## Background Paper

# Working Draft

# Chapter 1

# An Introduction to Transfer Pricing

[This paper is essentially a paper prepared by Members of the UN Tax Committee's Subcommittee on Practical Transfer Pricing Issues, but includes some Secretariat drafting and suggestions not yet considered by them – the Secretariat takes responsibility for any relevant errors and omissions.]

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## 1. What is Transfer Pricing?

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1.1 This introductory chapter intends to give a brief outline of the subject of transfer pricing and addresses the practical issues and concerns surrounding it, especially issues faced by, and approaches pricing" or similar, and where issues of tax avoidance and evasion may arise. A few examples illustrate these points:

Consider

governments give tax relief to prevent double taxation of the MNEs income, and if so, which one? These are some of the jurisdictional issues which arise with cross border transactions.

2.4 An added dimension to the jurisdictional issue is the spectre of transfer

2.10 From the governments'

pricing regulations Another

MNEs active in the European Union since 2001. Some of the approaches considered have included the possibility of a "common consolidated corporate tax base" and "home state taxation"<sup>1</sup>. Under both options transfer pricing would be

4.6 An argument in favour of using the arm's length principle is that it is

4.12 Overall, the underlying idea behind the arm's length principle is the attempt to place transactions, both uncontrolled and controlled, on equal terms in terms of tax advantages (or disadvantages) that they create. It has been widely accepted and has found its way into most transfer way

### (2) Functional analysis (Functions, Assets and Risks)

4.19 In dealings between two independent enterprises, the compensation usually reflects the functions that each enterprise performs, taking into account assets used and risks assumed. Therefore, in determining whether controlled and uncontrolled transactions are comparable, a proper study of all specific characteristics of an international transaction or functional activity needs to be undertaken, including comparison of the functions performed, assets used and risks assumed by the parties. Such a comparison is based on a "functional analysis".

4.20 A functional analysis seeks to identify and compare the economically significant activities and responsibilities undertaken by the independent and associated enterprises. An economically significant activity is considered to be any activity which materially affects the price charged in a transaction and the profits earned from that transaction.

4.21 Functional analysis is thus a key element in a transfer pricing exercise. It is a starting point and lays down the foundation of the arm's length analysis. The purpose of functional analysis is to describe and analyse the operations of an enterprise and its associated enterprises.

4.22 Functional analysis typically involves identification of 'functions' performed', 'assets' employed' and 'risks' assumed' (therefore named a "FAR analysis") with respect to the international transactions of an enterprise.

- 4.23 Functions that may need to be accounted for in determining the comparability of two transactions can include:
  - š Research and development
  - š Product design and engineering;
  - š Manufacturing, production and process engineering,
  - š Product fabrication, extraction and assembly;
  - š Marketing and distribution functions, including inventory management and advertising

- š Financial risks including method of funding, funding of losses, foreign exchange risk
- š Product risk including design & development of product, after sales service, product liability risk, intellectual property risk, risks associated with R&D, obsolescence / upgrading of product
- š Market risks including fluctuations in prices and demand, business cycle risks, development of market including advertisement and product promotion
- š Oredit and collection risks;
- š Entrepreneurial risk including risk of loss

4.29 Also, explicit contractual terms of a transaction involving members of a MNE may provide evidence as to the *form* in which the responsibilities, risks and benefits have been assigned among those members. For example, the contractual terms might include the form of consideration charged or paid, sales and purchase volumes, the warranties provided, the rights to revisions and modifications, delivery terms, credit and payment terms etc. This material may also indicate the *substance* of a transaction, but will usually not be determinative on that point.

4.30 It must be noted that contractual differences can influence *prices* as well as *margins* of transactions. The party concerned should document contractual differences and evaluate them in the context of the transfer pricing methods discussed in detail in a later chapter of this

4.44 The evaluation of the daim that a business strategy was being followed which decreased profits in the short term but provided for higher long term profits is one that has to be considered by the tax authorities carefully after weighing several factors. One factor being who bears the cost of the market penetration strategy? Another factor to consider is whether the nature of relationship reflects the taxpayer bearing the cost of the business strategy —for example, a sales agent with little responsibility or risk typically cannot be said to bear costs for a market penetration strategy. Another factor is whether the business strategy itself is prima facie plausible or needs further investigation; an endless "market penetration strategy" that has yielded no profits in many years might under examination have no such real basis in practice.

### (b) Transaction analysis

4.45 The arm's length price must be established with regard to transactions actually undertaken, the tax authorities should not substitute other transactions in the place of those that have actually happened and should not disregard those transactions actually undertaken unless there are special circumstances such as that the real economic substance of the transaction differs from its form or the transaction arrangements are not structured in the commercially rational manner that would be expected between independent enterprises. In general, restructuring of transactions should not be undertaken lightly as it may lead to double taxation due to divergent views by the nation states on how the transactions are structured. Whether authorities are able to do so will ultimately depend on their ability to do so under applicable local law, and even where it is possible, a good understanding of business conditions and realities is necessary for a fair "reconstruction". These issues are relevant not only to the administration of transfer pricing, but also to developing the underlying legislation at the beginning of a country's transfer pricing "journey" to allow effective administration (and to assist, and reduce the costs of, compliance by taxpayers) during the course of that journey.

### (c) Evaluation of separate and combined transactions

4.46 An important aspect of transfer pricing analysis is whether this analysis is required to be carried out with respect to individual international transactions or a group of international transactions having dose economic nexus.

4.47 In most cases, it has been observed that application of the arm's length principle on a transaction by transaction basis becomes cumbersome for all involved, and thus recourse is often had to the "aggregation" principle.

4.48 For example with transactions dealing with intangible property such as the licensing of "know how" (practical technical knowledge of how to do something, such as of an industrial process, that is not widely held) to associate enterprises it may prove difficult to separate out the transactions involved. Smilarly long term service supply contracts and pricing of closely linked products are difficult to separate out transaction wise.

4.49 Another important aspect of combined transactions is the increasing presence of composite contracts and "package deals" in an MNE group; a composite contract and/or package deal may contain a number of elements including royalties, leases, sale and licenses all

packaged into one deal. The tax authorities would generally consider the deal in its totality and arrive at the appropriate transfer price; in such a case comparables need to be similar (deals between independent enterprises). In certain cases, the tax authorities might find it appropriate for various reasons to allocate the price to the elements of the package or composite contract.

4.50 It must be noted that any application of the arm's length principle, whether on a transaction by transaction basis or on aggregation basis, needs to be evaluated on a case to case basis, applying the relevant methodologies to the facts as they exist in that particular case.

- (d) Use of an arm's length range
- 4.51 The arm's length principle as applied in practice usually results in an arm's

4.62 The tax authorities may evaluate the transactions separately to determine which of the transactions satisfy the arm's length principle. However, the tax authorities may also choose

# 5. Transfer Pricing Methods

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# 5.1 The key question

### (a) Profit comparison methods (TNMM/CPM)

5.11 These methods seek to compare the level of profits that would have resulted from controlled transactions with the return realised by the comparable independent enterprise. The TNNM compares the net profit margin realised from the controlled transactions with the net profit margin realised from the controlled transactions with the

(b) Profit split methods ("PSM")

5.13 Profit split methods take the combined profits earned by two related parties from one or a series of transactions and then divide the profits using a defined basis that is aimed at replicating the division of profits that would have been anticipated in an agreement made at arm's length. Arm's length pricing is therefore derived from both parties by working back from

products including the know how for further processing) or "package deals" consisting of some combination of the above.

6.7 In cases where both parties own valuable intangibles, typically the profit split method is used. In cases involving sub licensing of intangibles by associated enterprises to third parties, Cost Plus Method can be used. In case of a *sale* of an intangible, CUP may be used if there exists an internal comparable.

#### (iii) Intra group services

6.8 An intra group service, as the name suggests, is a service provided by one enterprise to another in the same MNE group. For a service to be considered an intra group service it must be similar to a service which an independent enterprise in comparable circumstances would be willing to pay for in house or else perform by itself. If not, the activity should not be considered as an intra group service under the arm's length principle. The rationale is that if specific group members do not need the activity and would not be willing to pay for it if they were independent, the activity cannot justify a

- (ii) Transfer pricing and the Model Conventions
- 7.3 The OECD Model Article 9 is a

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an alternative to the full scale documentation, in case transactions are simple and the tax due is not large. This may be especially important in responding to the needs and capabilities of small and medium enterprises (SMEs).

### 8. Transfer Pricing in Domestic Law

### (i) Introduction

8.1 Article 9 of 'tax treaties typically only regulates the basic conditions for adjustment of transfer pricing and advises the application of 'arm's length DI art ga 002 TC (arm's)Tj /

taxpayer compliance costs, but also to reduce the administration's costs of collection, as well as allowing the administration to concentrate scarce audit and other resources on the cases where more is likely to be at stake in terms of non compliance and revenue. One example of a "safe harbour" is a rule that a taxpayer is deemed to have an appropriate transfer price when the average export sales price is at least 90% of the average domestic sales in the domestic market during the same period and under similar payment terms. Another example is a list of parameters that, if followed, will assure sale and leaseback treatment to certain transactions under which partial or total relief from transfer pricing obligations is granted.

Safe harbour rules are, therefore, rules whereby if a taxpayer's reported profits are 8.6 within a range or percentage or under a certain amount, or the like, that amount can be relied on by a taxpayer as an alternative to a more complex and burdensome rule, such as applying the transfer price methodologies. A safe harbour cannot normally be used to the disadvantage of a taxpayer. There are some risks to safe harbours, such as that may favour low profit margin transactions that do not develop the economy in the long term, they may over time no longer reflect business realities, and may unreasonably either favour or dis favour certain taxpayers. Where they are unfavourable to taxpayers, the usual option of not following them, but instead following the "normal" rules, would generally be taken by taxpayers, but where they do provide unusually favourable treatment, including if business conditions have changed over time to make them unexpectedly favourable, it may become very difficult to change or remove such rules. In any case, consistent with the purpose of this Manual, introducing a safe harbour rule should involve analysis of whether, in a broad sense, even though not involving a precise analysis of every case; they essentially represent the real world application of the arm's length principle.

#### (iii) Controlled Foreign Corporation provisions

8.7 Some countries operate Controlled Foreign Corporation (CFC) rules. CFC rules are designed to prevent tax being deferred or avoided by taxpayers using foreign corporations in which they held a controlling shareholding in low tax jurisdictions and "parking" inoperateorAuld

prevent tax avoidance by such excessive leveraging, many countries have introduced rules to prevent thin capitalization typically by prescribing a maximum debt to equity ratio.

### (v) Documentation

8.9 Another important issue for implementing domestic laws is the documentation requirement associated with transfer pricing. Tax authorities need a variety of business documents which support the arm's length principle being met for the specified taxpayers. However, there is some divergence of legislation in terms of the nature of documents required, penalties imposed, and the degree of examiners' authority to collect information when taxpayers fail to produce such documents. There is also the issue of whether documentation needs to be "contemporaneous" as noted above.

8.10 In deciding requirements for such documentation, there needs to be, as already noted, a recognition of the compliance costs imposed on those required to produce the requirements, the issue of whether the benefit, if any, of such requirements from the administration's view in dealing with (for example) a small number of non compliant taxpayers are justified by a burden placed on taxpayers generally. A useful principle to bear in mind would be that widely accepted international approach, which takes into account compliance costs for taxpayers, should be followed unless a deviation can be dearly and openly inf

for taking action is often extended to some extent compared with general domestic taxation cases. However, too long a period during which adjustment is possible leaves taxpayers in certain positions with possible large financial risks. Countries should keep this issue of balance between the interests of the revenue and of taxpayers in mind

enterprises may also have an incentive to shift profits to jurisdictions in which tax laws, such as transfer pricing rules, are not enforced. Transfer pricing is a 'zero sum game' a situation in which the gain of taxable profits by one jurisdiction must be matched by a loss by the other jurisdiction. Consequently, some international enterprises might set their transfer prices to favour a jurisdiction expected to enforce its transfer pricing rules, in order to minimise the risk of transfer pricing adjustments and penalties in that jurisdiction. Moreover, transfer pricing disputes are generally time consuming and expensive.

## 9. Global Transfer Pricing Regimes

9.1 The UN and OECD Model Conventions, the OECD Guidelines and domestic legislation such as that of the USA have provided examples for the creation of transfer pricing legislation by nation states worldwide, as a response to increasing globalisation of business and the concern that it may be abused to the detriment of countries without such legislation. Many other countries rely on general anti avoidance rules to deal with the most abusive forms of transfer pricing, an issue considered under the chapter on the legal environment for transfer pricing.

9.2 By the end of 2009, there were around 53 countries with some form of specific transfer pricing legislation as shown by the light blue shading in the diagram below.

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# 10. Transfer Pricing as a

methods (CUP, Resale price, Cost plus) directly rely on comparables. These comparables have to be close in order to be of use for the transfer pricing analysis. It is often in practice extremely difficult, especially in some developing countries, to obtain adequate information to apply the arm's length principle for the following reasons:

(a) In developing countries there tends to be fewer organised players in any given sector than in developed countries; finding proper comparable data can be very difficult;

(b) In developing countries, the comparable information may be incomplete and in a form which is difficult to analyse because the resources and processes are not available. In the worst case, information about an independent enterprise may simply not exist. Databases relied on in transfer pricing analysis tend to focus on developed country data that may not be relevant to developing country markets (at least without resource and information intensive adjustments), and in any event, are usually very costly to access; and

(c) In many developing countries the economies of which have just opened up or are in the processing of opening up, there are many "first movers" who have come into existence in many of the sectors and areas hitherto unexploited or unexplored; in such cases there would be an inevitable lack of comparables.

10.7 Given these issues, critics of the current transfer pricing methods equate finding a satisfactory comparable to finding a needle in a haystack. Overall, it is quite clear that in developing countries finding appropriate comparables for analysis is quite possibly the biggest practical problem faced currently by enterprises and tax authorities alike, but the aim of this Manual is to assist that process in a practical way.

(b) Lack of knowledge and requisite skill sets

10.8 Transfer pricing methods are complex and time consuming, often requiring time and attention from some of the most skilled and valuable human resources in both MNEs and tax administrations. Transfer pricing reports often run into hundreds of pages with many legal and accounting experts employed to create them. This kind of complexity and knowledge requirement puts tremendous strain on both the tax authorities and the taxpayers, especially in developing countries where resources tend to be scarce and the appropriate training in such a specialised area is not readily available.

(c) Complexity

10.9 Rules based on the arm's length principle are becoming increasingly difficult and complex to administer. Transfer pricing compliance today typically involves huge and expensive databases and high level expertise to handle. Transfer pricing audits need to be performed on a case by case basis and are often complex and costly tasks for all parties concerned.

10.10 In developing countries, resources, monetary and otherwise, may be limited for the

taxpayer (especially a SME) who has to prepare detailed and complex transfer pricing reports and comply with the transfer pricing regulations, and may have to be "bought in". Smilarly the tax authorities of many developing countries do not have sufficient resources to examine the facts and circumstances of each and every case so as to determine the

based on the impact such differences would have on the controlled transaction price given the relative competitive positions of buyers and sellers in each market. The issue is dealt with in greater detail later in this Manual.

### 11. Summary and Conclusions

11.1 Transfer pricing is generally considered the major international taxation issue faced by MNEs today. It is an enormously important issue for many countries, developing and developed. Even though responses to it will in some respects vary, transfer pricing is a complex and constantly evolving area and no government or MNE can afford to ignore it.

11.2 For both governments and taxpayers, transfer pricing is difficult to grapple with; it tends to involve significant resources often including some of the most skilled human resources and costs of compliance. It is often especially difficult to find comparables, even those where some adjustment is needed for applying the transfer pricing methods.

11.3 For governments, transfer pricing administration is resource intensive and developing countries often do not have easy access to resources to effectively administer their transfer pricing regulations. Furthermore, from the government's perspective, transfer pricing manipulation reduces revenue available for country development, and with increasing globalisation, the potential loss of revenue may run into billions of dollars.

11.4 Overall, to simplify the international taxation system, especially transfer pricing, while keeping it equitable and judicious for all parties involved, is a difficult task. But a practical approach, such as proposed by this Manual, will help ensure the focus may