compliance burdens or restrictions to legitimate cross-border activity.

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Commodity Transactions

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Cost Contribution Arrangements

www.oecd.org/tax/beps.htm

Consult this publication on line at <http://dx.doi.org/10.1787/9789264241244-en>

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