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A practical summary of the 2022 OECD Transfer Pricing Guidelines

Johann H. Müller

For Caroline,

Stay curious my darling.

Johann H. Müller

This book is a part of the literature for students enrolled at
Johann Müller's Principles of International Transfer Pricing course
(www.johannmuller.teachable.com)
The original book is available on Amazon.com

A practical summary of the January 2022 OECD Transfer Pricing Guidelines

By Johann H. Müller

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PREFACE

How many of us still have time to read 660+ page guidelines? How many of us have time to take those guidelines and combine them with chapters adopted after the guidelines were published? How does a student begin to study a work of this size, without getting hopelessly lost?

This book reflects my love for systematic thinking and reducing clutter. It is aimed at giving fast, accurate, information through diagrams and summaries. I believe it may fill a need at a time where we are buried under information and do not always have time to read ten page articles, hundred-page court decisions, or six hundred page guidelines.

This book does not pretend to be a replacement of the 2022 OECD Transfer Pricing Guidelines; it is an introduction, giving an overview of the wide variety of topics covered, with paragraph references to the underling Guideline paragraphs, so that we know where to find them. The original work can be bought from the OECD. The book is also an introduction to my online transfer pricing course. More information is available on this YouTube channel.

For more information about me, please see my website, my YouTube channel, Taxpics and my LinkedIn profile.

Comments and suggestions about this book are welcome; please send them to me at johann.h.muller@gmail.com.

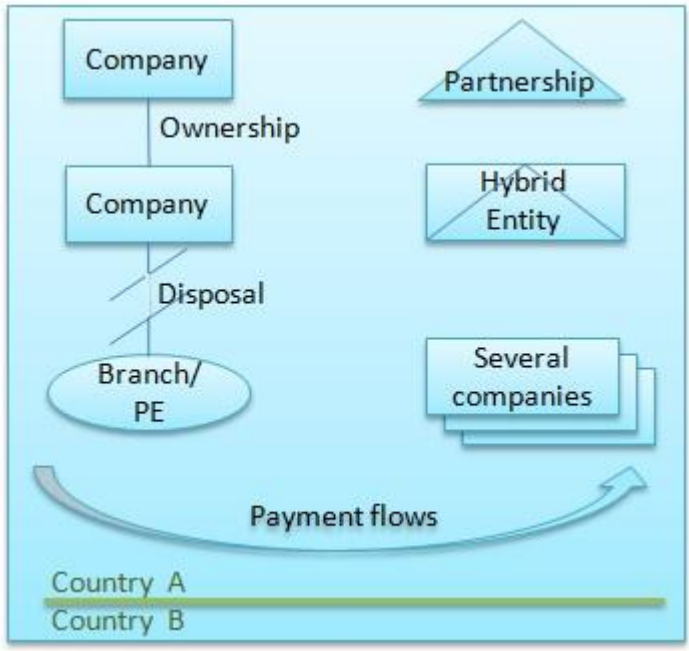
INTRODUCTION

In this book, the 2022 OECD Transfer Pricing Guidelines are summarized three times: first as a one-page overview, then as a longer executive summary and finally as an extended summary of most of the paragraphs of the 2022 OECD Transfer Pricing Guidelines. The extended summary references the actual paragraphs in the 2022 OECD Transfer Pricing Guidelines. As the 2022 OECD Transfer Pricing Guidelines is a live document, which is continuously updated, I will substitute existing the 2022 OECD Transfer Pricing Guidelines chapters and paragraphs with draft and final material published after 2022. These texts are clearly marked and will first concern the profit allocation to PEs, the profit split method and financial transactions, when those documents are finalised by the OECD.

The book follows the order of topics as given in the actual guidelines, albeit that I have added to Annexes to the different chapters in the chapters where they belong. This book is only descriptive: I have not given my opinion

about the choices made, though it is difficult to make a summary without some degree of interpretation.

Legend of symbols used

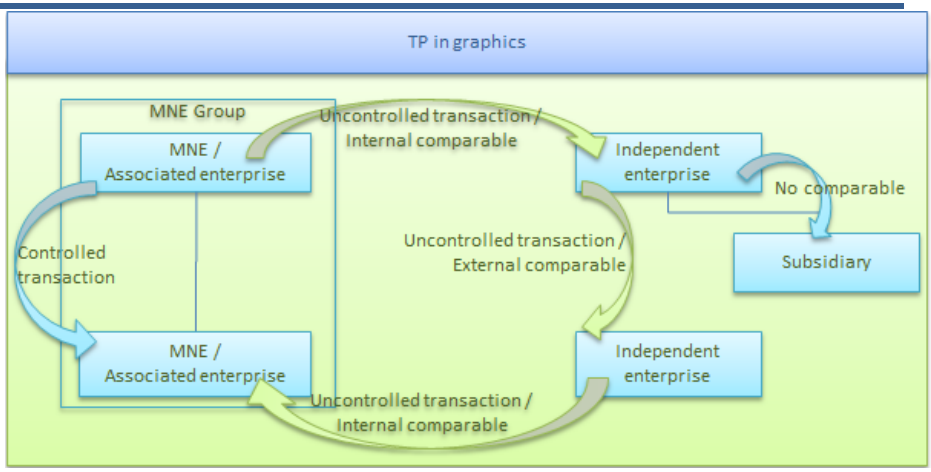


List of commonly used abbreviations

DEMPE	Development, Enhancement, Maintenance, Protection & Exploitation
MNE	Multinational Enterprise
MAP	Mutual Agreement Procedure
TPG	OECD 2022 Transfer Pricing Guidelines

Where a particular term is used a lot within one particular chapter, an abbreviation will be defined at the beginning of that chapter and used within that chapter only.

GENERAL INTRODUCTION TO TP



OVERVIEW

The TPG is divided into five main parts:

i) an introduction, consisting of a foreword, a preface and a glossary;
ii) the general mechanics of determining arm's length prices, consisting of guidance for applying the arm's length principle (Chapter I), the five transfer pricing methods (II) and comparability analyses (III);
iii) formal issues such as avoiding and resolving transfer pricing disputes (IV) and transfer pricing documentation (V);
iv) specific transactions such as intangibles (VI), intra-group services (VII), cost contribution agreements (VIII) and business restructurings (IX); and
v) annexes to various of the foregoing chapters and an appendix recommending the use of the TPG to governments and taxpayers.

The TPG first discusses the problem of profit allocation, the goals of the arm's length principle and the guidelines, and burdens of proof (Preface).

The general mechanics of determining arm's length prices

Chapter I introduces the arm's length principle. It defines it, defends it against alternatives such as formulary apportionment and discusses some fundamental concepts such as understanding intercompany financial and economic relations, assuming risk and having control over the risk assumed and accurately delineating the actual transaction, as opposed to the contractual agreement. It further discusses comparability, commercially rational transactions, loss making companies, government policies and customs valuations. Chapter II describes the five main methods to find arm's length prices and explains how to select the most appropriate one. The

methods are the so-called traditional transaction methods (CUPs, resale minus, cost plus) and the transactional profit methods (TNNM and (residual) profit split). Selecting a method is part of a larger process in a transfer pricing study, the comparability analysis which ensures that like is compared with like. Chapter III suggests how to do a comparability analysis, when to do it (before (the price setting approach) or after (the outcome testing approach)) and various compliance issues to consider.

Formal issues

Determining and verifying arm's length prices require documentation (chapter V). Documentation serves three purposes: it is a risk assessment and an audit tool for governments and it proves that the taxpayer has a considered transfer pricing policy. The TPG proposes a three tier system: a general overall Master file, more specific individual Country files and a Country by Country report. This chapter also discusses the timing of preparing documentation, materiality thresholds and ways of implementing documentation requirements. Chapter IV addresses governments on two main topics: compliance (transfer pricing compliance practices, safe harbours, and simultaneous tax audits) and dispute prevention and resolution (APA's, MAP's, corresponding adjustments, and arbitration). The annex to this chapter is an insightful discussion of bi-/multilateral APA processes describing eligibility conditions, the conduct and finalization of APA negotiations, and monitoring an APA's implementation.

Specific transactions

Guidance is given on transactions involving intangibles, intra-group services, cost contribution agreements and business restructurings. Intangibles need to be identified together with their owners and parties contributing to their value. The proceeds from the use or sale of those intangibles then need to be allocated to those parties based on the value of their DEMPE contributions and the risks assumed by them. Chapter VI ends with an extensive list of examples.

Intra-group services other than cost contribution agreements are discussed in chapter VII. It deals with primary issues such as identifying services and determining their arm's length charge, and provides several examples. It also provides for reduced documentation and a safe harbour mark-up for certain low value-adding intra-group services. Chapter VIII provides a definition and overview of cost contribution agreements, describes how to test them to the arm's length principle and how to make adjustments where needed. It also addresses issues regarding entering and leaving a cost contribution agreement and structuring and documenting cost contribution agreements.

Chapter IX deals with business restructuring. While governments cannot tell MNE's how to (re)structure their business, they can require that when taxpayers give up their future profits to group companies, they do it for the same price as for which they would give up those profits to third parties. This chapter defines business restructurings, discusses the link between risk and profits and the transfer of both, and shows how to determine arm's length payments at the time of the restructuring and thereafter. It argues when transactions should be recharacterised and provides a number of examples of business restructurings.

Finally, Chapter X deals with intra-group finances. It discusses the accurate delineation of financing transactions to determine when something is a loan and when not. It discusses the 5 comparability factors for financing and then it deals with the treasury function within a group and how that should be compensated for intra-group loans, cash pooling arrangements and hedging. Financial guarantees are discussed next and the central message is that group companies should not be charged for implicit support. Finally, the chapter deals with captive insurance and reinsurance within a group context.

EXECUTIVE SUMMARY

The general mechanics of determining arm's length prices

Chapter I - The arm's length principle

Chapter I introduces the arm's length principle. It defines it, defends it against alternatives such as formulary apportionment and discusses some fundamental concepts such as comparability, recharacterisation, loss making companies, government policies and customs valuations.

A comparability analysis ensures that an intercompany transaction is compared with a comparable transaction with third parties. First it is necessary to determine if the transaction is the best realistically available option: an independent enterprise is unlikely to accept a price for its product from one customer, if it knows that other potential customers are willing to pay more under similar conditions. To achieve this, the five factors in identifying the commercial and financial relations ("comparability factors" in the 2010 TPG) of both transactions need to be considered. The factors are: the i) the contractual terms, ii) the functions performed by the parties (taking into account risks controlled and assets used), iii) characteristics of the property or services transferred, iv) the economic circumstances of the parties, and v) the business strategies pursued by the parties.

The new chapter I.D provides tools for understanding the financial and economic relations between parties, how to accurately delineate the actual transaction when facts vary from contractual agreements and how to identify specific risks, who is assuming them, who is controlling them and who has the financial capacity to bear them. It also deals with outsourcing without losing control and how to test the commercial rationality of a transaction (the old "recharacterisation"). Loss makers should be tolerated for a limited period as unrelated parties would rarely perform permanently loss making activities. Government policies should be treated as market conditions and not as excuses for not applying the arm's length principle and customs valuations can be useful, even if determined by different methodologies.

Chapter II – transfer pricing methods

There are five main methods to find arm's length prices: the so-called traditional transaction methods (CUPs, resale minus, cost plus) and the transactional profit methods (TNNM and (residual) profit split). Chapter II describes them and explains how to select the most appropriate one.

One selects the most appropriate method based on: strengths and weaknesses of each transfer pricing method; nature of the relevant transaction; and

availability of reliable information on comparability, the degree of comparability and the reliability of comparability adjustments. Where several methods are equally reliable, the CUP is preferred over others, and traditional methods over transactional profit methods. CUP should be the preferred method for exchange traded commodities. It is not mandatory to use more than one method.

The CUP method compares the price charged for in a controlled transaction to the price charged in a comparable uncontrolled transaction in comparable circumstances. In the resale price method, the price at which a product is resold to an independent enterprise (the resale price) is reduced by an appropriate gross margin (the "resale price margin") from which the reseller should cover its selling and other operating expenses and an appropriate profit. This method is most useful for marketing operations. Fewer adjustments are normally needed for product differences than for CUP's, because minor product differences generally affect profit margins less than price. The cost plus method uses costs incurred by the supplier and adds an appropriate mark-up, to enable an appropriate profit considering the functions performed and market conditions. It is a useful method for transfer of semi-finished goods and providing services. Fewer adjustments are normally needed for product differences than for CUP's, because profit margins on costs are less sensitive to product differences than prices.

TNMM examines the net profit of a company relative to an appropriate base (e.g. EBIT over costs, sales, or assets). It operates like a cost plus or resale minus and compares the appropriate net profit indicator for the controlled transaction with the same net profit indicator for comparable uncontrolled transactions. In practice, this is the most widely used (maybe overused) method for most low risk, routine functions within an MNE – JHM. TNMM can be more tolerant to some functional differences in comparables than the traditional methods, but it also has several weaknesses one should be aware of and requires the same reliability standards as other methods (see II.B.2 & 3). Berry Ratios (gross profit over operating expenses) are a form of TNMM.

The transactional profit split method first identifies the profits to be split (the 'combined profits') and then splits them on an economically valid basis, approximating what unrelated parties would accept. It offers a solution for highly integrated operations, such as global trading of financial instruments, and transactions where both parties make unique and valuable contributions. Two possible ways of doing a profit split are the contribution analysis and the residual analysis. In the first, profits are divided based on available comparables, or on the relative value of functions performed by

each party. In the residual analysis each participant is first rewarded for its non-unique contributions (e.g. based on TNMM) and any residual profit/loss is allocated based on facts and circumstances, or relative bargaining power. In both analyses, any allocation keys should be reasonably independent (e.g. be based on third party sales, not intercompany sales). Typical keys are assets, capital, or costs; others are headcount, sales, time spent, where there is a relation to the profits.

Chapter III – Comparability analysis

Chapter III suggests how to do a comparability analysis after one has delineated the actual transaction and has established the significant comparability factors. It also suggests when to do it (before (the price setting approach) or after (the outcome testing approach)) and discusses various compliance issues.

There are typically nine steps to performing a comparability analysis, bearing in mind the five factors determining the commercial and economic relations at each relevant step: 1. identify the years covered; 2. analyse the taxpayer's circumstances; 3. understand the controlled transactions; 4. review internal comparables; 5. define sources for external comparables; 6. select the most appropriate method; 7. identify potential comparables; 8. make comparability adjustments; and 9. determine the arm's length prices. The process is not linear and it may be necessary to revisit previous steps several times. Ideally arm's length principle is applied on a per transaction basis, but sometimes it is better to combine closely linked transactions. It is good practice to disclose intentional set-offs and demonstrate they are at arm's length.

The cost plus, resale minus and TNMM methods require a tested party. The tested party is the one with the most reliable comparability results, typically the least complex party.

Comparables can be internal (taxpayer deals with an unrelated party) or external (two unrelated parties deals with each other). Comparables with other controlled transactions are irrelevant. Internal comparables may have a closer relationship to the transaction reviewed and easier information to come by, but they are not per definition more reliable and must still satisfy the five factors determining the commercial and economic relations. A source of external comparables is commercial databases. Comparable third party transactions can be identified through an additive, or a deductive approach. In the first, a list of potential third parties with comparable transactions are made, which is then refined through further information research. In a deductive approach companies in one sector are picked and are

then eliminated based on further search criteria. Identifying good comparables is crucial in a comparability analysis and the process should therefore be transparent, systematic, and verifiable.

Comparables may have to be adjusted in order to enhance their comparability e.g. to eliminate differences between accounting practices. Adjustments should only be made if they have a material effect; the need of numerous adjustments calls into question the reliability of the comparable.

Because transfer pricing is not an exact science, the most appropriate transfer pricing method will often produce a range of prices, not just one. Uncontrolled transactions with a lesser degree of comparability should be eliminated. Also, statistical tools, such as inter-quartile ranges, could be used to reduce the number of comparables and to enhance reliability. If the taxpayer price/margin is within the range, no adjustment should be made.

In terms of timing, (external) comparable data will generally not be available yet at the time of a transaction. In future reviews, care must be taken to avoid hindsight. Multiple year data can be useful, but is not a requirement; use it where it adds value. To manage the compliance burden, a pragmatic risk assessment strategy is sufficient, taking account of transaction size and complexity and stability of circumstances.

Formal issues

Chapter V – transfer pricing documentation

Determining and verifying arm's length prices require documentation. Documentation serves three purposes: it is a risk assessment and an audit tool for governments and it proves that the taxpayer has a considered transfer pricing policy. The TPG proposes a three tier system: a general overall Master file, more specific individual Country files and a Country by Country report. This chapter also discusses the timing of preparing documentation, materiality thresholds, frequency of updates, language, penalties, and confidentiality. Finally, it provides various templates both for reporting and for implementation of the reporting package.

The Master file requires six categories of information: i) the group structure; ii) the group's business(es); iii) its intangibles; iv) its intercompany finance; v) the group's financial and vi) tax positions. The local file supplements the Master file by focusing on material intercompany transactions with local affiliates. Taxpayers should consider transfer pricing before a transaction and confirm the arm's length nature of its results when filing their tax

returns. transfer pricing documentation requirements should include materiality thresholds based on the relative size and importance of the MNE group and local operating entities. The parents of groups generating a turnover of more than 750 million Euros must also file a Country by Country report. Documents

should not be required to be retained beyond reasonable periods and the storage mediums should be free, but retrievable. Governments may determine that database searches be updated every 3 years if operating conditions remained unchanged. Finally, penalties should not be imposed on taxpayers making reasonable, good faith efforts.

Chapter IV – Administrative approaches

Chapter IV addresses governments on two main topics: compliance (transfer pricing compliance practices, safe harbours, and simultaneous tax audits) and dispute prevention and resolution (APA's, MAP's, corresponding adjustments, and arbitration). The annex to this chapter gives an insightful discussion of bi-/multilateral APA processes, describing eligibility conditions, the conduct and finalization of APA negotiations, and monitoring an APA's implementation.

Countries' transfer pricing compliance rules should be clear and not overly harsh. Transfer pricing auditors should be flexible, should begin their analysis from the taxpayer's choice of method and should take the taxpayer's commercial judgement into account. Whilst the distribution of the burden of proof varies per country, it should never be misused, or be a justification for groundless or unverifiable assertions. In MAPs, the primary adjusting country bears the burden of proof.

Safe harbours allow eligible taxpayers to follow simplified transfer pricing rules for specific transactions, which lead to prices automatically accepted by the administrations adopting those rules. Some countries adopted safe harbours with favourable results. They work best with low transfer pricing risks and when adopted bilaterally or multilaterally. Safe harbour prices above or below arm's length prices could induce profit shifting; bilateral/multilateral safe harbours should limit this. Countries adopting unilateral safe harbours should be willing to modify their positions in MAPs. Safe harbours are never binding on countries which did not adopt them.

A simultaneous audit is an arrangement between governments to examine simultaneously and independently, on their own territory, a taxpayer with a view to exchange relevant information obtained via competent

authorities. These audits are useful where (uncooperative) third countries are involved, but also in complex transfer pricing cases. They may also speed up dispute resolution and reduce compliance costs.

When a taxpayer is adjusted in one country, it can request corresponding adjustments in the other countries involved in the adjusted transactions. If the other countries are unwilling, the taxpayer can request a MAP between the adjusting country and the unwilling one, to eliminate the subsequent double taxation. MAPs are based on article 25 of the OECD MC. Article 25'5 offers arbitration as a solution where tax authorities cannot come to an agreement on how to eliminate the double taxation. Though taxpayers have no right to participation in the intra-governmental discussions, they do have the option of accepting or rejecting a MAP/arbitration outcome; it is therefore good practice to keep them informed and get their input during the MAP.

One way to avoid adjustments and MAP's is to apply for an APA upfront. An APA determines the appropriate criteria (method, comparables plus adjustments and assumptions about the future) to determine the transfer pricing for future transactions. APAs differ from traditional private rulings in that they are more fact specific, investigate the facts presented and usually cover more than one transaction. Though APA's may initially strain resources, they provide advance certainty, provide a less adversarial environment between governments and taxpayers and can save time through easy renewal when relevant circumstances remain unchanged. The TPG recommend the use of bi-/multilateral APA's above unilateral ones, as the latter are potentially biased and shift the compliance burden to other governments.

Specific transactions

Chapter VI – Intangibles

Intangibles need to be identified together with their owners and parties contributing to their value. The proceeds from the use or sale of those intangibles then need to be allocated to those parties based on the value of their contributions and the risks assumed by them. Chapter VI ends with an extensive list of examples.

An intangible is something that is not a physical or a financial asset, is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated in a transaction between independent parties in comparable circumstances. Patents, know-how, trade secrets, trade names, trademarks, contractual rights, government licenses and other licenses are intangibles; group synergies and market specific

characteristics are not, as they are not owned or controlled by a single enterprise.

To analyse a transaction involving intangibles it is necessary to i) identify the legal owner, ii) identify parties performing value adding functions related to the intangible, iii) confirm whether intangible related contracts match behaviour, iv) identify the controlled value adding transactions relating to those intangibles, and v) determine the arm's length prices for those transactions, or recharacterize them if necessary. The legal owner is only entitled to all the intangible proceeds if it performs all the value adding functions, provides the assets and controls the risks regarding the intangible. Related parties should be properly compensated for all their work regarding intangibles, which could leave the legal owner with nothing.

There are two types of intangible transactions: those involving the transfer and those involving the use of intangibles. For both it is essential to identify with specificity the intangibles involved and the restrictions attached. After identifying the intangible transactions and the intangible owner and contributors, the arm's length conditions for a transaction can be found. When applying the arm's length principle, the circumstances of one party should not be used to dictate an outcome contrary to the realistic options of another. Though intangibles may be unique, it is usually possible to determine arm's length prices even where there are no reliable comparables. Important factors are: the functions, assets and risks of all parties, business reasons for the transaction, realistically available options, competitive advantages of the intangibles, the expected future economic benefits and other comparability factors. One sided methods like resale price and TNMM are generally not fit for directly valuing intangibles, but could sometimes be used for determining the residual value to be allocated to intangibles. In addition, valuation techniques could be used, particularly income based ones premised on the discounted value of projected income streams, as long are they are applied in accordance with the arm's length principle. Valuations made for operational business purposes are generally more reliable than ones for transfer pricing. Issues to bear in mind include the accuracy of projections, assumptions regarding growth rates, discount rates, use life, terminal values, and taxes.

Chapter VII – Intra-group services other than cost contribution agreements

Chapter VII deals with primary issues, such as identifying whether services were provided and determining their arm's length charge; it also provides reduced documentation requirements and a safe harbour mark-up for certain low value-adding intra-group services.

To determine whether services have been provided, different questions can be asked: was there a benefit, are the services shareholder activities, is there a duplication of services, were the benefits incidental, are the services centralized and what is the form of remuneration? Examples of centralised activities are planning coordination, budgetary control, financial advice, accounting and legal, factoring, computer services, etc. These qualify as services where third parties would pay for them.

To calculate the arm's length charge, it is necessary to first identity the actual arrangements. Thereafter, the price should be considered from all parties' point of view. Though independent parties would normally add a profit mark-up, there may be exceptions, e.g. because a mark-up would put the services above their market prices.

Low value-adding intra-group services which do not involve unique intangibles or significant risks and which do not involve R&D, manufacturing, distribution, group core business, financial transactions, exploration or internal comparables, may be provided on a cost plus 5% basis, provided certain documentation requirements are met. These requirements involve documenting the pool of costs underlying the services, the beneficiaries, allocation keys between beneficiaries and reasoning as to why the services are low value-adding services.

Chapter VIII – cost contribution agreements

Chapter VIII provides a definition and overview of cost contribution agreements; it describes how to test them to the arm's length principle and how to make adjustments where needed. It also addresses issues regarding entering and leaving a cost contribution agreement and structuring and documenting cost contribution agreements.

A cost contribution agreement is an agreement among enterprises to share costs and risks to develop, produce or obtain assets ("Development CCA's"), or services ("Services CCA's"). Participants' relative contributions should be proportionate to their relative expected benefits and must be consistent with what unrelated parties would agree to. Also, the value of each participant's contribution should be measured and the value should be consistent with the values third parties would assign. Imbalances between relative contributions and benefits can be repaired through balancing payments. The reality of an arrangement may differ from the cost contribution agreement terms, e.g. some participants may not have a reasonable expectation of benefit, in which case there is no cost contribution

arrangement. Administrations may then determine tax consequences consistent with arrangements independent parties would make.

A new participant may obtain an interest in existing cost contribution agreement assets via a transfer from existing participants. This transfer is to be compensated via a buy-in payment, which should be at arm's length. Buy-ins fall under general tax rules, e.g. for the transfer of intangibles. A buy-in is not a royalty. Similar rules apply for the exit from a cost contribution agreement, which triggers buy-out payments if the participant leaving transfers his part of cost contribution agreement assets to remaining participants.

Chapter IX – Business restructurings

While governments cannot tell MNE's how to (re)structure their business, they can require that when taxpayers give up their future profits to group companies, they do it for the same price as for which they would give up those profits to third parties. This chapter defines business restructurings, discusses the link between risk and profits and the transfer of both, and shows how to determine arm's length payments at the time of the restructuring and thereafter. It argues when transactions should be recharacterised and provides a number of examples of business restructurings.

A business restructuring is the cross-border redeployment by an MNE of functions, assets and/or risks. It may involve the transfer of intangibles, or the renegotiation of existing arrangements. Conversion of a fully-fledged manufacturer into a toll manufacturer is an example of a business restructuring. The transfer of risk is an important factor: in the open market, increased risk is compensated with an increase in expected return. Examining risk starts with examining contractual risk allocation. To see if contractual risk allocation matches economic substance, ask if parties' conduct match contracts. The risk bearer should have the functions to control the risk and the financial capacity to bear that risk.

To properly price a restructuring, it is necessary to understand the business restructuring itself and how it moves expected future profits ('profit potential'), which should be compensated. It is therefore necessary to compare parties' functions, assets, and risks before and after the business restructuring, to understand the business reasons behind the business restructuring and to compare the expected benefits to parties' realistically available options. Whether the restructured entity should receive compensation at the time of the business restructuring depends on circumstance, realistically available options and the following four questions:

i) did the amended agreement have an indemnity clause; ii) was that agreement at arm's length; iii) do commercial or case law provide for indemnification; and iv) would a third party indemnify?

The next question is if the restructured entity is also entitled to compensation after the business restructuring? It depends. If compensation is due, then the most appropriate transfer pricing method should be found. Next the relation between the restructuring and the post-restructuring compensation need to be considered together with the pre- and post-restructuring situations. Finally, issues such as location savings need consideration.

Though the arm's length principle is not different for post-restructuring transactions than for first set-up transactions, a business restructuring may involve a redeployment of functions, assets and risks, e.g. restructured entities have previous arrangements and relations in place whilst first setup entities have none. This may require compensation, but comparables may be a problem for business models hardly found between independent enterprises. Nonetheless, a reasonable solution should be found, using the most appropriate method to the nature of the transaction. Where a manufacturer/distributer, transfers its distribution activities to a party to whom it then sells its manufactured products, it could receive its compensation for the transfer of its distribution activities upfront, or through higher future sales prices. Tax administrations therefore need to look at the entirety of the arrangements. The allocation of location savings first depends on the question whether the savings are not passed on to the customer. If not, it depends on parties' functions, assets and risks and bargaining power. E.g. if a company moves its manufacturing to low cost country B where manufacturing is highly competitive with many third party contract manufacturers, it is unlikely that B can keep the location savings. (Please note the subsequent discussions on location savings in the revision of chapters I.D.6 and IX.III.E, JHM.)

What if taxpayers present a business restructuring as something else, or move something valuable as something with little value? An administration may adjust profits where the conditions differ from what independent parties would do and not all adjustments constitute non-recognition. They could constitute comparability adjustments or an alignment of contractual terms with economic substance or the actual conduct of parties. Recharacterisation should be limited to exceptional cases, satisfying the conditions of section I.D.2. Where comparable uncontrolled transactions exist, a related party transaction cannot lack commercial rationality, and should not be recharacterised. A business restructuring can be tax motivated and still be at

arm's length. A tax purpose does not justify non-recognition. If a transaction is recharacterised, administrations must determine the underlying reality behind a contractual arrangement and the alternative characterization should match that reality as close as possible.

Chapter X – Financial transactions

This chapter is from OECD (2020), Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10, OECD, Paris. It provides guidance on the arm's length aspects of financial transactions. It deals with intra-group loans, cash pooling, hedging, financial guarantees, and captive insurance. The chapter also gives guidance on establishing risk-free and risk-adjusted rates of return.

After a short introduction subchapter B deals with accurate delineation of financial arrangements. The message is that not everything that is called a loan is a loan and sometimes a loan may have to be divided into part loan and part capital contribution (where third parties would not have provided loans). This subchapter also discusses the contractual terms, a two sided functional analysis, characteristics of financial instruments, economic circumstances, and group financial strategies of group financial transactions.

Subchapter C deals with treasury functions and says – in short – that a group treasury should receive a services compensation where it bears limited risks and e.g. acts more like a conduit, and should receive a bank like remuneration when it carries risk like a bank. The subchapter deals with intra-group loans and note how it is important to see things both from a lender and a borrower's perspective. It reminds us to always consider parties' realistic available alternatives and then goes on to discuss various pricing approaches for intra-group loans, including the role of implicit support and group relations. Notably, bank opinions are not acceptable as references for intra-group loan pricing.

Subchapter C also deals with Cash pooling and Hedging. It explains the difference between physical pooling and notional pooling and then goes on to repeat that where the cash pool leader is a simple service provider, it should get a service fee as compensation. It is only where the cash pool leader bears and controls risks like a bank does that it should get an interest based compensation like a bank. Cash pool members should share in the group benefits from cash pooling and no circumstances should an individual member be worse off than it would be choosing another alternative to the cash pool.

Unfortunately subchapter C is rather inconclusive on hedging. Whilst it does not that the treasury function should get a service remuneration where it arranges hedges without bearing risk, the subchapter only concludes with remark that "an accurate delineation" should be made for fees in case where the legs of a hedge are placed in different group companies.

Subchapter D deals with financial guarantees. The chapter also starts with the accurate delineation of a guarantee, basically saying that implicit support is not chargeable intra-group transaction. Where an actual guarantee is granted, only that part of the guarantee which goes beyond implicit support is eligible for intra-group pricing. In no case should the guarantee fee exceed the benefit gained by the borrower after taking into consideration implicit support. The chapter concludes by discussing various pricing approaches such as the CUP method (unlikely), the yield approach, a cost approach, valuation of expected losses and a capital support approach.

Subchapter E deals with captive insurance. The chapter distinguishes between captive insurers and reinsurers, plus a variation on both, fronting, where a group company insures its risk with an unrelated insurer which reinsures some or all of that risk with another group company. The chapter describes the functions and risks of third party insurers and explains how captive insurers should apply similar concepts (such as risk portfolio diversification) if their transactions are to be recognised as insurance transactions for transfer pricing purposes. As always it is the parties actually taking on the risk and controlling the risk, that are entitled to the residual profit and risk from the insurance, not necessarily the formal insurer.

EXTENDED SUMMARY

The foreword of the TPG gives a great overview of the source documents of the 2022 TPG and the updates from the 2017 TPG.

Preface

The growth of MNEs presents increasingly complex taxation issues for themselves and for tax administrations (1), because of the difficulty of allocating taxable income per jurisdiction (2). Allocation is achieved by treating each enterprise (HQ, or PE) within an MNE group as a separate entity (5) and taxing each entity as dealing at arm's length with its related entities (6).

The goals of the arm's length principle are: (to set the right transfer prices) to secure an appropriate tax base per jurisdiction; and to avoid double tax (7). Transfer prices are the prices at which an enterprise transfers physical goods and intangible property to associated enterprises, or provides services to them (11). International consensus is required on how to establish cross-border transfer prices (12).

The 2022 TPG:

- focus on applying the arm's length principle to evaluate the transfer prices of associated enterprises;
- analyse the methods for determining whether the arm's length principle is satisfied and discuss their practical application (15); and
- are intended to be used in transfer pricing dispute resolution and adjustments (17).

Burden of proof:

- In a MAP, the State making the primary adjustment bears the burden of proof but, competent authorities are expected to take a cooperative approach (17).
- It would be inappropriate to rely on either the burden of proof or formal law, to make unfounded assertions about transfer pricing (18).

Updates since the 2010 Transfer Pricing Guidelines:

- In 2013 the guidance on safe harbours were revised to recognise that, if properly designed, they can relieve compliance burdens and generate certainty.
- In 2016 the guidelines were substantially revised under BEPS actions 8-10 and 13.
- In 2018 guidance on the profit split method was revised and guidance on

hard-to-value intangibles was added in an annex to chapter VI. In 2020 chapter X on intra-group financial transactions was added (19).

I – The arm's length principle

Chapter I is an introduction to the arm's length principle in four parts:

- Parts A and B1 give a definition of the arm's length principle and form a general introduction it;
- Parts B2 through C3 defend the use of the arm's length principle and reject formulary apportionment (not summarised); and
- Part D identifies commercial or financial relations, in particular risk assumption and control (D1) and recognises the accurately delineated transactions, not commercially irrational arrangements (D2). It then discusses losses (D3), government policies (D4), customs valuations (D5), location savings (D6), assembled workforce (D7) and group synergies (D8).

I.A. Introduction

As it may be difficult to determine a market price, governments should not assume that MNE's manipulate their profits. The need for arm's length adjustments arises irrespective of contractual prices or of parties' intentions. Thus, an adjustment does not affect contractual obligations for non-tax purposes and can be appropriate in the absence of tax planning (1.2). As wrong transfer prices distort tax revenues, governments may adjust profits to satisfy the arm's length principle (1.3). Non-tax factors distorting transfer prices in MNE's include conflicting governmental policies, import restrictions, exchange controls, cash flow requirements and shareholder expectations (1.4). Factors in an MNE can also enhance arm's length behaviour, e.g. local managers wanting to optimize their profits. However, as other MNE factors may be at play, evidence of hard bargaining alone may not be enough (1.5).

I.B. Statement of the arm's length principle

I.B.1. Article 9'1 OECD MC on related party transactions

"9'1 Where … conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

An analysis of intercompany transactions vis a vis transactions between unrelated parties is a comparability analysis and is at the heart of the arm's length principle (1.6). As the arm's length principle puts related and unrelated parties on an equal tax footing, it creates a level playing field which enhances global economic growth and investment (1.8). Some transactions

are difficult to price, e.g. regarding unique intangibles, but the transactional profit split method may provide a solution (1.9). For others, there is no universal solution, e.g. economies of scale or benefits of integration (1.10). The fact that some transactions only happen within a group does not mean they are not at arm's length (1.11). Finally, as adequate information may not always be available, it must be remembered that transfer pricing is not an exact science, but requires judgement by taxpayers and administrations (1.13).

B2 – C3. Rejection of formulary apportionment (not discussed further)

I.D. Guidance for the arm's length principle

I.D.1 Comparability

I.D.1. Identifying the commercial or financial relations

A comparability analysis is at the heart of the arm's length principle and has two key aspects: 1) identify the commercial or financial relations between associated enterprises so the transaction is accurately delineated; 2) compare the conditions and economically relevant circumstances of those transactions with those of comparable transactions between independent enterprises. This information is important for steps 2 and 3 of a comparability analysis (1.33).

Identifying the above relations, conditions and economically relevant circumstances requires an understanding of the MNE's industry (e.g. mining) and the factors affecting its business. These factors, which include business strategies, markets, products, supply chains, and key functions assets and risks, should be in the Master file (1.34). The process then focuses on each individual enterprise and what it does (e.g. production or sales). It identifies its commercial or financial relations with other associated enterprises expressed in transactions between them. To accurately delineate a transaction, its economically relevant characteristics must be found. Those are the transaction's conditions and the economically relevant circumstances in which it takes place (1.35).

The economically relevant characteristics or comparability factors to accurately delineate a transaction are: its contractual terms (I.D.1.1); each party's functions assets and risks and how the functions create value (I.D.1.2); the characteristics of the goods or services provided (I.D.1.3); the economic circumstances of the parties and their market (I.D.1.4); and the parties' business strategies (I.D.1.5). These should be in the Local file (1.36). Economically relevant characteristics/ comparability factors are used in two separate, but related, phases: when accurately delineating the transaction, and when comparing controlled transactions to uncontrolled ones.

First, accurately delineating the controlled transaction involves establishing the characteristics of the transaction and the functions, assets, and risks of the associated enterprises. The extent of economically relevance of a characteristic depends on how independent enterprises would value them (1.37). Independent enterprises will compare the transaction to their other realistically available options to meet their commercial objectives. Therefore, identifying the transaction's economically relevant characteristics is essential in revealing the range of characteristics considered by the parties in concluding that there is no clearly more attractive opportunity realistically available. The transaction may also have to be assessed within a broader arrangement of related transactions as third parties may have several options (1.38).

Second, is the Chapter III process of comparing controlled transactions and uncontrolled transactions to determine an arm's length price. Differences in economically relevant characteristics need to be considered when determining comparability and comparability adjustments (1.39). All arm's length principle methods relate to the concept that independent enterprises consider their realistically available options and the economically relevant differences. E.g., before purchasing a product, independent enterprises would consider equivalent products with comparable terms and conditions but a lower price. Comparability adjustments must be made for material differences. In no event can unadjusted industry average returns establish arm's length prices (1.40).

I.D.1.1 The contractual terms of the transaction

A transaction expresses parties' commercial or financial relations. A written contract between associated enterprises provides a starting point for delineating the actual transaction and the initially intended division of responsibilities, risks, and anticipated outcomes. Agreements may also be found in other communications between the parties (1.42).

Written contracts alone do not provide all the information for a transfer pricing analysis. Further information is provided by the economically relevant characteristics of the other four factors (see 1.36) to define parties' commercial and financial relations. The contract should be supplemented by the evidence provided by those other identified characteristics of the comparability factors (1.43). E.g. PCo in P owns SCo in S. SCo is an agent for PCo's branded products in S. The agency contract is silent about marketing. Analysis shows SCo launched an intensive media campaign in S to develop brand awareness. Further factual evidence should be sought about the media campaign (1.44).

If the characteristics of the transaction are inconsistent with the written contract, the actual transaction should be delineated in accordance with the actual conduct of the parties (1.45). The divergence of interests between unrelated parties ensures (i) that contractual terms reflect the interests of both, (ii) that parties hold each other to the contractual terms, and (iii) that those terms will be modified only if it is in the interests of both. If related parties' actual conduct does not conform to any written contract, further analysis must identify the actual transaction. Parties' actual functions performed, assets used and risks assumed should delineate the actual transaction (1.46).

Where there is doubt about the agreed transaction, one must consider all economically relevant characteristics and remember that terms may change over time. The change may reflect a new transaction, or merely reflect parties' original intention. Changes made in the assumption of risk when risk outcomes are known, do not reflect an assumption of risk since there is no risk anymore, see paragraph 1.78 (1.47). E.g. PCo owns SCo and licenses intellectual property to SCo for SCo's business. However, PCo performs customer negotiations to achieve SCo's sales and provides technical services support and staff to SCo. Many customers pay SCo, but require PCo as joint contracting party. The commercial or financial relations indicates that SCo cannot operate without support from PCo. In fact, PCo is not a licensor, but a principal (1.48).

Where no written terms exist, the actual transaction must be deduced from parties' conduct by identifying economically relevant characteristics of the transaction. Sometimes the actual outcome may not have been identified as a transaction, but still results in a transfer of material value. E.g. technical assistance may have been granted, or know-how may have been provided through secondment (1.49). E.g. it is observed that PCo's subsidiaries receive services from an independent party engaged by PCo. PCo pays for the services without being reimbursed. Thus, there are commercial or financial relations between PCo and the subsidiaries, which transfer value from PCo and for which PCo must be indemnified (1.50).

I.D.1.2 Functional analysis

Compensation between independent enterprises reflects the functions they perform. Therefore, a functional analysis is necessary to delineate a controlled transaction. It identifies economically significant activities and responsibilities, assets used, and risks assumed. It focuses on what parties actually do, including decision-making within the group, and how value is generated group wide. It analyses the interdependencies of functions and

individual contributions to value creation. The number of functions is not important; their economic significance in terms frequency, nature, and value to the parties is (1.51).

The actual contributions, capabilities, and other features of the parties can influence their realistically available options. E.g. an associated enterprise provides logistics services. It must operate warehouses with spare capacity to cope with the group's supply disruptions. Its functions therefore differ from independent logistics companies not offering similar capabilities for disruptions (1.52).

The functional analysis should consider the assets used, such as plant and equipment, valuable intangibles, financial assets, etc., and their nature such as age, market value, location, etc. (1.54). It may show that the MNE fragmented highly integrated functions across several companies (e.g. logistics, warehousing, marketing, and sales) with considerable interdependencies between them. The co-ordination of those interdependencies may be performed by some of those enterprises, by a separate enterprise, or both. The same for risk mitigation. Therefore, when analysing fragmented activities, it is important whether activities are interdependent and how they are co-ordinated (1.55).

I.D.1.2.1. Analysis of risks in commercial or financial relations [1]

For a functional analysis to be complete the material risks assumed by each party must be identified and considered. In the open market, increased risk is compensated by an increased expected return. Risk is therefore economically relevant in a transfer pricing analysis. (1.56). Risk is inherent in business and business opportunities. Identifying risks coincides with identifying i) functions and assets and ii) the commercial or financial relations between the associated enterprises to accurately delineate the transaction (1.57).

The assumption of risks affects the profit potential of a commercial opportunity, and the allocation of risks affects how profits or losses are allocated. Therefore, one must analyse what risks have been assumed by which party for a comparability analysis (1.58). This section provides guidance on the nature and sources of risk to identify risks with specificity. It also provides guidance on risk assumption. The detailed guidance does not indicate that risks are more important than functions or assets. It reflects the practical difficulties in identifying risks (1.59).

[1] The guidance in this chapter applies to all industries. Regulated financial services should consider the OECD 2010 AOA as appropriate.

The steps for analysing risk in a controlled transaction are:

1) Identify economically significant risks with specificity (see Section D.1.2.1.1).
2) Determine how significant risks are contractually assumed (see Section D.1.2.1.2).
3) Determine by functional analysis for specific significant risk, which associated enterprises perform control and risk mitigation functions, who bears consequences of risk outcomes, and who has the required financial capacity to bear those outcomes (see Section D.1.2.1.3).
4) Next determine whether the contractual risk is consistent with parties' conduct by analysing
(i) if they follow the contract under the principles of section D.1.1; and
(ii) if the risk bearer controls the risk and financially bears it (see Section D.1.2.1.4).
5) Where the party assuming the risk does not control it or lacks the required financial capacity, apply the guidance on risk allocation (see Section D.1.2.1.5).
6) Price the accurately delineated transaction, considering i) the financial and other consequences of risk assumption and ii) appropriately compensating risk management functions (see Section D.1.2.1.6) (1.60).

"Risk management" refers to the function of assessing and responding to risk associated with a commercial activity. It comprises three elements: (i) the capability to decide to take on, lay off, or decline a risk-bearing opportunity, together with actually performing that function, (ii) the capability to decide whether and how to respond to risks, together with actually performing that function, and (iii) the capability to mitigate risk, i.e. to take measures that affect risk outcomes, together with actually performing that function (1.61). Some, but not all, risk management functions can be outsourced. Also, risk management is not always a separate function, requiring separate remuneration. E.g. developing intangibles may involve mitigating risks by the development function itself. See Example 1 in paragraph 1.83 for contract R&D (1.62).

Risk management is not the same as assuming a risk. Risk assumption means taking on the consequences of risk and bearing the consequences of the risk materialising. E.g. a party hired to perform quality control of manufacturing, could also be mitigating and thus managing product recall risk, without actually bearing such risk (1.63).

Financial capacity to assume risk means access to funding to take on the risk, to pay for the risk mitigation functions and to bear the risk. Where a party

assuming risk receives intra-group funding, the financier assumes financial risk, but not the risk generating the need for funding. If the risk bearing financial capacity is lacking, risk allocation must be tested under step 5 (1.64).

Control over risk involves (i) the capability to decide to take on, lay off, or decline a risk-bearing opportunity and (ii) the capability to decide on whether and how to respond to risks associated with the opportunity (see 1.61). Day-to-day risk mitigation may be outsourced, (see 1.63). However, control of the risk requires the capability to determine the objectives of the outsourced activities, to hire the provider, to assess whether the objectives are being met, and to decide to adapt or terminate the contract (1.65).

The capability to make decisions and actually making them regarding a specific risk involve an understanding of the risk and the foreseeable upsides and downsides of the decision and its business consequences. Decision-makers should possess relevant competence and experience and have access to relevant information. They must be able to determine the objectives of gathering information, to hire the party doing this, to assess whether the right information is gathered and the analyses are adequate, and to adapt or terminate the contract with that provider. Neither a mere formalising of the outcome of decision-making, in the form of meetings organised for formal approval of decisions made elsewhere, nor the setting of the policy environment (see paragraph 1.76) qualifies as decisions sufficient to demonstrate risk control (1.66).

References to control over risk do not mean that the risk itself can be influenced or uncertainty nullified. E.g. risks associated with general economic conditions or commodity price cycles are typically beyond the scope of influence. Control over risk means the capability and authority to take on the risk, and to decide whether and how to respond to it, e.g. by timing investments or setting production levels (1.67).

Risk mitigation refers to measures expected to affect risk outcomes. E.g. reducing uncertainty or consequences of risk. It is not requiring risk mitigation measures to be adopted, since the uncertainty of some risks may be taken on without mitigation in order to maximise opportunities (1.68).

Illustrating control. ACo appoints BCo to manufacture products. Contractually ACo provides the product specifications and designs and determines production scheduling, including volumes and timing. This implies that ACo bears the inventory and product recall risk. ACo hires CCo to perform regular quality controls of the production. ACo specifies the quality control objectives and information to gather. CCo reports to ACo. Thus, ACo 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 it. ACo also takes decisions on risk mitigation like determining the objectives of the outsourced activities and the decision to hire the particular manufacturer and the party performing the quality checks (1.69).

Further illustration. An investor hires a fund manager to invest funds. The manager may make portfolio investments on a day-to-day basis reflecting the risk preferences of the investor. The risk of loss is borne by the investor. The investor controls its risks through four decisions: i) determining its risk preference and the required risk diversification of different investments, ii) deciding to hire that fund manager, iii) giving authority to the fund manager and setting its objectives, and iv) deciding the amount to invest. Moreover, the fund manager must report regularly. The fund manager's operational risk of losing a client, is distinct from the investor (1.70).

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

In a transfer pricing context, risk is defined as the effect of uncertainty on the objectives of the business. Risks are assumed in all a company's operations. A company identify uncertainties and develop appropriate risk mitigation strategies to create value. Risk has upsides and downsides. No business takes on risk without expecting a positive return. Attention to risk include activities around product strategy, product differentiation, identifying market trends, anticipating political and social changes, and creating demand. The significance of a risk depends on its likelihood and size. E.g. if a different flavour ice-cream may involve marginal developing, introducing, and marketing costs with little reputational risks, decision making may be delegated to local management with knowledge of local tastes. However, ground-breaking technology or innovative healthcare treatment may involve significant strategic decisions, require substantial investment, and create significant reputation issues. It therefore requires centralised management (1.71).

Risks can be categorized by their sources of uncertainty. There is no hierarchy or rigid categories. Risks can be externally or internally driven; externally driven risks are as relevant even though they are not generated by activities. This guidance should assist in obtaining specificity as vague risks cannot delineate the actual transaction.

a) Strategic or marketplace risks. External risks are caused by the economic environment, political and regulatory events, competition, technological advance, or social and environmental changes. Their assessment may define the products and markets to target and the

capabilities required, including intangibles and human capital. There is considerable potential if the company correctly identifies the external risk impact.

b) Infrastructure or operational risks. These concern uncertainties of business execution, including the effectiveness of processes and operations. The impact depends on the nature of the activities. Sometimes breakdowns can be crippling on operations or reputation. Other times companies bringing competing products to market faster and exploiting periods of market protection through patents are rewarded. Some infrastructure risks are external like transport links and laws and regulations, others internal like asset availability, employee capability, outsourcing arrangements, and IT systems.
c) Financial risks. There are specific financial risks related to the company's ability to manage liquidity and cash flow, financial capacity, and creditworthiness. Uncertainty can be external like economic shock or credit crisis, or internal like controls, investment decisions and credit terms.
d) Transactional risks. These include pricing and payment terms.
e) Hazard risks. External events like accidents and natural disasters which can sometimes be mitigated somewhat through insurance (1.72).

Determining the economic significance of risk and how risk affects pricing forms part of a broader functional analysis of value creation and determines comparability. Potential comparables should include the same level of risks and risk management (1.73).

E.g. An MNE distributes heating oil to consumers. The product is undifferentiated, the market competitive, the market size predictable, and players are price-takers. Margins are difficult to influence. Here, good credit terms with oil suppliers can reduce working capital to increase margin and can therefore be a crucial comparability factor (1.74).

E.g. An MNE toy retailer buys a wide range of products from third-parties. Its sales are concentrated in the last two months of the year, and a significant risk relates to the buying function making the right bets. Expertise is needed to evaluate the right bets in the local market. The buying risk can be magnified if the retailer negotiates exclusivity for a particular product (1.75).

Control over a risk focusses on the decision-making. This is not to say that other parties may not be involved in setting general policies, but policy-setting itself is not decision making. The board may set the level of risk the group as a whole is prepared to accept. Line management may then identify

and assess risk against commercial opportunities and operational entities must then perform ongoing risk management in pursuing opportunities. E.g. Inventory risk may be subject to policy-setting elsewhere in a group, but this wider policy-setting is not the same as taking specific decisions on inventory risk in an actual sales transaction between two group companies (1.76).

D.1.2.1.2. Step 2: Contractual assumption of risk

The party assuming risks may be identified in written contracts. Some risks may be explicitly assumed, other implicitly, e.g. non-contingent remuneration arrangements implicitly allocate some risks to service party (1.77). A contractual assumption of risk constitutes an ex-ante agreement to bear costs of an ex-post materialisation of downside outcomes in return for some or all ex-post positive outcomes. Ex-ante contractual assumptions should provide clear evidence to assume risk prior to its materialisation. Such evidence is essential to a tax administration's transfer pricing analysis since an audit may occur years later. The assumption of risk when outcomes are certain is not an assumption of risk, since there is no longer any risk. Similarly, ex-post reallocations of risk by tax administrations when risk outcomes are certain is inappropriate, unless based on this section D.1.2.1 (1.78)

It is economically neutral to take on risk in return for higher anticipated nominal income as long as the net present value of both options are equal. In a recourse free debt factoring arrangement between independent enterprises, the seller discounts the face value of its receivables in return for a fixed payment. Neither party will expect to be worse off, essentially because they have different risk preferences resulting from their capabilities to manage the specific risk (1.79).

Not every contractual exchange of potentially higher but riskier income for lower but less risky income is at arm's length. The next steps describe the information required to determine how enterprises operate in relation to the assumption and management of risk (1.80). The assumption of risk effects arm's length pricing between associated enterprises. One may not infer from the level of the price paid between associated enterprises that risks are borne in a particular manner. E.g. a manufacturer may claim to be protected from raw material prices in a cost plus arrangement, but the form of remuneration cannot dictate inappropriate risk allocations. It is how the parties actually manage and control risks, as set out next, that will determine the assumption of risks and dictate the most appropriate transfer pricing method (Price follows risk, risk does not follow price - JHM) (1.81).

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

The risk functions of the associated enterprises are analysed. This provides information about how the associated enterprises operate regarding economically significant risks. This is illustrated by the following examples and conclusions (1.82).

Example 1

ACo pursues a development opportunity and hires a specialist company, BCo, for part of the research. Under step 1 development risk has been identified as economically significant. Under step 2 it has been established that ACo assumes the development risk. The functional analysis under step 3 shows that ACo controls its development risk through exercising its capability and authority to make decisions on the development risk, like to perform part of the development work itself, to seek specialist input, to hire the particular researcher, the type of research and the objectives assigned to it, and the budget for BCo. ACo mitigated its risk by outsourcing. BCo reports back at predetermined milestones, and ACo assesses the progress and decides whether to continue. ACo has the required financial capacity to bear the risk and BCo has no capability to evaluate the development risk or decide ACo's activities. BCo's risk is to perform the research competently; it is distinct from ACo's development risk based on the functional analysis (1.83).

Example 2

BCo manufactures products for ACo. Under step 1 capacity utilisation risk and supply chain risk are identified as economically significant and under step 2 it is established that ACo assumes these risks. The functional analysis under step 3 provides evidence that BCo built and equipped its plant to ACo's specifications, that products are manufactured to technical requirements and designs provided by ACo, that volume levels are determined by ACo, and that ACo runs the supply chain, including procurement. ACo performs regular quality checks of the manufacturing. BCo builds the plant, employs, and trains competent manufacturing personnel, and determines production scheduling based on ACo's volume. Although BCo incurred fixed costs, it cannot manage the risk associated with cost recovery, since ACo determines volumes. ACo also determines significant costs relating to components, raw materials, and security of supply. Company B performs manufacturing services. Significant risks associated with generating a return from the manufacturing activities are controlled by ACo. Company B controls the risk that it fails to competently deliver services. Each company has the financial capacity to assume its respective risks (1.84).

Example 3

ACo acquired ownership of a tangible asset and enters into contracts for its use with unrelated customers. Under step 1 sufficient utilisation of the asset to cover ACo's costs is identified as economically significant. Under step 2 it is established that ACo has a service contract with group company CCo; the contract does not address utilisation risk. The functional analysis under step 3 shows that group company BCo decides that the investment is appropriate in light of anticipated commercial opportunities identified and evaluated by BCo; BCo provides the asset specifications and its unique features, arranges its construction in accordance with its specifications, and for ACo to acquire the asset. CCo decides how to utilise the asset, markets the asset, negotiates the contracts with customers and assures the asset is delivered to them and installed appropriately.

Although ACo is the legal owner it does not control the investment risk or the utilisation risk and cannot assess and make decisions relating to the risk mitigation activities. ACo does not control the economically significant risks associated with the investment or exploitation of the asset. Its functional contribution is limited to providing financing but ACo has no capability or authority to control the risk of investing in a financial asset or performs functions to evaluate the financing opportunity or consider the appropriate risk premium and other pricing issues (1.85).

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

The next step is to interpret the information from steps 1-3 and determine if the contractual assumption of risk is consistent with parties' conduct by analysing whether (i) they follow the contractual terms under the principles of I.D.1.1; and (ii) the party assuming risk exercises control over it and has the financial capacity to assume it (1.86). The significance of step 4 depends on the findings. In Examples 1 and 2 above, it may be straightforward and one can jump straight to step 6 (1.87).

It should be considered under step 4(i) whether the parties' conduct conforms to the assumption of risk under the written contracts. Where differences exist which are economically significant, parties' conduct should generally be taken as best evidence concerning their intention on risk assumption (1.88). E.g. a manufacturer, operating in US dollars sells goods to an associated distributor whose functional currency is Euros. The contract states that the distributor assumes all exchange rate risks. However, the distributor is charged by the manufacturer over an extended period in Euros. The written contract does not reflect the actual commercial or financial relations and the

assumption of risk should be determined by parties' actual conduct. See also example 7 in Chapter VI (1.89).

Step 4(ii) determines whether the party contractually assuming the risk, controls the risk and has the required financial capacity.

If in Example 1 the contract allocates development risk to BCo, and there is no evidence under step 4(i) suggesting the contract is not followed, then the facts remain that Company B has no capability to evaluate and control the development risk. The development risk is controlled by ACo. This means further consideration is required under step 5 (1.90).

If in Example 2 BCo is not reimbursed by ACo when there was a failure to secure key components on time, step 4(i) would show that contractual assumption of risk has not been followed in practice for supply chain risk. BCo does not have any control over the supply chain risk, ACo has. Therefore, further consideration is required under step 5 (1.91).

If in Example 3 the assumption of utilisation risk by ACo is consistent with the contract, step 4(ii) determines that ACo does not control investment and exploitation risks and has no decision-making function to taking decisions that affect the outcomes of these risks. Then further consideration is required under step 5 (1.92).

Sometimes step 3 may show more than one MNE can control a risk. However, control requires both capability and functional performance. Therefore, if the entity assuming risk (under step 4(i)) is the only party actually exercising control, then it controls the risk (1.93). There may also be more than one party exercising control over a specific risk. Where the enterprise assuming risk (under step 4(i)) controls that risk under 1.65-1.66, all that remains under step 4(ii) is to consider whether it has the required financial capacity. If so step 5 need not be considered (1.94). Where several parties assume a specific risk (under step 4(i)) and they together control that risk and each has the required financial capacity, that risk assumption should be respected. E.g. when jointly creating a new product (1.95).

If the enterprise assuming the risk under step 4(i) does not control the risk or lacks the required financial capacity, the step 5 analysis needs to be performed (1.96). 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. The

independent enterprise must perform comparable risk management functions (1.97).

D.1.2.1.5. Step 5: Allocation of risk

If step 4(ii) shows 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 required financial capacity to bear it, the risk should be allocated to the enterprise(s) exercising significant control and having that capacity. Other controlling parties should be remunerated appropriately (1.98).

Exceptionally no associated enterprise both exercises control and has the required financial capacity. A rigorous analysis of the facts and circumstances must be performed to identify the reasons and actions leading to this. Tax administrations will then determine the necessary adjustments and the transactions' commercial rationality under I.D.2 (1.99).

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

Next, the accurately delineated transaction should be priced as set out in these Guidelines. The assumption of a risk should be compensated with an appropriate anticipated return, and risk mitigation should be appropriately remunerated (1.100).

In example 1, ACo assumes and controls development risk and should bear the financial consequences. BCo should be appropriately rewarded for its development services, incorporating the risk that it fails to do so competently (1.101).

In example 2, the risks of generating a return for manufacturing are controlled by ACo, and the consequences should be allocated to ACo. BCo controls the risk of failing to competently deliver services, and its remuneration should include that risk and its funding costs for the manufacturing plant. Since capacity utilisation is controlled by ACo, the financial consequences of under-utilisation should be allocated to ACo (1.102).

In example 3 the risk allocation depends on analysis of functions under step 3. ACo does not have control over the economically significant risks associated with the investment in and exploitation of the asset. The functional contribution of ACo is limited to financing the asset but it has no capability and authority to control the risk of investing in a financial asset.

Therefore, ACo would only be entitled to a risk-free return[2]. A I.D.2. assessment may be necessary of the commercial rationality of the transaction (1.103). Further guidance is given in 6.60-6.64. The concepts reflected there apply equally to investments in tangibles (1.104).

A party should always be appropriately compensated for its risk control. Where a party contributes to risk control, but does not assume the risk, compensation in the form of sharing in the potential upside and downside, commensurate with its contribution, may be appropriate (1.105).

The difference between ex-ante and ex-post returns under Section VI.D arises from risks of future business outcomes. The ex-ante contractual assumption of risk should provide clear evidence of assumption prior to that risk materialising (see 1.78). Under this section, the transfer pricing analysis accurately delineates the transaction regarding risk. A party not assuming the risk, nor controlling it, is not entitled to unanticipated profits from that risk. In example 3 ACo gets none. So, if the asset is destroyed, that loss is allocated to the company controlling the investment risk and having the required financial capacity. That company must therefore compensate ACo (see §1.103) (1.106).

I.D.1.2.2 Risk-free and risk-adjusted rates of return

D.1.2.2.1 Determining a risk-free rate of return

A funder that does not perform decision making functions to control its funding risks is only entitled to a risk-free return on its investment. The funder's costs must be considered for this. The funded party is still entitled to an arm's length deduction for the funding. What does not go to the funder goes to the party controlling the funding risk (1.108).

A risk-free return is a hypothetical return on a no-risk investment. Generally certain government issued securities are used as reference point. This guidance does not suggest any particular government security (1.109-110). To eliminate currency risk, the reference government security must be the same as the funder's cashflows. If multiple countries issue bonds in that currency, the reference rate is that of the lowest one (1.111).

The temporal proximity of the reference security is important. The security should ideally be issued at the same time as the funding or have a similar remaining maturity (1.112). One should also consider the duration of the

[2] Company A could be entitled to less than a risk-free return if, e.g., the transaction is disregarded under Section D.2.

investment, as duration affects price. E.g. a short-term loan that is repeatedly renewed can be accurately delineated as a long-term investment (1.113).

Practical solutions may be needed for estimating a risk-free rate of return. E.g. say ACo can only get a risk-free rate of return for a one-year loan to BCo. Country X identifies three one-year securities in ACo's functional currency issued by countries X, Y and Z. The credit ratings are A, B and AA. Country X can select the AA security as the reference point with the lowest rate of return (1.114). Other reference points may be interbank rates, interest rate swap rates or repurchase rates of highly rated government securities (1.115).

D.1.2.2.2 Determining a risk-adjusted rate of return

Parties providing funding and exercising control over the funding risk can expect a risk adjusted rate of return (see 6.61, 1.85 and 1.103) (1.117).

For guidance on the relation between funding risk and operational risk, see 6.60-64 (1.118). E.g. FCo funds related DCo who develops an intangible. FCo controls the risk of funding DCo, including the risk of DCo's failure to develop the intangible and repay the loan. However, FCo is not assuming DCo's development risk, so if DCo is successful and receives residual profits, FCo is not entitled to those (1.119).

A risk adjusted rate of return has two components: a risk-free rate and a premium for the funder's risks (1.120). The return can be determined under different approaches, like a realistic alternative investment (1.122), bond issuances/loans which are uncontrolled (see 10.93) (1.123), or to add a risk premium to a risk-free return (1.124). E.g. in the example under 1.114, but where ACo is entitled to a risk-adjusted rate of return, Country X can use corporate bonds issued by local independent parties in the same industry as BCo (1.125).

Under a cost-of-funds approach, a profit margin proportionate the funder's risks could be added to the costs incurred by the lender (see 10.97-100) (1.126).

I.D.1.3 Characteristics of property or services

Differences in the characteristics often account for differences in their value. Therefore, comparisons may be useful in delineating the actual transaction. For tangible property this could be quality, reliability, availability; for services it could be the nature or extent thereof. For further guidance on intangibles see section VI.D.2.1 (1.127). Comparability

requirements are the strictest for the CUP method. Resale price, cost plus and TNMM are more tolerant to differences in this comparability factor, but still sensitive to differences in functions, assets, and risks (1.128). In practice, methods using profit level indicators often put more focus on functional similarities than product similarities (1.129).

I.D.1.4 Economic circumstances

Arm's length prices may vary across different markets even for transactions involving the same property or services. Relevant economic circumstances include geographic location, market size, available competition by other parties or (substitute) products, bargaining powers, purchasing power, government regulation, and various costs such as labour, capital, and transport. See also I.D.6 on local markets (1.130). Various cycles should also be identified. See 3.77 (1.131). Geographic markets should be identified. Multi-country comparability analyses may only be appropriate across homogenous markets. Some product, same market = acceptable multiple country comparability analyses (1.132 & 133).

I.D.1. 5 Business strategies

Business strategies include many aspects, 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 (1.134). They could also include market penetration schemes such as price cutting or higher costs to achieve market expansion (1.135). 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 such as the conduct of the parties, increased marketing activities and the beneficiaries of such strategies. This may create timing issues for tax administrations when it turns out that the purported strategy was not actually followed (1.136 & 137). Finally, there should be a reasonable expectation that the reward will justify the effort. Business strategies may fail, but independent parties would not pursue such strategies indefinitely (1.138).

I.D2 Recognition of the accurately delineated transaction

The above steps in I.D.1 would have accurately delineated the actual transaction (1.140). Every effort should be made for pricing this transaction. An administration should not disregard it or substitute it, unless the exceptional circumstances of 1.142-145 apply (1.141). Non-recognition can be contentious and a source of double taxation; it cannot apply where comparable transactions are seen between unrelated parties. Associated

enterprises can enter into a greater variety of transactions than unrelated parties, but a transaction that leaves the group worse off on a pre-tax basis indicates a lack of commercial rationality (1.142).

The key question is not whether third parties would enter into a transaction, but whether the transaction lacks the commercial rationality of third party arrangements (1.143). The replacing structure should comport as closely as possible with the facts of the actual transaction whilst achieving a commercially rational expected result (1.144).

Example 1 – irrational insurance

S1's manufacturing business requires significant inventory, plant, and machinery. As its property is prone to flooding, third party insurance is not available. Related S2 provides insurance for an annual premium of 80% of the value of the everything. This is commercially irrational as relocation or no insurance are more attractive realistic options. As the transaction is irrational it is not possible to price it (1.146). The insurance transaction is not recognised (1.147).

Example 2 – irrational intangibles transfer

S1 conducts research for intangibles to use in new products. It transfers all intangibles to be developed in twenty years to related S2 against a lump sum. The transaction is commercially irrational since neither can price the future input, outcomes, or their value. It should be recast in line with the available facts, e.g. to a financing arrangement, as research services, or as licensing (1.148)

I.D.3 Losses

While a related enterprise may remain in a loss making business to benefit its MNE group, an independent enterprise would not be prepared to tolerate losses that continue indefinitely (1.149). E.g. if an MNE wishes to cover a full product range, including loss making ones, then the group producers of the loss making products should be compensated, e.g. by an adequate service charge (1.150). Losses from business strategies should be expected for a limited period only, with the specific object of improving profits in the longer term; in addition, they should be accepted only if unrelated parties would (1.151).

I.D.4 Government policies

Government interventions (price controls, currency controls, and maximum management fees) should be treated as market conditions (1.152). Unrelated parties will still insist on some profit as a condition for transacting

(1.153). Special difficulties arise regarding blocked payments (e.g. through exchange control). Such transactions should be treated as much as possible as unrelated parties would do, e.g. compensation in kind where cash is not possible and the same compensation from related parties as from unrelated parties (1.153-156).

I.D.5 Use of customs valuations

Though their methodologies could be different, there can be a useful exchange of information between customs and tax authorities (1.157). There may be conflicting incentives, e.g. selling to a high tax jurisdiction requires high prices to keep profits low, but high customs duties (VAT or excise duties) favour lower prices (1.158).

I.D.6 Location savings and other local market features

See paragraphs 1.130, 132 and 6.120 for how local market features can affect comparability and arm's length prices (1.159).

I.D.6.1 Location savings

9.148-153 on location savings apply to all situations, not just business restructuring (1.160). It asks i) if such savings exist, ii) how much is saved, iii) whether the saving is passed on to third parties and iv) how independents would share the savings not passed on (1.161). If there are comparable local entities and transactions, comparability adjustments for these savings are unnecessary (1.162), if not, the comparability adjustments should consider all facts and circumstances ala 9.148-153 (1.163).

I.D.6.2 Other local market features

Other market features include local purchasing power, product preferences, market expansion or contraction, intensity of competition, local infrastructure, and the proximity of skilled labour (1.164). Local data should not require adjustments in this regard (1.165). Without local data, the questions of 1.161 should be answered, e.g. are local advantages kept or passed on (1.166). The (dis)advantages of local market features may also be transferred through business restructuring or intangibles and affect the price for these (1.167). Local market features are not intangibles, but contractual rights, government licenses and market expertise may be (1.168). Where business licenses are hard to come by e.g. for investment management services, they may affect investment service prices and profit margins. Group members' contributions in getting a local entity such a license should be considered too (1.170).

I.D.7 Assembled workforce

A uniquely qualified or experienced cadre of employees may affect the arm's length prices for services and should be considered in a comparability analysis (1.172). Transferring such a workforce saves the transferee costs and time, which should be reflected in the transaction price. In other situations, transferring a workforce creates termination liabilities, which also affects the price (1.173). Transfers/secondments of individuals do not require separate compensation (1.174), unless it includes the transfer of an intangible, e.g. a secret formula, through the employee; see chapter VI in general (1.175) and example 23 specific for intangibles and an assembled workforce (1.176).

I.D.8 MNE group synergies

Group synergies such as combined purchasing power, economies of scale, integrated IT, and communication systems, eliminated duplication and increased borrowing capacity can create comparability issues (1.177). Under 7.13 incidental group benefits are not intra-group services, but benefits generated by deliberate concerted actions are (1.178). Whether there have been deliberate concerted actions can only be determined by a thorough functional and comparability analysis[3] (1.179). Examples of concerted actions: centralised purchasing entities, or a parent negotiating a group wide discount; a unilateral offer from a third party to one member, hoping to also generate business with other members is not a concerted group action (1.180). If synergies arise from concerted group actions one should determine the nature of the (dis)advantage, its amount, and its allocation to group members (1.181). Such benefits should be allocated proportionate to members' contributions (1.182). Comparability adjustments may be warranted to account for group synergies (1.183).

Example 1: The P group has a AAA credit rating. Sub S only has a Baa rating on a stand-alone basis, but third party creditors lend money to S as if it has an A credit rating because it belongs to the P group. If S borrows € 50 million from an independent creditor at an A rating and the same amount from a comparable group company at the same credit rating, the interest on that group loan is at arm's length (1.184-186).

Example 2[4]: Same as 1, but S borrows from a bank at an A rating. P guarantees the bank loan and S gets a AAA rating. S owes P compensation

[3] Some countries consider a deliberate concerted action to always constitute a transaction. In a deliberate concerted action an associated enterprise performs functions, uses assets, or assumes risks which requires an arm's length compensation. See Example 5 hereafter.
[4] Example 2 does not provide guidance on guarantee fees. For further guidance for financial transactions see chapter X.

for upgrading from A to AAA status, but not from Ba to A. The guarantee constitutes a concerted group action (1.187).

Example 3: ACo is the group purchasing manager. Due to the group size it can buy $ 200 widgets for $ 110. What should it sell them for? A comparability and functional analysis suggest a $ 6 purchasing compensation per widget. Thus ACo should sell the widgets to group members from $ 116 (1.188).

Example 4: As 3, but ACo negotiates a group wide discount. A comparability and functional analysis now suggests a $ 5 price per widget as ACo no longer takes title to the widgets or holds any inventory (1.189).

Example 5: An MNE has manufacturing subs BCo and CCo in countries B and C and a shared services centre DCo in country D. B charges 30% tax and C 10%. DCo operates at arm's length on a cost plus basis. BCo and CCo each needs 5000 widgets for their manufacturing. X sells the widgets at $ 10 per piece and gives a 5% discount for orders above 7500. DCo orders 10000 widgets and asks that the full discount goes to CCo. Country B can make an adjustment and split the discount pro rata between BCo and CCo. DCo's combined purchase and requested discount constitute a deliberate concerted group action and the fact that BCo could not get the discount by itself is not relevant (1.190-193).

II Transfer Pricing Methods

This chapter discusses various transfer pricing methods in three parts:

- part I explains how to select the most appropriate method for the relevant circumstances;
- part II discuss the so-called traditional transaction methods (CUPs, resale minus, cost plus); while
- part III deals with the transactional profit methods (TNNM and (residual) profit split). The OECD is working on an update for profit split methods.

II.Part I: Selection of the transfer pricing method

II.I.A. Selecting the most appropriate method for the circumstances

Different methods fit different situations. Selection criteria are: strengths and weaknesses of each method; nature of the transaction; availability of reliable information on comparability; degree of comparability and reliability of comparability adjustments (2.2). If the selection criteria result in more than one equally reliable method, then the CUP is preferred over all other methods and traditional methods are preferred over transactional profit methods (2.3). Situations where transactional profit methods may nonetheless be preferred are: where each party makes valuable and unique contributions; where activities are highly integrated; and where there is limited public gross margin information and no internal comparables (2.4).

Transactional profit split methods compare the division of overall profits between unrelated parties, while other methods compare price, margin, or profit of particular transactions with unrelated parties (2.6). Transactional profit methods should never be used to overtax or under tax enterprises (2.7). Selecting the most appropriate method does not require an in-depth analysis of all methods (2.8). Other methods could be used if the taxpayer shows why the OECD methods were less appropriate than the chosen method (2.9); further, any method acceptable to all enterprises and tax administrations involved should be permitted. Rules of thumb cannot substitute a complete functional and comparability analysis (2.10). Tax administrations should refrain from marginal adjustments and should not discard useful information due to rigid comparability standards (2.11).

II.I.B. Use of more than one method

The arm's length principle does not require the use of more than one method, but if no single approach is conclusive, several methods used in conjunction should be allowed. See also 3.58-59. (2.12)

II.Part II: Traditional transaction methods

II.II.B. CUP method

II.II.B.1. In general

The CUP method compares the price charged in a controlled transaction to the price charged in a comparable uncontrolled transaction in comparable circumstances (2.14). An uncontrolled transaction is comparable if:

1. none of the differences between the transactions or the enterprises involved could materially affect the market price; or
2. reasonably accurate adjustments can eliminate such material differences (2.15). Difficulties in making such adjustments should not routinely stop the use of this method. Every effort should be made to enable the appropriate use of CUPs (2.16).

Subject to 2.2, the CUP would generally be appropriate for commodity transactions. Commodities are physical products with a quoted price used by independent parties. "Quoted price" is the price for the relevant period on an international or a domestic exchange, or transparent agencies or governments (2.18). Under the CUP method, the price may reference the quoted price at that time, if that price is widely used in the market for comparable third party transactions. The selected quoted price should be applied consistently (2.19). The transactions must be comparable. The commodities should have the same features and quality, transactional terms and volumes should be similar. Accurate adjustments should be made where required (2.20).

Taxpayers should provide reliable evidence, their price setting policy for commodities and other relevant information such as backgrounds of adjustments, pricing formulas and comparable third party agreements (2.21). The specific date and time selected is particularly relevant. Where parties provide reliable evidence of the pricing date at the time of the transaction, which is consistent with their actual conduct under I.1.D, tax administrations should follow. Administrations may set a different price consistent with parties' behaviour where their pricing date is inconsistent with their conduct. In case of lack of evidence, administrations may use the average quoted price of the shipment date, e.g. based on the bill of lading, subject to comparability adjustments (2.22)

II.II.B.2. Examples

- Can unbranded Brazilian coffee beans be a CUP for unbranded Colombian coffee beans? E.g. does source command a different price? Commodity prices may provide guidance (2.23).
- Can adjustments be made to compensate for the difference between

delivered prices and f.o.b.? Yes, as the effect of transportation and insurance costs is determinable (2.25)

- Finally, adjustments for volume discounts should be possible through relevant market research (2.26).

II.II.C. Resale price method

II.II.C.1. In general

The price at which a product is resold to an independent enterprise (the resale price) is reduced by an appropriate gross margin (the resale price margin) from which the reseller should cover its selling and other operating expenses and an appropriate profit. The method is most useful for marketing operations (2.27). Margins can be compared to internal comparables, or external comparables (2.28). Such transactions are comparable if they meet the two tests under B1 above (see 2.13-16).

Fewer adjustments are normally needed for product differences than for CUP's, because minor product differences generally affect profit margins less than price (2.29). The market compensation for similar functions tends to equalize across activities, but not so for products. Because the resale price method gives the compensation for a particular function (e.g. marketing), product differences are less significant (e.g. prices for blenders do not follow prices for toasters, but compensation for marketing either could) (2.30). This elasticity regarding products is not infinite, e.g. may not work for products with and without unique intangibles (2.33).

Differences affecting comparability:

- Differences between the compared enterprises, e.g. regarding management and operational efficiency. These will affect profits and thus the comparability of the margins (2.33).
- Differences in functions will require adjustments (2.34).
- If the reseller contributes substantially to the product physically or through intangibles (e.g. trademarks) (2.35).
- Short turnover periods are better as they reduce differences in risks on inventory or currency (2.36).
- Fewer activities produce smaller margins (e.g. forwarding agents vs. fully fledged distributors). Some activities may require separate compensation under another method (e.g. high marketing volumes under a cost plus) (2.37).
- A reseller carrying on substantial additional commercial activity employing e.g. intangibles, cannot be compared to one who does not, without adjustments (2.38)
- It may be relevant to look at companies further up and down a distribution chain to see who assume economically significant risks or value increasing

functions (2.39.

- Exclusivity may affect profit margins and or reseller effort, which requires examination. See also paragraphs 6.118 and 6.120. (2.40).
- Different accounting practices, e.g. treating R&D as an operating cost, or as costs of sales (2.41).

II.II.C.2. Examples

- If the same product is sold by ACo with warranties and by BCo without warranties, reasonably accurate adjustments are required to achieve comparability (2.42).
- The same product is sold with a warranty by CCo and DCo. CCo offers the warranty directly, but is compensated by it supplier through a lower price; DCo does not offer any warranty, but its supplier does so directly. If CCo books its warranty costs as costs of goods sold, its gross profit margins are comparable to DCo's. However, if CCo books its operating expenses, a comparability adjustment is required to compensate for its lower purchase price (2.42).
- A subsidiary sells products in one market with exclusivity and customer support. This cannot be compared to sales through independent distributors in other markets with no exclusivity or customer support, without making comparability adjustments (2.45).

II.II.D. Cost plus method

II.II.D.1. In general

This method uses costs incurred by the supplier and adds an appropriate mark-up, to enable an appropriate profit considering the functions performed and market conditions. It is a useful method for the transfer of semi-finished goods, for joint facility agreements, long-term buy-and-supply arrangements, or for providing services (2.45). Such transactions are comparable if they meet the two tests under 'II.II.B.1 In general', here above (see §2.13-16). Fewer adjustments are normally needed for product differences than for CUP's, because profit margins on costs are less sensitive to product differences than prices; 2.29-2.34 apply equally (2.47).

Differences affecting comparability:

- Differences between the compared enterprises, e.g. regarding management and operational efficiency, could affect comparability and may require adjustments (2.48).
- Different cost bases affecting the mark-up size, e.g. leased production assets vs. owned production assets (2.50).
- Differences in expenses, such as
  - Expenses reflecting a functional difference;

- Distinct unrelated functions may require separate unrelated compensation;
- Expenses related to non-arm's length capital structures (2.51).

- Accounting differences, e.g. some costs may be found in net profits only for one enterprise and in gross profits for another. Inclusion of operating expenses trigger issues mentioned in 2.70-2.73, requiring remedies from 2.74-2.81 hereafter (2.52).

There are three cost categories: direct production costs (e.g. raw materials); indirect production costs (general repairs across products); and operating expenses (general, supervisory and admin) (2.53). Generally, the cost plus method uses direct and indirect costs; some countries includes some operating expenses (2.54). Generally historical costs should be used, although average costs could be allowed in case of periodic fluctuations, product groups and shared production assets (2.55).

Costs allocated to the cost plus provider should be allocated to it, based on its functions; costs should not be redirected to avoid the mark-up. See chapter VIII on cost contribution agreements for the allocation of overhead (2.56). If it can be shown that goods cannot be sold for a higher price in a foreign market, only variable or incremental costs may be used for disposing of marginal production (2.57). Methods for determining costs should be consistent over time and across comparables. Costs in the mark-up basis should be acceptable for unrelated parties too, e.g. not costs caused by inefficiency (2.58).

II.II.D.2 Examples

ACo in country A manufactures widgets for mass products and sells them to its subsidiary BCo in B. ACo earns a 5% gross profit mark-up. X, Y and Z are independent manufacturers of similar widgets earning 3% to 5%. Unlike X, Y and Z, ACo books supervisory, general and administration costs as operating expenses, not as costs of goods sold. X, Y and Z's gross profit mark-ups must be adjusted for comparability (2.59).

ECo in F owns CCo in D. D has much lower wages than F. CCo assembles TVs for ECo as contract manufacturer. The cost plus is based on all costs connected to CCo's assembly activities (2.60).

ACo does contract research for related party BCo. This is a typical setup for the cost plus method. All ACo's research costs must be compensated and the plus should reflect how innovative and complex the research is (2.61).

II.Part III – Transactional profit methods (TPMs)

II.III.A Introduction

TPMs examine profits from particular transactions. Comparable profits methods and modified cost plus/resale minus methods are only acceptable to the extent they comply with the TPG (2.62). TNMM and the transactional profit split method are such methods (2.63).

II.III.B Transactional net margin method

II.III.B.1 In general

TNMM examines the net profit relative to an appropriate base like costs, sales, or assets. It operates like a cost plus or resale minus and compares the appropriate net profit indicator ("NPI") for the controlled transaction with the same NPI for comparable uncontrolled transactions. The NPI should be established by reference to external comparables where internal ones are not available and a functional analysis is required for comparability and necessary adjustments (2.64). While TNMM is not reliable if each party makes valuable, unique, contributions (2.65), a total lack of such contributions does not automatically make it the most appropriate method (2.66).

II.III.B.2 Strengths and weaknesses[5]

Strengths are: NPIs are less affected by transactional differences than CUPs; they more tolerant to some functional differences (2.68); and the method needs only one tested party. Weaknesses: NPIs can be affected by factors which affect price or gross margins less (2.70); they may be difficult to obtain for pricing transactions contemporaneously (2.71); finally, it may be difficult to determine corresponding adjustments where there are no transfer prices to work back to, e.g. if the taxpayer buys AND sells to related parties, where should the corresponding adjustment fall (2.72)?

II.III.B.3 Guidance for application

II.III.B.3.1 The comparability standard to be applied to TNMM

The TNMM's comparability analysis should not be less reliable than that of other transfer pricing methods, even where information is limited in practice (2.74). A mere similarity of functions is not sufficient for reliable comparisons; a high degree of similarity is required on various factors which can significantly influence NPIs (2.75).

NPIs can introduce increased volatility where: 1) factors influencing NPIs do not influence gross margins and prices, because of the variations of operating

[5] See example Annex I to chapter II.

expenses across companies and 2) factors, such as competition, influence gross margins, prices and NPIs. NPIs are less sensitive to differences in the extent and complexity of functions and of differences in levels of risk. However, they can be more sensitive to differences in capacity utilization, because fluctuations in indirect fixed costs hurt NPIs more than they hurt gross margins/mark-ups (2.76).

NPIs can be directly influenced by the threat of new competitors or products, management efficiency, cost of capital and business experience (think start-up costs). Each of these factors can in turn be influenced by other factors as well (2.77). E.g. a taxpayer sells top quality radios and the comparable sells simple radios. The top radio market may be expanding and have many niches, and the simple one not. The two parties could have widely differing profitabilities, depending on market share and competitive positions (2.78). These differences may affect the size of the arm's length range (2.79).

TNMM could be an outcome if it is used sensibly and with appropriate adjustments, but administrations fear the use of lower comparability standards in applying TNMM (2.80). Comparability measurements also need to be applied consistently, e.g. with regard to the classification of operating and non-operating expenses (2.81).

II.III.B.3.2 Selection of the net profit indicator

The selection of the NPI should consider various NPIs strengths and weaknesses, appropriateness, availability of reliable information and degree of comparability, including adjustments (2.82).

II.III.B.3.3 Determination of the net profit

Only items that are related to the controlled transaction and are of an operating nature should be considered (2.83). This may require segmentation of the taxpayer's financial data where the company also engages in unrelated transactions (2.84).

Likewise, external comparables must exclude unrelated transactions and must not be distorted by controlled transactions of that enterprise (2.85). Further, non-operating items such as interest and taxes should be excluded, as should exceptional and extraordinary non-recurring items. Exceptional and extraordinary items should be reviewed for comparability information (2.86). It would be appropriate to consider interest, where making and receiving advances constitutes the taxpayer's general business (2.89).

Where there is a correlation between credit terms and sales prices, interest income might be included in short term working capital, e.g. where a large retailer collects sales proceeds quickly, pays suppliers slowly and use the cash flow advantage to fund sales discounts (2.87). Currency results complicates comparability: they may or may not be of a trading nature and may or may not affect comparables; the same would apply for any hedging results of the currency risks (2.88).

Difficulties also arise where the accounting treatment of items is unclear, e.g. regarding depreciation, stock options or pension costs (2.90). The inclusion of start-up or termination costs depends on facts and circumstances (2.91).

II.III.B.3.4 Weighting the net profit

The denominator selection should be consistent with the comparability analysis and should:

- particularly reflect risk allocation. E.g. capital intensive activities like manufacturing involve investment risk which should be reflected in the NPI as return on investment of the party bearing that risk (2.92).
- focus on the value of functions performed. E.g. distribution expenses may be an appropriate base for distribution activities, operating expenses for service activities and operating assets for manufacturing (2.93).
- be reasonably independent from controlled transactions. E.g. when buying from related parties, cost of goods sold is not a good base for a NPI; likewise, in services to related parties, revenue would be unreliable (2.94).
- be reliably and consistently measurable both with the taxpayer and the comparable (see 2.99) (2.95).

II.III.B.3.4.1 Weighting to sales

An NPI of net profit over sales is frequently used for pricing related party purchases. The sales used should only be those of the related party products purchased, unless unrelated party purchases are immaterial (2.96). Sales rebates and discounts should reduce the sales revenue (2.97).

II.III.B.3.4.2 Weighting to costs

Costs should only be used where they a relevant indicator of the value of functions, assets, and risks. Generally, only the operating costs related to the controlled transaction should be taken into account (2.98). In practice such costs are often include direct costs, indirect costs, and allocated overheads.

Qualifying costs as pass-through costs with no profit margin should be done like third parties would do; a differentiation between “internal” and

"external" costs in this regard is irrelevant (2.99). Comparability issues may arise where it is not known what the comparable does (2.100).

The costs used may be actual, standard, or budgeted. Using actuals may take the service provider's incentive away for controlling such costs; independent parties typically factor in cost saving incentives. Independent parties can also use standard costs and attribute variances to the service provider (see 2.58) (2.101). The use of budgets raises concerns where budgets vary widely from actual numbers; independent parties would require safeguards (2.102).

II.III.B.3.4.3 Weighting to assets

This can be appropriate where assets indicate value added, e.g. in manufacturing and other asset/capital intensive activities. Only operating assets (tangibles, land, intangibles, inventory, trade receivables, etc.) should be used (2.103). The question is if book or fair market value should be used. Fair market value may be uncertain, but adjustments may enhance reliability; the most reliable measure should be used (2.104).

II.III.B.3.4.4 Other possible net profit indicators

Other NPIs could be floor area of retail points, weight of transported products, employees, etc., which provide a reasonable indication of the value added (2.105).

II.III.B.3.5 Berry ratios (BRs)

BRs are gross profits over operating expenses. Interest is generally excluded and depreciation included in operating expenses, depending on the circumstances (2.106). BRs are sometimes used inappropriately as they are very sensitive to the classification of costs as operating expenses or not and pass-through costs raise issues (see 2.99-100). BRs are appropriate where the value of functions is proportional to operating expenses and not to sales, and where the taxpayer does not perform other significant functions (2.107). They can still prove useful if taxpayers both buy from and sell to related parties: cost plus does not work here, as the provider is a related party and resale minus does not work, as the buyer is related: operating expenses are typically unaffected by related party transactions, unless they contain material related party charges (e.g. management fees) (2.108).

II.III.B.3.6 Other guidance

As third party data is often only company-wide data, the third party's functions in its total operations must closely align with the tested party's functions (2.109).

II.III.B.4 Examples of the application of TNMM

The example in §2.59 shows the need to adjust the gross mark-up. If the costs to be adjusted cannot be identified, it may still be possible to identify an NPI (2.111). The same applies for functional differences. If, in the example in §2.44 the comparable performed the technical support and the related costs could not be identified, NPIs may be easier if the technical support does not materially affect it (2.112). If, in the example in §2.42 the warranty expenses cannot be ascertained, but A's sales NPI is known, that might be applied to B (2.113).

Annex I to chapter II: Sensitivity of gross and net profit indicators

Illustration 1: Depending on circumstances, net profit margins can be less sensitive to differences in functions than gross margins.

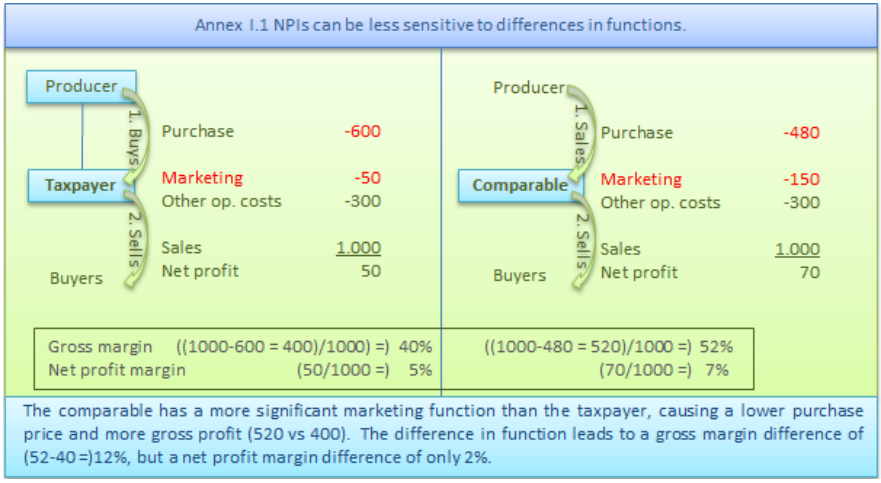


Illustration 2: Depending on the circumstances, net profit margins can be less sensitive than gross margins to differences in the level of risks (assuming the contractual allocation of risks is arm's length).

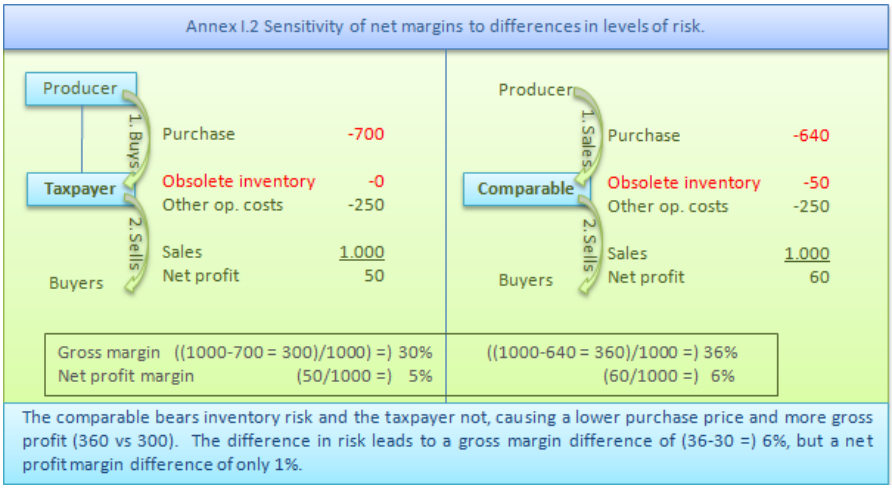
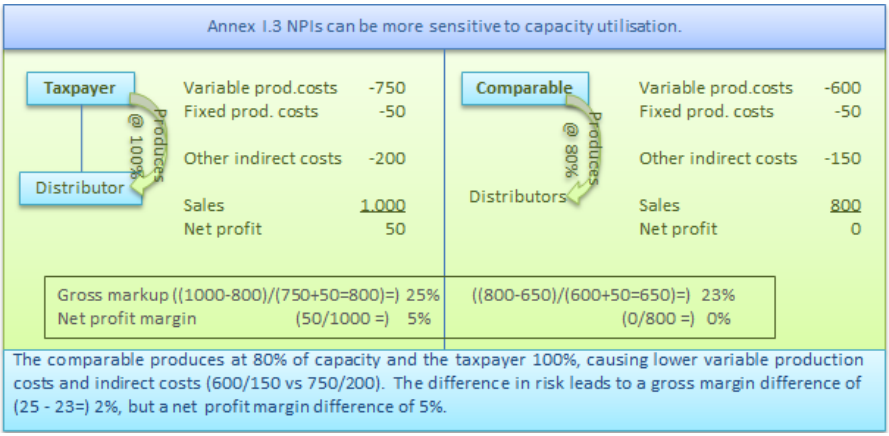


Illustration 3: Net profit indicators can be more sensitive than gross mark-ups or gross margins to differences in the capacity utilisation, depending on the facts and circumstances of the case.



II.III.C. Transactional profit split method ("TPSM")

II.III. C.1. General

The TPSM seeks arm's length outcomes for controlled transactions to approximate results between independent enterprises in a comparable transaction. It identifies the profits to split, to split it on an economically valid basis. The aim is aligning profits with value contributions. It is useful when compensation is more reliably valued through the relative value of contributions vis a vis each other, than by a direct valuation of those contributions (2.114).

"Profits" in this section include losses. Asymmetrical splits of profits and losses must be used with caution and properly documented (2.115).

II.III.C.2. When is a TPSM the most appropriate?

See paragraph 2.2 on selection and 2.4 to 2.7. There are no prescriptive rules for when a method is the most appropriate. (It depends on facts, circumstances, and information available – JHM.) The selection should consider the appropriateness and reliability of the selected method vis a vis other methods (2.116-118).

II.III.C.2.1. Strengths and weaknesses of the TPSM

TPSM:

* offers a solution where both parties make unique and valuable contributions. See Section C.2.2 below.
* offers a solution for highly integrated operations. See Section C.2.2.2.
* considers unique facts and circumstances e.g. in the shared assumption of economically significant risks (or the separate assumption of closely related economically significant risks) where TPSM considers the actual outcomes of the risks.
* directly evaluates all relevant parties (2.119-122).

A weakness of the TPSM is the difficulty in applying it. Taxpayers and tax administrations have difficulty accessing the detailed information required to apply a TPSM reliably. E.g. to measure the relevant revenue and costs for all associated enterprises on a common accounting and currency basis, or to identify appropriate operating expenses and to allocate costs between different activities. Identifying profit splitting factors can be challenging, one must document how the method is applied to profits to split. See Sections C.4 and C.5 (2.123).

It is argued that TPSM is rarely used among independent enterprises. This is not a factor: transfer pricing methods do not replicate arm's length behaviour, but establishes arm's length outcomes. See paragraph 2.129 for cases where independent parties do apply profit split (2.124).

II.III.C.2.2. Nature of the accurately delineated transaction

Accurate delineation of a transaction is important to determine if TPSM is applicable. It requires a two- sided analysis irrespective of the transfer pricing method. (See I.D.1.2.)

Where one party performs only simple functions, does not assume economically significant risks and does not make any unique and valuable contribution, TPSM is not appropriate (2.125-127).

A lack of comparable, uncontrolled transactions does not make TPSM appropriate. It may be better to use close but not perfect comparables, than an inappropriate method. See 3.38-3.39 on limitations in comparables. See also Section C.2.3 below (2.128).

Consider industry practices, e.g., if independent parties commonly use profit split in similar situations, there may be reasons for that, such as use of unique and valuable intangibles; likewise industry using other methods may point to a lack of such intangibles (2.129).

II.III.C.2.2.1. Unique and valuable contributions by each party

Contributions are "unique and valuable" where (i) they are not comparable to contributions by uncontrolled parties in comparable circumstances, and (ii) they represent a key source of actual or potential economic benefits. The two factors are often linked. E.g. the risks associated with contributions may be uncontrollable, which impacts risk assumption. E.g. 2 developer and manufacturers of 2 separate key components of a product may both make unique and valuable contributions. (See 6.50 to 6.58 and 6.133.) Neither controls the development risk of the whole product, but together they do. See Examples 1, 2, 3 and 4 in Chapter II Annex II (2.130).

Example 1: Pharma Cos

(The example names are added for benefit of the readers – JHM)

ACo owns SCo. ACo owns patent for a new pharmaceutical formula. It designed the clinical trials and performed the early R&D. ACo then licenses the patent to SCo to enhance the formula through further development and obtain regulatory approval. The final product is a global success. Accurate delineation shows both companies' contributions are unique and valuable. TPSM likely most appropriate method.

Example 2: Tea makers

ACo in A grows and processes amazing tea. ACo has extensive knowhow to find the right soil and uses its proprietary know-how to produce its unique tea blends. BCo, ACo's parent, buys ACo's tea for repackaging and branding. BCo has unique and valuable trademarks and turned the tea into a market leader in a number of markets through extensive advertising campaigns. The tea is sold at a premium. Accurate delineation shows both companies' contributions are unique and valuable. TPSM likely most appropriate method.

Example 3: Electronic Cos 1

ACo makes a new line of electronic products through R&D, production, and quality control. ACo determines the budgets, the direction, etc. Related BCo develop cutting-edge marketing resulting in a valuable trademark with associated goodwill. It validates impacts of marketing campaigns monthly. BCo developed a proprietary algorithm for customer feedback, resulting in it being able to predict demand and assure customers receive their orders within 48 hours. Accurate delineation shows both companies' contributions are unique and valuable. TPSM likely most appropriate method.

Example 4: Electronic Cos 2

Facts are as in 3, but BCo does more simple marketing, its customer feedback is relatively simple and its distribution activities ordinary. A functional analysis shows BCo's risk for marketing and distribution is not economically significant. TPSM is not appropriate as BCo's compensation can be reliably benchmarked.

Transactions involving unique and valuable intangibles

Where each party legally owns unique and valuable intangibles ask if they each assume the economically significant risks for those intangibles (see 6.65 to 6.68). The TPSM may be appropriate for a transfer of partially or fully developed intangibles (See 6.148-152, Example 5 in Chapter II Annex II and Section VI.D.4 for hard-to-value intangibles (2.131-132).

Example 5: Web crawler

WebCo design a web crawler to collect pricing data faster and more efficient. It licenses the crawler to related ScaleCo, who scales up the crawler and determines crawling strategy, to customise the crawler for potential customers. WebCo continues developing the base technology for ScaleCo to use. A functional analysis shows development risk to be economically significant and that both companies assume it.

Accurate delineation shows both companies' contributions are unique and valuable. TPSM likely most appropriate method.

II.III.C.2.2.2. Highly integrated business operations

A high degree of integration may require the TPSM. A high degree of integration means the way parties perform functions is highly interlinked. Complementary, but discrete, activities are not necessarily highly integrated. See Examples 6, 7 and 8 in Chapter II Annex II (2.133).

Example 6: Investment fund managers

AssetCo owns ACo in A and BCo in B; both companies manage investments in their own countries. FUNDCo, a third party, hires AssetCo to manage its funds in A and B. AssetCo contracts ACo and BCo to do the actual portfolio management. ACo and BCo form an investment management committee which monthly determines their portfolio investment management.

ACo's and BCo's services are not unique, but they run the same economically significant risk of losing investors if their portfolios do not perform and manage that in a highly integrated and interdependent fashion. TPSM likely most appropriate method. AssetCo's compensation will be zero.

Example 7: Logistics Cos

LCo in L and MCo in M provide logistics services: trade facilitation, freight forwarding and customs brokering. Each do import/export of goods from their country to the other's country (e.g. customer ships container from L to M). They perform the same services in a highly integrated manner, do similar marketing and customer relations functions, and depend highly on each other. They also jointly own and enhance a goods-tracking IT system.

Although comparables are available, their highly integrated operations and interdependence justifies using the TPSM. This is also the case if they share economically significant risks (which they do – JHM)

Example 8: Contract manufacturing

ACo owns BCo. ACo makes and distributes electronic devices. ACo subcontracts BCo to manufacture for it. ACo instructs BCo; BCo sources a key component from ACo. BCo sells finished products to ACo and has no other customers. BCo invested in specific machinery and tooling.

Accurately delineated, BCo does not make unique and valuable contributions and its risks are not economically significant. TPSM not appropriate.

Further examples:

* the global trading of financial instruments. See Part III.C of the AOA;
* a high degree of inter-dependency, e.g., in long-term arrangements where each party made a significant contribution whose value depends on the counterparty. Here, some form of flexible pricing that varies with, the outcome of risks may be observed (2.134, 135).

The extent of sharing economically significant risks is relevant. See C.4.1. Where a party contributes to controlling economically significant risk, but does not assume that risk, it may or may share in the potential upside and downside, depending on facts and circumstance. See 1.105. For highly inter-related or inter-dependent contributions, evaluation may be holistic. E.g. a unique contribution by one party may have greater value in combination with a unique contribution of another party. See 6.93-6.94 and Example 9 in Chapter II Annex II (2.136-138).

Example 9: Combined drugs

ACo in A is related to BCo in B. ACo developed a unique compound and BCo a unique enzyme. Separately neither have significant value, but a joint team of ACo and BCo engineers found that together the compound and enzyme creates a unique and valuable drug. ACo and BCo agree that BCo will manufacture and market the drug. The high level of integration and interdepency of both companies unique contributions justify the use of TPSM.

II.III.C.2.2.3. Shared assumption of economically significant risks, separate assumption of closely related risks

TPSM can be appropriate for shared economically significant risks or separate economically significant risks which are closely related and cannot be isolated. See Example 10 in Chapter II Annex II. Risks' economic significance should be analysed for their importance to the actual or anticipated relevant profits, not their importance to one enterprise. If parties share economically significant risks, they may split actual profits, not anticipated profits, since actual profits, reflect the playing out of those risks. Splitting anticipated profits covers the playing out of risks on one party only. See Section C.4.1 below (2.139-142).

Example 10: High tech key component

ACo designs, develops, and produces high tech industrial products. It produces a new line, incorporating a key component from related BCo. The success of the new line heavily depends on the key component, which can only be used in the new line.

ACo controls all functions and risks regarding production and sales and BC all functions and risks regarding the key component. Though each assume separately economically significant risks, the risks are highly interdependent. So a TPSM is appropriate, based on the gross profits of ACo, but not splitting OPEX.

II.III.C.2.3. Availability of reliable information

If information on reliable comparable uncontrolled transactions is available, the TPSM is generally not appropriate. If there is no comparables, information from unrelated party transactions is still relevant e.g. for splitting of profits (see Section C.3.1.1 below), or where a residual analysis approach is used (see Section C.3.1.2) (2.143-144).

II.III.C.2.4. Conclusions

The guidance here is not comprehensive, or prescriptive. Each case needs to be analysed on its own facts (2.145).

II.III.C.3. Guidance for application – in general

These Guidelines do not give an exhaustive list of ways to apply TPSM. Application depends on facts, circumstances, and available information to approximate profit splits of independent enterprises.

The relevant profits to split are:
• consistent with the functional analysis to reflect the assumption of economically significant risks, and
• capable of being measured in a reliable manner (2.146-147).

Also if TPSM is used:
• the life-time of the arrangement and the profit splitting factors should be agreed in advance,
• the taxpayer or tax administration should explain why TPSM is regarded as appropriate and how it is implemented, and
• the results to split should be determined consistently also in loss years (2.148).

C.3.1. Approaches to splitting profits

There are a number of approaches, e.g. by considering the relative contributions of each party (a "contribution analysis"), or a "residual analysis" considering less complex contributions (2.149).

II.III.C.3.1.1. Contribution analysis

Here, the profits are divided to reasonably achieve the same results independent enterprises would, supported by comparables if available. Otherwise, it is based on the relative value of contributions (see Section C.5.2 below). If the relative value of contributions can be measured, it is not necessary to estimate their actual market value. The relative value might be estimated by comparing the nature and degree of parties' contributions and assigning a percentage to it. See Section C.5 below. (2.150,151)

II.III.C.3.1.2. Residual analysis

Where some contributions can be valued by a one-sided method, a residual TPSM is appropriate. It divides the profits into those attributable to benchmarkable contributions and unique and valuable contributions, and/or ones involving economically significant risks. The residual profit is allocated on relative contributions, like the contribution analysis above and in Section C.5 below. See also Example 11 in Chapter II Annex II (2.152-153).

Example 11: Residual profit split

An electronic product is successful because of its electronic processes and a major component. The component is made by ACo and the rest (including processes) by related party BCo. Related party CCo takes care of distribution, a routine function, at an arm's length price. There are no CUPs for ACo's compensation for its unique component. Since BCo's price to CCo is known, the residual profit of ACo and BCo can be determined and reward the R&D of both ACo and BCo. Analysis shows that both companies' R&D expenditure reliably reflects the relative value of their contributions. The split is done as follows.

a) ACo and BCo P&Ls

Preliminary profit & Loss	ACo	BCo
Sales	50	100
Purchases	-10	-50
Manufacturing costs	-15	-20
Gross profits	25	30
R&D	-15	-10
Operating expenses	-10	-10
Net profit	0	10

Step 1: calculate the routine compensation
Comparable independent routine manufacturers earn a cost-plus 10% return, so ACo should get (15 x 10%=) 1,5 and BCo 2. The combined residual profit is then (0+10-1,5-2=) 6,5.

Step 2: allocate the residual profit
Total R&D spend is 25. ACo gets (15/25 x 6,5=) 3,9 and BCo gets (10/25 x 6,5=) 2,6.

Step 3: recalculate profits
ACo should get 1,5 routine compensation + 3,9 residual profit = 5,4.
BCo should get 2 + 2,6 = 4,6

Recalculated profit & Loss	ACo	BCo
Sales	**55,4**	100
Purchases	-10	**-55,4**
Manufacturing costs	-15	-20
Gross profits	30,4	24,6
R&D	-15	-10
Operating expenses	-10	-10
Net profit	**5,4**	**4,6**

This example exemplifies the mechanism of a residual profit split, it does not provide general guidance on how to do one.

II.III.C.4. Guidance for application – Determining the profits to split

The profits to split are those from controlled transactions. One must identify the level of aggregation, see 3.9-12. One first identifies and accurately delineates the transactions and the relevant income and expense. See C.4.2,

below and example 12 in Chapter II Annex II The relevant financial data must be harmonised for accounting practice and currency, and then combined. Selected accounting standards should be applied consistently from the start (2.154-155).

Example 12: Calculating profits to split

ACo in A, BCo in B and CCo in C are related. ACo and BCo design, manufacture, market and distribute products to unrelated parties and their activities are highly integrated. CCo does benchmarkable routine marketing and distribution in C. Design and manufacturing are key value drivers and ACo and BCo perform a complex web of transactions where each depend heavily on the other. They also share design and manufacturing risks and the TPSM seems to be the most appropriate method. ACo and BCo share the profits from countries A, B and C on their relative contributions, after giving C routine compensation for its contribution.

The relevant financial data must be put on a common basis by selecting the relevant accounting standards in advance, applying them consistently during the arrangement, and identifying and adjusting for material differences between those standards (2.155). Financial accounts are the starting point, but other reliable, transactional financial data such as cost accounting and product-line income statements are allowed (2.156). The data also needs to be segregated from other non-relevant transactions which can be extremely complex and needs to be documented (2.157).

Financial accounting may provide a starting point, but other financial data (e.g. cost accounting) is permitted if reliable, auditable, and sufficiently transactional. Product-line income statements or divisional accounts may also be useful. The financial data must be segregated. E.g. a product supplier in a profit split with an European marketing and distribution company must identify the profits arising from the European market, and exclude other markets. Similarly, if the distribution company also buys products from other sources, it must segregate those. Experience suggests that this can be complex (2.156-157).

II.III.C.4.1. Transactional profit splits of actual or anticipated profits

Determining the profits to split must align with the accurately delineated transaction. See Example 13 in Chapter II Annex II. Splitting actual profits is only appropriate if accurate delineation shows parties share the same risks or separately assume closely related risks. If one party does not share the risks, a split of anticipated profits is more appropriate. See scenario 1 of Example 13 in Chapter II Annex II (2.158-160).

Example 13: Profit split on budget or actual?

ACo in the retail fashion industry developed know-how and enhanced its trademarks and associated goodwill. ACo grants SubCo rights to use its know-how and trademarks for local fashion retailing. SubCo is strong in marketing in brand building through innovative strategies and activities. Accurately delineated, ACo and SubCo both make unique valuable contributions and the TPSM is appropriate.

Scenario 1:
ACo does not share SubCo's economically significant risks re. marketing and exploitation. Hence the TPSM should be based on anticipated gross profits excl. BCo's marketing & exploitation cost, e.g. a sales based royalty (see VI.D.6.2.3&4).

Scenario 2:
ACo and SubCo split SubCo's actual local profits; jointly perform marketing and distribution activities locally; and jointly assume SubCo's marketing and commercialisation risks. Here TPSM based on actual profits, including OPEX is appropriate.

One should not use hindsight, see 3.74. Unless there are major unforeseen developments which would result in renegotiation between independent parties, the profits split basis, the way of calculation, and any adjustments, must be based on information known or reasonably foreseeable when the transactions were made. The general starting point to accurate delineation is written contracts, see 1.42. (2.161)

II.III.C.4.2. Different measures of profits

Generally, the profits split are operating profits, but it could be gross profits, excluding OPEX. For gross profits, ensure the expenses incurred and profits allocated match the accurate delineation of the transaction. Profits to split depend on accurate delineation E.g., if parties share market risk (affecting sales) and production risks (affecting COGS), it is appropriate to split gross profits. If parties then also share risks affecting operating expenses, split operating profits (2.162, 163).

E.g. two associated enterprises contribute intangibles to produce innovative, complex products. They share the risks of success of the products, but not risks associated to selling (i.e. OPEX - JHM). Splitting gross profits may be more appropriate. Similarly, enterprises engaged in highly integrated worldwide trading operations may split gross profits if their shared risks and integration exclude operating costs (2.164).

Example 14 in Chapter II Annex II illustrates the principles of this section (2.165).

Example 14:

Scenario 1:

A and B manufacture the same widgets and create a unique and valuable intangible they both can use. The value of their contributions is proportional to their expenditure on the intangible. Their manufacturing is routine, worthy of a cost plus 10%.

a) Using operating profit:

Preliminary profit & Loss	ACo	BCo	Combined
Sales	100	300	400
Cost of Goods Sold	-60	-170	-230
Gross profits	40	130	170
Overhead expenses	-3	-6	-9
Other operating expenses	-2	-4	-6
Expenditure on the intangible	-30	-40	-70
Operating profit	5	80	85

Step 1: Determine the compensation for routine manufacturing
routine compensation A gets = 60 x 10% = 6
routine compensation B gets = 170 x 10% = 17
Total routine profit = 6 + 17 = 23.

Step 2: Determine the residual profit
If it is operating profit:
Profit to split = operating profit – routine profit = 85- 23 = 62
Residual A gets (Intangible expenditure/total expenditure) 30/70 x 62 = 26,57
Residual B gets 40/70 x 62 = 35,43

b) Using operating profit before overhead:

Preliminary profit & Loss	ACo	BCo	Combined
Sales	100	300	400
Cost of Goods Sold	-60	-170	-230
Gross profits	40	130	170
Other operating expenses	-2	-4	-6
Expenditure on the intangible	-30	-40	-70
Operating pr. before overhead	8	86	94
Overhead expenses	-3	-6	-9
Operating profit	5	80	85

Step 1: Determine the compensation for routine manufacturing
See above, total routine profit = 6 + 17 = 23.

Step 2: Determine the residual profit
Operating profit before overhead:
Operating profit + overhead – routine profit = 85 + 9 - 23 = 71
Residual A gets (Intangible expenditure/total expenditure) 30/70 x 71 = 30,43
Residual B gets 40/70 x 71 = 40,57

Scenario 2:
Sometimes it is appropriate to exclude a category of expenses where the profit split relies on those expenses. E.g. where intangible expenses are the profit splitting factor, the profit to be split can exclude those expenses. The facts are as in Scenario 1a, except that profits are now split before Expenditures on intangibles.

Preliminary profit & Loss	ACo	BCo	Combined
Sales	100	300	400
Cost of Goods Sold	-60	-170	-230
Gross profits	40	130	170
Overhead expenses	-3	-6	-9
Other operating expenses	-2	-4	-6
Operating pr. before overhead	35	120	155
Expenditure on the intangible	-30	-40	-70
Operating profit	5	80	85

Step 1: Determine the compensation for routine manufacturing (see above)
A gets 6, B gets 17, total routine profit is 23.

Step 2: Determine the residual profit to be split:
If it is operating profit before expenditure regarding the intangible:
Operating profit + expenditure on the intangible = 85 + 70 = 155
Profit to be split = 155 – routine profit (23) = 132

Residual profit A gets = 30/70 x 132 = 56,57
Residual profit B gets = 40/70 x 132 = 75.43

II.III.C.5. Splitting the profits

The relevance of uncontrolled transactions or internal data depend on facts and circumstances. See 2.146-2.148 for general guidance. Profit splitting factors should be:

• independent of transfer pricing policy formulation, i.e. based on objective data (e.g. sales to independent parties), not data from controlled transactions (e.g. intercompany sales),

• verifiable, and

• supported by comparables data, internal data, or both (2.166).

One approach is to split profits as done in comparable uncontrolled transactions. Possible sources of information include joint-venture arrangements, such as development projects in oil and gas; pharmaceutical collaborations; co-marketing or co-promotion agreements; arrangements between independent music record labels and music artists; uncontrolled arrangements in the financial services sector; etc (2.167).

It can be difficult to find reliable comparables. Nevertheless, external market data is relevant to assess the value of contributions. Where there is no direct evidence, profit allocation may be based on the relative contributions measured by functions, assets, and risks (2.168).

II.III.C.5.1. Profit splitting factors

Profits are divided using splitting factors. A functional analysis determines the relevant splitting profits, including their weighting where more than one factor is used. See examples 15 and 16 in Chapter II Annex II. The factor can be a figure (e.g. a 30%-70% split), or a variable (e.g. relative value of participants' marketing contributions) (2.169, 170).

Example 15:

ACo and BCo design and manufacture products in a highly integrated way and are responsible for marketing and distribution. They developed unique and valuable knowhow and other intangibles. They are engaged in a complex web of intercompany transactions, depend heavily on each other and share risks relating to strategy, operations (OPEX), design and manufacturing.

TPSM is the most appropriate method and the profit split can be based on the relative value of their contributions. An asset based splitting may be appropriate (due to the intangibles) if this correlates to the creation of value.

Profit splitting factors based on assets or capital (e.g. production assets, or costs (e.g. relative spending on R&D, engineering, marketing) may be used if reliably measurable. Costs may be a poor measure for intangibles (see 6.142); relative costs incurred by parties may be better (see 8.27-8.28). Other profit splitting factors include incremental sales, or employee compensation (relating to the individuals involved in key functions). Headcount or time spent with similar responsibilities, or other factors could also be acceptable (2.171, 172).

The Local File and the Master File could provide information for profit splitting factors. It should be remembered that the Master File only provides a high-level overview, not details (2.173).

II.III.C.5.2. Reliance on data from the taxpayer's own operations (internal data)

Where comparables are lacking, consider internal data. The types of internal data depend on facts and circumstances (see 2.147, 148, 166). E.g., where an asset-based profit splitting factor is used, valuation techniques may be useful, such as discounted projected future income streams, see VI.D.2.6.3. See also 2.104 for asset- based profit splitting factors (2.174, 175).

Where cost-based profit splitting factors are used, one needs transactional accounts that identify expenses related to the controlled transaction. The expenditure types (e.g. salaries, depreciation, etc.) and the criteria to identify relevant expenses should be applied consistently to all parties. Internal data may also be helpful where the profit splitting factor is a cost accounting system, e.g. employee costs (2.176, 177).

Internal data are essential to value the parties' contributions and should be based on a functional analysis. If profit is split on relative importance of functions, such evaluation should be supported by reliable objective data. Pay attention to identifying contributions of unique and valuable intangibles and assumptions of economically significant risks (2.178).

II.III.C.5.3. Examples of profit splitting factors

II.III.C.5.3.1. Asset-based profit splitting factors

Asset-based or capital-based profit splitting factors can be used if assets, or capital correlate to value creation and is applied consistently. See paragraph 2.104 for comparability issues for asset valuation. See also example 15 in Annex II to this chapter. Where parties contribute intangibles, the intangibles

can be difficult to identify and valuate. See Chapter VI and examples in Annex I to Chapter VI (2.179, 180).

II.III.C.5.3.2. Cost-based profit splitting factors

A profit splitting factor on expenses is appropriate when expenses incurred correlates to value contributed. E.g., marketing expenses if advertising generates unique and valuable marketing intangibles; R&D expenses for manufacturers. But if parties contribute different valuable intangibles, a cost based factor generally does not work. Also risk-weighting is an appropriate consideration. E.g., where failure risk at an early stage is several times higher than at a later stage or in the development of incremental improvements, the costs incurred in that early stage will have a higher risk weighting. Employee remuneration can be relevant where staff skills and experience are generating profits (2.181).

Further issues must be considered such as differences in the timing of expenditure; or that costs may be part of a larger cost pool. For location savings, the manner in which independent parties allocate retained location savings must be considered; see Section I.D.6. Cost-based factors can be sensitive to differences and changes in accounting. Costs must therefore be clearly identified in advance and the factor applied consistently to all parties (2.182).

In some cases, the relevant period of time is important. E.g., if there is a lag between the expenses incurred and value created, which periods' expenses should be used. This determination can affect profit allocation. The selection of profit splitting factors must be appropriate to the particular facts and circumstances; see Section C.5.1 above. Example 16 in Chapter II Annex II illustrates this Section (2.183).

Example 16:

ACo, BCo and CCo agree to the greenfield development of a new product. Each will be responsible for 1 key component. TPSM is found to be the most appropriate method and a functional analysis shows that their relative expenses correlate to their creation of value. So profit is split based on relative development costs. This result is akin to that of a cost contribution agreement (see 8.4).

II.III.D Conclusion on transaction profit methods

When applying TNMM, adjustments should be where differences with comparables can materially affect the NPIs (see 2.74-81) (2.153). The recognition of the TPSM does not mean that third parties use TPSM to set prices. Adjustments (on an aggregate basis) may be required (see 3.9-12)

(2.154). Countries will generally have a degree of tax system sophistication before applying transactional profit methods (2.155).

III Comparability analysis

Before dealing with chapter III, it is helpful to look at the guidance given on comparability in section I.D which discusses the importance of realistically available options and the five factors to determine the commercial and economic relations. Chapter III then gives guidance on how to perform a comparability analysis (III.A) and discusses timing issues such as the use of hindsight (III.B) and various compliance issues (III.C).

III.A. Performing a comparability analysis

This section is divided into seven subsections: it starts by describing a typical comparability analysis in 9 steps (A1), after which it discusses analysing the taxpayer's circumstances (A2) and reviewing the controlled transaction and choosing the tested party (A3). The next sections deal with uncontrolled transactions (A4), selecting comparables (A5), making adjustments to the chosen comparables (A6) and identifying the arm's length range (A7).

Searching for comparables is part of a comparability analysis, but not the whole comparability analysis. A comparability analysis starts with an analysis of the taxpayers' controlled transaction and the comparability factors. That transaction is then compared to uncontrolled transactions (3.1). Although the aim should be to find the most reliable comparables, an exhaustive search of all possible sources is not required (3.2). It is good practice to provide sufficient information for other parties to repeat the search process (3.3).

III.A.1 Typical comparability analysis process

The following 9 steps are typical, but not compulsory (bearing in mind the five factors to determine the commercial and economic relations at each relevant step - JHM): 1. identify the years covered; 2. analyse the taxpayer's circumstances; 3. understand the controlled transactions; 4. review internal comparables; 5. define sources for external comparables; 6. select the most appropriate method; 7. identify potential comparables; 8. make comparability adjustments; and 9. determine the arm's length prices (3.4). The process is not linear and it may be necessary to revisit previous steps several times (3.5).

III.A.2 Broadly analysing taxpayer's circumstances

This involves analysing the taxpayer's industry, competition, economic and regulatory factors, but not yet the specific transaction's attributes (3.7).

III.A.3 Reviewing controlled transaction and choice of tested party

The review will identify the tested party, the most appropriate method, the financial indicator, comparables and comparability adjustments (3.8). This section deals with the evaluation of the taxpayer's transactions (A.3.1), intentional set-offs (A.3.2), the choice of the tested party (A.3.3), and the available information on the controlled transaction (A.3.4).

III.A.3.1. Evaluating taxpayer's separate and combined transactions

Ideally the arm's length principle is applied on a per transaction basis, but sometimes it is better to combine closely linked transactions. E.g. i) in case of long term contracts to supply commodities or services; ii) several rights for the use of intangibles; iii) ranges of closely related products (see also example 26 of chapter VI) (3.9). Other transactions may need separate evaluation, e.g. package deals. The tax administration should nevertheless compare the sum of the individual elements against the arm's length principle for the total package (3.11). Tax administrations should examine package deals between related parties like they would such deals between unrelated parties (3.12).

III.A.3.2. Intentional set-offs

An intentional set-off is one that associated enterprises incorporate knowingly into the terms of the controlled transactions e.g. by licensing a patent in return for some know-how. Similar arrangements exist between unrelated parties (3.13). Set-offs vary in size and complexity from one to one deals, to deals generally balancing over time, although the latter is highly unlikely between unrelated parties (3.14).

It is good practice to disclose intentional set-offs and demonstrate they are at arm's length (3.15). Transactions may have to be evaluated separately to see if all are at arm's length. International related set-offs may not be comparable to domestic unrelated set-offs, e.g. because of withholding taxes (3.16).

III.A.3.3. Choice of the tested party

The cost plus, resale minus and TNMM methods require a tested party. The tested party is the one with the most reliable comparability results, typically the least complex party (3.18). For example, A manufactures P1 and P2 for B. B has unique intangibles for P1 and closely directs A's manufacturing thereof; A has unique intangibles for P2 where B is only a simple distributor. A should be tested for P1 and B should be the tested party for P2 (3.19).

III.A.3.4. Information on controlled transaction

To select and apply the most appropriate method, information is needed on the comparability factors and the functions, assets, and risks of all parties. One sided methods still require a functional analysis of the non-tested parties as well, to properly characterise the controlled transaction (3.20). The information on the tested party must be available to both domestic and foreign administrations; foreign administrations generally have no reason to ask for more information on untested parties than provided for in 3.20 other than that in the Master file and Country by Country Report (see chapter V) (3.22). In a transactional profit split, information is needed on all parties, including the five factors identifying the commercial and economic relations and financial information (3.21). Administrations should consider the difficulties taxpayers may have in collecting information about foreign related enterprises (3.23).

III.A.4 Comparable uncontrolled transactions

This section is divided into 5 subsections: general observations (A.4.1), a discussion of internal (A.4.2) and external comparables (A.4.3), the use of non-transactional third party data (A.4.4) and limitations of available comparables (A.4.5).

III.A.4.1 In general

Comparables can be internal (taxpayer deals with an unrelated party) or external (two unrelated parties deals with each other) (3.24). Comparables with other controlled transactions are irrelevant (3.25) and the presence of minority shareholders does not make related party transactions necessarily at arm's length (3.26).

III.A.4.2 Internal comparables

Step 4 of the 9 steps (3.4) reviews internal comparables. Internal comparables may have a closer relationship to the controlled transaction and information may be easier to come by (3.27). They are not by definition more reliable, must still satisfy the five factors determining commercial and economic relations (1.33-1.118), and should follow the guidance on 3.47-3.54 regarding comparability adjustments (3.28).

III.A.4.3 External comparables

Three sources of external comparables are discussed: databases, foreign comparables and secret comparables (3.29).

III.A.4.3.1 Databases

Limitations of commercial databases: they are not available in all countries; they may have different types of info for different types of companies in the same country; they are made for other, non-transfer pricing purposes; they are not always detailed enough; and databases compare results of companies, not transactions. See also 3.37 (3.31). There is no need for commercial databases e.g. if there are internal comparables (3.32). Commercial database info may need to be refined with other public information (3.33).

Proprietary databases raise concerns regarding data coverage. They should be made available to tax administrations if used by taxpayers, for transparency purposes (3.34).

III.A.4.3.2 Foreign source or domestic comparables

Foreign data should not be rejected by definition. It should be tested case by case against the five factors identifying the commercial and economic relations, see 1.112-113 on market differences. Different accounting standards may also apply (3.35).

III.A.4.3.3 Information undisclosed to taxpayers ('Secret comparables')

It is unfair for tax administrations to use data from other taxpayers, unless that data can be disclosed to the taxpayer (3.36).

III.A.4.4 Use of non-transactional third party data

Aggregated, non-transactional data could be used as comparables, if reliable. Whether segmented or company wide data is better depends on facts and circumstances. Segmented data may be more transactionally focused, but company wide data may correspond better to a particular taxpayer (3.37).

III.A.4.5 Limitations in available comparables

Comparables will rarely be perfect and will require various comparability adjustments (3.38). A transactional profit split may be appropriate without comparable data, if it is consistent with a functional analysis (3.39).

III.A.5 Selecting or rejecting potential comparables

Comparable third-party transactions can be identified through an additive, or a deductive approach. In the first, a list of potential third parties with comparable transactions are made, which is then refined through further information research. It is a similar approach to using internal comparables and may encompass both internal and external comparables (3.40-41). In a deductive approach companies in one sector is picked (typically in a database

– see 3.24-39). Companies are then eliminated based on further search criteria (3.42).

The selection criteria can be qualitative (product portfolios or business strategies) or quantitative. Quantitative criteria include: size of e.g. sales, assets, or number of employees; intangible related criteria; importance of export sales; inventory sizes; and special third parties like start-ups or insolvents (3.43).

The deductive approach concentrates on the process, making it more transparent and verifiable. However, the quality of the outcome depends on the search tool quality, which may be low for some countries (3.44). Thus, one approach is not better than the other and they can even be combined e.g. to make the additive a refinement of the deductive results, where databases miss important comparables (3.45).

Identifying good comparables is crucial in a comparability analysis and the process should therefore be transparent, systematic, and verifiable. This requires selection and exclusion criteria to be transparent (3.46).

III.A.6 Comparability adjustments

To be comparable means that none of the differences between the things compared could materially affect the condition being tested, or that reasonably accurate adjustments can mitigate that effect. This requires judgement (3.47).

III.A.6.1 Different types of comparability adjustments

Examples of adjustments include: adjustments to eliminate differences between accounting practices, capital, functions, assets, and risks; or segmentation to eliminate non-comparable transactions (3.48). See the Annex to Chapter III for a working capital adjustment (3.49).

III.A.6.2 Purpose of comparability adjustments

Only make adjustments if they increase the reliability of the results. Consider the materiality of the difference, quality of the data and the reliability of the adjustment approach (3.50). Only make adjustments if they have a material effect. The need for numerous adjustments calls into question the reliability of the comparable (3.51). Sophisticated adjustments can create the illusion of scientific, reliable search (3.52).

III.A.6.3 Reliability of adjustments performed

Do not treat working capital adjustments as routine and country risk adjustments as suspicious; only make those adjustments which improve comparability (3.53).

III.A.6.4 Documenting and testing comparability adjustments

Transparency is required: explain adjustments, give reasons for them, show how they are calculated, show their effect, and show how they improved comparability (3.54).

Annex to chapter III: Working capital adjustment ('WCA')

Here is one way to calculate a WCA to compensate for differences in the working capital of the tested party and a comparable. Such adjustments are usually found when applying TNMM, but could also apply to cost plus or resale minus pricings (1).

A WCA may be needed when, in a competitive environment, one company has a different payment deadline than another. ACo demands immediate payment, BCo after 60 days. BCo carries an interest cost for 60 days, which ACo does not (2). Likewise, ACo may generally pay its suppliers 60 days later than BCo, and again BCo would carry an extra interest cost compared to ACo (3). The same would apply for differences in inventory levels/risks (4).

A WCA is a compensation for the time value of money (5). To make a WCA: i) identify the differences in working capital between the tested party and the comparable (e.g. be cash in/out for sales/purchases, and cash stuck in inventory); ii) calculate a value for the differences; and iii) adjust the result with the calculated value.

Working capital adjustment illustrated					
TestedCo	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Sales	179,5	182,5	187	195	198
EBIT	1,5	1,83	2,43	2,54	1,78
EBIT/Sales	0,8%	1,0%	1,3%	1,3%	0,9%
Working capital at yearend					
Trade receivables (R)	30	32	33	35	37
Inventory (I)	36	36	38	40	45
Trade Payables (P)	20	21	26	23	24
Total WC charge (R + I - P = X)	46	47	45	52	58
Total WC charge as a % of sales (X / Sales = Y)	25,6%	25,8%	24,1%	26,7%	29,3%

Comparable	Year 1	Year 2	Year 3	Year 4	Year 5
Sales	120,4	121,2	121,8	126,3	130,2
EBIT	1,59	3,59	3,15	4,18	6,44
EBIT/Sales	1,3%	3,0%	2,6%	3,3%	4,9%
Working capital at yearend					
Trade receivables (R)	17	18	20	22	23
Inventory (I)	18	20	26	24	25
Trade Payables (P)	11	13	11	15	16
Total WC charge (R + I - P = X)	24	25	35	31	32
Total WC charge as a % of sales (X / Sales = Z)	19,9%	20,6%	28,7%	24,5%	24,6%

Working capital adjustment	Year 1	Year 2	Year 3	Year 4	Year 5
TestedCo's Y	25,6%	25,8%	24,1%	26,7%	29,3%
Comparable's Z	19,9%	20,6%	28,7%	24,5%	24,6%
Difference (Y - Z = D)	5,7%	5,1%	-4,7%	2,1%	4,7%
Interest rate (i)	4,8%	5,2%	5,0%	5,5%	4,5%
Adjustment (D*i =m)	0,3%	0,3%	-0,2%	0,1%	0,2%
Comparable's EBIT/Sales (n)	1,3%	3,0%	2,6%	3,3%	4,9%
Adjusted working capit Comparable (m + n)	1,6%	3,2%	2,4%	3,4%	5,2%

Notes:

- Use year average working capital numbers if yearend numbers are skewed in any way.
- Try to use interest rates that accurately reflect the parties' rates of borrowing/deposits.
- Do not make WCA's if they cannot improve the reliability of the comparison.

III.A.7 Arm's length range

III.A.7.1 In general

Because transfer pricing is not an exact science, the most appropriate transfer pricing method will often produce a range of prices, not just one. Reasons include: similar conditions are only approximated, or different parties may establish different prices for the same transaction (3.55). Uncontrolled transactions with a lesser degree of comparability should be eliminated from the range (3.56). Where some comparability defects remain unquantifiable and unadjustable, statistical tools, such as inter-quartile ranges, could be used to reduce the number of comparables and to enhance reliability (3.57). Ranges may also stem from the use of different appropriate methods: overlaps may increase accuracy, whilst no overlaps may question the appropriateness of (one of) the methods (3.58). Wide ranges also question the reliability of the data or indicate the need for adjustments (3.59).

III.A.7.2 Selecting the most appropriate point in the range

If the taxpayer's price/margin is within the range, no adjustment should be made. Outside, the taxpayer should have the chance to argue that the arm's length principle is still satisfied and within the range. If it cannot, an adjustment is appropriate. Where the range results are equally reliable, an adjustment anywhere in the range is appropriate; in case of comparability defects (see 3.57), measures of central tendency (e.g. the median) could be better (3.60-62).

III.A.7.3 Extreme results: comparability considerations

Extreme results include both losses and unusually high profits. Both require further investigation for comparability defects, but neither should be excluded just for being different (3.63). The fact that independent enterprises would not continue loss making activities indefinitely does not mean that all loss makers should be excluded. The facts and circumstances surrounding a company determine its comparability, not its results (3.64). Loss makers should however trigger further investigation to ensure they do not reflect abnormal business conditions or deviant risk levels (3.65). The same applies for abnormal profits (3.66).

III.B. Timing issues in comparability

This chapter deals with timing. It discusses when to collect data (B.1 and B.2), how to value highly uncertain events (B.3), data published after the event (B.1 and B.4) and multiple year data (B.5). See also chapter V, 5.27 and 5.36 for documentation (3.67).

III.B.1 Timing of origin

While data concerning comparable transactions at the time of the controlled transaction may be the most reliable, such data will generally not be available yet at that time (3.68).

III.B.2 Timing of collection

Information on comparable transactions can be collected ex-ante, to set an arm's length price of the controlled transaction (the price setting approach), or ex-post, e.g. at year end, to test if the controlled transaction was at arm's length (the outcome testing approach, leading to year-end adjustments), or a combination of both (3.69-70). All three variations are found across member states and authorities are encouraged to resolve double tax stemming from the use of different approaches (3.71).

III.B.3 Valuation highly uncertain at outset and unpredictable events

In considering unpredictable, highly uncertain future events, taxpayers and administrations should refer to what independent enterprises would do (3.72). If the valuation is so uncertain that third parties would require price adjustment clauses or the value change so fundamental that third parties would renegotiate, related party transactions should copy (section VI.D.4 apply to all transactions with valuation uncertainties). If not, adjustments are inappropriate: mere uncertainty does not require ex-post adjustments per se (3.73).

III.B.4 Data from years following the transaction

Care must be taken to avoid hindsight, but later data, including the further conduct of parties, could e.g. determine the appropriateness of comparables (3.74).

III.B.5 Multiple year data

Multiple year data can be useful, but is not a requirement; use it where it adds value (3.75). Multiple years can clarify facts and circumstances, e.g. whether losses were incidental, systematic, or reflect the end of a product's life cycle. It can also illuminate long term arrangements (3.76), product life cycles and business life cycles (3.77). They may improve the selection of comparables (e.g. regarding stability or anomalies in information) (3.78). They do not automatically imply the use of multiple year averages (3.79).

III.C. Compliance issues

The extent of the compliance burden and its costs needs to be considered (3.80). There is no need for an exhaustive search of all possible relevant sources (3.81). A pragmatic risk assessment strategy is sufficient, taking account of transaction size and complexity and stability of circumstances (3.82). Although the arm's length principle applies equally to SME's, pragmatic solutions may be appropriate to limit their compliance burden (3.83).

IV Administrative approaches to avoiding and resolving transfer pricing disputes

This chapter addresses governments on a variety of topics. A short introduction (A) is followed by two tracks: a compliance track, dealing with transfer pricing compliance practices (B), safe harbours (E) and simultaneous tax audits (D); and a dispute prevention and resolution track dealing with APA's (F), MAP's and corresponding adjustments (C) and arbitration (G).

IV.A. Introduction

Disputes may arise even when the TPG are followed because taxpayers and administrations apply the TPG differently (4.1). If different administrations apply the TPG differently, the same income can be taxed with different related taxpayers (economic double tax), or with the same taxpayer (juridical double tax, e.g. PE's) (4.2). Chapter IV deals with disputes. It covers compliance issues, such as audits, burden of proof and penalties (IV.B); MAP and corresponding adjustments (IV.C); simultaneous tax audits (IV.D); and ways to minimize disputes such as safe harbours (IV.E) and APA's (IV.F); and arbitration (IV.G) (4.3).

IV.B. transfer pricing compliance practices

Tax compliance rules remain within the province of each country. However, they require clarity and should not be overly harsh: the latter may shift revenue between countries. Compliance practices have cross border effects (4.4). Three aspects which may affect MAPs are: examination practices (B.1), burden of proof distribution (B.2), and penalty systems (B.3). This section provides general guidance and reasonable approaches (4.5).

IV.B.1 Examination practices

Examination practices vary from country to country (4.6). transfer pricing cases are fact intensive, complicated, and often time consuming. Many tax administrations have transfer pricing specialists (4.7). Prices will often be in ranges and it will be unclear what the most appropriate method should be (4.8), which makes transfer pricing error prone for both bona fide taxpayers and tax auditors. Therefore, auditors should be flexible and take the taxpayer's commercial judgement into account. They should begin their analysis from the taxpayer's choice of method (4.9) and consider the taxpayer's process of price setting. See 1.5 (4.10).

IV.B.2 Burden of proof

The distribution of the burden of proof varies per country. Where it is on the tax administration and the taxpayer is not in good faith, the administration is often allowed to make estimates which the taxpayer must then disprove (4.11). Tax administrations should not make unreasonable demands on taxpayers just to get to the ability to estimate (4.12). Where the burden is on the taxpayer, it often shifts to the administration after the taxpayer argued a reasonable case (4.13). The distribution of proof should not be used as a weapon. E.g. we have ACo and AGov in country A and BCo and BGov in country B. Assume that ACo has the burden of proof in country A and BGov bears that burden in country B. If AGov makes an unreasonable adjustment accepted by ACo, BGov must prove AGov wrong, while BCo may have little incentive to help (4.14). Likewise, if ACo is uncooperative and AGov makes an estimated assessment, BCo may have no incentive to show that AGov was wrong (4.15). The burden of proof should not be misused, or be a justification for groundless or unverifiable assertions (4.16).

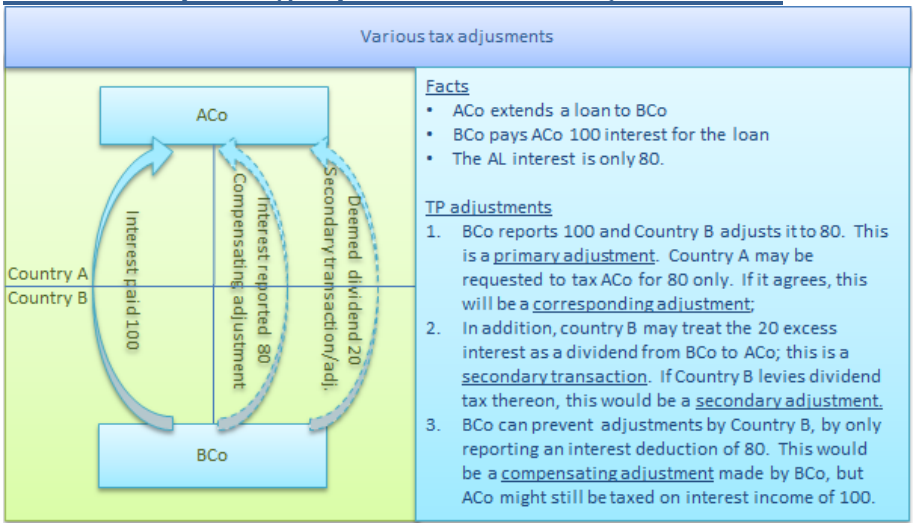
In MAPs, the country making the primary adjustment bears the burden of proof (4.17).

IV.B.3 Penalties

Penalties generally make non-compliance more expensive than compliance. If a subsequent MAP results in a reduction in the adjusting country, there should be possibilities to mitigate penalties (4.18). It is difficult to compare penalties by country as similar penalties may have different names and penalties should be judged within the context of a country's overall compliance system (4.19). Most transfer pricing penalties are civil (administrative), not criminal, and concern money (4.20). Procedural compliance penalties tend to be lower than penalties for understatements of income (4.21). Some countries refer to penalties as interest or additional tax (4.22). Only a few countries penalize "no-fault" understatements of income (4.23). A penalty system should not be overly harsh (4.25), as it may give taxpayers an incentive to overstate income in that jurisdiction, thus failing to promote transfer pricing compliance (4.26). Penalties should be proportionate to the offence committed (4.27).

The OECD recommends avoiding i) sizeable no-fault penalties on good faith errors and ii) sizeable penalties on taxpayers making reasonable efforts in good faith to be at arm's length (4.28).

IV.C. Corresponding adjustments and MAP, art. 9 & 25[6]



IV.C.1 MAPs

MAPs are based on article 25 of the OECD MC (4.29). MAPs cover three areas: i) taxation not in accordance with the convention, typically initiated by taxpayers; ii) cases on interpretation of the convention; and iii) cases not covered by the convention. MAPs also apply to economic double tax, see paragraph 10 of the commentary to article 25 (4.30).

Article 25'5 covers arbitration. Arbitration can be requested by the taxpayer if states do not agree within two years and is binding on the states if the taxpayer accepts the arbitration decision. States can agree to arbitration, even if their treaty does not contain an arbitration clause. EU members signed an Arbitration Convention in 1990 (Convention 90/436/EEC) (4.31).

IV.C.2 Corresponding adjustments, article 9, paragraph 2

Taxpayers can request corresponding adjustments. The primary adjusting administration may also lower its adjustment, thus reducing the size of the corresponding adjustment needed to avoid double tax (4.32). The consultation procedure in article 9'2 does not imply that there can be no article 25 MAP consultation, if the treaty does not contain article 9'2 (see paragraphs 10-12 of the commentary to article 25) (4.33).

A corresponding adjustment can either be made by recalculating the taxpayer's local profits, or by giving a local tax credit for the foreign

[6] The BEPS countries have agreed a minimum standard with respect to the resolution of treaty disputes, see BEPS action 14. This section C is not an explanation of that standard.

adjustment with the related party. The former is most common (4.34). Corresponding adjustments are not mandatory (4.35). Corresponding adjustments can be applied to the years of the adjusted transactions, or e.g. the year when the primary adjustment is made or is accepted. Whilst the first is more appropriate, the latter may get around time limitations (4.36).

Some countries reduce the need for primary adjustments by allowing compensating adjustments. In a compensating adjustment, a taxpayer reports an arm's length price for tax purposes, even if that price differs from the price used for other purposes (4.38). However, as most countries do not allow this, double taxation may occur which should be solved through MAPs (4.39).

IV.C.3 Concerns with the procedures

Taxpayers are concerned that transfer pricing MAP cases may not be resolved, due to their complexity; article 25'5 offers a solution, through introducing arbitration. The commentary also suggests alternative dispute resolution mechanisms (4.40). Taxpayers also fear competent authorities may trade some cases against others; the OECD recommends that each case should be decided on its own merits, bearing in mind BEPS action 14. Likewise, countries should not retaliate or introduce new adjustments to offset corresponding adjustments (4.41). Further concerns within MAPs include 1) denial to MAP in transfer pricing cases (C.4.1); 2) time limits (C.4.2); 3) lengthy completion (C.4.3); 4) limited taxpayer participation (C.4.4); 5) limited guidance on procedural requirements (C.4.5); and 6) a lack of interest and penalty suspension (C.4.6) (4.42).

IV.C.4 Recommendations to address the concerns

IV.C.4.1 Denial to MAP in transfer pricing cases

The failure to allow transfer pricing cases into MAP may frustrate a primary objective of tax treaties. BEPS action 14, element 1.1 requires a commitment to provide access to MAP (4.43). Action 14 includes other helpful elements: element 1.2 – MAP access in cases about anti-abuse provisions; element 2.1 – publishing MAP rules and guidelines; element 3.1 – identifying specific information and documentation to be submitted; element 2.6 – clarifying that audit settlements do not preclude MAP; and element 3.1 – procedures to inform both competent authorities of a MAP request (4.44).

IV.C.4.2 Time limits

The existence of time limits and their variety should be considered in order to minimise double taxation (4.46). Article 25'2 makes it clear that MAPs should be implemented regardless of national time limits; some countries entered reservations. If treaties do not override national time limits,

administrations should move quickly and suspend time limits during the MAP (4.47). Alternatively, treaties may limit the period within which a country can make a primary adjustment; however, as many countries do not accept this, it is recommended that tax administrations stick to their national limits for adjustments without extension. Tax administrations should give taxpayers early warning of anticipated cross border adjustments (4.48).

BEPS Action 14, element 3.3 recommends that countries include article 25, paragraph 2, second sentence in their treaties (4.49). If a country cannot, it should include language to put time limits on primary adjustments, both for article 9 and article 7 (4.50). Tax administrations are generally recommended to make their primary adjustments within their own domestic time limits and only go beyond that when a taxpayer's consent is truly voluntary (4.51).

The three-year limit to submit a MAP request, runs from the first adjustment notification. Countries are encouraged to agree longer periods (4.52) and should interpret the starting date in the way most favourable to the taxpayer (4.53). Taxpayers can request a MAP as soon as an adjustment is likely, not only once it is made; early consultation may lead to easier resolution (4.54).

IV.C.4.3 Duration of MAPs

Correspondence is often an unsatisfactory substitute for face-to-face meetings, which can solve issues in a relatively short time (4.55). BEPS Action element 1.3 requires competent authorities to strive to solve MAPs within twenty four months. This is helped by adequate staffing, performance indicators, adequate recourse requirements and peer reviews[7] (4.56). The adoption of mandatory arbitration after two years will reduce lengthy MAPs (4.57).

IV.C.4.4 Taxpayer participation

MAP requests should not be rejected without good reason (4.58). Though taxpayers have no right to participate in government to government MAP discussions, they do have the option of accepting or rejecting a MAP outcome (4.59). A MAP is not litigation, which is why the taxpayer's participation is discretionary (4.59). Taxpayers should provide the competent authorities with all relevant information, particularly in complex cases, and administrations should provide taxpayers that right (4.60). It is good practice to keep taxpayers informed and get their input during the MAP. See the OECD Manual for Effective Mutual Agreement Procedures (4.61).

[7] See BEPS Action 14 and peer reviews.

IV.C.4.5 Publication of applicable procedures

BEPS Action 14, element 2.1 requires authorities to publish MAP guidance, including how to make MAP requests. Element 2.2 allows the OECD to publish country profiles on MAPs at www.oecd.org/tax/beps/country-map-profiles.htm (4.62). Element 3.2 requires states to set out the specific taxpayer information to be submitted in MAP; and element 2.6 that audit settlements cannot preclude MAPs. Best practice 8 ask clarification of the relation between MAPs and court cases; practice 10 clarification on MAP, interest, and penalties; practice 11 on APAs and MAPs; and 9 MAP access in bona fide taxpayer initiated foreign adjustments (4.63). Competent authorities should routinely communicate their guidance with each other and update their country profiles (4.64).

IV.C.4.6 Collections of tax deficiencies and accrual of interest

Countries are encouraged to adopt suspension procedures for taxes, interest, and penalties during MAPs, to prevent taxpayers from paying tax twice during the MAP. BEPS Action 14, best practice 6 recommends suspension of collection during MAP under local rules (4.65). Compiling interest on outstanding or overstated payments and differing interest rules should be considered during the MAP and described in the Action 14 country profiles (4.66). Interest issues may also arise if the secondary adjustment years vary from the primary adjustment years; a solution may be for both states not to charge/pay interest, although it could involve different legal entities (4.67).

IV.C.5 Secondary adjustments

To make an actual allocation of profits consistent with the primary adjustment, some countries assert a constructive transaction (secondary transaction), such as a constructive dividend, loan, or capital contribution. Such transactions are sometimes used as an anti-avoidance measure against the avoidance of withholding taxes on actual dividends (4.68). Constructive loans may trigger constructive interest payments for subsequent years (4.69). Secondary transactions may lead withholding taxes (secondary adjustments) e.g. on the deemed distribution which leads to double taxation if not recognized by the other country (4.70). Article 9'2 does not cover this (4.71).

Some countries reject secondary adjustments for the difficulties they pose (4.72) and administrations are encouraged to structure their secondary adjustments so as to minimize the risk of double tax (4.73). Some countries allow taxpayers to actually make profit distributions, or set up accounts receivable as repatriations conforming to the primary adjustment, and in lieu of a secondary adjustment (4.74). Where repatriation agreements were made,

they should be included in MAP discussions on the underlying primary adjustments (4.78).

IV.D. Simultaneous tax examinations

IV.D.1 Definition and background

Simultaneous tax examinations are a form of mutual assistance. They are useful where third (uncooperative) countries are involved, but also in complex transfer pricing cases. They may also speed up dispute resolution and reduce compliance costs (4.79). A simultaneous audit is an arrangement between parties to examine a taxpayer simultaneously and independently each on their own territory, with a view to exchange relevant information obtained via competent authorities (4.80). Authorities often conclude detailed working arrangements under article 26 (4.81).

IV.D.2 Legal basis for simultaneous examinations

Simultaneous examinations are governed by article 26, which is open ended (4.82). All information obtained is confidential. Where taxpayers must be informed of simultaneous audits or exchanges of information under local law, administrations should inform their counterparts accordingly (4.84).

IV.D.3 Simultaneous tax examinations and transfer pricing

Differences in country time limits may be met through early exchanges of information and examination schedules (4.85). Tax inspectors often meet to coordinate the audit, sometimes with taxpayer participation. In countries where taxpayers have the right to be consulted before information is exchanged, the rule should also be applied to simultaneous audits. (4.86).

Simultaneous audits may:

- be useful where costs are shared or profit allocated between different jurisdictions;
- facilitate specialist knowledge sharing among administrations (4.87);
- promote compliance, especially with uncooperative taxpayers (4.88);
- identify potential disputes at an early stage and allow administrations to arrive at concurring statements and identifying disagreements on facts or legal treatment (4.89);
- allow administrations to make early corresponding adjustments, get taxpayer agreement and avoid litigation (4.90);
- facilitate MAPs through the build-up of more complete factual evidence (4.91); and
- give taxpayers a more active role in resolving disputes than a MAP would (4.92).

IV.D.4 Recommendation

The CFA drafted an OECD Model Agreement under which countries can perform simultaneous examinations in 1992 (4.93) and recommends simultaneous examinations. If a simultaneous examination leads to adjustments, countries should strive to avoid resulting double tax (4.94).

IV.E. Safe harbours

IV.E.1 Introduction

Transfer pricing can be resource intensive, making countries consider safe harbours (4.95). The previous version of the TPG was negative about safe harbours (4.96), but some countries adopted them nonetheless with favourable results (4.97). Safe harbours work best with low transfer pricing risks and when adopted bilaterally or multilaterally (4.98). They can save administrations resources and give taxpayers more certainty (4.99).

IV.E.2 Definition and concept of safe harbours

Safe harbours allow eligible taxpayers to follow simplified transfer pricing rules for specific transactions which lead to prices automatically accepted by administrations adopting those rules, or by exempting them from general transfer pricing rules (4.101). Safe harbours apply to specific categories of taxpayers or transactions with regard to general transfer pricing rules (4.102). For this section, they do not include measures not determining arm's length principles, such as simplified documentation or thin capitalization (4.103). They include rebuttable presumptions where a taxpayer has the right to prove the presumed price not to be at arm's length in its case (4.104).

IV.E.3 Benefits of safe harbours

Benefits of safe harbours are: 1) simplifying compliance and reducing costs; 2) providing certainty on price; 3) more efficient use of administrations' resources (4.105).

IV.E.3.1 Compliance relief

Properly designed safe harbours eliminate the need for data collection, analysis, and documentation, thus significantly reducing the compliance burden. This is especially helpful in low risk areas (4.106-107).

IV.E.3.2 Certainty

Taxpayers are provided certainty that their prices will be accepted if they meet the eligibility conditions (4.108).

IV.E.3.31 Compliance relief

Administrations do not need transfer pricing experts to monitor whether a taxpayer meets the eligibility requirements for a safe harbour. Such experts can be used for more complex or higher risk transactions (4.109).

IV.E.4 Concerns over safe harbours

Concerns about safe harbours include that they may: use pricing that is not at arm's length (E.4.1); increase the risk of double (non) tax (E.4.2); open avenues for tax planning (E.4.3); and raise issues of equity (E.4.4) (4.110).

IV.E.4.1 Divergence from the arm's length principle

A safe harbour may not correspond to the most appropriate method, e.g. where CUPs are available (4.111). The safe harbour approximation of arm's length principles could be improved through frequent reference updates, but this could undermine simplicity (4.112). These disadvantages could be avoided if safe harbours are elective, if taxpayers do not only deviate when it is in their favour. This could be avoided through upfront notification requirements or electing the safe harbour for minimum periods (4.113).

IV.E.4.2 Risk of (non-) double tax and MAP concerns

Safe harbour prices above or below arm's length will induce profit shifting, especially where high safe harbours are combined with significant understatement penalties (4.114). This could lead to double taxation. In addition, the administrative burden saved by the safe harbour country is effectively shifted to the other administration (4.115). The double taxation stemming from elective safe harbours may outweigh the cost of transfer pricing complexity (4.116). Countries adopting unilateral safe harbours should avoid double taxation and be prepared to allow modifications in MAPs (4.117). Low unilateral safe harbours give no guarantee that the taxpayer will report the same information in other countries, leading to double non-taxation (4.118). These problems could be avoided through bilateral/multilateral safe harbours (4.119), as different countries will have divergent interests (4.120). See annex I to chapter IV for sample agreements (4.121).

IV.E.4.3 Safe harbours may open avenues for tax planning

E.g. if safe harbours cover small or simple transactions, taxpayers may be tempted to break larger transactions into smaller pieces (4.122). Likewise, taxpayers performing better than their peers could benefit from safe harbours using industry averages (4.123). Bilateral/multilateral safe harbours will limit this (see 4.119) (4.124). It is for countries to decide if they will allow some tax leakage in exchange for administrative simplicity (4.125).

IV.E.4.4 Equity and uniformity issues

Safe harbour eligibility criteria should not put competing taxpayers on opposite sides of qualification, or allow unintended beneficiaries (4.126).

IV.E.5 Recommendations on the use of safe harbours

Properly designed safe harbours can help (4.127) and the benefits may outweigh the problems. Elective safe harbours can limit divergence from the arm's length principle. Safe harbour outcomes must be modifiable in MAPs (4.129). The use of bilateral/multilateral safe harbours is encouraged (4.130). Safe harbours are never binding on countries which did not adopt them (4.131). Safe harbours are unlikely to work for complex, high risk, transfer pricing matters (4.132).

Annex I to chapter IV

This annex includes three sample Memoranda of Understanding (MoU's) which competent authorities can adopt bilaterally as mutual agreements under article 25'3. The competent authorities are free to amend the samples. A precedent is the agreement between the US and Mexico for maquiladora operations.

Sample MoU for low risk manufacturing

Preamble

1. The competent authorities reached an understanding on the arm's length prices for low risk manufacturing services/../… This MoU provides legal certainty to Qualifying Enterprises by establishing specific procedures.

2. The MoU is entered into under Article 25 and implements article 9. It applies from … to … and will by default be extended automatically for 5 years.

3. Enterprise = meaning of 3'1 of the Treaty.

Qualifying Enterprise ("QE")

4. A QE is a) an active tax resident of a Contracting State; b) its principal business is manufacturing in its Residence State for an associated enterprise in the other state (Other Enterprise); c) entered into a manufacturing agreement with that enterprise; d) will not surpass a low threshold on R&D; e) will not do marketing, distribution, etc.; f) will not bear distribution risks; g) have limited other functions; h) have at least x% manufacturing related assets; and i) will have limited finished inventory.

5. A QE will refrain from certain industries and not exceed certain limits in terms of sales, assets, other transactions, or transfer pricing adjustments.

Qualifying Transactions

6. Qualifying Transactions are rendering manufacturing services or selling self-manufactured products to the Other Enterprise.

Taxable income of the QE

7.a) If the QE holds title to raw materials and work in progress inventory, a percentage of all costs excl. net interest, FX results and non-recurring costs.
7.b) If the Other Enterprise holds title to raw materials and work in progress inventory, a percentage of all costs excl. net interest, FX results and non-recurring costs.

8. Each state agrees that this will be arm's length prices.

Permanent Establishment

9. States agree that the Other Enterprise will not have a PE in the QE state for the Qualifying Activities.

Election and Reporting Requirements

10. The QE and the Other Enterprise will file a notice with both states to apply this MoU to the Qualifying Transactions.

11. The notice shall include agreement with the MoU, the period of application, promise consistent reporting in both states, describe the Qualifying transactions, identify the enterprises, provide audited accounts, detailed calculations of the taxable income and a commitment to provide requested info within 60 days.

12. Electing enterprises will be exempt from national documentation requirements outside this MoU.

13. Enterprises not electing this MoU procedure remain subject to national documentation requirements.

14. Disputes regarding the MoU will be solved by MAP.

15. Competent authorities may exchange necessary information under article 26 of the Treaty.

Termination

16. Either state may terminate this MoU by notifying the other competent authority and publishing the notice. Termination affect financial years starting after the following 31 December.

Sample MoU for low risk distribution

This MoU is the same as the low risk manufacturing MoU, except that the QE must market and distribute the Other Enterprise's products to unrelated parties or purchase them and resell them to unrelated parties and may not manufacture or assemble these products (articles 4 & 6). The taxable income must be a percentage of the net sales (article 7).

Sample MoU for low risk R&D

This MoU is the same as the low risk manufacturing MoU, except that the QE must perform R&D services on behalf of the Other Enterprise, will not carry any R&D risk, or retain an interest in the developed R&D and may not manufacture, assemble, market, or distribute products (articles 4 & 6). The taxable income must be a percentage of all costs excl. net interest, FX results and non-recurring costs. (article 7).

IV.F. Advance pricing arrangements (APA's)

IV.F.1 Definition and concept of APAs

An APA determines appropriate criteria (transfer pricing method, comparables plus adjustments and assumptions about the future), to determine the transfer pricing for future transactions. See annex II to chapter IV for guidelines. BEPS Action 14, best practice 4 recommends countries to implement bilateral APA programmes (4.134). Generally, APAs should determine methodology and assumptions, not price (4.135). Price is too specific a prediction to be reliable, e.g. say not interest will be 6%, but say it will be LIBOR + x% (4.136). Further, a profit split should only be used if the allocation of functions between enterprises are stable and included as part of the critical assumptions (4.137).

The specificity of an APA is more reliable when identifying appropriate critical assumptions and using ranges and historical industry data (4.138). Unreliable predictions should be excluded (4.139).

Unilateral APAs may affect the tax liability of enterprises in other countries, so other administrations should be informed to enable them to participate in a bilateral APA. Unilateral APA's should not request taxpayers to waive their right to MAP (4.140). Most countries prefer bilateral/multilateral APAs as it is better at reducing double taxation and provide more certainty. This section does not discuss unilateral APAs, unless specifically stated (4.41). Tax administrations find APAs useful in profit allocation and income attribution for global securities and commodities trading, multilateral cost contribution agreements and article 7 allocations (4.142).

APAs differ from traditional private rulings in that they are more fact specific, investigate the facts presented and cover more than one transaction (4.143). APAs can cover all or some of a taxpayer's intercompany transactions; if administrations agree, it can also cover past years. BEPS Action 14, element 2.7, requires the possibility to roll back APAs (4.147).

The cooperation of associated enterprises with regard to documentation is essential in APAs (4.144) and they are usually allowed to participate in the APA process (an advantage over MAPs) (4.145). Upon conclusion of an APA administrations should confirm to associated enterprises that no transfer pricing adjustments will be made if the terms of the APA are followed, unless business operations or economic circumstances change significantly (4.146). Administrations can monitor APA compliance through annual taxpayer filings, or limited audits (4.148). They can cancel an APA (retroactively) in case of fraud, misrepresentation, or failure to comply with

the APA terms; other administrations should be informed accordingly (4.149).

IV.F.2 Possible approaches for legal and administrative rules governing APAs

APA's are within the scope of article 25'3, which also applies to individual cases, as well as article 26 (4.150). Administrations may also rely on domestic authority, e.g. to conclude specific rulings, if the domestic text is broad enough (4.151). Where treaty law overrides domestic law, a treaty with article 25, should be sufficient to conclude an APA (4.152).

IV.F.3 Advantages of APAs

An APA gives certainty and provides a favourable investment environment (4.153). Taxpayers and administrations can consult in a non-adversarial spirit, stimulating information flow with taxpayers and better relations among administrations (4.154). They can prevent costly, time-consuming, examinations and litigation (4.155) and reduce the possibility of double (non) taxation. They can also significantly reduce workload in MAPs where eventual double tax occurs (4.156). Finally, the cooperative spirit may enhance administrations' knowledge and understanding of complex business situations (4.157).

IV.F.4 Disadvantages relating to APAs

Unilateral APAs: They shift administrative burdens to other administrations. Further, those administrations may not agree with the APA and e.g. be unwilling to make corresponding adjustments, thus eliminating certainty. (4.158-159).

APAs may initially strain resources. It will follow taxpayers' agendas, which may differ from administrations'; renewal should be less time-consuming (4.161). Previous APA's may dictate the future APAs despite e.g. market differences (4.162). APAs may only interest compliant taxpayers, and taxpayers trying to not repeat previous bad auditing experiences; APAs thus divert resources from non-compliant taxpayers. APAs may also be sector specific, requiring resources for specific expertise (4.163).

Administrations may require more info in an APA than an audit. This should be avoided and administrations should recognize that public competitor information is limited; not all taxpayers have extensive investigation resources; and only parents may have specific group transfer pricing knowledge (4.165). APAs may subject taxpayers to extensive scrutiny without sheltering them from subsequent audits; administrations should not

make APAs unnecessarily cumbersome (4.166). They should also not misuse information given or positions taken in APAs in subsequent audits. Unsuccessful APAs should not influence or trigger normal audits (4.167). Tax administrations should ensure confidentiality of information received during an APA (4.168). APAs can be expensive and may therefore only be available to larger enterprises (4.169).

IV.F.5 Recommendations

IV.F.5.1 In general

Several countries have experience with APAs and seem satisfied. Success depends on proper specificity, administration, safeguards, flexibility, and transparency (4.170). The CFA monitors use and promotes consistency (4.171).

When considering an APA's scope, attention should be paid to the reliability of predictions (4.172). APAs should be concluded bilaterally or multilaterally where possible (4.173). Administrations should endeavour to make APAs accessible, e.g. by allowing streamlined processes for small taxpayers (4.174). Greater uniformity will benefit all and administrations may set up working agreements with other competent authorities. Information should be available simultaneously to all administrations in bi-/multilateral APAs (4.175-176).

IV.G. Arbitration

Tax disputes have become increasingly international. Without arbitration, tax authorities may not always come to an agreement on how to alleviate double tax (4.177). Arbitration was introduced into the model convention (article 25'5) in 2008. It is an integral part of MAP and not an alternative route (4.178). Arbitration should make MAP's more effective and give taxpayers more faith in MAP (4.179).

Annex II to chapter IV

A. Background

A.1 Introduction

See 4.171 (1). This annex tries to improve the consistency of the application of APA's for OECD and non-OECD administrations and describes how taxpayers can best contribute to an APA (2).

A.2 Definition of an APA

An APA is a procedural arrangement between taxpayers and tax administrations intended to solve potential transfer pricing disputes in advance. It differs from classical rulings in that it extensively reviews in detail and verifies the factual assumptions on which it is based and continues to monitor those assumptions throughout the APA period (3). See also 4.134 and 142 (4). There are unilateral APA's involving only one tax administration and bilateral or multilateral APA's. The TPG favours bi-/multilateral APA's, see 4.173 (5). APA's generally cover cross border situations with multiple taxpayers, but can also cover one taxpayer and its PE's. See section B3 hereafter for special issues with multilateral APA's (6). Definitions hereafter: Bi-/multilateral APA's are MAP APA's; MAP APA's and unilateral APA's are jointly referred to as APA's. Competent Authorities (competent authority's) can conclude MAP APA's outside a treaty (7). Where this is not possible, the goals of MAP APA's can also be achieved through other means (8).

A.3 Objectives of the APA process

The APA process aims to i) facilitate principled, practical, and co-operative negotiations, ii) resolve transfer pricing issues expeditiously and prospectively, iii) use taxpayer and administration resources more efficiently, and iv) provide some predictability for the taxpayer (9).

The process should be administered in a non-adversarial, efficient, and practical fashion. The OECD Forum on Tax Administration developed to assist administrations in such risk assessments (10). A key objective of MAP APA's is to eliminate double taxation; unilateral APA's are deemed inappropriate for this (11). A MAP APA should be neutral as regards tax residence, where the request was initiated, and the taxpayer's audit status or selection for audit. See also paragraph 4.167 on possible misuse by administrations of information acquired in an APA (12).

B. Eligibility for a MAP APA

B.1 Treaty issues

MAP APA's are governed by article 25 of the OECD MC and administered at the discretion of the administrations. BEPS Action 14, best practice 4, recommends countries to implement bilateral APA programmes, since APA create greater certainty; information on bilateral APAs should also be included in the Action 14 country profiles (13). An administration should examine why a taxpayer requests a unilateral and not a MAP APA and promote the latter where appropriate (14). If a taxpayer requests a MAP APA in one country only, that country should inform the other relevant countries as soon as administratively practical (15). Countries are not obliged to enter into MAP APA's and a taxpayer must qualify for the treaty's benefits to apply for the APA (16).

B.2 Other factors

A taxpayer can request a MAP APA whilst under audit. This does not automatically suspend the audit, but may inform the audit of the methodologies applied in the MAP APA where relevant (17). The ability to conclude a MAP APA is dependent on the full cooperation of the taxpayer and it associated enterprises. This commitment should be sought upfront (18).

A competent authority ability to conclude a MAP may be limited, e.g. by legal decisions, but not made impossible (19). When considering whether to conclude a MAP APA, administrations may ask whether: i) the proposed methodology respects the TPG; ii) the request raises "difficulties or doubts as to the interpretation or application of the Convention" likely to significantly increase the risk of double taxation as meant under article 25, third paragraph of the OECD MC; iii) the MAP APA transactions are ongoing and how long still; iv) the MAP APA transactions are seriously contemplated; v) there is an ongoing audit, the outcome of which can be expedited by a MAP APA (20)?

B.3 Multilateral MAP APAs

There is no multilateral way of implementing multilateral MAP APA's, other than through a series of bilateral MAP APA's. Requesting them simultaneously and concluding them through multilateral negotiations should lower costs (21). Issues to consider include: i) it may be unlikely to apply a single transfer pricing method to all (22), ii) it may be necessary to exchange information between all affected parties, even if it does not directly concern their particular bilateral agreement (23); iii) there may be problems of confidentiality preventing that exchange, which have to be solved on a case by case basis (24), or could be solved by asking the taxpayer to relay the

information instead; and iv) it may be required – and would be OK – to interpret the mutual agreement article in the treaty extensively enough to encompass a multilateral APA.

Where global trading is conducted on a fully integrated basis, multilateral APA's have become the norm (27).

C. Request for MAP APAs

C.1 Introduction

Since the primary responsibility for providing information lies with the taxpayer, it should initiate the proceedings by submitting a detailed proposal for review and be prepared to provide further information (28).

C.2 Preliminary discussions

Having a preliminary meeting before submitting a formal request provides a possibility to discuss the suitability of an APA and the type and extent of required information. It also gives the taxpayer the chance to discuss any concerns e.g. about confidentiality, or the term of the APA (29). It also allows for the discussion of suitability of a MAP APA where appropriate (30). The discussions could clarify the expectations and objectives of the taxpayer, while the administration could explain procedures, expected content of a proposal and a time frame (31).

The meeting could be anonymous as long as sufficient information is provided for a meaningful discussion. More than one preliminary meeting may be required (32). It may also be useful for the different competent authorities to exchange views on the appropriateness of a MAP APA at this stage. Such discussions do not have to be face to face (33).

C.3 MAP APA proposals

C.3.1 Introduction

The purpose of the proposal is to give the competent authority's all the relevant information needed to evaluate the MAP APA request and to undertake mutual agreement discussions. Ideally its form and content have already been agreed at preliminary meetings (34).

C.3.2 Activities usually covered in a MAP APA process

A MAP APA resolves issues covered by articles 7 and 9 of the OECD MC (35). It can cover all or only some of a taxpayer's issues, though it may be difficult to evaluate some issues in isolation (36). A MAP APA can also cover other transfer pricing issues than transfer pricing methodology (37).

C.3.3 Content of a MAP APA

The content will depend on the facts and circumstances of each case and on the relevant administrations' requirements. Generally, the information should be relevant to the proposed methodology and to demonstrate its application. It should also be consistent with the TPG (38). Paragraphs 4.165-168 and chapter V should be borne in mind.

Due to the prospective nature of APA's, the following non-prescriptive list of issues may be of relevance: a) the transactions, products and arrangements to be covered; b) the enterprises and PE's involved; c) other countries participating; d) information on the worldwide group structure, history, financial statements, products and assets; e) the proposed transfer pricing methodology and support for it; f) the underlying assumptions and the effect of changes to them; g) the years to be covered; h) market conditions; i) pertinent ancillary tax issues; j) the proposal's compliance with national laws, tax treaties and OECD guidelines; and k) other relevant information (39).

C.3.4 Comparable pricing information

The proposal should discuss the availability of comparables and the search for them. If no comparables are found, the proposal should demonstrate how the chosen methodology accurately reflects the arm's length principle (40).

C.3.5 Methodology

The proposal should include a full description of the chosen methodology which should be supported by data which can be updated by the taxpayer and be reviewed by the administrations during the APA period (41). The effect of the methodology on budgetary figures for the APA period, and the preceding periods (where relevant), should also be demonstrated (42).

C.3.6 Critical assumptions

The operational and economic conditions within which the APA transactions are assumed to take place must be described. It must also be explained how the chosen methodology will cope with changes in those assumptions. Critical assumptions concern changes which undermine the reliability of the chosen methodology, e.g. new technology, government regulations or a loss of consumer acceptance. Their occurrence could lead to a revision or cancellation of the APA (43). It is helpful to set the parameters upfront for changes of these assumptions which can be tolerated without affecting the APA (45). These assumptions do not have to be controlled by the taxpayer.

In general, they would include assumptions about: a) domestic law and treaties; b) taxes and government regulations; c) economic and market conditions; d) the functions, assets and risks of the companies involved; e) exchange and interest rates and capital; f) accounting and income classification; and g) participating enterprises and their legal form (44). An APA's tolerance to exchange rate movements may be enhanced by agreeing price adjustments upfront which will be triggered within certain ranges of currency movements (46).

C.3.7 Unexpected results

A MAP APA may be setup to include flexibility to cope with changes in other facts and circumstances in order to avoid unexpected results. Such results could otherwise leave some administrations with unfulfilled expectations (47). An example would be to cover a wider variation between projected and actual sale volumes upfront by including e.g. prospective price adjustment clauses or by allowing prices to vary with volumes (48). Alternatively, an acceptable range of results could be agreed upfront, e.g. that a royalty will be accepted as long as it was at least x% of profits (49).

If results fall outside the agreed range, the consequences depend on what has been agreed upfront (50).

C.3.8 Duration of the MAP APA

There are two conflicting objectives: the desire for reasonable certainty as long as possible and the desire for the most accurate predictions. As the latter deteriorates with length of time, it shortens the realistic available period for certainty. Experience shows that MAP APA's last 3 – 5 years on average (51).

D. Finalisation of the MAP APA

D.1 Introduction

The ability of administrations to expediently reach an agreement depends on the willingness of the taxpayers to provide necessary information promptly. Lengthy negotiations into the APA period make it difficult to avoid hindsight (52). Tax authorities are encouraged to devote sufficient qualified resources to process. Informal goals for, and publication of, completion times may help (53). After receiving a MAP APA proposal, there is a fact finding, review and evaluation process, followed by competent authority discussions (54).

D.2 Fact finding, review and evaluation

D.2.1 General

In reviewing a MAP APA proposal, administrations may: request further information from the taxpayer; carry out field work (site visits, interviews, etc.); seek expert opinion; and research information from other sources (55). The aim is to have all relevant information for the negotiations. It should be ensured that the taxpayer provides the same information to all administrations, at the same time where possible (56). Administrations should give all such information the normal secrecy, confidentiality, and privacy safeguards as other taxpayer information; information should be exchanged under the normal exchange of information treaty rules (57).

Though competent authorities would conduct independent reviews of the MAP APA proposal, some joint fact finding activity (e.g. site visits) can enhance efficiency (58).

D.2.2 Role of taxpayer in the fact finding, review and evaluation process

Taxpayers should ensure that all administrations have the same facts and an understanding of them. This could be done by facilitating fact finding meetings where practical and distributing notes thereof, as well as arranging for necessary translations. The taxpayer should confer with its administration when mutually appropriate and should be kept informed of the negotiation progress (59).

D.3 Conduct of the competent authority discussions

D.3.1 Coordination among the competent authority

The involvement of all participating tax administrations as early as possible is recommended as it maximizes efficiency (60). The mutual agreement discussions should be conducted in a timely manner and competent authorities should devise an appropriate plan regarding designated case handlers, exchanging information and scheduling meeting dates (61). Early and frequent discussions avoid unpleasant surprises; discussions may be face to face, by conference calls or video conferences (62).

D.3.2 Role of the taxpayer in competent authority discussions

The taxpayer's role is more limited than in the fact finding process as MAP is a government to government process. Taxpayers may still be required to make certain presentations and then leave, or be on standby to answer factual questions arising during the discussions. The taxpayer should avoid presenting new factual information or making supplementary representations, as such could require additional review and postpone the final agreement (63).

D.3.3 Withdrawal from the APA process

Any party may withdraw at any time, but withdrawal at a late stage is to be discouraged. Upon withdrawal no party has any obligation to the others and any previous undertakings or agreements would be of no force or effect. Administrations should inform taxpayers of the reasons of their withdrawal and give them an opportunity to make representations (64).

D.3.4 Mutual agreement document

Participating competent authorities should prepare a draft agreement and give taxpayers an opportunity to comment, in order to enhance the acceptability of the outcome (65). The agreement should contain the following minimum information: a) names and addresses of the enterprises covered; b) the transactions, arrangements and time period covered; c) the agreed methodology, comparables and ranges of results; d) a definition of terms; e) critical assumptions; f) agreed procedures to deal with factual changes; g) tax treatment of ancillary issues; h) requirements the taxpayer must fulfil to keep the MAP APA valid; i) details of the taxpayers obligations to tax administrations; and j) confirmation that all information submitted will be protected from disclosure to the fullest extent possible (66).

D.4 Implementation of the MAP APA

D.4.1 Giving effect to the MAP APA and providing confirmation to the taxpayer

Tax administrations should confirm the acceptance of their agreement by the taxpayers (67). The confirmation form can vary per country, but should be consistent with the MAP APA and give the taxpayer the same benefits as the agreed MAP APA. The confirmation can cover additional matters such as local ancillary issues, or (additional) documentation requirements (68).

D.4.2 Possible retroactive application ("Roll back")

Retroactive application of the MAP APA is not obligatory, but may be instructive where comparability exists. If the taxpayer wishes to roll back the MAP APA, the consent of all affected administrations need to be obtained. BEPS Action 14, element 2.7, requires countries to allow bilateral APAs to be rolled back where time limits allow and facts and circumstances are the same for earlier years (69).

E. MAP APA monitoring

Administrations must know whether taxpayers abide to the MAP APA, as it would no longer be applicable if they do not (70).

E.1 Record keeping

Taxpayers and administrations should agree the documentation (and translations) to be maintained, the retention time and the response time. These should be in line with chapters IV and V (71).

E.2 Monitoring mechanisms

E.2.1 Annual reports

A taxpayer may be required to file an annual report in line with its local confirmation agreement, to demonstrate its compliance to the MAP APA (72).

E.2.2 Audits

A MAP APA does not prevent audit activity, but would limit the scope of transactions covered by the APA to compliance with the APA. Administrations may ask taxpayers to show that: a) it complied with the APA; b) representations made remain valid and material changes have been reported; c) the agreed methodology is accurately and consistently applied; and d) critical assumptions made remain valid (73).

E.3 Consequences of non-compliance or changes in circumstances

The consequences of non-compliance depend on a) the APA MAP terms; b) further agreements between the competent authorities; and c) domestic laws and procedures. Suggested guidelines follow hereafter (75). There are three alternatives: revocation with retroactive effect is the most drastic; next is cancellation with prospective effect; finally, the MAP APA may be revised (76).

E.3.1 Revoking a MAP APA

A tax administration may revoke a MAP APA if: a) there was a misrepresentation, mistake, or omission attributable to a taxpayer, or b) participating taxpayers failed materially to comply with a fundamental term or condition of the MAP APA (77). In view of the consequences, the administration should consider the revocation carefully and inform and consult with all other parties on a timely basis (78).

E.3.2 Cancelling a MAP APA

A MAP APA could be cancelled if: a) there was a misrepresentation, mistake, or omission that was not attributable to a taxpayer, b) participating taxpayers failed materially to comply with the MAP APA; c) there was a material breach of critical assumptions; or d) there was a materially relevant change in tax laws or a treaty provision (79). The cancellation date may be determined by the nature of the cancellation event and may be a specific date

or the end of a particular year (80). A cancellation may be waived if a taxpayer can show reasonable cause and is prepared to make proposed adjustments by the tax administration. This may also lead to a revision of the MAP APA (81). The administration should inform and consult with all other parties on a timely basis (82).

E.3.3 Revising a MAP APA

The taxpayer should be required to notify affected administrations of any material changes. The MAP APA may then need to be revised, though it may have sufficient built in flexibility which would not require a revision (see C.3.7 on unexpected results here above - JHM) (83). The taxpayer's notification should be filed as soon as practical after the change occurs or the taxpayer become aware of it, but at the latest at the time of its annual report (84).

The revision should state its commencement date as well as the termination date of the original MAP APA. If a precise date is not possible, a subsequent year may be applied instead. Where no agreement on revision is reached, the MAP APA will be cancelled and a termination date needs to be established (85).

E.4 Renewing a MAP APA

A renewal request should be made by the time determined by the participating administrations. It is advisable to have this date well before the expiry of the existing MAP APA (86). The level of detail required for renewal should be less than for the original proposal, to the extent the taxpayer can demonstrate that there are no material changes to facts and circumstances. Renewal is not automatic and depends on the consent of all parties involved (87).

V Documentation

This chapter discusses transfer pricing documentation in six subsections. After a brief introduction (A), three objectives of transfer pricing documentation are discussed (B). The TPG propose a three-tiered approach with a master file and local files, akin to the EU Joint Transfer Pricing Forum, and a country-by-country report of some high level data (C). It also talks about various documentation compliance issues such as timing and materiality (D). Finally, after a short discussion on implementation of documentation rules (E), four annexes give detailed guidance on the contents of master files, country files, country-by-country reporting and the implementation package.

V.A. Introduction

This chapter gives guidance to taxpayers and tax administrations (5.1). Many tax administrations find transfer pricing documentation insufficiently informative (5.3). The proposed guidance balances usefulness of data with increased compliance burdens, noting that clear and widely adopted rules can reduce compliance costs (5.4).

V.B. Objectives of transfer pricing documentation requirements

The three objectives of transfer pricing documentation are:

- Forcing taxpayers to consider their transfer pricing for intercompany transactions (B.1);
- Providing governments with enough information for informed risk assessments (B.2);
- Providing governments with useful information for conducting appropriately thorough transfer pricing audits; further info may be needed (B.3) (5.5).

V.B.1 Taxpayer's assessment of its compliance with the arm's length principle

Transfer pricing documentation can assist taxpayers in creating a culture of compliance. Contemporaneous compliance requirements can restrain justifications made up after the fact (5.7). Compliance is supported through requiring contemporaneous documentation and through penalties rewarding timely preparation (5.8). Taxpayers' limited resources require the documentation burden to be reasonable (5.9).

V.B.2 transfer pricing risk assessment

Selecting appropriate cases through effective risk identification at an early stage is crucial; the OECD Handbook on transfer pricing risk assessment is a useful tool for this (5.10). This requires access to sufficient, reliable, information early on through transfer pricing documentation (5.11). Other risk identification tools include transfer pricing forms filed with tax returns, mandatory questionnaires, and cooperative discussions with taxpayers. (5.12).

V.B.3. transfer pricing audits

Transfer pricing audits can be fact-intensive and require detailed financial, factual or industry information (5.13). The tax administration must have the ability to obtain all relevant documents within a reasonable period. The administration's access should not be limited to the transfer pricing documentation package relied on for risk assessment (5.14), or to information available with the local taxpayer only, or only within its own country (5.15).

V.C. A three-tiered approach to transfer pricing documentation

The master file contains standardized information relevant for all MNE members (C.1); the local files describe material intercompany transactions of local taxpayers (C.2); and the country by country report has info of an MNE's global allocation of income, taxes paid and economic activity (C.3) (5.16).

V.C.1 Master file

The master file provides a high level overview to place the group's transfer pricing practices into perspective. Cross references in the master file to other attached documents should be sufficient, rather than repeating that info (5.18). The master file requires five categories of information: i) the group structure; ii) the group's business(es); iii) its intangibles; iv) its intercompany finance; and v) the group's financial and its tax positions (5.19). An MNE should generally be presented in one master file, though separate master files are allowed for independent or newly acquired divisions. In the latter case, group functions should be in the master file. All countries can always see all master files (5.20). See Annex I for info required (5.21).

V.C.2. Local file

The local file supplements the master file by focusing on material intercompany transactions with local affiliates. Cross references in the local file to the master file, rather than copying from the master file, can suffice (5.22). See Annex II for info required (5.23).

V.C.3. Country-by-Country report

This report (CbC report) requires aggregate tax jurisdiction income and tax numbers plus entity level details about residence and main activities (5.24). It is not a substitute for detailed transfer pricing analyses and should not be used for global formulary apportionment by governments (5.25). See Annex III for info required (5.26).

V.D. Compliance issues

This subchapter deals with various compliance issues such as contemporaneous documentation, the time frame within which to prepare documentation, materiality of transactions, the length documentation should be retained, frequency of updates, language of the documentation, compliance related penalties and confidentiality.

V.D.1 Contemporaneous documentation

Taxpayers should consider transfer pricing before the pricing of a transaction and confirm the arm's length nature of its results when filing its tax return (5.27). They should not be expected to incur disproportionate costs and burdens, e.g. in data searches for proportionately small amounts (5.28).

V.D.2 Time frame

Different countries have different requirements (5.29); best practice is that local files are finalised when filing the local income tax returns and that the master file be updated by the due date for filing the ultimate parent return (5.30). Since tax numbers may not be available until companies have filed their tax returns, the filing of Annex III may be extended till one year after closing of ultimate parent's fiscal year (5.31).

V.D.3 Materiality

Transfer pricing documentation requirements should include materiality thresholds based on the relative size and importance of the MNE group and local operating entities. Standards should be set by individual countries based on local conditions (5.32). SME's may be required to file more limited information, but should still report cross border intercompany transactions (5.33). Annex III should include all entities, regardless of size of activities (5.34).

V.D.4 Retention of documents

No retention beyond reasonable periods should be asked for, but some situation may require longer storage, e.g. long term contracts. Governments should be mindful of difficulties in locating prior year documentation

(5.35). The storage medium is free, but information should be promptly and usefully retrievable in the form required by local rules (5.36).

V.D.5 Frequency of documentation updates

Both Master and local files should be reviewed and updated annually (5.37), but governments may determine that database searches be updated every 3 years if operating conditions remained unchanged (5.38).

V.D.6 Language

The transfer pricing documentation language is determined by local laws, but countries are encouraged to permit the use of commonly used languages. Countries may request translations where needed (5.39).

V.D.7 Penalties

Many countries adopted penalties to make non-compliance costlier and could lead taxpayers to favour one country over another (5.40). Penalties should not be imposed on taxpayers for failing to produce information it does not have. However, no penalty does not mean no adjustments. Taxpayers should not avoid penalties because other parties are responsible for transfer pricing documentation (5.42). Alternatively, compliance incentives such as penalty protection/limitation or moving the burden of proof to government for adjustments may apply (5.43).

V.D.8 Confidentiality

Administrations should take all reasonable steps to ensure confidentiality of confidential information. Disclosures required in litigation should be limited to the necessary (5.44). See the Global Forum secretariat toolkit for keeping exchanged information confidential (5.45).

V.D.9 Other issues

Local comparables, where available, will generally be more reliable than regional comparables (5.46). Requirements for third parties' preparation or auditing of transfer pricing documentation is not necessary (5.47).

V.E. Implementation

The OECD/G20 developed the following guidance on the implementation of transfer pricing documentation and CbC reporting (5.48).

V.E.1 Master file and Local file

These files' standards should be implemented locally. Countries agree that confidentiality and use of the Chapter V, Annex I & II standards should be considered when doing so (5.49).

V.E.2 CbC report

V.E.2.1 Timing: When should the CbC Reporting requirement start?

Required for fiscal years beginning on or after 1 January 2016. As filing is required one year after close of fiscal year, first reports were due by 31 December 2017. Fiscal year = consolidated reporting period for financial statement purposes (5.50).

V.E.2.2 Which MNE groups should be required to file the CbC Report?

All groups are required to file the report each year, except (5.51): groups with an annual consolidated group revenue in the immediately preceding year of less than Euro 750 million. This should exclude 85-90% of MNE groups, but still include about 90% of corporate revenues (5.52 - 53). This threshold will be reconsidered in 2020 (5.54).

There will be no exemption (including special industries, investment funds, or non-corporate entities), except that groups may report all their article international transportation income (art. 8 income) in the country to which that income is allocated (5.55).

V.E.2.3 Necessary conditions underpinning the obtaining and the use of the CbC Report

Countries agree to the following conditions (5.56)

Confidentiality

Countries will have legal protections of confidentiality and use, which will be at least equal to that of information under the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (5.57).

Consistency

Countries will adopt CbC filing requirements for their ultimate parent companies which neither require more nor require less info than the information in Annex III (5.58).

Appropriate use

CbC info should be used in accordance with 5.25 and not be the basis for income allocation formulary adjustments. Competent Authorities must promptly concede any such adjustments in MAP's. CbC reports may form the basis for further enquiries, but in case the CbC report is not exchanged under a treaty with a MAP article, countries commit to introduce competent authority procedures to resolve undesirable economic outcomes (5.59).

V.E.2.4 The framework for government-to-government mechanisms to exchange CbC Reports and implementation package

V.E.2.4.1 Framework

Countries should require CbC reports from their parent entities in a timely manner and exchange that information automatically with countries where the MNE operates. If the country i) has not required the reports, ii) has no competent authority agreement to exchange the reports, or iii) has been found failing to exchange the information in practice, a secondary mechanism would allow local filing or an alternatively designated parent jurisdiction (5.60).

V.E.2.4.2 Implementation Package

The G20/OECD developed the implementation package in Annex IV, including i) model legislation for requiring a CbC report; and ii) implementing arrangements for the automatic exchange of information, including competent authority agreements (5.61). Participating countries must introduce their domestic legislation timely and expand their international exchange of information agreements. The implementation package will be monitored and outcomes considered in 2020 (5.62).

Annex I: transfer pricing documentation – Master file

- Organisational structure: legal entities, their ownership and geographic location of operating entities.
- MNE business description: Important profit drivers; supply chain of 5 largest products/services and all others generating more than 5% of group turnover (can be graphic or chart); intra-group services (other than R&D); main geographic markets for above products and services; functional analysis of principal value creators; important business restructurings and M&A during year.
- MNE's intangibles: Overall intangible strategy; lists of material intangibles and intercompany agreements; description of transfer pricing policies; and details of material transfers.
- MNE's intercompany finance: Important external finance; details of group finance companies; and transfer pricing policies.
- MNE's financial and tax positions: consolidated financial statements; lists and brief descriptions of APA's and tax rulings.

Annex II: transfer pricing documentation – Local file

- Local entity: local management, who they report to and where; org charts; details of local business and business strategies; current or prior year business restructurings and intangibles transfers; and key competitors.
- Controlled transactions: describe transactions; aggregate intercompany

charges by category of transactions per country; details on associated enterprises, copies of material inter-company agreements; a detailed functional and comparability analysis plus changes compared to prior year, most appropriate transfer pricing methods per transaction category; reasons for selecting tested parties; list of important assumptions, reasons for multi-year analysis; list of CUPs if any; description of comparability adjustments; reasons for assuming arm's length principles are arm's length; financial info used in applying transfer pricing method; and copies of rulings and APAs concerning above related transactions.

- Financial information: local financial accounts; reconciliation with transfer pricing documentation; and comparables data.

Annex III: Model template for country-by-country reporting

Instruction highlights:

- **Consolidated Financial Statements (CFS)**: The financial statements of a group where the group is presented as a single entity.
- **Constituent Entity**: Any separate business unit that i) is included in the Consolidated Financial Statements (or would be, had there been CFS's); ii) is only excluded from CFS on materiality grounds; and any PE of i) or ii).
- **PE's**: PE's should be treated as separate entities where they (not their HQ's) are situated and be reported on a deconsolidated basis.
- **Sources of data**: Should be same from year to year, but could be consolidated reporting packages, statutory accounts (in MNE's functional currency), regulatory financial statements or internal management accounts.
- **Revenues**: Should not exclude dividends.
- **Income Tax Paid**: Includes withholding taxes withheld and paid by others, e.g. interest withholding tax.
- **Income Tax Accrued**: Should not include taxes deferred or tax provisions made.
- **Stated capital**: PE's should only be included when there is a defined regulatory capital in the PE jurisdiction.

Table 1. **Overview of allocation of income, taxes and business activities by tax jurisdiction**

Name of the MNE group: Fiscal year concerned: Currency used:										
Tax Jurisdiction	Revenues			Profit (Loss) before Income Tax	Income Tax Paid (on Cash Basis)	Income Tax Accrued – Current Year	Stated Capital	Accumulated Earnings	Number of Employees	Tangible Assets other than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							

Table 2. **List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction**

Name of the MNE group: Fiscal year concerned:																	
Tax Jurisdiction	Constituent Entities Resident in the Tax Jurisdiction	Tax Jurisdiction of Organisation or Incorporation if Different from Tax Jurisdiction of Residence	Main Business Activity(ies)														
			Research and Development	Holding or Managing Intellectual Property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing or Distribution	Administrative, Management or Support Services	Provision of Services to Unrelated Parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding Shares or Other Equity Instruments	Dormant	Other[1]
	1.														
	2.														
	3.														
	1.														
	2.														
	3.														

1. Please specify the nature of the activity of the Constituent Entity in the "Additional Information" section.

Table 3. **Additional Information**

Name of the MNE group: Fiscal year concerned:
Please include any further brief information or explanation you consider necessary or that would facilitate the understanding of the compulsory information provided in the Country-by-Country Report.

Annex IV: CbC implementation package

Model legislation related to CbC Reporting

Article 1: Definitions of Group (collection of related enterprises), MNE Group (Group with 2 or more enterprises in 2 or more jurisdictions, that is not an Excluded MNE Group), Excluded MNE Group (Group with turnover of less than 750 million Euros), Constituent Entity (), Reporting Entity (the CbC filer), Ultimate Parent Entity, Surrogate Parent Entity (sole appointed substitute filing CbC report), Fiscal Year (annual accounting period of Ultimate Parent Entity), Reporting Fiscal Year, Qualifying competent authority, International Agreement, Consolidated Financial Statements, and Systemic Failure (country suspending automatic exchange of info or persistently failing to automatically provide CbC reports).

Article 2: Filing obligation. Each Ultimate Parent must file a CbC report. A Constituent Entity must file a CbC report in its country if its tax authorities do not get it from the Ultimate Parent country or the Surrogate Parent country.

Article 3: Notification. A Constituent Entity must notify its local tax administration if it is the Ultimate Parent Entity or Surrogate Parent Entity by the last day of the groups Reporting Fiscal Year. Local entities must notify their local authorities who their Ultimate/Surrogate Parent Entity is.

Article 4: CbC Report. A description of Annex III and the requirement for information to be filed in an identical form.

Article 5: Time of filing: 12 months after last day of Reporting Fiscal Year of MNE Group.

Article 6: Use and Confidentiality of CbC Report Information. Use for high-level transfer pricing and BEPS risks; no transfer pricing adjustments. Information is confidential like information received under the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.

Article 7: Penalties. Local existing transfer pricing penalty regimes.

Article 8: Effective date. Reporting Fiscal Years of MNE Groups starting on or after 1 January 2016.

Multilateral Competent Authority Agreement on the Exchange of CbC Reports ('MCAA')

Section 1: Definitions. Jurisdiction, competent authority, Group, MNE Group, Excluded MNE Group, Constituent Entity, Reporting Entity, CbC Report, 2015 Report (BEPS Action 13), Co-ordinating Body (Article 24'3 tax treaty body), Co-ordinating Body Secretariat (OECD 24'3 secretariat), and Agreement in effect (agreement between two competent authorities to automatically exchange information)

Section 2: Exchange of Information with Respect to MNE Groups. Competent authorities will annually automatically exchange their CbC reports with competent authorities of other Constituent Entities of the MNE Group, unless they have listed themselves as being non-reciprocal jurisdictions. Non-reciprocal jurisdictions will send, but will not receive CbC reports

Section 3: Time and Manner of Exchange of Information. Specify the currency of the CbC report amounts. CbC reports are exchanged within 18 months after the last day of the fiscal year by reciprocal jurisdictions and 15 months by non-reciprocal jurisdictions, through a common XML.

Section 4: Collaboration on Compliance and Enforcement. Competent authorities will inform each other of possible errors in information exchange or non-compliance by Reporting Entities.

Section 5: Confidentiality, Data Safeguards and Appropriate Use. All information is subject to the confidentiality rules of the Convention on Mutual Administrative Assistance in Tax Matters (as amended by protocol). Information will be used for high-level transfer pricing and BEPS risks and economic and statistical analysis. It will not be used as substitute for a detailed transfer pricing analysis. Inappropriate adjustments will be conceded in any CA proceedings. Competent authorities will inform the Co-ordinating Body Secretariat of non-compliance with this section.

Section 6: Consultations. Competent authorities will consult in case of undesirable economic outcomes stemming from adjustments from further enquiries based on CbC reports. They will also consult in connection with difficulties from the implementation or interpretation of this agreement and inform the Co-ordinating Body Secretariat of conclusions reached.

Section 7: Amendments. This agreement may be amended by written consensus. Amendments are effective 1 month after the last signature.

Section 8: Term of Agreement. A competent authority must notify the Co-ordinating Body Secretariat when signing this agreement that its country has the necessary laws in place requiring CbC reports, whether it is a reciprocal jurisdiction, its methods of electronic data transmission, that it has the legal framework for confidentiality, and provide a list of countries with which it will follow this agreement. Subsequent changes must be notified too.

The agreement comes into effect when two countries list each other as described above. Signatories can see each other's' filed information.

Section 9: Co-ordinating Body Secretariat. This body will notify all competent authorities of any notifications it receives under this agreement.

Done in English and French, both being equally authentic.

CA Agreement on the Exchange of CbC Reports on the basis of a Double Tax Convention ('DTC CAA')

Section 1: Definitions like Jurisdiction A&B, competent authority, Group, MNE Group, Constituent Entity, Reporting Entity, CbC Report and 2015 Report.

Section 2: Exchange of information with Respect to MNE Groups. Competent authorities will annually exchange automatically the CbC Reports received from Reporting Entities where the report shows resident Constituent Entities or PE's in the other competent authorities jurisdiction.

Sections 3 – 8: Substantially same as Sections 3-8 MCAA, but without references to Co-ordinating Body Secretariat.

CA Agreement on the Exchange of CbC Reports on the basis of a Tax Information Exchange Agreement ('TIEA CAA')

Sections 1 - 8: Substantially same as Sections 1 – 8 of DTC CAA, but replacing references to DTC's with references to TIEA's.

VI Special considerations for intangibles

The purpose of this chapter is to provide guidance for transactions involving intangibles. An item or activity can convey value and must be considered even it is not addressed in this chapter (6.2). Chapters I-III also apply to intangibles. Comparability involving intangibles require an understanding of an MNE's global business across its entire supply chain and require accurately delineating the transaction under section I.D.2 (6.3). (i) VI.A identifies intangibles; VI.B examines legal ownership and the MNE contributions; VI.C outlines typical intangible scenarios; VI.D gives guidance on the arm's length principle, pricing, and hard-to-value intangibles; and VI Annex gives illustrating examples (incorporated throughout the chapter) (6.4).

VI.A. Identifying intangibles

VI.A.1 In general

Difficulties can arise from a definition of intangibles which is too broad or too narrow (6.5). An intangible is something that is not a physical or a financial asset[8], is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated in a transaction between independent parties in comparable circumstances (6.6).

Intangibles are not always recognized for accounting purposes, e.g. because they are expensed and not capitalized (6.7). Legal protection may affect the value of an item but is not a condition for defining it as an intangible, nor is separate transferability (6.8). Market conditions, such as the level of disposable income, or market size or competitiveness are comparability factors, not intangibles (6.9). Identifying intangibles and pricing them are separate processes. Not all intangibles deserve compensation or give rise to premium returns, e.g. non-unique know-how. See 6.17 for a definition of "unique" (6.10). Likewise, not all R&D or marketing produce or enhance intangibles (6.11).

Intangibles must be identified with specificity, as should their manner of creating value, their interaction with other elements and their DEMPE functions and risks. Vagueness is insufficient for arguing for added value (6.12).

[8] A financial asset is any asset that is cash, an equity instrument, a contractual right, etc.

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

This guidance applies for transfer pricing only, not for the definition of royalties under article 12 of the OECD MC, for customs purposes (6.13), or for other tax purposes (6.14).

VI.A.3 Categories of intangibles

This chapter does not categorise or differentiate intangibles into soft and hard or marketing and other groups (49-50). Where the guidelines refer to "unique and valuable" intangibles, it means intangibles that are not used by other parties and whose use is expected to generate greater economic benefits (6.15). "Unique and valuable" intangibles: i) are not comparable to intangibles used by other parties in comparable transactions; and ii) their use may yield greater economic benefits (6.17).

VI.A.4 Illustrations

These illustrations are for clarification only (6.18).

1. Patents are intangibles. They can generate significant income or savings through their exclusivity, which is unrelated to the patent's cost (6.19).
2. Know-how and trade secrets are intangibles that can relate to manufacturing, marketing, R&D or other commercial activities. Their value depends on the strength of their confidentiality, which can sometimes be protected under unfair competition laws or employment contracts (6.20).
3. Trademarks, trade names and brands are intangibles. A brand is often thought of as a combination of intangibles imbued with social and commercial significance (6.21-23).
4. Contractual rights and government licences are intangibles. Such licenses must be distinguished from compliance requirements such as registration obligations (6.24).
5. Licenses and similar limited rights in intangibles are themselves intangibles (6.26).
6. Goodwill and ongoing concern value generally cannot be separated from other business assets (see also 9.93-95) (6.27). It is not necessary to define these terms or state when they are intangibles; if a feature of a business allows it to charge higher prices, such features should influence prices between related parties regardless of the feature's label. See 6.2 (6.28). Goodwill is not a residual category: relevant intangibles must be described with specificity (6.29).
7. Group synergies are not intangibles, as they are not owned or controlled by a single enterprise (see I.D.8) (6.30).
8. Market specific characteristics are not intangibles, as they are not owned or controlled by an individual enterprise (see I.D.6) (6.31).

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

The question how to allocate the returns of exploiting intangibles and the related costs is crucial[9]. The legal owner may initially receive the proceeds from an intangible, but other members may have performed value adding functions or used assets (including funding for DEMPE functions, see 6.59) which must be compensated. Section B confirms that (6.32). Difficulties include i) no comparable transactions; ii) no comparable intangibles; iii) intangibles may be used and owned by different group members; iv) difficulty in isolating a single intangible's impact; v) various intangible DEMPE functions may be spread over different group members; vi) value creation and returns may be split in time; and vii) ownership may be split from important intangible functions. However, the arm's length principle can yield an appropriate allocation in most cases (6.33).

To analyse a transaction, it is necessary, as provided in I.D.1, to:

1. identify the intangibles with specificity as well as the DEMPE risks;
2. identify the contractual arrangements including legal ownership;
3. identify parties performing DEMPE functions and controlling outsourced functions and economically significant risks;
4. confirm whether contracts match actual behaviour and whether the 4.ii test of 1.90 is fulfilled;
5. delineate the actual transaction taking into account risk allocation under I.D.1.2.1
6. determine the arm's length prices unless recharacterisation is necessary under I.D.2 (6.34).

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

Legal rights and contractual arrangements form the starting point of a transfer pricing analysis. Contracts can describe roles, responsibilities, functions, cost allocations, etc. (6.35) (6.36). Where no documentation exists or facts differ therefrom, the actual transaction must be deduced from the conduct of the parties (see I.D.1.1). It is good practice for related parties to document their decisions and intentions regarding allocation of significant intangibles prior to or at the time of transactions (6.36). Some intangibles are protected by law, others by contract and still others by neither (6.37-39).

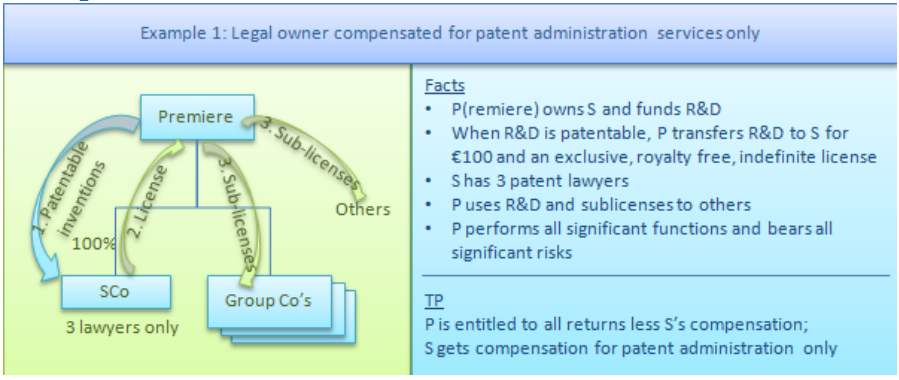
The legal owner is the owner for transfer pricing purposes. Where there is no legal owner, the entity deciding and restricting the use of the intangible will

[9] Exploitation includes both the transfer and the use of an intangible.

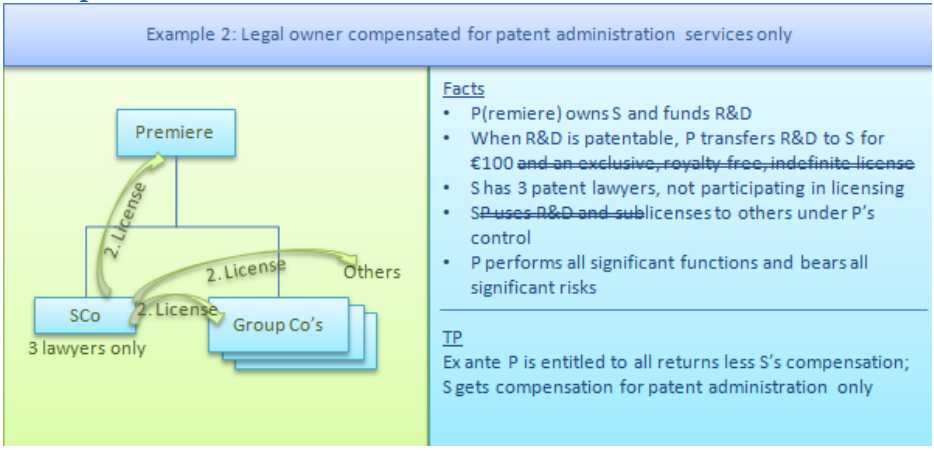
be considered to be the owner (6.40). Intangibles and licenses related to intangibles are considered different intangibles with different legal owners (6.41).

The question of ownership is not a question about compensation. In transfer pricing, a legal owner may receive the initial returns of its intangible, but may have no right to retain that. Its ultimate return depends upon its functions performed, assets used, risks assumed, and the contributions of other group members. If the legal owner is solely a title holding entity, it will only be entitled to a return for holding that title (6.42). See examples 1 – 6 of the Annex (6.43).

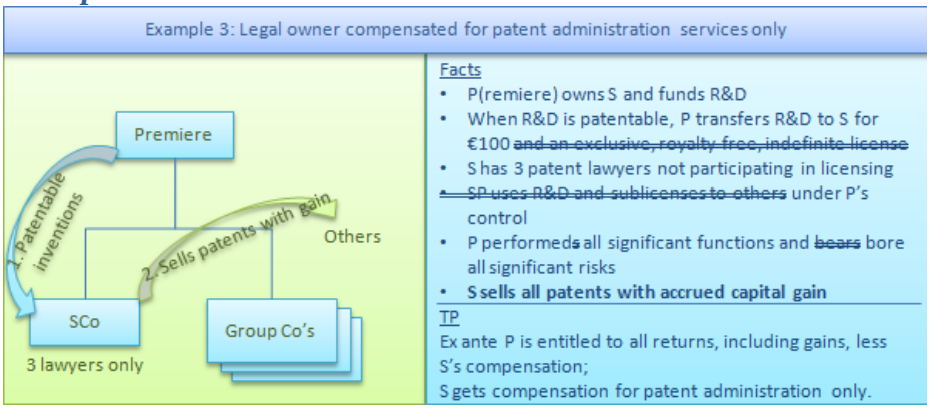
Example 01 – Premiere 1



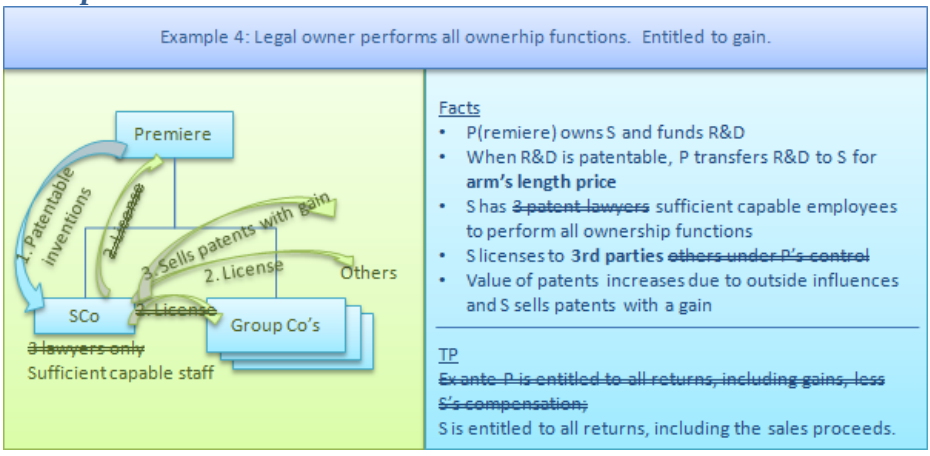
Example 02 – Premiere 2



Example 03 – Premiere 3



Example 04 – Premiere 4



Example 05 –Premiere 5

Same as example 04, except patents decrease in value. In this case S will also be stuck with the loss.

Example 06 – ACo develops intangible

The costs of an intangible may precede its proceeds. Compensation for intangible contributions can therefore be made on ex-ante (predicted) proceeds, or ex-post (actual) proceeds (6.44). Compensation is generally on an ex-ante basis, and may be fixed or contingent depending on facts and circumstances. The accurately delineated transaction will determine which entity assumes and bears risks (6.45). Section B.2 refers to ex-ante compensation, unless stated otherwise (6.46).

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

The legal owner is not necessarily entitled to income from an intangible after compensating others for their functions, assets, and risks (6.47). The anticipated contribution of functions performed by group members of creating intangible value should be appropriately rewarded, based on a functions, assets, and risks analysis (6.48). Importance of contributions vary with circumstances. E.g. if ACo buys a fully developed intangible and has group members exploit it through manufacturing and distribution, ACo selected the intangible, analysed its benefits, purchased it, and funded it. It should keep the intangible return, other than compensating group members for manufacturing and distributing. For more complicated scenarios, where the intangible is not fully developed, or acquired from related parties; see guidance hereafter (6.49).

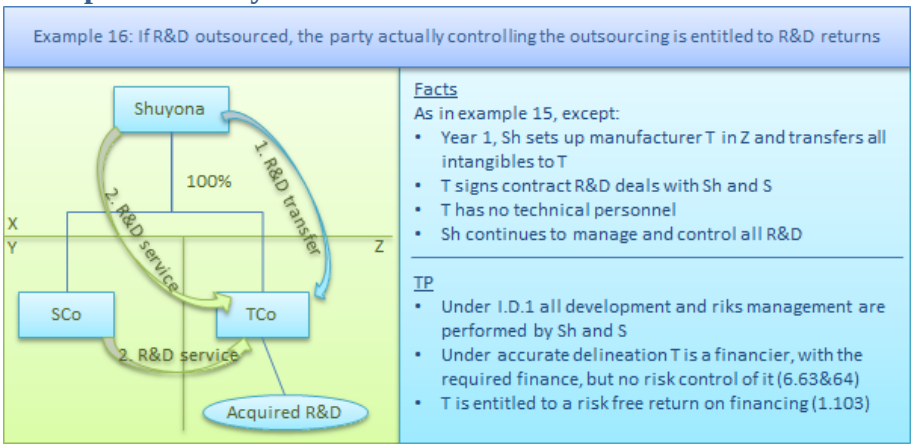
VI.B.2.1 Performance and Control of functions

Identifying contributing parties is key to allocating returns from exploiting intangibles (6.50). If the legal owner were to retain all returns, it should either perform all contributions or outsource and control them (6.51). Related parties performing and/or controlling contributions must be adequately compensated as provided under 6.53-58 hereafter (6.52). If control of the outsourced functions is outsourced as well, it needs to be compensated as well (see I.D.1.2.1 on risk control) (6.53). If the owner neither controls nor performs the DEMPE functions, it would not be entitled to any ongoing benefit attributable to those functions; it may nonetheless be entitled to compensation for its assets used and risks assumed (see B.2 -3 and I.D.1.2) (6.54).

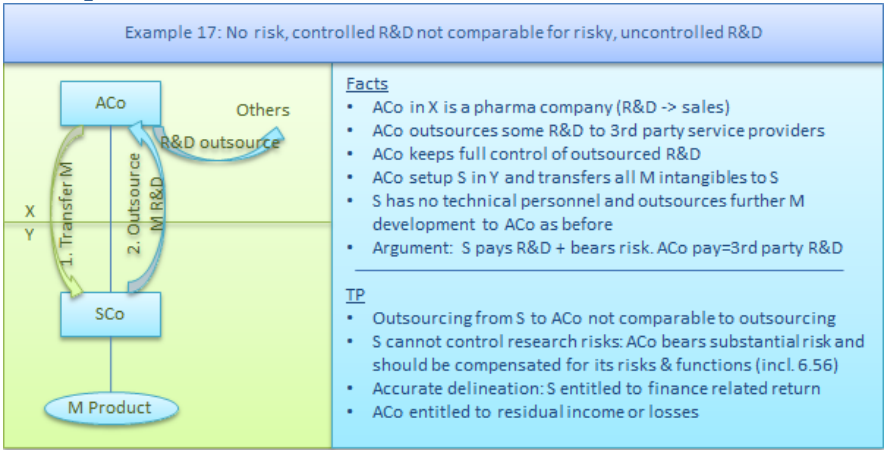
The relative value of functions depends on facts and circumstances and their compensation should be value based (see VI.B.2.2) (6.55). Important functions include design and control of research and marketing, management and control of budgets, control over strategic decisions and decisions regarding protection of intangibles, and ongoing quality control. Important functions usually make a significant contribution to intangible value and require appropriate compensation (6.56). Where there is a lack of

comparables, profit split, valuation techniques, or recharacterisation may be appropriate. If the legal owner outsources most important functions, it should not get any material portion of exploitation results; apply I.D.1.2. See examples 16 and 17 (6.57).

Example 16 – Shuyona 3



Example 17 – ACo Pharma



It is necessary to carefully evaluate transactions where related parties perform these important functions, and those parties should not be the tested party when using one sided methods (see example 6 here above) (6.58).

VI.B.2.2 Assets

If a party provides funding only and does not control risks or perform other functions related to an intangible, it's anticipated return should be limited to what similar third parties would receive. See I.D.1.2.1.6 and example 3 in 1.85 and 1.103 (6.59). Funding and risk taking are related, but the nature of

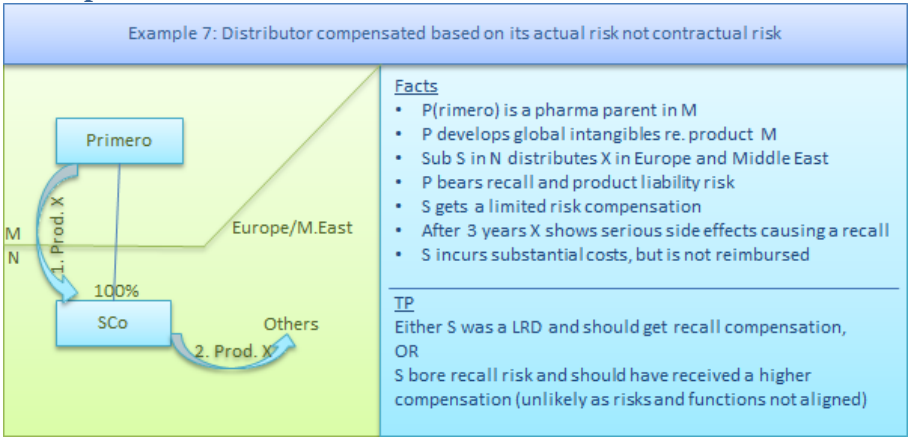
the risk depends on circumstances, such as the debtor's creditworthiness, securities provided and size of the receivable relative to the creditor's total assets. (6.60).

The first step is to identify the economically significant risks (see I.D.1.2). It is important to distinguish the DEMPE risks from the funding risks (6.61). The contract will generally determine the funding terms. The funding return should be risk adjusted and consider the realistic options of both parties[10] (6.62). The funder's risk controlling activities depend on the investment, but requires the capability to make relevant decisions, perform the funding function and control any outsourcing (see 1.65-66) (6.63). Creditworthiness and proposed use of the funds are funding decisions. The closer the funding risk is related to the intangible development risk, the greater the funder's need to assess and monitor the development progress (6.64).

VI.B.2.3 Risks assumed

Import risks in a functional analysis involving intangibles include i) development risks, ii) product obsolence, iii) infringement risk, iv) product liability and v) exploitation risk (6.65). The legal owner should compensate parties assuming DEMPE risks as accurately delineated under I.D.1 (6.66). In determining who assume risks, see I.D.1.2 and the 5 steps of 1.60 (6.67) Mismatches between contractual risk allocation and actual risk bearing must be adjusted. See example 7 (6.68).

Example 07 - Primero



[10] Further guidance will be provided on financial transactions in work undertaken in 2016 and 2017.

VI.B.2.4 Actual, ex-post returns

Unanticipated events such as natural disasters, changes in competition, technological break-throughs, or wrong financial projections can cause differences between ex-ante (anticipated) and ex-post (realised) returns. Question is how to allocate those differences (6.69). This requires identifying the parties actually assuming the risks causing those outcomes (I.D.1). Other parties will only share in the outcomes if they perform important 6.56 functions, contributes to control (see 1.105), or if third parties would do profit sharing. Also consider if the ex-ante compensations were in fact at arm's length, especially for intangibles with highly uncertain values (see VI.D.4) (6.70).

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

The legal owner is only entitled to all the anticipated returns if it performs all the value adding functions, provides the assets and assumes the DEMPE risks regarding the intangible. If others perform DEMPE functions or assumes risk, they must be compensated some or all of the anticipated return (6.71). Differences between ex-post outcomes and proper ex-ante estimations go to those in fact assuming risks (I.D.1), performing important functions (6.56) and contributing to risk control (1.105) (6.72).

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

The transactions to be analysed are those which occurred according to the actual conduct of the parties (6.73). Arm's length prices for the transactions should take into account the contributions to anticipated intangibles and their value at the time they are contributed (6.74).

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

Arm's length price considerations include i) the level and nature of the activity undertaken and ii) the amount and form of the compensation (6.75).

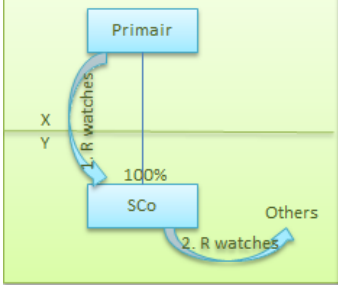
VI.B.4.1 Development and enhancement of marketing intangibles

How should the legal owner compensate a related enterprise performing marketing functions: compensation for services, or for enhancing the intangible's value (6.76)? This requires an assessment of i) the rights and obligations from legal registrations, ii) the functions, assets and risks and costs of parties, iii) the anticipated intangible value and iv) the compensation provided. If the distributor is a mere agent with no risk, a service compensation would appropriate (6.77), but if it bears costs and risks, the potential benefits shared with the distributor should be analysed: e.g. does it have a long term contract and exclusivity. Where costs exceed those of

similar third party distributors, additional compensation is due. See examples 8-13 (6.78).

Example 08 – Primair 1

Example 8: Reimbursement of marketing to distributor, leaves owner with IRR

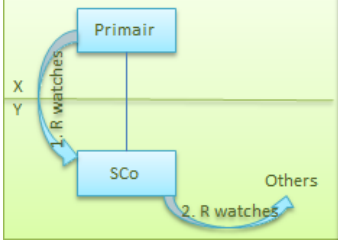


Facts
- P(rimair) in X makes watches under R trade mark
- R name is unknown in Y
- P incorporates S as R watch distributor in Y
- P&S 5 year royalty free marketing&distribution contract
- S only markets and distributes R watches in Y
- P controls marketing plans and budget
- S receives small service profit for marketing
- After 2 years R brand is well established in Y

TP
P is entitled to retain the income on the R brand from Y exceeding S's routine return

Example 9 – Primair 2

Example 9 If distributor performs in line with reliable comparables, no adjustments needed

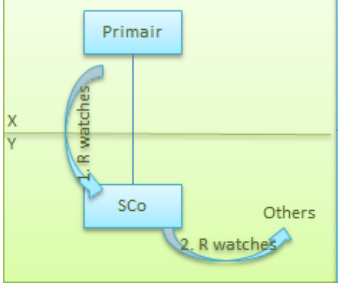


Facts
As in example 8, except:
- S ~~P~~ controls marketing plans and budget
- '~~S receives small service profit for marketing~~S buys the watches cheaper
- S's costs and profit are in line with similar 3rd parties

TP
S's costs, risks and returns are in line with similar 3rd parties and no adjustments are needed

Example 10 – Primair 3

Example 10: If distributor underperforms to reliable comparables, adjustments are needed

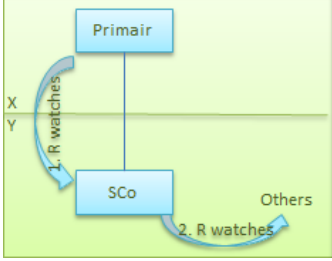


Facts
As in example 9, except:
- S spends far more on marketing than its comparables
- S's costs are higher and profit lower ~~are in line with~~ than similar 3rd parties

TP
Depending on facts and circumstance of a FAR analysis on P&S:
- P price to S for R watches should be reduced;
- P&S should enter into a residual profit split; or
- P should compensate S for part of marketing

Example 11 – Primair 4

Example 11: Owners should bear marketing costs, where distributor has no earn-back period



Facts

As in example 9, except:

- S&P conclude a 3 year royalty free marketing&distribution contract with no extension
- 3rd parties, do not spend a lot on marketing in such cases

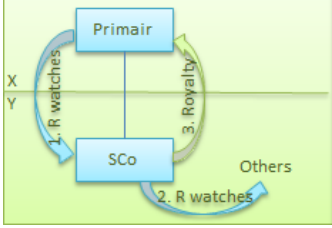
TP

The short term allows no earn back period and requires S to be compensated for marketing expenses either:

- directly, or
- throug reduced watch prices

Example 12 – Primair 5

Example 12: If 3rd parties don't pay royalty, dissallow interco royalty causing lower interco profits



Facts

As in example 9, except:

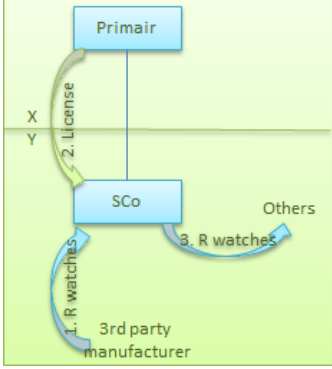
- New 5 year agreement after 3 years with royalty to P
- Sales in 4 and 5 consistent, but royalty erodes S's profit
- 3rd parties do not pay royalties and have higher profits

TP

An adjustment dissallowing the royalties would be appropriate

Example 13 – Primair 6

Example 13: If distributor underperforms to reliable comparables, adjustments are needed



Facts

As in example 10*, except:

- P outsources manufacturing to 3rd party
- P&S conclude 5 year exclusive royalty agreement for R watches in Y
- S buys watches from 3rd party and pays royalty to P

TP

Depending on facts and cirmstances of a FAR analyisis on P&S

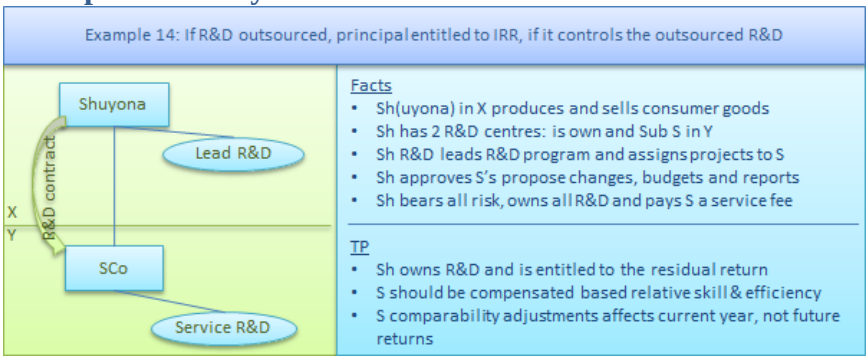
- P price to S for royalty should be reduced;
- P&S should enter into a residual profit split;
- P should compensate S for part of the marketing;
- P should compensate S for the renegotiation in year 3.

* Example 9 with more marketing costs

VI.B.4.2 Research, development, and process improvement arrangements

The above also apply to R&D, where it matters whether the researchers have unique skills and use their own intangibles (6.79), and apply to manufacturing services e.g. leading to process or product improvements; see examples 14-17 (6.80).

Example 14 – Shuyona 1



Example 15 – Shuyona 2

See examples 16 and 17 here above.

VI.B.4.3. Payments for the use of the company name

Generally, no payment is required for mere recognition of group membership (6.81), but legally protected trademarks providing financial benefits to the user should be compensated (6.82). The payment should be related to the financial benefit, other realistic options available and the value added to the trademark by the user (6.83).

If a successful business acquires another successful business and forces the target to use its name, compensation for that compulsory use is not self-evident: the financial benefit test still applies (6.84). The question is also whether the target should be compensated for furthering the acquirer's name at the cost of its own (6.85).

VI.C. Transactions involving the use or transfer of intangibles

It is necessary to identify and properly characterize the specific controlled transactions involving intangibles. See I.D.1 on contractual terms, Chapter IX Part I Section C on intangibles involved and example 19 (6.86). There are

two types of intangible transactions, those involving intangible transfers (see VI.C.1) and those involving use (VI.C.2) (6.87).

Example 19 – PCo department stores

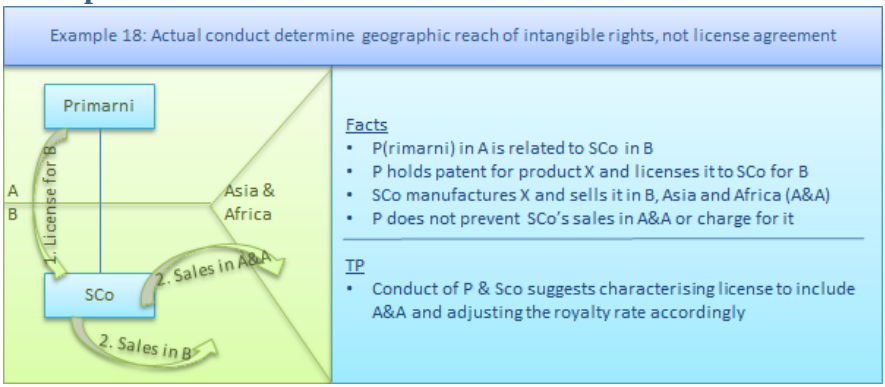
PCo operates several department stores successfully for many years in Country A. It incorporates SCo in Country B to open a department store there. SCo incorporates all PCo's knowhow and marketing tactics in its store and the store is much more successful than local competition. Country A can impute a royalty to PCo for the intangibles made available to SCo.

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

VI.C.1.1 Transfers of intangibles or rights in intangibles

See also VI.D.1-3 (6.88). It is essential to identify with specificity the intangibles transferred and the restrictions attached to such transfers. Not the labels given, but a functional analysis should determine the nature of the transferred rights (6.89). Restrictions can be significant, e.g. whether or not the licensor or the licensee retains full rights to all enhancements. These affect both value and comparability (6.90). Section I.D.1 applies in identifying the specific nature of the transfer and its limitations (see example 18) (6.91).

Example 18 – Primarni



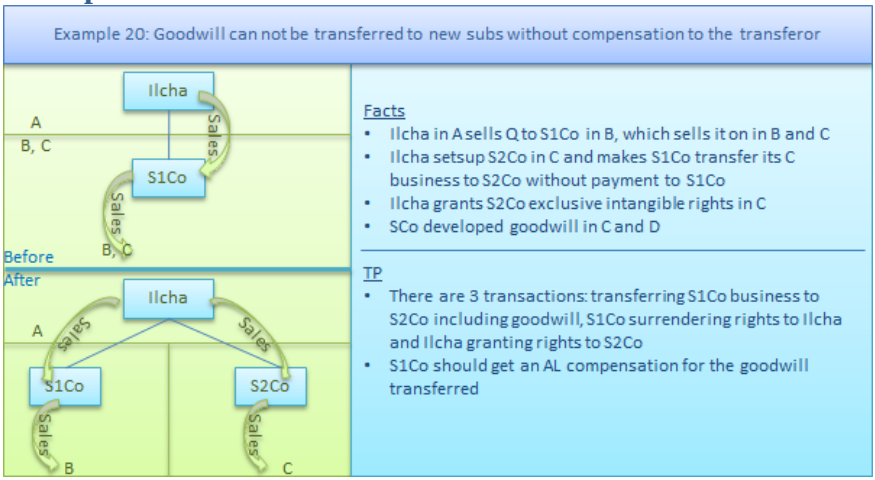
VI.C.1.2 Transfers of combinations of intangibles

Two related issues arise when transferring combinations of intangibles: i) the nature and economic consequences of interactions between them and ii) assuring that all intangibles transferred have been identified (6.92, 93, 95).

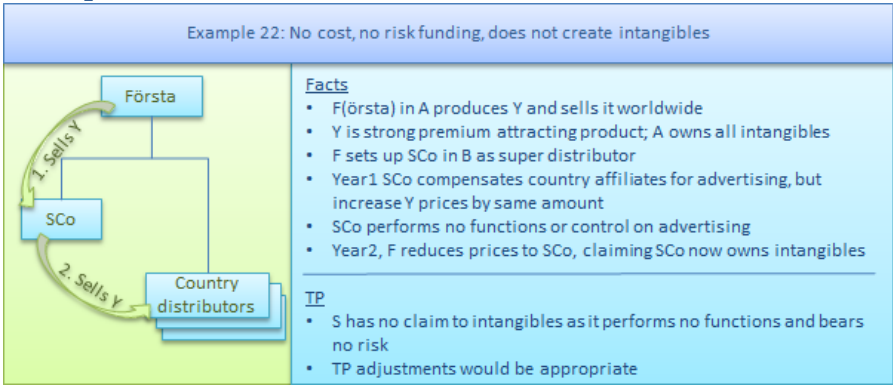
Ad i. Some intangibles are more valuable in combination (6.93). E.g. pharma products can have several intangibles, such as patents, testing results, government approval for selling, and a trademark. The combination's value

far exceeds the sum of its parts (6.94).
Ad ii. Intangibles may be so intertwined that they cannot be transferred separately. E.g. a license to use a trademark, includes the right to its reputational value, both of which should be priced. See example 20 (6.95). Likewise, intangibles should not be artificially separated, see example 22 (6.96). Identifying the actual intangibles transferred, is identifying the actual transactions (6.97).

Example 20 – Ilcha



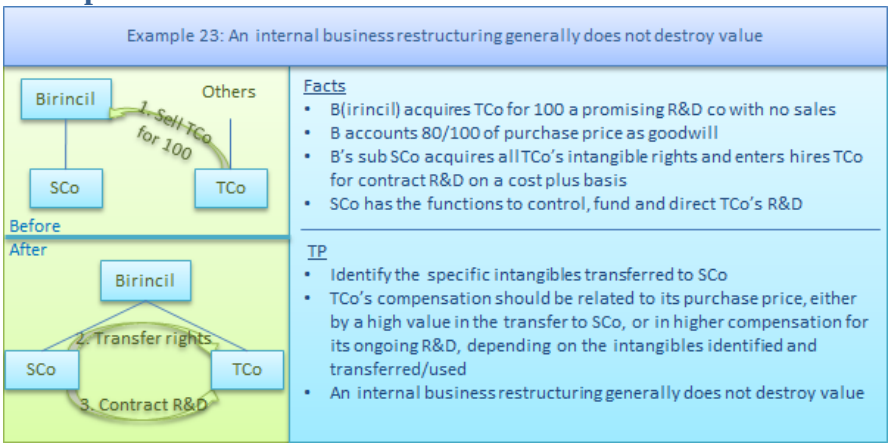
Example 21 – Första



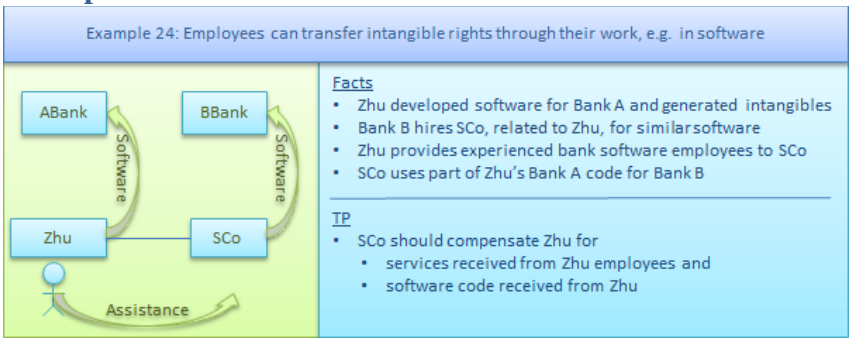
VI.C.1.3 Transfers of intangibles or rights in intangibles in combination with other transactions

When intangibles are said to be transferred with other transactions, it is important to identify them and to price them. See examples 23-25 (6.98).

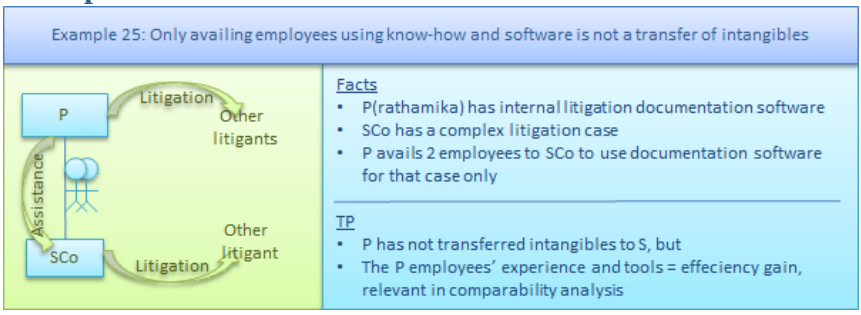
Example 23 – Birincil 2



Example 24 – Zhu



Example 25 – Prathamika



Intangibles may or may not be separable from that which they are transferred with; this affects comparability (6.99). An example of a combined transaction is a business franchise arrangement, where it may be necessary to remember that the total value of the intangibles and the services is greater than the sum of the different parts (6.100). Transfer of software with rights to upgrades, and a maintenance service commitment could be an example of

a transaction that is inseparable and requires aggregate arm's length pricing (6.101).

The delineation of a transaction does not necessarily dictate the most appropriate transfer pricing method to be used (e.g. services must be cost plus, and unique intangibles must be profit split); facts will determine the method (6.102). Further, the determination whether transactions should be aggregated or separate involves delineation of the actual transaction undertaken, which is also needed for determining the most appropriate transfer pricing method (6.103).

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

Intangibles may be used in related party transactions without getting transferred, e.g. using know-how in manufacturing or other services and using marketing intangibles in sales. These intangibles should be identified and taken into account in a comparability analysis. See also VI.D.1 and VI.D.4 (6.104). E.g. a car manufacturer uses patents adding significant value to its cars. This affects comparability, e.g. vis a vis the most appropriate method and choice of the tested party (6.105). Likewise, the use of valuable geo data and sophisticated analytical software by an exploration company would affect selection of the most appropriate method and the tested party (6.106).

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

After identifying the intangible transactions and the intangible owner and contributors, the arm's length conditions for a transaction should be found. Chapters I-III and the 9 steps of comparability apply (6.107). Section D gives additional guidance for applying chapters I-III (6.108). D1 concerns all transactions, D2 the transfer of intangibles, D3 the transfer of intangibles with highly uncertain values and D4 hard-to-value intangibles and D5 intangibles connected to goods or services (6.109).

VI.D.1 General principles applicable in transactions involving intangibles

Realistically available options of all parties to the transaction must be considered (6.111-112). The circumstances of one party should not be used to dictate an outcome contrary to the realistic options of another (6.113). A price consistent with realistic options of all parties can often be identified. If the minimum price for a transferor exceeds the maximum price for a buyer, the transaction may be disregarded under I.D.2, or another adjustment may be

required. Similar considerations may apply to suboptimal resource allocations (6.114).

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

This chapter discusses comparability in general (2.1) and risk in particular (2.2), as well as comparability adjustments (2.3). It then goes on to discuss the use of databases (2.4), selection of the most appropriate method (2.5 and 6) and different forms of payment (2.7).

Transfers include sales and transactions economically equal to sales, including licensing (6.115).

VI.D.2.1 Comparability of intangibles or rights in intangibles

Intangibles often have unique characteristics, making their benefits and profit potential likewise. This complicates comparability analyses (6.116). The following intangible features are discussed below in connection with comparability: exclusivity (1.1), legal protection (1.2), geographic scope (1.3), useful life (1.4), stage of development (1.5), rights to enhancements (1.6) as well as the expected future benefits from these features (1.7) (6.117).

VI.D.2.1.1 Exclusivity

Exclusivity is an important comparability factor, e.g. because it eliminates competitors (6.118).

VI.D.2.1.2 Extent and duration of legal protection

These are important factors, because it too can prevent competition. Legal protection tends to be of less importance, e.g. compared to know-how (6.119).

VI.D.2.1.3 Geographic scope

A global grant of an intangible may be of more value than a country grant (6.120).

VI.D.2.1.4 Useful life

The nature and duration of legal protections could affect useful life, as could the rate of technological change (6.121). Intangibles forming the basis for ongoing research have a useful life extending beyond the economic life of current products (6.122).

VI.D.2.1.5 Stage of development

Intangibles are often transferred just before they become commercially viable, e.g. in pharma. In conducting a comparability analysis, the likelihood of commercial success must be evaluated, e.g. using relevant industry data on partially developed products (6.123-124).

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

The rights to enhancements, revisions and updates can be important e.g. where products become obsolete quickly (6.125). Another question is if the transferee obtains the right to use intangibles for further development, e.g. using an existing software platform. Such use can speed up work, creating first mover advantages (6.126).

VI.D.2.1.7 Expectations of future benefit

All the above concern expected future benefits. Intangibles with different benefit expectations may not be comparable (6.127).

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

Risk and risk allocation related to future economic benefits must be considered against chapter IX, part I, section B.2. Types of risk to consider are:

- future development: commercial viability, costs, and likelihood of success;
- product obsolence, e.g. through competitor products;
- infringement risk: likelihood of infringement and likelihood of enforcement success (6.128).

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

Paragraphs 3.47-3.54 apply. Adjustments may be difficult and proportionately large adjusted amounts may be unreliable, possibly leading to the use of methods less sensitive to finding comparable intangibles (6.129).

VI.D.2.4 Use of comparables drawn from databases

Section III.A.4.3.1 and 3.38 apply (6.130).

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

See paragraphs 2.1-11. Attention is needed for i) the nature of the intangibles, ii) difficulties with comparables and iii) difficulties with certain transfer pricing methods (see chapter II) (6.131). Transactions structured in

different ways may have similar economic consequences, e.g. services using intangibles and transfers of intangibles. Thus, the label of a transaction is less important (6.132).

It is important not to assume that all residual profit follows legal ownership. Selection of the method depends on the functional analysis, taking into consideration all factors and not just routine functions and intangibles (6.133).

See also 2.11, 3.9-12, 37, 58, 59 and Chapter VI, section C (6.134-135).

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

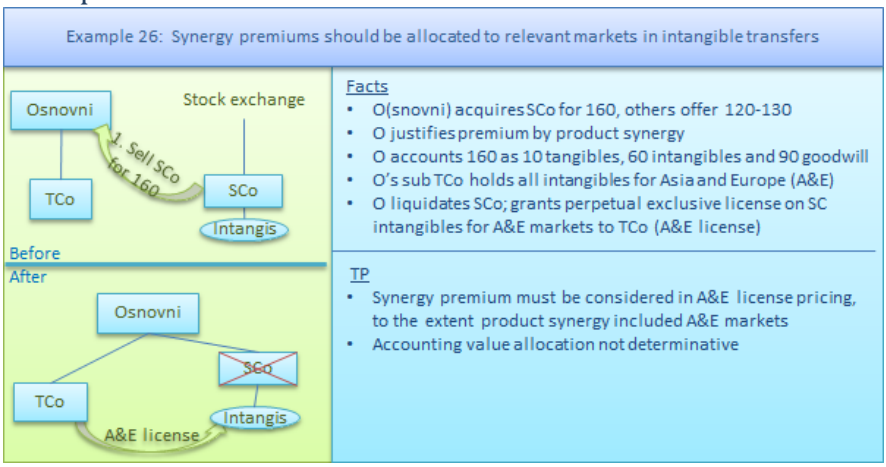
It is usually possible to determine arm's length prices even where there are no reliable comparables (6.138). Important issues are: the functions, assets and risks of all parties, business reasons for the transaction, realistically available options, competitive advantages of the intangibles, the expected future economic benefits and other comparability factors (see section VI.A.4) (6.139). Also, the effect of related-party-only type arrangements on agreed prices and conditions must be accounted for (6.140).

One sided methods like resale price and TNMM are generally not fit for directly valuing intangibles, but could sometimes be used for determining the residual value to be allocated to intangibles (6.141). The use of cost based methods is unreliable due to a frequent lack of correlation between costs and value of intangibles, except for internal business operations of non-unique intangibles (6.142-143). Rules of thumb cannot substitute a proper functional and comparability analysis, see 2.9A (6.144). The most useful transfer pricing methods for intangibles tend to be CUP's and profit split (6.145).

VI.D.2.6.1 Application of the CUP method

Where CUP's exist, 2.13-20, I.D.1 and chapter VI, section D.2 1-4 apply. Reliable comparables may be difficult to find (6.146). Intangibles transferred immediately after their acquisition from third parties are useful comparables; see examples 23 and 26 (6.147).

Example 26 – Osnovni



VI.D.2.6.2 Application of transactional profit split methods

Profit split could be used where there are no CUPs. Section II.C applies (6.148).

Profit split can be used for selling full rights in intangibles; accuracy of projected revenues should be considered; see section VI.D.2.6.4.1 (6.149). For partially developed intangibles, profit split is sometimes based on the relative value of contributions, including the useful life thereof if there were no further developments (6.150). However, caution is due as the cost of the contribution may have no correlation to the value of the intangible, which may affect reliability. See section VI.D.4 on hard-to-value intangibles (6.151).

Where limited rights in intangibles are transferred, the profit transferred thereby is a factor, but this should be modified by the transferee's own contributions to the intangible and its profits. Attention should be paid to the conditions of the transfer and it should not be assumed that all residual profits should be allocated to the transferor; this must be determined through a functional analysis (6.152).

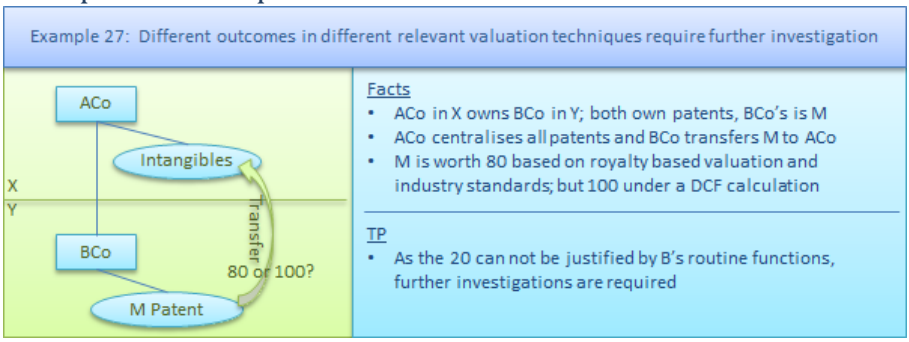
VI.D.2.6.3 Use of valuation techniques

Where comparables cannot be found, valuation techniques could be used, particularly income based ones premised on the discounted value of projected income streams (6.153). The techniques must be applied consistent with the arm's length principle (6.154). The valuation's underlying assumptions must be analysed, in particular for inherent conservatism. This requires particular

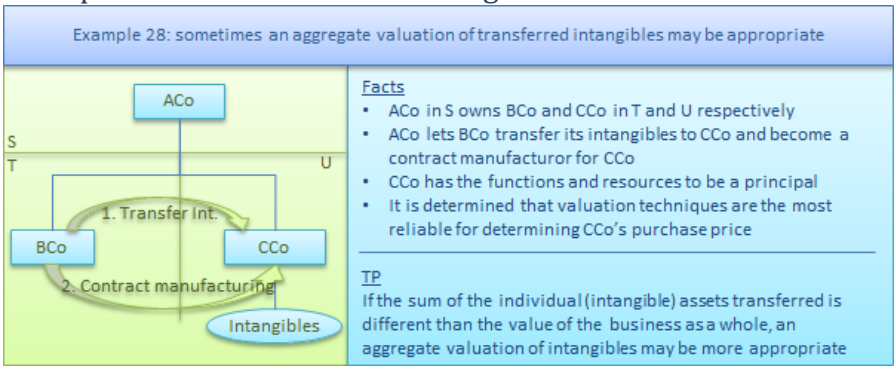
scrutiny of valuations for accounting purposes (6.155). The transfer pricing guidelines do not provide a comprehensive summary of valuation techniques, nor an endorsement of any particular standards (6.156).

There are many variations of discounted cash flow of projected future income valuations[11]. They require estimations of financial projections, growth rates, discount rates, useful life, tax implications and terminal value. The calculation should be made from the perspectives of all parties. See examples 27-29 (6.157).

Example 27 – ACo patent owner

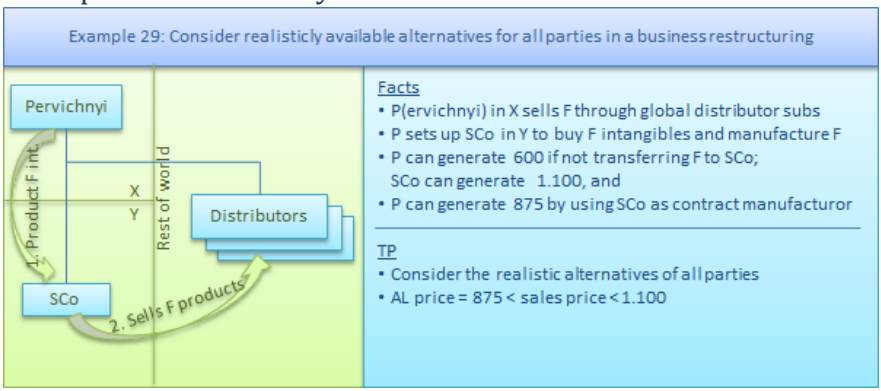


Example 28 – ACo centralises intangibles



[11] Income, rather than cash flow projections, may be more reliable for transfer pricing purposes. Both must be applied consistently and references to cash flow should be read to include income projections as well.

Example 29 – Pervichnyi



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

Value estimates can be volatile, with small changes in assumptions leading to large fluctuations in outcome. This can be compounded by simultaneous changes in assumptions (6.158). Taxpayers and administrations should therefore be transparent in all their assumptions and be prepared to defend their reasonableness. It is good practice to include a sensitivity analysis of assumptions as part of transfer pricing documentation (6.160). The purpose of the valuation could be relevant as well as inconsistencies with other valuations made by the taxpayer. Valuations made for operational business purposes may be more reliable than ones for transfer pricing (6.161).

The following issues are addressed hereafter: accuracy of projections (4.1), assumptions regarding growth rates (4.2), discount rates (4.3), useful life and terminal values (4.4) and taxes (4.5) (6.162).

VI.D.2.6.4.1 Accuracy of financial projections

To the extent financial projections depend on future developments in the marketplace, they are speculative (6.163). Therefore, the purpose of those projections can be important. Non-tax projections tend to be more reliable than tax ones (6.164). The further into the future projections stretch the less reliable they become (6.165). Whilst track records are no guarantees for the future, projections regarding products with a track record are more reliable than those for new products without any (6.166).

Development costs should not be considered if there will be no future development expenditure, e.g. fully developed patents (6.167). See VI.D.3-4 for highly uncertain valuations (6.168).

VI.D.2.6.4.2 Assumptions regarding growth rates

The basis for growth rates should be considered and it should be remembered that it is unusual for revenues to grow at a steady rate over a long period; industry and company experience can provide guidance (6.169).

VI.D.2.6.4.3 Discount rates

Discounts rates are critical as they account for the time value of money and the uncertainty of future cash flows (6.170). Discount rates based on a WACC ("Weighted Average Cost of Capital") should not be taken as a given: the specific facts of the case should be evaluated (6.171). Intangibles may be the most risky assets of a business; the likelihood of expenses (e.g. R&D) may be higher than the likelihood of subsequent income. The discount rates should reflect all these risks (6.172).

Some risks can be reflected in financial projections or discount rate; the same risk should not be reflected in both (6.173).

VI.D.2.6.4.4 Useful life of intangibles and terminal values

Useful life must be determined on basis of facts such as duration of legal protections, the nature of the intangible and the rate of technological change (6.175). Some intangibles can exceed their legal life through subsequent generations and part of future cash flows may have to be allocated to those legally expired intangibles. However indeterminate useful life does not warrant non-routine returns into perpetuity (6.176). Such intangibles can be allocated a terminal value (6.177).

VI.D.2.6.4.5 Assumptions regarding taxes

Future income taxes should be determined i) on future cash flows, ii) for amortisation benefits and iii) on capital gains (6.178).

VI.D.2.7 Form of payment

Taxpayers have substantial discretion in choosing between lump sums, periodic payments, or contingent payments. I.D.1.1 applies (6.179). Different forms entail different risks, e.g. payments contingent on future sales have greater risk for the transferor than lump sum payments. The form must match the contracts, the actual conduct and the abilities of the parties. The specified amounts should reflect the relevant discount rates, including changes in risk due to e.g. contingency clauses (6.180).

VI.D.3 Arm's length pricing when valuation is highly uncertain at the time of the transaction

When valuation is highly uncertain, the question is what unrelated parties would do. The guidance of section I.D, chapter III and this chapter are relevant (6.181). Independent parties may establish pricing at the outset, taking into account foreseeable future events (6.182); adopt shorter term agreements or include price adjustment clauses as protection against uncertainty (6.183); or bear some uncertainty provided that major unforeseen events would lead to renegotiations (6.184). Tax administrations should follow what unrelated parties would settle for, including contingency clauses or making prospective modifications (6.185).

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

Tax administrations may find it difficult to establish what profits were reasonably foreseeable in case of "unexpected" developments. They are largely dependent on taxpayers' insights (see 1.191) (6.186). Differences between ex-post outcomes and ex-ante agreements provide pointers that foreseeable developments were inadequately considered (6.187). So ex-post evidence provides presumptive, but rebuttable evidence regarding foreseeable developments and the reliability of ex-ante information (see 6.193 - 194). It should be distinguished from hindsight, disregarding whether information could reasonably have been known when entering a transaction (6.188)

Hard-to-value intangibles are (rights in) intangibles that at the time of transfer i) have no reliable comparables and ii) highly uncertain future cash flows, making it difficult to predict their ultimate success (6.189). Hard-to-value intangibles transactions involve intangibles that are: partially developed; only exploited several years later; are not hard-to-value intangibles but are integral to development of hard-to-value intangibles; exploited in novel manners; transferred for a lump sum; and/or used or developed under a cost contribution agreement (6.190). Hard-to-value intangibles information asymmetry makes it difficult for tax administrations to evaluate the reliability of taxpayer information until ex-post outcomes are known (6.191). Ex-post outcomes should only be presumptive evidence where administrations are unable to confirm the reliability of ex-ante information. A multi-year analysis under III.B.5 may also be appropriate (1.192).

The approach does not apply to hard-to-value intangibles transfers if: i) the taxpayer provides details of ex-ante projections used and reliable evidence that any significant difference is due to unforeseeable events or that their playing out probabilities were not significantly over-/underestimated; ii) the transfer is covered by a bi-/multilateral APA; iii) any significant difference

effects the hard-to-value intangibles compensation by 20% or less; or iv) 5 years of commercialisation passed during which no significant difference surpassed projections by more than 20%[12] (6.193). Re i): if ex-post sales of an intangible were 1000, but ex-ante expectations only 100 and higher volumes were due to higher demand stemming from an unforeseen natural disaster, the ex-ante pricing should be recognised (6.194).

Access to MAP for hard-to-value intangibles cases are important (6.195).

Annex II to Chapter VI: Guidance for tax adminstrations on HTVIs

1. Introduction

The HTVI approach protects tax administrations from the information asymmetry with taxpayers, by allowing them to consider ex post outcomes as presumptive evidence about the appropriateness of ex ante pricing. Taxpayers can rebut the presumptive evidence by demonstrating the reliability of date used when concluding the transaction (2). The tax administration problem is the reliance on data from the taxpayer, to objectively evaluate the taxpayer (5). HTVI guidance provide a tool for tax administrations; where actual income is higher or lower than anticipated outcome, presumptive evidence shows the original valuation should have been different (6).

Administrations may also consider other relevant data that should have been reasonably know and considered at the time of the transaction (8) and even HTVI is not applicable, other parts of the TPG may justify an adjustment (9). However, the HTVI should be applied to promote taxpayer certainty and reduce double tax, and administrations should act on HTVI transactions as soon as possible (10).

Ex post outcomes may manifest themselves outside of audit cycles or statutory limitations, so tax administrations should endeavour to identify and act upon HTVI transactions as soon as possible (11-13). Applying the HTVI approach should be based on:

* when considering ex post outcomes, administrations should ask if taxpayers could have reasonably known the information about the probability of the manifested outcome;
* a revised assessment should consider price adjustment clauses and

[12] In some sectors intangibles are transferred with contingent clauses for second or further uses. Where this occurs, the time period begins again with the new commercialisation.

contingent payments; and
* ex post outcomes should be identified and acted upon soonest (17).

2. Examples:

Example 1

Year 0: ACo in A has a patented pharmaceutical compound. ACo completed Phases I & II clinical trials. ACo transfers the patent to related SCo in S to do Phase III trials. Parties estimate the price at 700, based on: i) expected future income and i) maximum sales of 1000 per annum and commercialisation in year 6 (21, 22).

Scenario A

Years 3-4: Tax audit in year 4. Shows commercialisation already in year 3, due to faster Phase III trials. Sales in 3 - 4 at levels predicted for years 6, 7 (23). The administration revises the transfer price to 1000, which is at arm's length. The administration can assess additional profits of 300 in Year 0 (24, 25).

Scenario B

Facts assumed like in 23 above. The administration revises the transfer price to 800 due to the earlier sales. The 800 is at arm's length. The administration could assess additional profits of 100 in Year 0, but the 20% exemption of 6.193 prevents that (26, 27).

Example 2

Same facts as 21-22 hereabove. Years 3-7: Tax audit in year 7 for 3 - 5 shows sales for 5 – 6 significantly above projections, being 1500 per annum (28). The administration revises the transfer price to 1300, which is at arm's length, but not necessarily the Net Present Value of the transferred rights. The administration can assess additional profits of 600 (29, 30) by adjusting year 0, but third parties may have made adjustments that do not look that far back, such as additional payment arrangements from year 3 due to the early market approvals (31, 32).

The principles in this example apply to both audits for years 0-2 or 3-5 (33).

3. Dispute prevention and resolution for the HTVI approach

The goal is to improve consistency in applying the HTVI approach. There may also be other tools, like APAs (34, 35). BEPS Action 14 recommends bilateral APAs with possible rollbacks (36). In case of double tax, MAPs also apply. Here it is important that the taxpayer can start the MAP, without waiting until an assessment is actually made; it suffices taxation that will not

be in line with the treaty and that such is not only possible, but probable (37, 38). BEPS Action 14 recommend jurisdictions to permit taxpayers to request multiyear resolutions under MAP for recurring issues (39).

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

The effect of intangibles used in the provision of goods or services must be considered when determining arm's length prices (6.196). This subsection discusses intangibles as a comparability factor (5.1) and how to determine arm's length prices with (5.2.1) and without (5.2.2) comparables.

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

Paragraphs section I.D.1 and chapter III apply (6.197). In cost plus, resale minus and TNMM, the simplest party is often the tested party, however, if the tested party is using intangibles, those intangibles must be considered as a comparability factor (6.198), e.g. a distributor may have marketing intangibles and logistical know-how (6.199).

In many cases parties to comparable uncontrolled transactions may have similar intangibles and the comparability may be high (6.200). If there is a mismatch between the tested party and the comparable, comparability adjustments should be made. See VI.D.2.1-4 (6.201). Care is due in rejecting potential comparables; assertions of unspecified intangibles or significant goodwill is insufficient. Reject when only one transaction involves clearly specified, valuable unique intangibles (6.202).

VI.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

VI.D.5.2.1 Situations where reliable comparables exist

Where reliable comparables exist, any of the five methods are acceptable (6.204). Sections VI.D.2.1-4 apply. Only if the tested party has unique, valuable, intangibles are comparability adjustments needed (6.206). Where the comparable has different intangibles, quantification of the difference can be difficult. Unquantifiable differences may require a method less reliant on comparables (6.207). Other comparability adjustments may be required, e.g. for market differences, location advantages, business strategies, workforce, or corporate synergies (6.208).

VI.D.5.2.2 Situations where reliable comparables do not exist

A transactional profit split may be applied where there are no reliable comparables, e.g. where both parties make unique and valuable contributions (6.209). Chapter II.III.C contains relevant guidance (6.210). The intangibles, their contribution and their value should be identified; there should be no vagueness (6.211). Where appropriate, transfer pricing methods or valuation techniques not dependent on comparable transactions may be utilised. The selected alternative must reflect the contribution of intangibles and other factors to the value creation (6.212).

VII Special considerations for intra-group services

This chapter deals with intercompany services not related to cost contribution agreement. After an introduction (A), and discussing the main issues, such as identifying services and determining an arm's length charge (B), examples are provided (C).

VII.A. Introduction

The chapter discusses issues that arise in determining if intercompany services were provided and at what price; it does not cover cost contribution agreements (7.1). MNE's must arrange for administrative, technical, financial, and commercial services for themselves. This chapter gives guidance on appropriately identifying the services and allocating their costs (7.2). Intragroup services may sometimes involve intangibles, such as know-how contracts, making them difficult to delineate. See the aggregation principles of chapter III (7.3).

Intra-group services may vary considerably and are fact and circumstance dependent. Think e.g. highly integrated vs decentralised groups (7.4).

VII.B. Main issues

There are two main issues: have services been provided (B.1), and if so, what is the arm's length charge (B.2) (7.5)?

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

VII.B.1.1. Benefits test

The question whether a service was provided, depends on whether the recipient received a benefit it would be willing to pay for, or perform for itself (7.6). This depends on facts and circumstances (7.7). Some services are performed to satisfy an identified need, e.g. repair of manufacturing equipment. Reliable documentation is essential to prove the service provider's costs. (7.8).

VII.B.1.2. Shareholder activities

Activities performed solely because of ownership interest ("shareholder activity") should be distinguished from stewardship activity, which may include services, such as planning for operations, emergency management or technical advice (7.9). Shareholder activities include: parent shareholder meetings and share issues; issuing consolidated financial reports; M&A fund raising; the parent's tax compliance; and corporate governance of the MNE

as a whole. Fund raising on behalf of a subsidiary to acquire a target is a service from the parent to the subsidiary (7.10).

VII.B.1.3. Duplication

Companies should not pay for services they already provide for themselves or purchase from others. Such duplication is only chargeable as a service where it is temporary (e.g. in a reorg), to reduce risks, or fulfils a regulatory requirement. Some "duplication" covers different aspects of a wide area, e.g. marketing, and is not duplication (7.11).

VII.B.1.4 Incidental benefits

Incidental benefits are spin-off effects from services provided to other members and should not be charged. E.g. a decision to reorganize some members, may also benefit others, but the others would not pay a third party for it (7.12). Another example is benefits through passive association, e.g. having a higher credit rating as a group member than as a standalone entity. Passive association does not equal active promotion, e.g. providing bank guarantees for better credit ratings. See I.D.8 on group services (7.13).

VII.B.1.5 Centralised services

Examples of centralised activities are planning coordination, budgetary control, financial advice, accounting and legal, factoring, computer services, etc. These qualify as services, as third parties would ordinarily pay for them (7.14).

VII.B.1.6 Form of the remuneration

The form of compensation should be as with third parties: e.g. remuneration for financial services is typically built into the spread, or a commission built into the price of procured goods (7.15).

If services are available "on call", is an on call premium due? It depends on facts and circumstances, e.g. third parties do pay lawyers retainer fees, and buy service contracts for prioritized computer repair (7.16). It depends though on the likelihood of need (low need, low fee), historic use (low use, no/low fee) and general availability at short notice (7.17).

Payments may indicate services; the mere specification of a service as management fees, does not show provision of such services; and the absence of payments or agreements should do not prove absence of a service either (7.18).

VII.B.2. Determining an arm's length charge

VII.B.2.1 In general

To calculate the arm's length charge (B.2.2.3), it is necessary to first identity the actual arrangements (B.2.2.)

VII.B.2.2 Identifying actual arrangements

This section deals with the types of charges for services: direct charge methods and indirect charge methods. Indirect charges can either be separate charges based on allocation keys, or be included into another charge (e.g. support charges, built into license fees).

Tax administrations must determine what arrangements were put in place to facilitate charges (7.20).

VII.B.2.2.1 Direct charge methods

Some arrangements for charging can be readily identified and the direct charge method can be used (7.21). This may particularly be the case where the enterprise provides similar services to third parties (7.22).

VII.B.2.2.2 Indirect charge methods

In many cases direct charges are difficult to make and indirect charges are used. Indirect charges are generally not acceptable for services regularly provided to third parties. (7.23). The nature of services may dictate use of indirect charges, e.g. central sales promotions, may affect the number of goods sold by affiliates. Another case is where the required administration for direct charging would be disproportionate to the benefit transferred (7.24).

Allocation keys used should be appropriate to the circumstances and produce charges commensurate with the benefits charged for (7.23). Allocation keys could be turnover, employees, etc. and should relate to the nature of the service (e.g. number of employees for payroll services) (7.25).

Where the indirect charge is included in other charges (e.g. support charges in license fees), double charges/double deductions should be avoided (7.26).

VII.B.2.2.3 Form of the compensation

The compensation due may be included in other charges. E.g. licensing may include technical services; avoid double charges and double deductions (7.27)

For "on call" services, first services may be "free" as they are included in the on call charge (7.28).

VII.B.2.3 Calculating the arm's length compensation

Pricing should be considered from all parties' point of view (7.29).

VII.B.2.3.1 Methods

The most likely transfer pricing methods will be CUP or a cost based method (plus or TNMM) where there is no CUP. For cost based methods, the costs included should be consistent for controlled and uncontrolled transactions. Exceptional cases may require more than one method (7.31). A functional analysis of all parties may be helpful and both the short and long term impact of services should be considered as well as the fact that some cost may never produce the benefits expected (7.32).

In cost based methods, the costs may need comparability adjustments (7.33). If the service provider is only an agent, e.g. renting advertising space, the mark-up should be for the agency function, not the service: i.e. Do not add a plus on the advertising space fees, only on the costs of being an intermediary (7.34).

VII.B.2.3.2 Considerations on including a profit element

The issue may arise whether a charge should provide a profit for a service provider, considering e.g. the recipient's economic alternatives where the supplier's cost exceeds market price (7.35). Exceptionally, administrations may accept cost-based-only services, e.g. where the additional tax revenue from mark-ups does not justify the additional burdens. This is unlikely for principal activities or where direct charging is possible (7.37).

VII.C. Some examples of intra-group services

This section has examples for illustrative purposes only (7.38).

- A group debt-factoring centre pooling currency and debt risks performs a chargeable service, probably on a CUP basis (7.39).
- A contract manufacturer gets instructions from its principal and bears low risks. A cost plus compensation is appropriate (7.40).
- Contract research can be compensated on a cost plus basis, if the research company is insulated from financial risk and the principal gets the R&D intangibles. See also realistically available options under VI.B.2 (7.41).
- A group service centre can administer licences (collect license fees and fight infringements), without exploiting those rights (7.42).

VII.D. Low value-adding intra-group services (LWS)

D.1 defines LWS; D.2 sets out an elective simplified approach with a simplified benefits test; D.3 gives documentation and reporting guidance; and D.4 addresses withholding taxes. The simplified approach recognises the link between LWS and costs and allocates those costs to the beneficiaries with a consistent low mark-up (7.43).

VII.D.1 Definition of LWS

LWS are services performed by one or more group members to one or more other group members which are i) supportive; ii) not part of the group's core business; iii) do not require or create unique valuable intangibles; and iv) do not involve or create significant risks for the service provider (7.45).

The guidance does not apply to LWS rendered to unrelated parties as well, as those generate internal comparables (7.46). The following also do not qualify: i) core business; ii) R&D; iii) manufacturing and production; iv) purchasing manufacturing or production materials; v) sales, marketing, and distribution; vi) financial transactions; vii) exploration, extraction or processing natural resources; or viii) corporate senior management (7.47). These services can still be LWS, they just don't qualify for the simplified approach (7.48).

LWS qualifying for the simplified approach are: i) accounting and auditing; ii) handling accounts receivable and payable; iii) HR activities; iv) handling health, safety, and environment data; v) IT services; vi) communications and public relations; vii) legal services; viii) tax compliance; and ix) general administration (7.49).

Examples: a) if a shoe manufacturer parent routinely performs credit risk analyses for itself and its subsidiaries, the services to the subsidiary are LWS. However, if an investment bank parent does credit analyses on potential counterparties, using sophisticated, confidential software and algorithms, doing those analyses for subsidiaries and their customers is not an LWS.

LWS may be the core business of the group member providing the service (e.g. an IT shared service centre of a non-IT group), but not of the group itself (7.51)

VII.D.2 Simplified determination of arm's length charges for LWS

Simplified approach is based on idea that all LWS should be allocated to beneficiaries. Advantages are: 1) reduced compliance on benefits test and arm's length pricing; 2) greater certainty for MNE's; and 3) targeted

documentation for tax administrations. The approach must be applied consistently on a group wide basis across all countries (7.52). However, if the government of one country does not adopt the simplified approach, the MNE can still use it in other countries. Diversified MNE's may also adopt the simplified approach on a sub-holding level (7.53).

VII.D.2.1 Application of the benefits test to LWS

Tax administrations should refrain from reviewing the benefits test under the simplified approach with VII.D.3 documentation (7.54), also with regard to the extent of the benefits received. Administrations should only consider benefits by categories, not by charge, e.g. only payroll processing, not individual acts thereof. A single annual invoice should suffice. Separate demonstration of benefits may be required for services with only one recipient (7.55).

VII.D.2.2 Step 1 - 2: Determination of costs pools

First. Calculate annually the pool of costs of service providers by category. Costs = direct costs, indirect costs, and an appropriate part of operating expenses (e.g. general and administrative). Pool per service category, identifying the accounting cost centres used. Identify 7.61 pass-through costs (7.56).

Second. Identify and remove costs for services from one member to one other member (7.57).

VII.D.2.3 Step 3: Allocation of LWS costs

Allocate the costs that benefit the recipients. Select one or more allocation keys depending on the services. Apply consistently per service category. Allocation keys should reasonably reflect the level of benefit expected and the underlying need for the services. E.g. for employees, headcount; for IT, users; for fleet management, vehicles; accounting, total transactions, or assets (7.59). Use more sophisticated keys where needed, but with prudence, bearing in mind the added value. Taxpayers should describe reasons why allocation key produces reasonable outcomes (7.60).

VII.D.2.4 Step 4: Profit mark-up

Apply a 5% mark-up to all costs in the pool, except pass through costs under 2.93 and 7.34. No benchmarking needed. 5% can also be applied for LWS from one member to one member as identified under 7.57 (7.61).

VII.D.2.5 Step 5: Charge for LWS

The charge = i) costs incurred under 7.57 + 5% mark-up + pooled costs allocated under 7.59 + 5% mark-up (7.62).

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

Tax administrations may include thresholds for reviewing the simplified approach. Threshold could e.g. be financial ratio of recipient (LWS/total costs or turnover), or group-wide ratio (7.63).

VII.D.3 Documentation and reporting

Documents needed include i) a description of the categories of LWS, their beneficiaries, why the services are LWS, why needed, the expected benefits, the allocation keys and why they are appropriate; ii) written agreements for the services; iii) cost pool documentation and calculations including list of categories and relevant costs; and iv) calculations of allocation keys (7.64).

VII.D.4 Levying withholding tax on charges for LWS

Tax administrations are encouraged to only apply withholding tax to the mark-up (7.65)

VIII Cost Contribution Arrangements ("CCAs")

VIII.A. Introduction

Section B gives a general definition of CCA's, their relationship to transfer pricing and types of CCAs; C gives guidance on applying the arm's length principle, determining the participants, their expected CCA benefits, the value of their contributions, their balancing payments and the tax treatment of all these; and D gives guidance on the entry into, withdrawal from and termination of a CCA (8.2). Section E enumerates recommendations and documents required for CCAs and the Annex provides 5 examples of CCAs.

VIII.B. Concept of a cost contribution agreement

VIII.B.1 In general

A cost contribution agreement is a contractual agreement to share contributions and risks to develop, produce or obtain assets, services, or rights, expecting benefits for each participant. Participants exploit their interests in cost contribution agreement assets as owners and not as licensees (8.3). No transfer pricing analysis difference exist between cost contribution agreements and other intercompany transactions, but CCAs do have specific characteristics warranting special consideration (8.4).

A key feature is sharing contributions and receiving expected benefits proportionate to those contributions. Each participant must be entitled to benefits from the CCA assets produced/services provided without paying additional consideration (8.5). Though some benefits may have a longer time to materialise or may not be successful, each participant's interest should be established from the outset (8.6).

CCAs can simplify multiple transactions, e.g. by replacing a web of intercompany arm's length charges and payments in complex cross licensing agreements. However, this streamlining does not affect the required valuation of separate contributions (8.7). E.g. an MNE has three production sites with their own R&D teams. They can enter into a CCA to generate production process improvements to each participant (8.8)

VIII.B.2 Relationship to other chapters

All other chapters of the TPG are applicable where relevant, especially I.D, 6.60 – 64 on controlling financial risk and VI.D.3 -4 on hard-to-value intangibles (8.9).

VIII.B.3 Types of CCAs

Most common are CCAs to jointly develop intangible or tangible assets ('development CCAs') and for obtaining services ('services CCAs'). Development CCAs create future ongoing benefits and often involve significant risks; services CCAs create current, more certain, and less risky benefits (8.10). CCAs developed assets may only have one legal owner, but other participants have proportional rights and do not have to pay for use of those assets (8.11).

VIII.C. Applying the arm's length principle

VIII.C.1 In general

Participants contributions and reasonably expected benefits must be consistent with what unrelated parties would agree to. The expectation of a proportionate mutual benefit is fundamental to a CCA. Also, unlike intra-group licensing, participants share proportionately in both the profits and the losses of the development risk (8.12). It is necessary that the value of each participant's contribution must be valued and matched against their expected benefits. As there can be uncertainty, especially for development CCAs, taxpayers should be prepared to substantiate their claims regarding the CCA (8.13).

VIII.C.2 Determining participants

A party without an expected benefit from the CCA, or who cannot exploit its CCA benefit in its own business, is not a CCA participant, but a service provider to the CCA (see 8.18) (8.14). A party is also not a participant if it does not control the CCA risks assumed, or the financial capacity to bear those risks: chapter I.D applies (8.15).

Where contributions are different in nature, 6.64 is applicable regarding the link between the development risk and the other contributions on the one hand and linking development progress with further other contributions on the other (8.16).

A CCA can outsource some of its activities, but at least one CCA participant should control that outsourcing (8.17). If the service provider is a related party to one or more CCA participants, chapters I-III, VI and VII apply (8.18).

VIII.C.3 The amount of each participant's contribution

Expected benefits could be based on additional income generated or costs saved or a relevant allocation key like sales, units used, or headcount (8.19). Projections are needed for future benefits together with the provision for

prospective adjustments to reflect changes in relevant circumstances. In case of significant differences between expected benefits and actual outcomes, tax administrations may enquire what independent parties would do and which developments were reasonably foreseeable, without using hindsight (8.20).

Where an arrangement covers multiple activities, where e.g. not all participants participate (equally) in all activities, different sets of allocation keys may be required per activity. See also chapter VII for indirect allocation methods regarding services (7.23-26) (8.21).

In all cases, prospective adjustments may be needed to account for differences between expected and actual benefits. Thus CCAs should require periodic reassessment (8.22).

VIII.C.4 Determining whether the allocation is appropriate

Each participant's contributions must be valued (8.23). Contributions could be services, development activities or pre-existing tangibles or intangibles. Balancing payments may also be required (8.24). The value attributed at the time of the contribution must be at arm's length (8.25). The value of current contributions must be based on the value of the functions performed, not the potential value of the resulting further application of the technology, or costs (see 6.79) (8.26).

It may be more administrable to pay current contributions at cost. If so, pre-existing contributions should recover the opportunity costs of the ex-ante commitment to contribute. E.g. a contract that commits an existing R&D workforce, should reflect the opportunity costs of alternative R&D endeavours, e.g. a mark-up over R&D costs (see example 1A hereafter) (8.27).

Cost could be a practical means to value current contributions where the difference with value is relatively insignificant, but not for development CCAs (see examples 1-3 hereafter) (8.28). Where cost is permitted the initial analysis should be based on budget. The reason for significant differences between budget and actual could point to changes in the cope of activities that may not be equally beneficial to all. However, in general, where cost is an appropriate basis, actual costs may be an appropriate measure (8.29).

All contributions, including those made at inception of the CCA should be considered. Contributions could include property or services shared with the CCA, in which case the portion of the share should be determined in order to measure the contribution (8.30).

For development CCAs contributions in the form of controlling and managing the CCA, its actions and risks are generally important functions (8.31). E.g. ACo in A and BCo in B conclude an intangibles development CCA. BCo can exploit it in B and A in the rest of the world; ACo is expected to have 75% of total sales and BCo 25%. ACo and BCo have experience in developing intangibles. ACo contributes pre-existing intangibles and BCo proprietary analytical techniques, both valued under chapters I-III and VI. BCo will further do 80% of day to day research, ACo 20% under a 90:10 A:B leadership. These two current contributions should be valued and analysed separately (8.33).

VIII.C.5 Balancing payments

Where a participant's overall contributions are smaller than its expected benefits, the arm's length principle would generally require balancing payments (8.34). Such adjustments may result from the original CCA agreement or a periodic re-evaluation (8.35). Balancing payments may also be required by tax administrations (8.36).

In development CCAs, variations may occur in a particular year, but if the CCA is otherwise acceptable, tax administrations should look at overall contributions vs overall benefits over a multi-year period and should refrain from single year adjustments (8.37).

In the example in 8.33, ACo's pre-existing contributions is worth 10 mio and BCo's 6 mio. I.e. ACo contributes (10/16 =) 62.5%, but gets 75%. It therefore has to make a balancing payment of (75% x 16mio – 10mio = 12 mio – 2 mio =) 2 million to BCo (8.38).

VIII.C.6 Accurately delineating the actual transaction

The actual transaction under I.D may differ from the CCA terms. E.g. one party may not have a reasonable expectation of a benefit and parties may have focussed more on a tax benefit than on cooperation. If one party performs nearly all the CCA activity, or significant balancing payments are made that may indicate a funding transaction instead (8.39).

The guidance on hard-to-value intangibles of VI and commercial rationality of I.D.2 apply to CCAs as well (8.40)

VIII.C.7 The tax treatment of contributions and balancing payments

These should be treated like the same activity would be treated under the general rules of tax systems outside of a CCA (8.41). Balancing payments

are an additional contribution by the payer and a reduction in the contribution of the payee (8.43)

VIII.D. CCA entry, withdrawal, or termination

Membership changes trigger a reassessment of participants proportionate shares. A new participant obtains an interest in previous CCA activity from the existing participants. The latter must receive an arm's length compensation, a 'buy-in payment' (8.44). The payment should consider the entrant's share in the overall expected benefits and value of any of its pre-existing contributions (8.45). A departing participant disposes of its interest in the results of past CCA activity and could demand an arm's length 'buy-out payment' (8.46). Service CCAs may require no payments as their contributions and benefits tend to be current.

Chapters I-III and VI are fully applicable for all payments. (8.47). Buy-in and buy-out payments should be treated like the same acquisitions/disposals would be treated under the general rules of tax systems outside of a CCA (8.48).

When a CCA terminates, each participant retains an interest in the results of the CCA activity or is appropriately compensated for loss thereof (8.49).

VIII.F. Recommendations for structuring and documenting CCAs

A CCA agreement should: a) only include parties expecting to derive proportionate benefits from the CCA; b) specify the nature and extent of each participant's interest in CCA results and their share of the benefits; c) allow contributions, balancing and buy-in payments only for beneficial CCA interests; d) determine shares of contributions in accordance with the transfer pricing guidelines, including balancing payments; e) provide prospective changes to reflect material changes in proportionate benefits among participants; f) and make adjustments upon entrance to and exit from the CCA (8.50).

Chapter V requires the master file to include important intercompany service agreements such as CCAs and the local file to include descriptions of intercompany transactions. This requires all CCA participants to have full access to details of the CCA activities, the identity and location of parties involved, projections upon which contributions and benefits are based, and budgeted and actual expenditures. If these are not included in the master and local files, it should be made available upon request (8.51).

Useful information concerning the initial CCA terms include: a) a list of participants and b) parties otherwise involved with the CCA; c) the activities of the CCA and how they are managed and controlled; d) its duration; e) manner of measuring benefits and projections used; f) how expected future benefits will be exploited; g) form and value of initial contributions and valuation of ongoing contributions; h) allocation of DEMPE responsibilities for assets and how they will be managed and controlled; i) exit and entrance procedures; and j) provisions for balancing payments and adjustment procedures (8.52).

Useful information over the duration of the CCA include: a) changes made and their consequences; b) a comparison of projections to the actual sharing of benefits; and c) annual expenditure in the CCA, the form and value of contributions and how contributions are valued (8.53).

Annex to Chapter VIII – Examples to illustrate the guidance on cost contribution arrangements

Example 1

Contributions should be assessed at arm's length prices to produce arm's length results (1). ACo and BCo enter into a CCA. ACo performs Service 1; BCo Service 2. Both companies "consume" both services (2). The costs and value of the services are as follows (3):

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 * 120 per unit)	3 600	(63% of total contributions)
Value of contribution made by Company B (20 units * 105 per unit)	2 100	(37% of total contributions)
Total value of contributions made under the CCA	5 700	

ACo provides 30 units of Service 1 and BCo 20 units of Service 2. The CCA calculation of costs and benefits are: ACo and BCo each consume 15 Service 1 and 10 Service 2 units: ACo's benefit (4):

Service 1: 15 units * 120 per unit	1 800	
Service 2: 10 units * 105 per unit	1 050	
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	1 050	
Total	2 850	(50% of total value of 5 700)

The value of each company's contributions should correspond to their respective expected benefits, i.e. 50%. The total value of contributions is 5 700, so each party contribute 2 850. ACo's contribution is 3 600 and BCo's 2 100. Thus, BCo should pay ACo 750 (5).

If contributions were measured at cost both companies would contribute 50% of the total costs, or 2 500 each. BCO would then pay ACo 500 (instead of

750) (6). In the absence of the CCA, ACo would buy 10 Service 2 units for 1 050 and BCo 15 Service 1 units for 1 800, resulting in a payment of 750 from BCo. This shows that the arm's length result is only achieved when CCA contributions are measured at value (7).

Example 1A

The facts are the same as Example 1. Under paragraph 8.27, an alternative way to achieve the same result is through the following two-step process (8).
Step 1 (contributions measured at cost): ACo bears 50% of the total cost of 5 000 = 2 500. ACo's cost is 3 000 and BCo's 2 000. BCo should pay ACo 500 (9).
Step 2 (accounting for additional contributions): ACo produces 20 value above costs per unit; BCo 5. ACo consumes 10 Service 2 units (50 value over cost); BCo 15 Service 1 units (300 value over cost). Accordingly, ACo should be compensated 250 for its additional 250 contribution (10).

The two-step method provides for sharing of costs plus separate payments for additional value contributions. This might reflect pre-existing contributions, like intangibles owned by one of the participants and may therefore be most usefully applied to development CCAs (11).

Example 2

Same facts as Example 1, except the per-unit value of Service 1 is a low-value 103. The calculation of the costs and value are as follows (12):

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 contributions)
Value of contribution made by Company B (20 units * 105 per unit)	2 100	(40.5% of contributions)
Total value of contributions made under the CCA	5 190	

Under the CCA ACo's and BCo's contributions should correspond to their shares of expected benefits, i.e. 50%. Total contributions = 5.190, so each must contribute 2 595. ACo contributes 3.090 and BCo 2.100. So, BCo should pay ACo 495, thus "topping up" its contribution to 2.595 and reducing ACo's by the same (13).

Since all contributions are low-value services, contributions may be valued at cost. The cost of ACo's contribution is 3.000 and BCo's 2.000. Accordingly, BCo should pay ACo 500 (14).

Example 3

Same facts are as Example 1, except that the per-unit value of Service 2 is 120 (same as Service 1 and not low value) (15).

Benefit to Company A:		
Service 1: 15 units * 103 per unit	1 545	
Service 2: 10 units * 105 per unit	1 050	
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	1 050	
Total	2 595	(50% of total value of 5 190)

ACo and BCo each consume 15 units of Service 1 and 10 units of Service 2:
Benefit to Company A:

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 * 120 per unit)	3 600	(60% of total contributions)
Value of contribution made by Company B (20 units * 120 per unit)	2 400	(40% of total contributions)
Total value of contributions made under the CCA	6 000	

Service 1: 15 units * 120 per unit	1 800	
Service 2: 10 units * 120 per unit	1 200	
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	1 200	
Total	3 000	(50% of total value of 6 000)

The total value of contributions is 6.000, so each must contribute 3.000. AC's contribution is 3.600. BCo should make a balancing payment of 600. Example 3 shows that assessing contributions at cost is not arm's length even where the arm's length mark-up is identical (16).

Example 4

ACo and BCo undertake the development of an intangible through a CCA. The intangible should be highly profitable based on BCo's existing intangibles, track record and experienced R&D staff. ACo performs, through its own personnel, all the expected functions for an independent exploitation right in the resulting intangible under paragraphs 8.14 to 8.18. The intangible takes five years to develop before commercial exploitation and is anticipated to have value for ten years thereafter (17). ACo contributes to development funding (USD 100 million per year for five years). BCo contributes the development rights irrespective of the outcome of the CCAs objectives and performs all DEMPE activities. The value of BCo's contributions must be determined under Chapter VI (18). The intangible is anticipated to result in global profits of USD 550 million per year (years 6 to 15). BCo will have exclusive exploitation rights in country B (USD 220 million per year in years 6 to 15) and ACo can exploit the intangible in the rest of the world (USD 330 million per year) (19).

Considering ACo's and BCo's realistic alternatives, ACo's contribution value equals a risk-adjusted return on its R&D funding commitment. This is USD 110 million per year (for years 6 to 15 - the example assumes that a funding investment of USD 100 million should earn profits of USD 110 million per year; this is no guidance as to an arm's length price), not the CCAs USD 330 million. Therefore, ACo needs to pay for this additional value through balancing payments of USD 220 million per year in years 6 to 15 (20).

Example 5

Same facts as Example 4 except the functional analysis indicates ACo has no capacity to make decisions to take on or decline the risk-bearing opportunity of its participation in the CCA. It also has no capability to mitigate the risks (21). In accurately delineating the transactions, the functional analysis therefore indicates that ACo is not entitled to a share in the CCAs output (22).

IX transfer pricing aspects of business restructurings

While governments cannot tell MNE's how to (re)structure their business, they can require that when taxpayers give up their future profits to group companies, they do it for the same price as for which they would give up those profits to third parties.

This is a long chapter in five parts: a definition of business restructurings (Introduction); a description of the link between risk and profits and the transfer of both (Part I); determining arm's length payments at the time of the restructuring (Part II) and thereafter (Part III); and identifying the actual transactions and recharacterisation (Part IV).

IX Introduction

What is a business restructuring? This part defines the transactions and issues covered (A) and the chapter's relation to article 9 of the OECD MC(B).

IX.A Scope

IX.A.1 Business restructurings that are within the scope of this chapter

A business restructuring is the cross-border reorganisation of commercial or financial relations between related enterprises. Relationships with third parties may be a reason (9.1). Business restructurings typically consist of converting enterprises with relatively higher levels of functions or risks into ones with relatively lower levels, centralizing valuable intangibles, or regionally centralising functions such as procurement (9.2).

IX.A.2 Issues that are within the scope of this chapter

This chapter discusses the transfer pricing aspects of business restructurings within the context of article 9 (9.5). Business restructurings typically reallocate profit potential, so how does the arm's length principle apply in a realistic, pragmatic manner (9.6)? This chapter does not cover article 7 (see AOA), domestic anti-abuse rules (e.g. CFC), or VAT (9.7-8).

Applying article 9

The arm's length principle applies to business restructurings just as it does to other intercompany transactions. The question is what unrelated parties would do in similar circumstances. The guidance in this chapter should be applied in accordance with the rest of the guidelines, in particular chapter 1 (9.9).

Part I – Arm's length compensation for the restructuring itself

IX.I.A. Introduction

A business restructuring may involve cross-border transfers of something of value or renegotiation of existing arrangements. First, one must accurately delineate the transactions that comprise the business restructuring by identifying the commercial or financial relations involved and the conditions attached to those relations, see section B. Section C discusses the recognition of those accurately delineated transactions and section D the relationship between a business restructuring and the reallocation of profit potential. Section E deals with the transfer pricing consequences of transferring something of value and section F, the consequences of renegotiating existing arrangements (9.10).

The arm's length principle is tested per associated enterprise. The fact that a business restructuring makes sense at a group level, does not eliminate individual restructured entity perspectives (9.12).

IX.I.B. Understanding the restructuring itself

The arm's length principle requires the accurate delineation of the controlled transactions comprising the business restructuring, being:
i) the identification of the commercial or financial relations between the associated enterprises; and
ii) the conditions and economically relevant circumstances attaching to those relations.

Particularly relevant aspects of the commercial or financial relations between the parties are:
• The distribution of functions, assets, and risks before and after the restructuring (section B.1);
• The business reasons and expected benefits (section B.2);
• Other realistically available options (section B.3).

Chapter I, section D.1 is particularly relevant and requires the examination of the contractual terms of the business restructuring (section D.1.1); the functions performed by each party before and after the restructuring (section D.1.2); the economic circumstances of the parties (section D.1.4) and their business strategies (section D.1.5).

Finally, compare the accurately delineated transaction to comparable transactions between independent enterprises (see paragraph 1.33) (9.13 & 14).

IX.I.B.1 Identifying the restructuring transactions: functions, assets, and risks before and after

Business restructurings can take various forms and involve two or more companies (9.15). It is important to accurately delineate the transactions and the functions, assets, and risks before and after; see chapter 1.D (9.16). Conditions formalised in writing provide a starting point for delineation. Where there are no written documents or parties' actual behaviour differ materially, the actual transactions must be deducted from parties' conduct (9.17). Accurate delineation requires a functional analysis, focussing on what parties actually do pre- and post-restructuring (9.18).

IX.I.B.1.1 Analysing risk in the context of business restructurings

The profit potential of a commercial opportunity is affected by the risks associated with that opportunity. Profits or losses resulting from the opportunity are allocated in accordance with the assumption of those risks. Therefore, risk allocation before and after a restructuring is an essential part of the functional analysis for tax administrations (9.19). The 6 steps of section I.D.1.2.1 is applicable for determining which party assumes a specific risk by reference to control and financial capacity. E.g. an analysis may show that the same party that bore inventory risk before a restructuring also bears it thereafter (9.20).

A second example would concern credit risk. A 1.64 and 1.65 analysis will show which party has the capability to control the risk and financial capacity to assume it. You cannot transfer a risk you did not assume before and you should get profit potential after you assumed the risk. E.g. if a fully-fledged distributor is reimbursed by an associated enterprise for bad debts, then the fully fledged distributor cannot transfer a bad debt risk (9.21).

It is important to assess whether a risk is economically significant and therefore allows a significant reallocation of profit potential. Significance is determined by size and likelihood of materialising. Accounts may provide info if recorded (e.g. bad debts and inventory write downs), but many risks (e.g. market risks) are not accounted for (9.22). E.g. when converting a full-fledged distributor to a limited-risk one, authorities may analyse inventory risk in terms of: its role in the business model (e.g. speed to market); its nature (perishable or not); investment levels; causes of write downs; historic write downs; insurance costs and history of damage (9.23).[13]

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IX.I.B.2 Understanding the business reasons for and expected benefits from the restructuring, including synergies

Business explained that MNEs increasingly need business restructurings to centralize, due to global competition, economies of scale, specialization, and efficiency. At the time of business restructuring, it is good taxpayer practice to document anticipated synergies per entity, and assumptions used (see section I.D.8). Where deliberate actions are taken, the enterprises contributing to the synergies should be compensated after the restructuring (9.24). E.g. a group may centralise its procurement function (as in paragraph 1.160). The procurement company may assume risks associated with buying, holding, and on-selling goods and should be compensated for them, in accordance with their economic significance. However, profits from the group's purchasing power must be passed on to the participants generating that power (paragraph 1.168) (9.25).

Anticipated synergies may not be increased profits, but simply keeping competitiveness (9.26).

IX.I.B.3 Other options realistically available to parties

Independent enterprises will consider realistically available options and choose the most attractive (9.27). A tax administration should evaluate each accurately delineated transaction in determining whether there are clearly more attractive opportunities realistically available, if need be, in the context of a broader arrangement (9.28).

At arm's length, it may be that there are no options, e.g. a customer evoking an exit clause in a long-term contract. If the restructured party transfers rights or assets, it should be compensated as discussed under E below (9.29). However, it may be that an entity has more attractive options realistically available, including the option not to enter into a restructuring, and adjustments may be necessary (9.30). Not every realistically available option has to be documented, just ones that are clearly more attractive should be considered (9.31).

IX.I.B.4 Transfer pricing documentation for business restructurings

The master file and local files require details of business restructurings (9.32). MNEs are recommended to document their business restructuring decision and intentions up front, especially regarding risk assumptions and transfers, using the framework of section I.D.1.2.1 (9.33).

IX.I.C. Recognition of accurately delineated transactions that comprise a business restructuring

MNEs are free to organise their business operations as they see fit. In making commercial decisions, tax considerations may be a factor. Tax administrations, however, have the right to determine the tax consequences of the structure put in place (9.34). Business restructurings often lead to global business models, hardly found between independents, e.g. global supply chains. This does not mean the restructuring is not at arm's length. A tax administration should not disregard a restructuring unless paragraph 1.122 applies. In that case, the substituted structure must align with the actual facts. E.g. where a factory is closed-down, a recharacterisation cannot ignore the shutdown and where substantive business functions are actually relocated, that relocation cannot be ignored (9.35). While it is generally appropriate to look at the commercial rationality of a business restructuring for an MNE as a whole, business restructurings involving different unrelated elements, should be considered element by element (e.g. moving intangibles unrelated to the centralisation of a procurement function) (9.36). In addition, the arm's length principle should still be tested at the level of the separate entities involved (9.37).

The fact that a business restructuring is tax driven, does not have to mean that it is not at arm's length (this chapter does not cover domestic anti-abuse rules, see 9.8). However, if the MNE group is worse off on a pre-tax basis, the commercial rationality may be questionable (see paragraph 1.142) (9.38).

IX.I.D. Reallocation of profit potential under a business restructuring

IX.I.D.1 Profit potential

Independent enterprises are not always compensated for changes in their profit potential; the question is where that is the case. See subchapters E and F hereafter (9.39). Profit potential means expected profits. It is often used for valuation purposes of intangibles, ongoing concerns, or indemnification for changing existing arrangements (9.40). Profit potential is not simply the profits from the indefinite continuation of the status quo: a party may have no rights or assets and thus no compensable profit potential (9.41).

IX.I.D.2 Reallocation of risks and profit potential

The general guidance on risks is found in section I.D.1.2.1, which should be applied to business restructurings (9.43). E.g. a fully-fledged manufacturer or distributor being converted to a contract manufacturer or commissionaire. The question is whether compensation is due for the change in risk profile, whether the restructured entities are better or worse off and whether risks are assumed in accordance with section I.D.1 (9.44-45). This

will depend on the profit potential before and after and the expected duration of the new arrangements. It is necessary to evaluate whether historic profits are an indicator for future profit potential. The distributor may have had volatile, or high historic profits and expected volatile, medium or high profits for the near future. Different future expectations would make a guaranteed two percent profit going forward more, or less, attractive (9.46). An independent party may trade high volatility for low stability, where future profits hover around zero or a low multiple year average, it would generally not do so where profits are generally high, always positive, but volatile, whilst it might do so if profits were historically low to medium but there are significant new risk factors at play (9.47).

IX.I.E. Transfer of something of value

IX.I.E.1 Tangible assets

Transfers of tangible assets generally do not raise significant transfer pricing issues, except for inventories (9.49). E.g. if a fully-fledged manufacturer and distributor become a toll manufacturer/stripped distributor, inventory risks are transferred to the new principal. What are the arm's length prices for existing inventory, based on a comparability analysis? It could be CUPs for raw materials and finished goods; resale minus for finished goods (less compensation for unperformed functions); or cost plus, if the market value allows for a plus (9.50-52). The choice of method depends on who is the least complex. See paragraphs 3.18-19 (9.53).

In practice, third parties would likely consider inventory as part of the total deal (9.54).

IX.I.E.2 Intangibles

It can be difficult to identify and value transferred intangibles. Intangibles include patents, trademarks, trade names, know how, trade secrets, customer lists and distribution channels (9.55). The determination of the arm's length price should be conducted in accordance with section VI.D.1 (9.56).

IX.I.E.2.1 Disposal of intangibles or intangible rights to a foreign central location

Some business restructurings centralize intangibles, such as manufacturing patents, for sound business reasons; others use intangibles (as licenses) without transferring them. It is important to remember that the legal ownership of an intangible by itself does not confer any right ultimately to retain returns derived from exploiting the intangible (see paragraph 6.41); the compensation required to be paid to 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 (see paragraph 6.54) (9.57). E.g. where a group centralises its patents, it is important to delineate the actual transaction and understand whether they do this for administrative simplicity (see example 1 to chapter VI), or whether the DEMPE characteristics of parties are changed (9.58).

However, sound commercial reasons for an MNE group, may not be sound for individual entities; the arm's length test must be applied at the level of each entity (9.59).

The transfer and licensing back of intangibles should also be assessed from all parties' perspectives, in particular analysing risk control and the performance of DEMPE functions (9.60). With independent parties, there will generally be a correlation between the transfer price and the license back price: e.g. it will not transfer for 100 to license back for 10 years at 100 per year. Either one of the prices is not at arm's length, or the arrangement should be delineated as something else, such as a financing arrangement (see example 16 in chapter VI) (9.61).

IX.I.E.2.2 Intangible transferred at a time when its valuation is highly uncertain

Valuation in the pre-exploitation phase can be difficult. The question is what independent parties do with high uncertainty. See section VI.D.3 (9.62). If the intangible is a hard to value intangible, section VI.D.4 is applicable (9.63).

IX.I.E.2.3 Local intangibles

When converting fully fledged entities to limited risk ones, the question is whether local intangibles remain with those entities (9.64). E.g. a distributor's remaining local marketing intangibles should be considered in post business restructuring functional analysis if it continues to perform DEMPE functions related to these intangibles (see section VI.B.2.1) (9.65).

IX.I.E.2.4 Contractual rights

Contractual rights can be valuable intangibles and should be compensated at arm's length (9.66). If an entity voluntary foregoes benefits in favour of another, e.g. by cancelling valuable long term contracts to allow another group entity to enter into similar contracts, profit potential may be transferred (9.67).

IX.I.E.3 Transfer of activity (ongoing concern)

IX.I.E.3.1 Valuing a transfer of activity

The transfer of a business activity can involve tangibles, intangibles, and liabilities. The valuation should reflect all elements e.g. for R&D activities, it could be the possible value of the workforce in place (see section I.D.7) (9.68). Valuation of the aggregate may be greater, and more reliable, than the valuation of the separate parts. Valuation methods from third party acquisitions could be useful, see the guidance of section VI.D.2.6.3 (9.69). E.g. if manufacturer M1 transfers its manufacturing activity (machines, inventories, know-how and contracts) to M2, this is not a transfer of separate assets only (9.70).

IX.I.E.3.2 Loss-making activities

If a business restructuring saves an entity from (further) loss making, the entity is not losing a profit making opportunity (9.71). Compensation for the transferee depends on what third parties would do (9.72). However, a loss making activity could provide synergy (cheap printers, expensive ink), or group benefits; the group should compensate the loss maker for the latter (see section I.D.3) (9.73).

IX.I.E.4 Outsourcing

In outsourcing, a party voluntary restructures in exchange for savings. Independent parties do not necessarily require explicit compensation if the anticipated savings outweigh the restructuring costs. See also chapter I.D.6 and IX.II.E on location savings (9.74).

IX.I.F. Indemnification of the restructured entity for renegotiation of existing arrangements

The question is whether a restructured entity should be compensated in any way (9.75). A restructured entity may suffer restructuring costs (write offs, dismals), re-conversion costs and/or a loss of profit potential (9.76). If something of value is transferred, section E applies (9.77). Not all restructurings require indemnification. Whether compensation is due depends on facts circumstances as determined by accurately delineating the arrangements before and after the restructuring, and the realistically available options (9.78). After accurate delineation, the following should be considered:

1. does commercial law support indemnification (see F1 below);
2. is the existence or absence of an indemnification clause at arm's length (see F2 below); and
3. which party should bear the indemnification costs (see F3 below) (9.79)?

IX.I.F.1 Whether commercial law supports indemnification of the accurately delineated transaction

Possible recourse under commercial law might provide helpful insights. Under such rules, a terminated party may have a right to compensation even in the absence of an indemnification clause (9.80).

IX.I.F.2 Whether the indemnification clause, as accurately delineated, is at arm's length

The contract should be the starting point to review whether an indemnification clause was in place and was respected. However, this may not suffice as the contract may not be at arm's length (9.81). The divergent interests of independent parties ensures that i) contractual terms reflect both their interests; ii) that parties keep each other to the contract; and iii) only deviate from the contract if it is in the interest of both (see 1.46) (9.82). If the contractual indemnification is comparable to that between independent parties in comparable circumstances, it is at arm's length (9.83). If not, the rights and assets of parties should be considered at the time of concluding the contract and renegotiating it, in view of the options realistically available to parties; see section I.D and section IX.B (9.84). Another aspect to examine is the correlation between the normal terms of the contract and the termination terms, as they influence the distribution of risks between parties during the contract and upon termination (9.85). E.g. a business restructuring may lead to the termination of employment contracts and whether such costs should be reflected in the indemnification (9.86).

If a changed agreement required a significant investment, this creates an investment risk if the investment cannot be used for other clients (9.87), e.g. a highly specialized manufacturing plant. If a customer can cancel such a contract after three years, whilst the earn back period is five, the manufacturer would have to write off the plant (9.88). An independent party will mitigate that risk and may require an indemnification clause, a put option, or a higher production price per unit for taking on the early termination risk (9.89).

In general, mitigation of risk is only relevant if the risk is actually assumed. See Example 2 in paragraph 1.84 and paragraph 1.102 where risks are controlled solely by another entity and the manufacturer should not suffer the financial consequences of early termination, as it did not control that risk (9.90). A similar issue may arise where development efforts lead to early losses recaptured by later profits; does the developer share in the results, or merely accepts deferred payments? See Section I.D.1.2.1 (9.91).

IX.I.F.3 Which party should ultimately bear the costs of indemnification

The analysis should consider the perspectives of both parties and the answers will depend on facts and circumstances (9.93). E.g. B manufactures for related party A; A changes the contract from B to related party C. If B can get indemnification, should it be paid by A, C, or another party? Start with the accurate delineation of the actual transactions (9.94). A might pay, if the payment is smaller than its savings with C (9.95). C might pay (B, or A, or B through A) if the NPV of its future income will exceed the payment (9.96). A and C might share. Finally, another party might pay if benefits accrue to it (9.97).

Part II – Remuneration for post-restructuring controlled transactions

If future profits (profit potential) were moved away from a restructured entity, should this entity, or could it, receive compensation on top of, or instead of, the compensation received at the time of the business restructuring? First, the difference between structuring (no profit potential moved and thus no future compensation) and restructuring is discussed (A). Then, guidance is given for the most appropriate transfer pricing method for post-restructuring compensation (B). The next two subchapters deal with the relation between the restructuring and the post-restructuring compensation (C) and the pre- and post-restructuring situations (D). Finally, location savings are discussed (E) and an example of a business restructuring is given (F).

IX.II.A Business restructuring versus "structuring"

IX.II.A.1 General principle: same application of arm's length principle

The arm's length principle is not different for post-restructuring transactions than for first set-up transactions; to do so would create competitive distortions (9.98). However, a business restructuring involves changes, meaning additional transactions to which section IX.1 apply (9.100). A comparability analysis may also reveal factual differences, which may affect the comparability analysis; see section IX.D (9.101).

IX.II.A.2 Possible factual differences between restructured situations and first setup situations

Differences can arise, e.g. where restructured entities had previous arrangements in place and first setup entities had none. Such previous arrangements may limit the options available (see paragraphs 9.27-9.31). E.g. a well performing fully fledged distributor would not need a trial period to show its worth, whereas a new one would (9.102). An ongoing business relationship may also create an interrelationship between pre- and post-restructuring arrangements, see section C hereafter (9.103). Another

difference would be market penetration, needed by a new entrant, but not a converted distributor (9.104). When an established fully fledged distributor is converted to an LRD, it may differ from an existing LRD, because of its past functions, assets, and risks. Question is if such functions, assets, and risks, e.g. intangibles, affects pre-restructuring, post restructuring, or restructuring compensation or a combination thereof (see section X.I.E.2 and chapter VI) (9.105). A related question is whether a transfer of risks concerns only future risks, or where the cut-off should lie, e.g. regarding bad debts (see section I.D.1.2.1) (9.106).

IX.II.B Application to business restructuring situations: transfer pricing method for post-restructuring controlled transactions

The selection of a transfer pricing method is determined by an analysis of the economically relevant characteristics of the accurately delineated transactions. The label formally given to the transaction is of little relevance. E.g. a "commissionaire" can still have intangibles or market risks and a contract manufacturer unique know how. The compensation does not dictate risk allocation or the most appropriate method: it is actual risk control and financial capacity to bear risk that does (9.108).

Comparables may be a problem for business models hardly found between independent enterprises; however a lack of comparables does not mean that the transaction is commercially irrational (9.110). CUP's may be available for manufacturing, sales, and some services, including outsourcing (9.111). A comparability analysis should identify material differences and necessary and possible adjustments (9.112). Though data will not always be perfect, or available, a reasonable solution should be found, using the most appropriate method to the nature of the transaction (9.113).

IX.II.C Relationship between restructuring and post restructuring compensation

There can be a relationship where a taxpayer disposes a business to a related party with whom it should contract thereafter; see 9.74 (9.114). Likewise, for a manufacturer/distributer, transferring its distribution activities to a party to whom it then sells its manufactured products. Such a manufacturer could receive its transfer compensation upfront, or through higher future sales prices (9.115). Such agreements may be difficult to monitor for tax administrations and they need to look at the entirety of the arrangements (9.116).

IX.II.D Comparing pre- and post-restructuring situations

A comparison of pre- and post-restructuring transactions for transfer pricing is not conforming article 9, as neither involve uncontrolled transactions; this is different from the profit potential in IX.I (9.118). In addition, it is not always all functions, assets and risks that are transferred to the other party (9.119). However, such a comparison may help to understand the restructuring itself and the available options[14] (9.120). The analysis of the business before and after a restructuring may reveal that the restructured entity still performs a number of functions, but under contract. An actual delineated transaction will guide to an arm's length price (9.121).

E.g. An MNE manufactures and sells products of which the value is determined by the brand. Group manufacturers and distributors receive routine compensations while Company A employs 125 people to perform the DEMPE functions of the brand. Company A gets the residual profit. Then a restructuring takes place and the brands are moved to Company Z, managed by a local trust company. Company A's management flies to Z once a year to validate strategic decisions. Company A still has 125 employees fulfilling the same DEMPE functions, but now on a cost plus basis. An accurate delineation of the restructuring lead to the conclusion that this is in fact a funding arrangement between Company A and Company Z and that the commercial rationality should be tested under Section I.D.2 (9.122-9.124).

IX.II.E Location savings

A business restructuring may relocate activities to a place where costs (labour, real estate) are lower. See section I.D.6 (9.126). The question is how independent parties would share such savings (9.127). E.g. a company in A designs, manufactures and sells brand name clothes. It moves manufacturing to low cost country B. As the garment industry is highly competitive with many third party contract manufacturers, it is unlikely that B can keep the location savings (9.128 - 129).

In another example A in X provides highly specialized engineering services. X wages are high, so A opens B in Y where similar quality services are cheap. A outsources to B. If B's services are unique, restricting A's options, A may be forced into a profit split with B (9.130-9.131).

[14] See 9.27-31 for realistic available options and 9.102-106 for pre- and post-restructuring

X Financial transactions

X.A Introduction

X.B Interaction with Section D.1 of chapter 1

Chapter X.B looks at whether a loan is actually a loan and the five comparability factors surrounding loans. It summarise characteristics of debt instruments and the functions of lenders and borrowers.

X.B.1 Should a purported loan be treated as a loan

The commentary to art. 9 the OECD MC paragraph 3(b) notes that article 9 is also relevant to determine if a loan is a loan (10.5). Sections I.D.1 and I.D.2 apply (10.6-7). National law may take other approaches to delineate debt, which is allowed. This section gives guidance for countries using chapter I (10.8-10). Transaction labels do not constrain the transfer pricing analysis of what is a loan (10.11).

Economically relevant characteristics to delineate a transaction include: fixed repayment dates; interest; the right to enforce payment; rank of the funding; financial covenants and security; source of interest; ability of the borrower to get loans for third parties; use of funds for capital assets; and failure of repayment. E.g. BCo receives funds from related party CCo denominated as 10-year loan. It is clear that BCo cannot service the full loan and that a third party would not provide such a loan. Accurately delineated for purposes of the interest BCo would pay at arm's length, the maximum that a third party would lend BCo (if anything at all – see X.C.1.1.1 on lender and borrower perspectives) is a loan, the rest is not (10.12-13).

X.B.2 Identifying commercial and financial relations

Chapters I-III apply. Accurate delineation requires considering the relevant industry sector factors affecting business performance, such as capital intensity, different commercial needs, or industry regulations (10.14-15). It requires an understanding of how the MNE responds to those factors, e.g. prioritising different projects, significance of an individual group member, or whether there are group debt:equity ratios (10.16).

Accurate delineation also requires investigation into the 5 comparability factors and a consideration of what independent parties would do (10.17-18). Independent parties would consider all realistically available options (see 1.38) for both parties (see X.C.1.1.1) (10.19). It is likely that potential comparables will differ from the tested transaction and require comparability adjustments if possible. Quantitative factors (e.g. currency differences) may be easier to adjust than qualitative ones (e.g. debtors with different business strategies) (10.20).

X.B.3 Economically relevant characteristics of actual financial transactions

X.B.3.1 Contractual terms

Contractual terms between related parties may not be detailed enough; it may be necessary to look at other documents and consider the actual conduct of parties and the economic principles that govern independent relationships (1.22).

X.B.3.2 Functional analysis

For an intra-group loan, the key functions of the lender are: an evaluation of the loan risks; having the capital required; determining the loan terms; organising; and documenting the loan. The functions that would have been performed by an unrelated lender are relevant (10.24). If the lender is not controlling the risks or lacks financial capacity, those should be allocated to the party that does. E.g. ACo lends funds to BCo. Accurate delineation shows that actually ParentCo controls the loan risk and has the capacity to do so. Then ACo is only entitled to a risk-free return (see I.D.1.2.1) (10.25).

The key functions for the related borrower are: ensuring the availability of funds to repay the principal and interest; providing collateral; and monitoring and fulfilling all other loan obligations (10.26).

If an entity is both lender and borrower (e.g. centralised treasury) consider chapter X.C, in particular 10.44 and 10.45 (10.27).

X.B.3.3 Characteristics of financial instruments

There are many different financial instruments. It is important to document a transaction's features and attributes (e.g. amount, maturity, repayment schedule, purpose, seniority, geographical location, currency, collateral, guarantees, and fixed or floating interest) (10.28-29).

X.B.3.4 Economic circumstances

For comparability, market differences may not affect prices such that reliable comparability adjustments cannot be made (10.30).

Underlying circumstances (currencies, location, regulations, business sector and timing) can substantially change pricing (10.31). So can central bank lending rates or a credit crisis. Thus the timing of the issue is important which makes multiple year data less useful (10.32). Currency differences are important. Different growth rates, inflation rates and volatility in exchange rates can influence prices. Even the same currency may have different prices in different markets due to local regulations and restrictions (10.33)

X.B.3. Business strategies

Different strategies can significantly influence a loan's terms and conditions. E.g. independent lenders may lend in mergers and acquisitions what they

would not otherwise because these are times of change. See also I.D.1.5 (10.34-35). A strategy analysis also includes considering an MNE's global financing policy, existing loans, and shareholder interests. E.g. ACo grants a 10-year loan to related BCo for short term working capital. The group strategy is to use 1-year revolving loans for short term working capital. Therefore, accurately delineated, the ACo-BCo loan may be treated as a 1-year revolving loan instead (10.36-37).

X.C Treasury function

Chapter X.C looks at the treasury function with regard to intra-group loans, cash pools and hedging.

The management of group finances is important and potentially complex. Different treasury structures involve different degrees of centralisation. A centralised treasury has full control over the financial transactions of an MNE, with individual members being responsible for operational matters only (10.39-40).

A key treasury function may be to optimise liquidity across the MNE; this concerns daily operations. Corporate financial management concerns longer term investment strategies and planning. Financial risk management deals with financial risks to optimise the costs of capital (10.41-42). Other treasury activities include debt and equity raising and relationship management with bankers and credit rating agencies (10.43). For TP it is important to delineate that actual individual transactions, not to just label it as "treasury" (10.44).

Generally treasury is a support function (e.g. for cash pools) and chapter VII may apply (10.45). It also could be the central contact point for external borrowing, receiving compensation for its coordination activities (see 1.168) (10. 46). Treasury should receive appropriate compensation for more complex functions (10.47).

Economically significant group risks are generally managed at a group level rather than by treasury itself, although treasury may be responsible for daily execution of managing e.g. investment return levels, cash flow volatility and debt:equity ratios (10.48-49).

X.C.1 Intra-group loans

Chapter X.C.1 deals with the aspects of intra-group financing especially pricing.

X.C.1.1 General considerations

X.C.1.1.1 The lender's and borrower's perspectives

Both the lender and the borrower perspectives should be considered as they may not align. Section I.D.1 applies regarding both parties' risks (10.51-52). The lender will consider factors relating to the borrower and other investment

opportunities. It will include a thorough credit assessment of the borrower including understanding the borrower business and the loan purpose. In considering if an intra-group loan is arm's length, the same processes done by an independent lender are relevant (10.53-55).

With a parent loan, the parent already has control of the borrower. This means that the formal absence of security may be less relevant as the borrower's assets may already be controlled by the parent as collateral (10.56). The lender will also consider changes in the borrower's and the market's economic circumstances in terms of credit risk (10.57).

Borrowers can only use the same asset once as collateral. They will therefore consider pledging collateral against their overall financing and all realistically available options (10.58). They too will consider economic changes and their own risk of default (10.59).

Macroeconomic changes can change finance costs. Possible renegotiations will depend on realistically available options (10.60). Loan conditions may be influenced by regulations e.g. on insolvency law (10.61).

X.C.1.1.2 Use of credit ratings

Credit ratings can serve as a useful measure of creditworthiness. Group membership (implicit support – JHM) is also an economically relevant factor. Creditworthiness can be determined for the whole group/ultimate parent or for a specific debt issuance (10.62-63).

X.C.1.1.2.1 The credit rating of an MNE or MNE group

The rating of an MNE is an opinion of its general creditworthiness. The lower, the more the risk and the higher the price (10.64). Financing transactions with external lenders are also reliable comparables for interest rates (see 10.94-95) (10.65).

Credit rating depends on quantitative and qualitative factors which influence creditworthiness between borrowers with the same rating. There may also be other differences between rated parties such as industry risk (10.66). Start-ups and recent mergers effect credit ratings. Therefore it is important that the MNE documents the reasons for selecting a particular credit rating (10.67-68).

X.C.1.1.2.2 The credit rating of a specific debt issuance

An issuer rating is the rating of an MNE in general. An issue rating is the rating of one particular debt issuance, considering its specific terms. An issue rating for a particular debt is more appropriate to use to price a controlled financial transaction (10.69-70).

X.C.1.1.2.3 Credit rating determinations

In most cases public rates are only available for the MNE group, not individual members. Specific MNEs often use publicly available tools or independent rating agency methodologies to replicate the MNE group rating for the individual member (10.71).

X.C.1.1.2.4 Use of publicly available financial tools or methodologies to approximate credit ratings

These tools depend on first calculating the default probability or likely default losses. The results are then compared to market databases to arrive at a price range. Potential issue is that this is not a direct comparison to an actual transaction. The rating methodology in public financial tools may differ significantly from that of credit rating agencies. The latter are a result of more rigorous analyses. Therefore these tools are more reliable where they can be shown to produce similar ratings than independent credit rating agencies (10.72-74).

Finally, financial metrics use may be influenced by present and past controlled transactions where such transactions are not at arm's length (10.75).

X.C.1.1.3 Effect of group membership

Group membership is important because: 1) the external funding policies of group management informs of the terms and conditions the MNE would accept with independent lenders and 2) the MNE may receive implicit support from the group in case of difficulty (see 1.158) (10.76).

Implicit support does not requirement payment, see Example 1 at 1.164-166 and X.D.3 (10.77). The relative status of a member in an MNE may determine the impact of implicit support: more importance may signal more support. Important members' credit rating will be close to that of the MNE group (10.78). Consequences of supporting or not supporting an MNE member is also a key consideration. Consequences include legal obligations, operational integration, shared names, and reputation. The impact of implicit support is a matter of judgement and support may change according to changes in circumstances; this is not the case with a formal guarantee (10.79-80).

X.C.1.1.4 Use of MNE group credit rating

Due to many variables a separate entity credit rating derived from publicly financial tools (see 10.72) may not be reliable. In such a case the credit rating of an MNE group could be used, especially where the particular member is important to the group. Where an MNE does not have an external credit rating, a credit analysis may be conducted at the group level instead (10.80-81).

X.C.1.1.5 Covenants

Covenants give lenders some protection and limit their risks (10.83). Insurance covenants require or prohibit certain borrower actions without lender consent (e.g. additional debt or disposing of assets) (10.84). Maintenance covenants refer to financial indicators (e.g. debt:equity ratio-JHM) to be met and act as early warning systems; they protect unrelated lenders against information asymmetry (10.85). As there is less information asymmetry within an MNE, the absence of a maintenance covenant may therefore be less relevant for pricing purposes (10.86).

X.C.1.1.6 Guarantees

A lender would need to evaluate the guarantor like it evaluates the borrower to see if the guarantor can cover the borrower. See section X.D (10.87).

X.C.1.2 Determining the ALP of intra-group loans

X.C.1.2.1 CUP method

Widespread borrowing and the availability of information of loan markets make it easy to apply the CUP method. Information available often include details on the loan and the borrower credit rating (10.90).

The interest for a tested loan can be benchmarked against publicly available data of comparable loans, generally resulting in a range of interest rates (10.91). Comparables need not be standalone; a loan to an MNE member from an independent lender, or from one MNE group to a different MNE could be comparable (10.92). Interest can also be based on the return of realistic comparable alternative transactions such as bond issuances, uncontrolled loans, deposits, convertibles, or commercial papers, where needed with comparability adjustments (10.93).

Internal CUPs should not be overlooked. It may be possible to find loans within the MNE with independent lenders (which may need comparability adjustments). See Example 1 at 1.164-166 (10.95).

X.C.1.2.2 Loan fees and charges

Unrelated lenders may charge e.g. commitment fees or arrangement fees. If charged between related parties, they should be evaluated like other intercompany transactions (10.96).

X.C.1.2.3 Cost of funds

This approach can be used in the absence of CUPs. The cost of funds reflects the lender's borrowing costs, plus the expenses of arranging and servicing the loan, a risk premium, and a profit premium (the lender's cost of equity to support the loan) (10.97). This must be considered relative to other lenders' costs of funds as the borrower will favour the cheapest lender (10.98). It

should also consider other realistic available options to the borrower as these may be cheaper (10.99).

In conduit loan situations, it may be more appropriate to use the costs of the agency function than costs of funds, see 7.34 (10.100).

X.C.1.2.4 Credit default swaps

Credit default swaps reflect the risk of the underlying financial asset. Their spreads could be used to calculate the risk premium of intra-group loans (10.101). Credit default swaps may be subject to high market volatility such as their own liquidity or volumes of contracts negotiated. They therefore require careful consideration (10.102-103).

X.C.1.2.5 Economic modelling

Common economic models calculate interest as a risk-free rate plus premiums associated with default risk, liquidity risk, expected inflation and maturity (10.105). Their reliability depend on the parameters factored into them and they do not represent actual transactions. Therefore comparability adjustments may be required (10.106).

X.C.1.2.6 Bank opinions

Written opinions from banks are sometimes referred to as "bankability" opinions (10.107). These are not actual transactions and not actual offers. They therefore generally cannot serve as evidence of arm's length terms and conditions (10.108).

X.C.2 Cash pooling

X.C.2.1 Cash pooling structures

Cash pools can help to achieve more effective liquidity management, reduce external borrowing, and enhance an MNE's aggregated cash balance. It can also reduce financing costs and banking transaction costs (10.109).

Cash pooling is the pooling of cash balances as part of short term liquidity management. A common structure is that members of an MNE conclude a contract with one unrelated bank rendering cash pool services and open bank accounts with that bank (1.110). Two basic cash pooling arrangements are physical and notional; there are more types e.g. involving multiple currencies (10.111).

X.C.2.1.1 Physical pooling

Here the bank accounts of pool members are transferred daily to a central account of the cash pool leader. Deficits are brought to 0. The leader deposits a net surplus or borrows to cover a net debt (10.112).

X.C.2.1.2 Notional pooling

Debit and credit balances are combined without physical transfers. The bank usually requires cross guarantees from cash pool members. The bank notionally charges interest or pays interest on net deficits or deposits (10.113). Transactional costs may be less than in physical pools. The pool leader functions are limited, as should be its compensation; overall savings are shared among pool participants (10.114).

X.C.2.2 Accurate delineation of cash pooling transactions

The delineation depends on facts and circumstances (10.115). Cash pool members with credit positions are not necessarily comparable to normal bank depositors as it is not depositing money (10.116). They are participating in providing liquidity for the benefit of the pool participants (10.117).

Membership should not put members in a worse position than their next best option (10.118). Cash pooling can be treated as harvesting group synergies by deliberate actions (see I.D.8), and the nature of the advantage, the amount of the benefit and the distribution of that benefit must be determined by a functional analysis (10.119-120). An advantage could be less interest paid/more interest received which should be shared among members after the cash pool leader received an arm's length reward under X.C.2.3 (10.121).

Where debit or credit cash pool positions are long term, accurate delineation my treat them as deposits or loans instead. "Long" may be "year after year" (10.122-123).

As tax authorities are national, transfer pricing documentation should provide information on the overall pool structure, the returns to the cash pool leader and the members of the cash pool (10.124).

The economically significant risks of the cash pool (e.g. liquidity and credit risk) must be examined to determine the compensation for the cash pool leader. Liquidity risk comes from mismatches between debit and credit balances of members. Credit risk comes from the possible inability of members to repay their cash withdrawals (10.125-127).

X.C.2.3 Determining the ALP of cash pooling transactions

X.C.2.3.1 Rewarding the cash pool leader function

Generally, cash pool leaders perform co-ordination or agency functions and should receive limited compensation. Other functions should be compensated according to the TPG, as appropriate (10.130-131).

Example 1

Parent XCo has subsidiaries HCo, JCo, KCo and LCo in a physical cash pool with subsidiary MCo as cash pool leader. MCo sets up an arrangement with an unrelated bank. The facility MCo may draw upon is guaranteed by XCo.

MCo pays less interest/receives more interest than if there was no pooling arrangement. A functional analysis shows MCo does not bear credit risk and is just a co-ordinator. MCo should not receive the interest spread reward a bank would, but a compensation for its co-ordination services (10.133-137).

Example 2

TCo performs group treasury functions to other MNE members. TCo raises funds by issuing bonds and borrowing from unrelated banks. TCo operates a cash pool and decides how to invest surpluses, fund short falls. TCo sets intra-group interest rates and needs to cover differences with external rates. TCo bears credit risk, liquidity risk and currency risk. It performs functions and bears risks going beyond mere cash pool co-ordination and has the financial capacity to do so. TCo's compensation may include earning a spread between its borrowing and lending positions, provided pool members are not left worse than their next best option (10.138-142).

X.C.2.3.2 Rewarding the cash pool members

Cash pool members are rewarded after the cash pool leader is compensated by allocating the remaining cash pool benefits (10.143). The compensation depends on facts and circumstances. Then banking arrangements with the cash pool leader and realistic available options of cash pool members may inform what comparable interest rates could be (10.144-145).

All cash pool members should be better off. The benefit could be enhanced interest rates, but also e.g. a permanent source of financing, reduced exposure to external banks or access to liquidity (10.146).

X.C.2.3.3 Cash pooling guarantees

A facilitating bank may require cross guarantees and rights of set-off. This depends on specific facts and circumstances, but in general the cross-guarantees may only represent an acknowledgement that it is detrimental for members not to support the cash pool leader. Thus guaranteed borrowers may not benefit beyond the level of implicit group support in which case no guarantee fees are due. Support in case of default should be treated as a capital contribution (10.147-148).

X.C.3 Hedging

Within an MNE group risks are often hedged centrally on a net basis by treasury. Thus individual entities may be exposed while the group is not (10.150). Mechanisms to centralise hedges include: 1. the identification of the natural hedges within the MNE, so no formal hedging contracts are made and 2. the delegation of responsibility for hedging to an MNE group treasury entity, with the hedging contracts arranged in the name of a. the operating companies; or b. another MNE group entity (10.151).

If treasury arranges the hedge contracts related entities enter into, it should receive a service compensation (10.152). If the hedge and the risk hedged are in different entities (see above), it would be inappropriate to match the hedges in the same entity without the accurate delineation of the actual transactions and their commercial rationality (10.153). *More guidance on paragraph 153 would have been useful – JHM.*

X.D Financial guarantees

First, understand the nature and extent of the guarantees and their consequences. A financial guarantee requires the guarantor to stand in if the guaranteed party fails. Guarantees vary from formal written guarantees to implicit support due to MNE membership. In this section a guarantee is a legally binding commitment (10.154-155).

X.D.1 Accurate delineation of financial guarantees

X.D.1.1 Economic benefit derived from a financial guarantee

The accurate delineation requires consideration of the benefits for the borrower, beyond implicit support (10.156). Guarantees can influence the interest due or the amount to be borrowed (10.157).

X.D.1.1.1 Enhancement of the terms of the borrowing

For the lender, an explicit guarantee reduces the risk, possibly giving the borrower a similar credit rating to the guarantor. Pricing is done as described under X.C.1.2 for loans (10.158). The borrower may be prepared to pay for the guarantee if overall it is not worse off than without the guarantee, taking into account any implicit support (10.159). If the guarantee provides no benefit for the borrower, a third party borrower would not pay for it (10.160).

X.D.1.1.2 Access to a larger amount of borrowing

There are two issues: whether part of the loan is actually a loan to the guarantor and whether the guarantee fee paid for the rest is at arm's length. The loan to the guarantor should subsequently be treated as an equity contribution to the borrower (10.161).

X.D.1.2 Effect of group membership

This section expands on X.C.1.1. Anything less than a legally binding commitment is not an explicit assumption of risk; letters of comfort do not qualify unless they constitute legally binding commitments. No fees are due for implicit support (10.162-163).

A borrower would not pay for a guarantee if it does not expect a benefit from it. Where a formal guarantee only presents an acknowledgement of a pre-existing situation (e.g. the guarantor is already bound to support the borrower through other legal documents or circumstances), no guarantee fee would be due (10.164).

The same applies for cross-guarantees where the facts show that the guarantees do not improve the credit rating of the members beyond implicit support. In case of default the support should be treated as a capital contribution (10.165).

X.D.1.3 Financial capacity of the guarantor

An actual delineation should also consider the guarantor's financial capacity. A guarantee from a guarantor with the same or lower credit rating than the borrower could still provide a benefit for the borrower where the guarantee effectively gives the lender access to wider recourse (10.166-167). The financial capacity also requires investigation to the correlation between the borrower and the guarantor's businesses. Strong correlation may reduce the effectiveness of the guarantee (10.168).

X.D.2 Determining the ALP of guarantees

X.D.2.1 CUP method

The CUP method is usable where independent guarantors provide comparable guarantees. However, it is unlikely to find publicly available information about comparable guarantees between unrelated parties. Also, an independent guarantor's fees will include costs for raising capital and satisfying regulatory requirements, which related guarantors may not incur (10.170-173).

X.D.2.2 Yield approach

This method calculates the difference between the interest due with and without a guarantee (10.174). It is important to distinguish between the benefit from an explicit guarantee and implicit support. Only the benefit of the explicit guarantee beyond that of implicit support can be the basis of a fee (10.175). If the borrower has an independent standalone credit rating, that rating usually includes implicit support (10.176). The borrower has no incentive to pay a guarantee fee equal to or beyond the yield calculated here before (10.177).

X.D.2.3 Cost approach

This method estimates the value of the expected loss of the guarantor or by the capital required to support the risk assumed by the guarantor (10.178).

There are a number of possible calculation models. Popular ones operate on the premise that the guarantee equals another financial instrument such as put options, or credit default swaps and their price approximate the guarantee fee (see X.C.1.2 for reliability of credit swaps) (10.179). Pricing is dependent on the assumptions made and both the perspectives of the borrower and the guarantor should be considered (10.180).

X.D.2.4 Valuation of expected loss approach

This method calculates the probability of default and adjusting for possible recovery rates in case of default. This is applied to the nominal guaranteed amount and the guarantee is priced as a return on the required capital (10.181).

X.D.2.5 Capital support method

Suitable where the difference between the guarantor and the borrower's risk profiles can be addressed by giving the borrower more capital. The guarantee is then based on the return on that capital to the extent it does not stem from the other overall activities of the borrower (10.182).

X.D.3 Examples

X.D.3.1 Example 1

MCo has a AAA rating. Related DCo BBB. Implicit support raises DCo's rating to A and an explicit guarantee from MCo raises it to AAA. An A rating = 8% of interest, and AAA 6%. MCo charges DCo 3% for the explicit guarantee. An independent enterprise would not accept the guarantee as it is better of paying 8% without a guarantee than 6% plus a 3% fee (10.184-186).

X.D.3.2 Example 2

Facts are as Example 1, but a comparable guarantee costs 1-1.5%. An explicit guarantee is a deliberate group action and DCo should be willing to pay 1-1.5% to MCo as it is better off with a guarantee (10.187-188).

E Captive insurance

X.E.1 Definition and rationale for captive insurance and reinsurance

Some MNEs choose to consolidate certain risks through captive insurance. I.e. have an entity whose insurance business is insurance for its related entities (10.189-190). Here, reinsurance means insurance to unrelated captive insurers (See Part IV of the OECD Report on the Attribution of Profits to Permanent Establishments for more detailed definitions.) (10.191). Reasons for captive insurance include stabilising premiums, benefiting from tax and regulatory arbitrage, access to reinsurance markets, mitigating volatility in market capacity, and cost savings. Further, certain risks may be uninsurable with third parties (which may raise commercial reality concerns intragroup) (10.193-194).

X.E.2 Accurate delineation of captive insurance and reinsurance

Remember that risk mitigation is part of risk management but is not risk control (see 1.61 and 1.65); taking on a risk is different from insuring that risk (the functions of the risk taking entrepreneur and the risk insurer are different JHM) (10.195). The reward for the insured party and the insurer can be very different (e.g. the insured may receive much more than it ever paid). The insurer carries out a risk mitigation function without assuming

that risk. The insurer mitigates its risk e.g. by diversifying its portfolio of insured risks (10.196-197).

Captive insurance can be managed internally or by third parties. Internal managers must be identified and appropriately rewarded (10.198). Hallmarks of a genuine insurance business:

- diversification and pooling of risk;
- there is real economic impact for the whole MNE through a better capital position;
- the captive insurer and the reinsurer are regulated under similar regimes;
- the insured risk is insurable with third parties;
- the captive has the required skills including investment skills; and
- the captive has a real risk of suffering losses (10.199).

X.E.2.1 Assumption of risk and risk diversification

Assumption of insurance risk can only take place if the captive has the financial capacity to satisfy claims, which requires consideration of its available capital and realistic options. This requires close chapter I scrutiny where the captive invests its premiums back into related parties (10.202).

Insurance also requires diversification like large commercial insurers do to allow statistical laws of averages to apply (10.203). Diversification includes combining non-correlated risks and varied geographical exposures (10.204). A captive can also diversify by insuring a significant portion of external, non-group risks (10.205). Alternatively the size of the MNE must provide the required breadth and depth of risk diversification, which will require accurate delineation under chapter I (10.206). Exclusive internal risk diversification may generate lower capital efficiencies (10.207) and may under accurate delineation lead to the conclusion that the captive is not running an insurance business (10.208).

X.E.2.2 The assumption of the economically significant risks

The economically relevant risks associated with the insurance policies must be identified with specificity. See the Authorised OECD Approach to PE profit allocation for a description of those risks as well as the activities that form part of the underwriting function. To have control, the captive cannot only set parameters for insurance policies or control the policy environment, but must actively decide which risks to underwrite and under what terms and conditions and whether to reinsure (10.209-211).

If the captive does not have the required skills, an accurate delineation may not allocate the insurance premiums and their returns to the captive, but to the group member actually assuming and controlling the risk (10.212).

X.E.2.3 Outsourcing the underwriting function

Where outsourcing is permitted, special consideration is considered to determine if the captive is controlling that outsourcing (10.213).

X.E.2.4 Reinsurance captives – Fronting

A reinsurance captive is a captive insurer issuing reinsurance under a fronting arrangement. In fronting the first contract of insurance is between an MNE group member and an unrelated insurer (the fronter); the second is a reinsurance between the fronter and the group captive insurer. The fronter receives a commission to cover its costs and any part of the risk that it retains (10.214). The key issues in accurately delineating the transaction are whether the transactions are genuine insurance/reinsurance and whether premiums are at arm's length (10.215).

X.E.3 Determining the ALP of captive insurance and reinsurance

X.E.3.1 Pricing of premiums

CUPs may be available (10.217). They may encounter difficulties in determining comparability adjustments. Differences with comparables may include less functions performed by the group company, less business volume, or less capital (see 10.221) (10.218).

Alternatively an actuarial analysis may determine the likely arm's length premium. However, this may be complex, does not cover actual transactions and may require comparability adjustments (10.119).

X.E.3.2 Combined ratio and return on capital

This two staged approach considers both profitability of claims and return on capital. First identify the captive's combined ratio (claims and expenses as a percentage of receivable premiums). Find benchmarked combined ratios of unrelated comparable insurance companies and apply that to the group captive's expenses and claims. Second, measure the captive's return on investment against an arm's length return by considering the captive's capital and its return on investment in related parties. The underwriting profit from step 1 plus the investment income from step 2 equals total operating profit (10.220).

A group captive's capital requirements may be much lower than that of one underwriting unrelated parties because of regulatory and commercial factors. Commercial insurance must be capital efficient and may over capitalise to minimise borrowing costs; group insurers do not have that driver (10.221).

X.E.3.3 Group synergy

A captive that reinsures its risk, helps saving the costs of third party intermediaries, is pooling group risks and benefits from the power of collective negotiation. The benefits come from the concerted actions of the

group. The captive should receive an appropriate reward for its basic services only, with the rest of the benefit divided among group participants through reduced premiums (10.222).

E.g. an MNE has 50 subsidiaries worldwide risking earthquakes. A group captive reinsures that geographically diversified risk with third parties. The synergy benefit derives from the collective purchasing and should be shared among the group pro-rated to their premiums (10.223).

X.E.3.4 Agency sales

Agents require compensation. Where an insurance sales agent and an insurer or reinsurer are related, a comparability analysis consider must consider parties' circumstances giving rise to profits and alternative providers must be considered (10.224).

E.g. ACo sell high tech goods. At the point of sale ACo offers customers product insurance for 3 years with related party BCo. ACo gets a small commission and all profits go to BCo. Benchmarks show that ACo receives an arm's length commission but BCo's profit surpasses benchmarks. One must consider how the extra profit is realised and each party's contribution. ACo has the customer contact advantage. It could sell the policies to an unrelated insurer and keep most of the profit for itself instead. BCo cannot find another such agent. BCo should earn a benchmarked return and ACo the residual (10.226).

Appendix: transfer pricing lists

The five methods (Chapter II)

1. Comparable uncontrolled price (CUP); One sided
   Traditional transaction method
2. Resale minus; One sided
   Traditional transaction method
3. Cost plus; One sided
   Traditional transaction method
4. Transactional Net Margin Method (TNMM); One sided
   Transactional profit method
5. Transactional Profit Split. Two sided
   Transactional profit method

Five factors in identifying commercial and financial relations (Paragraph 1.36)

1. Property/services characteristics
2. Functional analysis
3. Contractual terms
4. Economic circumstances
5. Business strategies.

The six risk allocation steps (Chapter I.D.1.2.1)

1. Identify economically significant risks with specificity
2. How are significant risks contractually assumed
3. Which enterprises perform risk control and mitigation functions and has the financial capacity to bear the consequences of risk outcomes
4. Is contractual risk consistent with parties conduct?
   i in terms of section D.1.1
   ii whether the risk bearer controls the risk and has the financial capacity to do so
5. If party assuming risk does not control risk or lack financial capacity, apply guidance on risk allocation
6. Price the transaction as accurately delineated

The 5 requirements for controlled outsourcing (Paragraph 1.65)

1. The capability to determine the objectives of the outsourced activities
2. The capability to hire the provider of the functions
3. The capability to assess whether the objectives are being adequately met
4. The capability to adapt or terminate the contract with that provider
5. The performance of the above.

The nine comparability analysis steps (Chapter III.A.1)

1. Determine the years to be covered
2. Make a broad analysis of the taxpayer's circumstances
3. Understand the controlled transaction(s)
4. Review existing internal comparables
5. Determine available sources of external information
6. Select the most appropriate transfer pricing method
7. Identify potential comparables
8. Make appropriate comparability adjustments
9. Determine the arm's length prices

The three key factors

1. Functions performed;
2. Assets used; and
3. Risks assumed.

Types of comparables (Chapter III.A.4.1)

1. Internal comparables (3.27)
2. External comparables (3.29)

Timing of pricing (Chapter III.B.2)

1. Ex-ante: Price setting approach (3.69); and
2. Ex-post : Outcome testing approach (3.70)

DEMPE functions and risks (Chapter VI.B)

Development, Enhancement, Maintenance, Protection and Exploitations

I teach transfer pricing and international corporate taxation in a variety of formats: online automated, online face to face, and in person. My typical audiences are: governments, universities, tax professionals with continued education requirements, professional service providers and post graduate students following the Chartered Institute of Taxation's exams for an Advanced Diploma in International Taxation (#CIOT and #ADIT).

In my teaching I bring to the table my 25+ years experience in international tax and transfer pricing from working in Amsterdam, London, New York and Copenhagen; working for large law firms, accounting firms, the Danish government and various multinationals. I also published books and numerous articles on taxation, and am currently the editor of PE Plus, an international database on the taxation of permanent establishments.

To remain relevant, I also frequently do interim assignments in tax departments of MNE's, focusing on transfer pricing and international tax. If you are in need of interim assistance, please reach out to me.

Please have look at:
http://johannmuller.net - my personal business website;
https://johannmuller.teachable.com - my online school, offering various courses;
https://www.youtube.com/user/taxpics - my Youtube channel where I discuss various tax topics; and
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