1 INTRODUCTION

The transfer pricing global legislative framework has undergone several and relevant changes during the past year in the wake of continuing international guidelines. In 2017, international organizations have largely focused on providing additional guidance on the implementation of significant reforms that were introduced in past years. The Organisation for Economic Co-operation and Development (OECD) continued to provide several guidelines on specific transfer pricing issues which could be viewed as a follow-up to ensure effective implementation of the BEPS Action Plan.[1] While the OECD largely played an active monitoring role by overseeing the implementation of action plans, the United Nations (UN) published its revised Practical Manual on

1. OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10—2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2015).

Transfer Pricing for Developing Countries[2] (UN TPM) with updated country practices. The European Union (EU) undertook several measures mainly for ensuring tax transparency. Further, the European Commission (EC) continued investigations into illegal state aid in connection with transfer pricing rulings and, during the latter part of the calendar year, released a 'blacklist' of noncooperative tax jurisdictions for the first time. The World Customs Organization (WCO) issued its second case study[3] in light of its continued intent to align transfer pricing and customs valuation. The Platform for Collaboration on Tax (PCT)—a joint initiative of the International Monetary Fund (IMF), OECD, UN, and World Bank Group (WBG)—published the final toolkit[4] providing practical guidance to developing countries on issues related to the access of comparables data for transfer pricing analyses.

The above guidance, directives, and reports were aimed at complimenting the guidelines that have come into force as part of the legislative changes in several countries. The work of international organizations also provided further clarity and support to tax administrators and multinational enterprises (MNE) in understanding the evolution of transfer pricing provisions both locally and globally.

This chapter will examine the above developments in detail. While section 2 will describe the developments under the work of the international organizations, section 3 will look into the influence of these developments on country specific transfer pricing legislations and jurisprudence.

2 RECENT DEVELOPMENTS ON THE WORK OF INTERNATIONAL ORGANIZATIONS

Having released its BEPS Final Reports, the OECD published its revised Transfer Pricing Guidelines[5] (OECD TPG). This 2017 edition of the OECD TPG incorporates substantial changes reflecting the 2015 BEPS Final Reports on Actions 8–10, "Aligning Transfer pricing Outcomes with Value Creation" and on Action 13, "Transfer Pricing Documentation and Country-by-Country Reporting." The OECD TPG also includes revised guidance on safe harbor rules that were approved in 2013 which aims to promote certainty in tax positions. More about the work of the OECD is covered in section 2.1.

The 2017 UN TPM covered four key aspects: (1) transfer pricing in the current global context, (2) the arm's length principle; (3) policy implementation concerns; and (4) country specific transfer pricing practices, including those in India, Brazil, China, South Africa, and Mexico. section 2.2 captures these revisions in detail.

The EU's presence in international transfer pricing developments was significant during 2017. The EC continued its efforts into investigations to assess whether

2. United Nations, *Practical Manual on Transfer Pricing for Developing Countries* (April 2017).
3. World Customs Organization, *Customs Valuation and Transfer Pricing, Case Study 14.2* (October 30, 2017) *Source*: http://www.wcoomd.org/en/media/newsroom/2017/october/second-case-study-on-transfer-pricing-and-customs-valuation.aspx.
4. World Bank. *A toolkit for addressing difficulties in accessing comparables data for transfer pricing analyses*. Platform for Collaboration on Tax. Washington, D.C.: World Bank Group (June 2017).
5. OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, Paris; OECD Publishing.

countries have granted MNEs undue incentives in formulating and delivering transfer pricing legislations or its interpretation of tax rulings resulting in illegal state aid. Moreover, intensive work has been conducted on enhancing transparency surrounding many issues including the exchange of tax rulings and County-by-Country Reports (CbC Reports). The EU Joint Transfer Pricing Forum (JTPF), as part of its ongoing work program for 2015–2019, agreed to the Final Report[6] on the "Use of Comparables" in the EU. The report establishes best practices and solutions by way of recommendations to improve comparable searches for transfer pricing in the EU. These developments are covered in section 2.3.

The toolkit on issues related to the access of comparables data for transfer pricing analyses, jointly published by the IMF, OECD, UN, and World Bank Group, was a response to the request by the Development Working Group of the G20 to provide guidance on transfer pricing matters for developing countries. Finally, the WCO's second case study illustrated the use of transfer pricing information in the course of verification of the customs value by tax officers in a practical situation. These developments are covered in section 2.4.

2.1 Transfer Pricing Developments at the OECD

Published on July 10, 2017, the revised OECD TPG substantially reflects the changes resulting from incorporating the 2015 BEPS Final Reports on Actions 8–10 and Action 13. These amendments to Chapters I, II, V, VI, VII and VIII were approved by the OECD Council and incorporated into the OECD TPG already in May 2016.[7] The key revisions are summarized below.

(i) Revisions to specific chapters[8]

- the current provisions of Chapter I, section D of the OECD TPG have been deleted in their entirety and replaced by new guidance;
- numerous paragraphs have been added to Chapter II of the OECD TPG immediately following paragraph 2.16;
- a new paragraph has been inserted following paragraph 2.9 of the OECD TPG;
- the current provisions of Chapter V of the OECD TPG have been deleted in their entirety and replaced by new guidance and annexes;
- the current provisions of Chapters VI, VII, and VIII of the OECD TPG and the annex to these chapters have been deleted in their entirety and replaced by new guidance and an annex.

6. *See* EU (2016), *Study on comparable data used for transfer pricing in the EU*, EU Publishing, Brussels (December 8, 2016). *Source*: https://ec.europa.eu/taxation_customs/business/company-tax/transfer-pricing-eu-context/joint-transfer-pricing-forum_en (last accessed January 8, 2017).
7. *See* OECD Press Release (June 15, 2016). *Source*: http://www.oecd.org/tax/transfer-pricing/oecd-council-approves-incorporation-of-beps-amendments-into-the-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations.htm.
8. *See* Petruzzi, R., *Global Transfer Pricing Developments*, in: Lang, M., Storck, A. & Petruzzi, R. (eds), *Transfer Pricing Developments Around the World* (Vienna: Kluwer, 2017), pp. 1–46.

(ii) Business restructuring[9]

Further, the revised OECD TPG and confirms to the guidance on business restructurings introduced by the reports on BEPS Actions 8–10 and 13. These changes were approved by the OECD Council in April 2017. The 2017 guidance provides that transactions owing to business restructuring are to be accurately delineated. This entails the identification of parties' commercial or financial relations and the conditions attached to those relations, which then helps in ascertaining the value of transfer within the MNE groups.

It is pertinent to note that specific emphasis has been placed on the delineation of transactions in two scenarios, i.e., in pre-restructuring and post-restructuring. It is observed in the guidelines that a comparative analysis influences arm's length compensation, risk assessment between the parties and, therefore, the selection of the appropriate transfer pricing method for the transaction. As a first step to delineation of the transactions, written contracts between contracting parties are to be analyzed, i.e., before and after undertaking the restructuring, in order to obtain evidence of the roles and responsibility of the MNEs involved and the compensation model that supports the determination of arm's length compensation. The revised OECD TPG also states that the accuracy of demarcation should be based on a valuation that is undertaken specifically for the restructuring from a transfer pricing perspective, and the arm's length price of each delineated transaction is to be obtained independently instead of a combined result for the MNE group as a whole.

Another key suggestion emanating from the revised OECD TPG is the emphasis on the identification of group synergies owing to business restructuring. The guidelines state that the factors that could result in synergies are to be identified. Such synergies act as an indicator of risk borne by parties to the restructuring process and would lead to determination of appropriate compensation for contributing to synergistic outcomes.

(iii) Safe harbor[10]

The revised guidance also includes amendments concerning the topic of safe harbors with respect to Chapter IV. These changes were approved by the OECD Council in May 2013. The primary aim has been to encourage the use of bilateral or multilateral safe harbors in order to reduce compliance burdens while ensuring that issues of double taxation or double nontaxation do not arise.

The publication of the revised OECD TPG incorporating the changes resulting from the 2015 BEPS Final Reports on Actions 8–10 and Action 13 has officially initiated a "new era" for the interpretation and application of transfer pricing rules around the world. Taxpayers and tax administrations can now count on guidance that is more detailed and are clearer on various topics. Nevertheless, the new guidance continues to develop the understanding of the arm's length principle based on an economic

9. *See* OECD (2017), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris, at pp. 365–413.
10. *See* OECD (2013), *Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines*, (May 16, 2013), Paris. *Source*: https://www.oecd.org/ctp/oecd-approves-revision-section-e-tp-guidelines.htm.

interpretation.[11] This interpretation, although better able to align transfer pricing outcomes with value creation, might potentially lead to increasing diverging views not only between taxpayers and tax administrations but also between tax administrations of different countries. Therefore, it will be of outmost importance in the future, on the one hand, to continually invest in training and resources dedicated to transfer pricing topics (both for taxpayers and tax administrations) and, on the other, to improve the efficiency and effectiveness of mechanisms of avoidance and resolution of transfer pricing disputes (e.g., rulings, APAs, MAPs, and arbitration).

Moreover, although the OECD TPG has been drafted in an OECD framework, 60 countries have been involved in the work leading to the finalization of BEPS Actions 8–10,[12] including emerging economies as well as developing countries. Therefore, it will need to be assessed whether non-OECD countries will also more systematically accept and apply the new OECD TPG in the future.

2.1.1 *Transfer Pricing Documentation and Country-by-Country Reporting*[13]

The BEPS Action 13 Final Report had suggested a standardized approach to three-tiered transfer pricing documentation[14] that includes a master file, local file, and CbC Report. After the incorporation of the above reports into Chapter V of the revised OECD TPG, the OECD provided additional guidance throughout the year in order to facilitate a smooth transition into the new compliance requirements for both MNEs and tax policy experts in countries.

Questions and clarification were raised by the MNE groups and tax administrators in the run up to implementation. More specifically, the year 2017 being the first year during in which the filing of the CbC Report is undertaken, the intense data collection and reporting in the form and manner prescribed by the OECD required continuous engagement between international bodies and complying jurisdictions. For this purpose, the OECD, as of December 2017, updated and published the following guidance:

11. For further information on this topic, *see* Petruzzi, *The Arm's Length Principle: Between Legal Fiction and Economic Reality*, in: Lang, M., Storck, A. & Petruzzi, R. (eds), *Transfer Pricing in a Post-BEPS World* (Vienna: Kluwer, 2016), pp. 1–27.
12. Albania, Argentina, Australia, Austria, Azerbaijan, Bangladesh, Belgium, Brazil, Canada, Chile, Colombia, Costa Rica, People's Republic of China, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Georgia, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kenya, Korea, Latvia, Lithuania, Luxembourg, Malaysia, Mexico, Morocco, Netherlands, New Zealand, Nigeria, Norway, Peru, Philippines, Poland, Portugal, Russian Federation, Saudi Arabia, Senegal, Singapore, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Tunisia, Turkey, United Kingdom, United States, and Vietnam.
13. For further information on this topic, *see* Kaeser/Bremer, *Transfer Pricing and Documentation Requirements*, in: Lang, M., Storck, A. & Petruzzi, R. (eds), *Transfer Pricing in a Post-BEPS World* (Vienna: Kluwer, 2016), pp. 187–207.
14. *See* OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2015), p. 9.

Last Updated	*Guidance*	*Purpose*
November 2017	Guidance on implementation of Country-by-country Reporting: BEPS Action 13[15]	Consistency in implementation and Resolving key questions from tax administrators and MNEs
September 2017	Guidance on the appropriate use of information contained in Country-by-Country reports[16]	Guidance on infrastructure necessary for maintaining critical information contained in CbC Reports
September 2017	Handbook on Effective Implementation[17]	Filing and use of CbC Reports, the exchange of CbC Reports, operational aspects of CbC Reporting and guidance, stakeholder engagement and training
September 2017	Handbook on Effective Tax Risk Assessment[18]	To support countries in the effective use of CbC Reports by incorporating them into a tax authority's risk assessment process and highlighting the challenges in using CbC Reports with potential solutions. Also, other data sources that should be used alongside CbC Reports in tax risk assessments

Key concerns of CbC Reports that were addressed are further elaborated below.

2.1.1.1 *Issues Relating to the Definition of Items Reported in the CbC Report*

During 2017, the definition of revenues was clarified to include extraordinary income and gain from investment activities and states that such income needs to be aggregated for reporting purposes. Regarding the definition of related parties, the associated enterprises defined in Action 13 are to be interpreted as 'Constituent Entities' for reporting purposes. Also, regarding the question on a specific situation when there is more than one constituent entity in a reporting jurisdiction, the guidance has clarified

15. *See* OECD (2017), Guidance on the Implementation of Country-by-Country Reporting–BEPS Action. 13, OECD, Paris (November 2017). Source: www.oecd.org/tax/guidance-on-the-implementation-of-country-by-country-reporting-beps-action-13.pdf.
16. OECD (2017), *BEPS Action 13 on Country-by-Country Reporting—Guidance on the appropriate use of information contained in Country-by-Country reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD, Paris. Source: www.oecd.org/tax/beps/beps-action-13-on-country-by-country-reporting-appropriate-use-of-information-in-CbC-reports.pdf.
17. OECD (2017), *Handbook on Effective Implementation*, OECD, Paris (September 2017). Source: www.oecd.org/tax/guidance-on-the-implementation-of-country-by-country-reporting-beps-action-13.pdf.
18. *See* OECD (2017), Country-by-Country Reporting: *Handbook on Effective Tax Risk Assessment*, OECD, Paris. Source: www.oecd.org/tax/beps/country-by-country-reporting-handbook-on-effective-tax-risk-assessment.pdf.

that an aggregation of intra-jurisdictional transactions is preferred from a reporting point of view. However, in a situation when a particular country's laws may require the Ultimate Parent Entity to undertake consolidated reporting for tax purposes and such a consolidation eliminates intra-group transactions at the level of individual line items, it is advised that the taxpayers be provided with the option of consolidated reporting and keeping in mind the consistency of reporting across the years. Further clarification on the treatment of income taxes accrued and paid for reporting purposes have been provided. The clarification also states that financial statements should be prepared using fair value accounting and how negative accumulated earnings are to be considered for reporting purposes.

2.1.1.2 Issues Relating to the Entities to Be Reported in the CbC Report

The guidance has clarified that investment entities are not exempt from the CbC Report requirements. The guidance discusses the possibility of a company that is a subsidiary of an investment holding company, incorporated with the purpose to control other entities could constitute an MNE group requiring compliance if the group revenue exceeds the threshold. The necessity of transacting companies of an MNE group to fulfill compliance requirements is driven by the accounting policies. The guidance provides clarity on situations when the IFRS[19] or the accounting standards followed by the jurisdiction of the ultimate parent entity need to be considered. Also, treatment of minority shareholders and guidance on pro-ration of such shareholders for consolidation and reporting purposes have been discussed.

2.1.1.3 Issues Relating to the Filing Obligation for the CbC Report

Since the CbC Report requirement is a threshold based compliance (i.e., it applies only to groups with consolidated revenues exceeding EUR 750 million), the definition of consolidated group revenue has been clarified to include all of the revenue that is (or would be) reflected in the consolidated financial statements. Further, in situations when the ultimate parent entity (or the surrogate entity) that is required to undertake the compliance follows a shorter accounting period, the guidance suggests that one of the below methodologies could be adopted to identify the consolidated group turnover, i.e.: (i) the actual total consolidated revenue; (ii) revenue of the shorter period extrapolated to a twelve-month accounting period; or (iii) pro-rated share of EUR 750 million for the relevant accounting period. It is also important to note that the options could lead to conflicting views on whether the reporting requirement threshold is breached. To avoid such conflicts, the guidance suggests that the ultimate parent entity or the surrogate entity can undertake a voluntary compliance.

19. *Source*: http://www.ifrs.org/about-us/.

2.1.1.4 Issues Relating to Mergers/Acquisitions/Demergers

As per the guidance that was issued, the consolidation of group revenue for reporting purposes should be undertaken regardless of the restructuring undergone during the fiscal year of reporting. Further guidance on specific fact patterns where ambiguities could arise is provided in the guidance.

Further, apart from the above guidance, the OECD has enabled activation of the automatic exchange relationships between the jurisdictions to enable seamless transfer of CbC Reports under the multilateral competent authority agreement on these reports. The automatic exchange commencing June 2018 is set to empower tax administrators with key information with an MNE group level view. Currently, 1,400 automatic exchange relationships are in place among jurisdictions committed to exchanging CbC Reports including those under EU Council Directive 2016/881/EU and bilateral competent authority agreements; this includes 31 countries with the United States (US).[20]

A key concern among the MNE groups ever since the inception of the CbC reporting (CbCR) rules has been the security and confidentiality of information made available to the tax administrators of multiple jurisdictions. In order to address potential challenges, in September 2017, the OECD published *Guidance on the appropriate use of information contained in Country-by-Country reports*.[21] The guidance refers to the Action 13 Report which restricts the use of the CbC Report to the purpose of: (i) high level transfer pricing risk assessment; (ii) assessment of other BEPS related risks; and (iii) economic and statistical analysis, whenever appropriate. From a transfer pricing perspective, the issue on how the data contained in the CbC Reports would influence transfer pricing audits has been the main concern for the MNE groups. Through this guidance, the OECD states that the information contained in CbC Reports could be used for high level transfer pricing risk assessment but should not form the fundamental basis on which transfer pricing audits are concluded. It is imperative that tax administrators consider the CbC Reports as an important tool in conducting audits. However, the risk of tax administrators using information to arrive at a formulary apportionment assessment cannot be ruled out. The guidance states jurisdictions involved in exchange of CbC information should undertake measures to restrict access to CbC Reports in order to avoid misuse and provides six control questions[22] that need to be considered for an internal check on the appropriate use of CbC Reports. This guidance is assumed to be significant due to the potential conflicts that could arise between two taxing States on the usage and interpretation of data available in the CbC Reports. It is expected that the OECD will provide further guidelines on best practices

20. *See* OECD Press Release (December 21, 2017). *Source*: http://www.oecd.org/ctp/exchange-of-tax-information/beps-action13-jurisdictions-implement-final-regulations-for-first-filings-of-cbc-reports.htm (last accessed December 27, 2017).
21. *See* OECD (2017), *BEPS Action 13 on Country-by-Country Reporting—Guidance on the appropriate use of information contained in Country-by-Country reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD, Paris. *Source*: www.oecd.org/tax/beps/beps-action-13-on-country-by-country-reporting-appropriate-use-of-information-in-CbC-reports.pdf.
22. *See Supra* n. 20, p. 10.

and possible case studies where CbC Reports are misused. Given that June 2018 marks the commencement of exchange of CbC Reports, more work by the OECD on this front is foreseen.

Further, from an operational perspective, the OECD provided updated and new Information Technology (IT) tools and supporting guidance[23] to undertake the technical implementation of the exchange of tax information under the Common Reporting Standard (CRS), on CbC Reports, and in relation to tax rulings (ETR). A dedicated XML Schema and User Guide have been developed to provide structured feedback on received CbC Reports. This portal is aimed at ensuring swift and uniform electronic transit of CbC Reports between jurisdictions.

In summary, while the OECD undertook several steps during 2017,[24] further clarification on how the CbC Report should be read in conjunction with the master file and local file are required. In this context, on the one hand, the OECD might need to analyze solutions that could limit the risk of any misuse by tax administrations of the information contained in the new documentation requirements. The OECD could further analyze issues in connection with data protection and loss of confidentiality while balancing the use of information that is obtained to assess if the TP policy is not in line with reality. Also, the topic of sharing the information provided by the new documentation requirements is a relevant one that could raise many issues. For example, once the new standards have been fulfilled by taxpayers, numerous questions would need to be assessed in order to guarantee that this information is not inappropriately shared.[25]

2.1.2 *Hard-to-Value-Intangibles*

The Final Report on Actions 8–10 of the BEPS Action Plan had suggested providing an implementation approach to pricing Hard-To-Value-Intangibles (HTVI) in the framework of Section D.4 of Chapter VI of the OECD TPG. Pursuant to this commitment, on May 23, 2017, the OECD invited comments on the discussion draft[26] on HTVI.

The key considerations in the discussion were the following:

- Basic principles for enabling the implementation of the HTVI approach
- Specific examples that clarify the implementation of the HTVI approach under specific scenarios

23. *See* OECD (2017), *Country-by-Country Reporting XML Schema: User Guide for Tax Administration*, OECD, *Source*: http://www.oecd.org/tax/beps/country-by-country-reporting-xml-schema-user-guide-for-tax-administrations.pdf.
24. For more information, refer to Chapter 5 of this book.
25. *See* Petruzzi, R., Navisotschnigg, F., *BEPS and EU requirements for Country-by-Country Reporting*, in: Lang, Haunold (eds.), *Transparenz und Informationsaustausch: Der gläserne Steuerpflichtige* (Vienna: Linde, 2017), pp. 51–78.
26. *See* OECD (2017), *BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles*, OECD/G20 Base Erosion and Profit Shifting Project, OECD, Paris. *Source*: http://www.oecd.org/tax/transfer-pricing/BEPS-implementation-guidance-on-hard-to-value-intangibles-discussion-draft.pdf.

- Finally, the suggestion to pursue the option of a Mutual Agreement Procedure (MAP) under the applicable treaty in resolving disputes arising out of valuing HTVI.

Various commentators have provided their views[27] on the outcome of the discussion draft. At this stage, the OECD is evaluating these comments, and further clarification or consultations can be expected. Key concerns raised by the stakeholders is the use of *ex-post* data that is available to tax authorities thereby granting the benefit of hindsight during the course of transfer pricing audits, an option that the taxpayers would not have simply owing to the timing difference and limited capabilities of estimating the value of HTVI at the time of reporting the transaction. For reducing the complexity of issues, the OECD has encouraged the use of a MAP for resolving potential disputes.

2.1.3 *Transactional Profit Split Method*[28]

In continuation with the work on the transactional profit split method (TPSM), the OECD has held public consultations on transfer pricing matters related to this topic. This consultation was a culmination of the long drafting exercise starting from the time of publishing the BEPS Actions 8–10 and leading to an initial discussion draft in 2016[29] which was subsequently revised on June 22, 2017.[30] The comments from different parties were made available to the public, and a corresponding public consultation was held on November 6–7, 2017 to discuss these comments.[31]

Under the revised draft, the OECD has provided greater clarity on its position on the TPSM by specifying conditions under which it is applicable along with a list of ten examples that illustrate its application. The 2017 draft sought to improve the shortcomings of the 2016 draft in addressing the implementation aspects of the TPSM.

As a highlight and a change compared to the 2016 Discussion Draft, the 2017 Discussion Draft rightly left out the considerations on the form of integration, i.e., the sequential integration and the parallel integration, when deciding whether the TPSM is the most appropriate method. First of all, the reality of MNEs may reflect a more complex way of integration that falls outside the defined sequential and parallel

27. *See* OECD (2017), *Comments Received on Public Discussion Draft, BEPS Action 8: Implementation Guidance on Hard-to-Value Intangibles*, OECD/G20 Base Erosion and Profit Shifting Project, OECD, Paris. *Source*: http://www.oecd.org/ctp/transfer-pricing/Public-comments-received-on-the-Implementation-Guidance-on-Hard-to-Value-Intangibles-2017.pdf.
28. For further information on this topic, *see* Chapter 8 in this book.
29. OECD (2016), *BEPS Public Discussion Draft BEPS Actions 8–10: Guidance on Profit Splits*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2016). *Source*: https://www.oecd.org/tax/transfer-pricing/BEPS-discussion-draft-on-the-revised-guidance-on-profit-splits.pdf.
30. OECD, *BEPS Public Discussion Draft BEPS Actions 8–10: Revised Guidance on Profit Splits*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2017). *Source*: https://www.oecd.org/ctp/transfer-pricing/Revised-guidance-on-profit-splits-2017.pdf.
31. OECD, *BEPS Comments received on Public Discussion Draft BEPS Actions 8–10: Revised Guidance on Profit Splits Part I and Part II*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2016).

integration in the 2016 Discussion Draft. Secondly, the highly integrated sequential operations in practice may indeed prove to be cases of when the TPSM is the most appropriate method. For example, the concerned entities in many arm's length joint ventures in which one entity performs the preliminary R&D work and the other is responsible for sale and marketing of the products in a sequential manner agree to share the joint profits generated in the end. Instead of focusing on sequential integration and parallel integration, the 2017 Discussion Draft introduced the very useful concept of inter-dependency together with interrelation as an indicator to picture the level of integration. The new considerations in the context of integration are very useful for indicating to what extent high integration may be evident in the application of the TPSM.[32]

While there has been commendable improvements to the work on TPSM, there are a few gaps that have been highlighted in the comments provided by stakeholders. It has been observed that the distinction between "actual" and "anticipated" profits seems artificial and, therefore, could lead to counterproductive outcomes in its current format.[33] It is expected that the OECD will clarify or modify the definition of these terminologies in order to avoid ambiguities. The question on adjustments to the purchasing power parity (PPP) made for profit splitting amounts has largely been answered by various stakeholders with concerns of the consistency of accounting and the cumbersome steps that would further be needed to make its application effective.

Further, it has been suggested that further guidance is to be provided on the splitting of losses under the specific scenarios. For the splitting of losses, focus may need to be primarily on the entity that controls the risks as it normally has a negative perception of the result or to look at the responsibilities that are perceived to give rise to risks realization.[34] Moreover, the RACI model and the bargaining analysis could generate reliable transfer pricing results if dealt with properly in the application of the TPSM.[35] Also, it is suggested that the OECD considers including more references to the value chain analysis as an important tool in a transfer pricing analysis that appears to be subsumed under the reference to functional analysis[36] in the 2017 guidance. The OECD is expected to finalize the drafts and issue the final version in 2018.

32. *See* Storck, A. Petruzzi, R & Peng, C. OECD, *BEPS Comments received on Public Discussion Draft BEPS Actions 8–10: Revised Guidance on Profit Splits Part II*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2016) pp. 199–213.
33. *See* PWC, OECD, *BEPS Comments received on Public Discussion Draft BEPS Actions 8–10: Revised Guidance on Profit Splits Part II*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2016) pp. 99–102.
34. Storck. A et al., Global Transfer Pricing Conference: Transfer Pricing Developments around the World, 24 International Transfer Pricing Journal 4 (2017), 270–279.
35. Petruzzi R. & Peng X., The Profit Split Method: Historical Evolution and BEPS Insights, Transfer Pricing International 1 (2/2017), 44–54 (peer reviewed).
36. *See* Storck, A. Petruzzi, R & Peng, C. OECD, *BEPS Comments received on Public Discussion Draft BEPS Actions 8–10: Revised Guidance on Profit Splits Part II*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2016) pp. 199–213.

2.1.4 *Attribution of Profits to Dependent Agent Permanent Establishments and to Warehouses*[37]

The BEPS Action 7 "*Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7*" Final Report[38] covered issues related to the existence of PEs in specific situations and recommended amendments to Article 5 of the OECD Model while it provided an indication that further work would follow. The *2017 PE Discussion Draft*[39] (2017 PE Draft) was built on the work undertaken earlier and comments received on the respective discussion drafts that dated July 4, 2016. Further consultation was undertaken on November 6–7, 2016 to discuss these comments with an aim to provide final guidelines by 2018.

The *2017 PE Draft* clarified that changes made to Article 5(5) and 5(6) of the Model Tax Convention (MTC) by the report on Action 7 have modified the threshold for the existence of a *deemed PE* under Article 5(5). However, they have not modified the nature of the *deemed PE*. Therefore, the attribution of profits to that PE is deemed to exist under the pre-BEPS version of Article 5(5) and will, therefore, be applicable to a PE that is considered as existing under the post-BEPS version of Article 5(5). Broadly, the profits to be attributed to a PE are to be determined in accordance with Article 7 of the relevant tax treaty, i.e., profits attributable to a PE are those that the PE would have derived if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions. The *2017 PE Draft* explained that the above principle applies regardless of whether a tax administration adopts the Authorized OECD Approach (AOA) contained in Article 7 of the 2010 version of the MTC or any other approach used to attribute profits under a previous version of Article 7 of the MTC.

The *2017 PE Draft* contains four examples illustrating the attribution of profits to PEs resulting either from the changed definition of a Dependent Agent Permanent Establishment (DAPE) or from the anti-fragmentation rule. The first two examples relate to the DAPE and illustrate that the profits of such a PE in the case of sales and marketing activities would generally be equal to the revenue from the sales of goods related to the intermediary's sales activities minus: (i) an arm's length purchase price of the goods from the DAPE's head office; (ii) other expenses attributable to the PE; and (iii) the arm's length remuneration of the dependent agent enterprise. In the third example in which the PE performs procurement activities, the profits of the PE would equal the arm's length sales price of the goods to the PE's head office minus: (i) the

37. *See* Cottani, C., *Commissionaire Arrangements/Low-Risk Distributors and Attribution of Profits to Permanent Establishments*, in: Lang, M., Storck, A. & Petruzzi, R. (eds.), *Transfer Pricing in a Post-BEPS World* (Vienna: Kluwer, 2016), pp. 159–186.
38. OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing). *Source:* http://www.oecd.org/tax/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report-9789264241220-en.htm.
39. OECD, *Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments* (June 22–September 15, 2017). *See* https://www.oecd.org/tax/transfer-pricing/beps-discussion-draft-additional-guidance-attribution-of-profits-to-permanent-establishments.pdf.

amounts paid by the intermediary to the unrelated suppliers; (ii) other expenses attributable to the PE; and (iii) the arm's length remuneration of the intermediary. In all of the three examples, the rights and obligations relating to the contracts that are concluded on behalf of the nonresident entity or in which it plays the principal role are attributed to the PE. The final example demonstrates what profits should be attributed to a PE that are recognized as a result of the anti-fragmentation rule (i.e., a warehouse PE providing storage and delivery services and an office PE providing merchandising and collection of information services).

In summary, to avoid conflicting outcomes, it would be ideal to consider merging Article 7 and Article 9 to jointly reflect the same understanding of the arm's length principle. However, as an immediate measure, further guidance on aligning different outcomes of both articles is necessary and, in such a process, the following aspects could be considered:[40]

- Clarification on the separate legal entity approach, without any deviation, is the core principle that has to be followed.
- Clarification on the substance-over-form approach to be adopted uniformly across the two articles with emphasis on the actual conduct of the parties over and above the details evident from the contract. If the actual conduct of the parties is strictly followed under Article 9, the potential for differences to the application of Article 7 tends to be close to nil since the actual conduct of parties and the performance of significant people functions show a close teleological similarity.
- Clarification on capital allocation between associated enterprises and in a PE context should follow considerations related to corporate finance methodology rather than inflexible rules.

2.1.5 Digitalization of the Economy

The OECD has long recognized the need for adaptive tax systems and has made fair attempts to address the challenges of digitalization of the economy as part of its BEPS Project within its Action 1 Final Report.[41] However, in light of the pace of changes, even before some of these recommendations are understood and translated into effect by different stakeholders including MNEs and tax administrations, the dynamic nature of digitalized businesses outpace the implementation time. A key feature of digitalized businesses has always been the lack of need for physical presence. The absence of physical presence reduces the applicability of traditional international tax principles. Apart from these business realities, key MNEs have used innovative means of tax planning to minimize tax charges. Google, for example, charges its affiliates with

40. *See* Storck, A. Petruzzi, R & Holzinger, R. OECD, *Comments received on Public Discussion Draft on Attribution of Profits to Permanent Establishments*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2016) pp. 403–413.
41. *See* OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD Publishing, Paris.

royalties for the use of its search engine. The income stream from these arrangements is paid to Bermuda using a so-called Double Irish Dutch sandwich structure. The lack of market comparables for intangibles poses a problem for tax authorities because it is difficult to determine what the arm's length nature is of some transactions.[42]

Notwithstanding the shortcomings of the existing tax systems, many countries have contemplated while some have implemented (or are in the process of implementing) legislations to tackle the digitalization of the economy during 2017. The ideas of modifying the existing PE concept or introducing an equalization levy was originally discussed in BEPS Action 1.[43]

On September 22, 2017,[44] stakeholders were invited by the Task Force on the Digital Economy (TFDE)[45] to provide comments on the tax challenges of the increasing digitization of the economy. This was followed by a public consultation on November 1, 2017. A final report should be prepared by the OECD that will be presented to the leaders of the G20 in April 2018.

The presence of a virtual PE has been a key focus of discussion and debate in considering the tax implications of the digitalized economy. A tax nexus based on "significant economic presence" would lead to the expansion of the scope under the existing definitions in the treaties. Highly digitalized business models are characterized by high mobility, reliance on data, use of networks synergies, etc. The assets that generate the most value for these businesses are brand, platform, know-how, data, etc.[46] While there has been an emerging consensus to view data as the key driver of value creation, the debate is expected to shift toward the means of valuing the relative contribution of data across the digital value chain.

To aid attribution, the use of a value chain analysis has been proposed as a key tool for identifying value creation.[47] Moreover, the use of Blockchain technology can potentially considerably improve the performance of this analysis. The VCA deploys terminologies such as "use value" and "exchange value" and/or "total value" that may be useful in establishing the nexus of a digital PE and the quantum in the attribution of profits to it.[48] This establishes the need to modify the way functional analyses are conducted and also the way data is considered in determining the functional profile of digital businesses. Customers who generate unconscious value to the business could be considered key value drivers.[49] With this aim, the concept of PE may be reinterpreted. "Data" can be perceived as "natural resources" under Art. 5(2)(f) or active customers might provide the sufficient nexus with the market jurisdiction. The transfer pricing

42. *See* Juranek S, Schindler D, Schjelderup G. *Transfer Pricing Regulation and Taxation of Royalty Payments*. J Public Econ. Theory (2017), 1–17.
43. *Supra* n. 40, pp. 165–166.
44. *See* OECD Press Release, *Source*: http://www.oecd.org/tax/beps/public-comments-received-on-the-tax-challenges-of-digitalisation.htm (last accessed December 27, 2017).
45. TFDE is a subsidiary body of the OECD Committee on Fiscal Affairs which includes non-OECD and non-G20 country participants.
46. Petruzzi, R. & Buriak, S., *Addressing the Tax Challenges of the Digitalization of the Economy: A Possible Answer from a Proper Application of Transfer Pricing Rules?* (forthcoming).
47. *Supra* n. 45, p. 34.
48. *Supra* n. 45, p. 34.
49. *Supra* n. 45, p. 34.

according to the author, the first step is to make clear that an accurate definition of what is meant by the term "developing" vis-à-vis "developed" country cannot be found in tax-relevant publications of international organizations.[1] Therefore, the chapter will assume the terms "emerging economy" and developing "country" having the same meaning from a transfer pricing standpoint.

It is also true, though, that the obstacles in accurately delineating the difference (if any) between a "developing" and an "emerging economy" makes the work of transfer pricing specialists easier in asserting that the arm's length principle is neutral in its application, i.e., it is immaterial whether it is the tax administration of a developed or developing economy that carries out a comparability analysis based on the arm's length principle. What can be significantly diverging between the tax administrations of an OECD, *rectius*, developed country/economy, and a developing/emerging one is the level of administrative resources to be deployed in guaranteeing a proper enforcement of any legislation.

Arguably, "emerging" and "developing "tend to be construed as synonyms when it comes to assessing that, since the late 1990s, the economies of these countries presented higher growth rates than developed ones.[2] In this respect, countries like Brazil, China, and India but also countries like Russia and South Africa (the latter countries collectively labelled as "BRICS") whose tax administrations have played a significant role in shaping the international tax policy landscape in recent years seem to express the view that—within their domestic boundaries—the arm's length principle may be construed in a way that best fits their sovereign national interests.

Therefore, this paper will discuss the key areas of transfer pricing developments intervened within each of the above-mentioned countries and/or regions but with a focus on Brazil, China, and India as the latter countries present rather peculiar features when it comes to the transfer pricing legislative setting and actual enforcement.

To this end, the above-mentioned analysis is performed in order to assess whether consistency or, rather, subtle contradiction exists with the internationally endorsed principles and administrative practices that the OECD and the United Nations tried to lay down.

As a general remark, what seems rather odd—yet very significant in terms of geopolitics—is the fact that, on the one hand, the OECD is in full swing in deploying all of its resources to guarantee a swift and sound implementation of the BEPS Action Plan irrespective of whether or not a country is part of such an international organization. In this regard, the initiative falling under the OECD "Inclusive Framework"[3] tries to

1. To understand the difficulties linked with drawing a clear distinction between "developed" and "developing," it is worth noting that, in the 2016 edition of its World Development Indicators, the World Bank made a decision to no longer distinguish between "developed" and "developing" countries in the presentation of its data.
2. *See* the anecdotal evidence shown by Korotayev A., Zinkina J. [http://cliodynamics.ru/index.php?option=com_content&task=view&id=361&Itemid= developing country. The term implies inferiority of a developing country or undeveloped country compared with a developed country, which many countries dislike.
3. The OECD, as a response to the call of the G-20 Leaders, OECD members, and G-20 countries, has developed an Inclusive Framework ("IFW") on BEPS which allows interested countries and jurisdictions to work with the OECD and G-20 members on developing standards on BEPS related

respond to such a challenge; as of January 2018,[4] more than 100 countries have agreed to develop consistent BEPS standards in their own domestic legislation. Yet Brazil, China, and India have given their own—at times contradictory—interpretations of such international commitment in managing their domestic transfer pricing systems.

Moreover, the work of the United Nations in funneling a consistent approach to transfer pricing legislation should also be taken into account. In this regard, the significant achievement of the 2017 update of the United Nations Transfer Pricing Manual reflects the consistent approach taken by the UN Committee of Experts on Taxation matters of which the Transfer Pricing specialist constitutes its Subcommittee. Next to that, the recently created Capacity Development Unit, formed in 2012, has a close relationship with the Committee of Taxation Experts, and much of its work is targeted at disseminating the results of the Committee's work to developing countries through publications, training programs, and technical assistance. For example, the Capacity Development Unit has designed and delivered several courses on transfer pricing for developing countries in Africa and South America based on the Committee's *United Nations Practical Manual on Transfer Pricing for Developing Countries*. In addition, a successful pilot technical assistance project on transfer pricing has been carried out with Ecuador and will be extended to other countries.

Along the line of these initiatives, it came as no surprise then that, in April 2016, the United Nations, the OECD, the International Monetary Fund (IMF), and the World Bank Group (WBG) formed "The Platform for Collaboration on Tax" (the "Platform") as the institutional framework for enhanced cooperation by the four international organizations in delivering assistance to developing countries to strengthen their tax systems, including their transfer pricing systems.

Notwithstanding the above, the relationship between the Platform and the OECD "Inclusive Framework" is somewhat unclear. The Inclusive Framework is meant to be responsible for monitoring and supporting the implementation phase of the BEPS Project; it is open to all countries that are prepared to commit to the BEPS minimum standards. Developing countries can participate in the Inclusive Framework with equal rights and are entitled to receive capacity-building assistance from international organizations that will allow them to implement BEPS countermeasures effectively. The Platform and the Inclusive Framework are intended to cooperate closely. The activities of the Inclusive Framework will inform the work of the Platform, and the Platform will bring issues arising from its work to the attention of the Inclusive

issues and reviewing and monitoring the implementation of the whole BEPS Package as monitoring implementation and the impact of the different BEPS measures is a key element of the work ahead. The Inclusive Framework is a new global tax governance network created by the OECD to facilitate implementation of its signature tax coordination project, i.e., the OECD/G-20 Base Erosion and Profit Shifting (BEPS) initiative. The OECD intends the Inclusive Framework to engage participating states in "an inclusive dialogue on an equal footing to directly shape standard setting and monitoring processes." This entails, without expressly defining, a vision of international tax policy negotiation in which all participating states have a meaningful say in the decision-making that affects them. Should this be the actual goal, achieving an equal footing will require a significant institutional commitment to overcome the vast differences in resources, capacity, and relative bargaining strengths of the participating states.
4. For further references, *see* http://www.oecd.org/tax/beps/beps-about.htm.

Framework. However, at this stage, it is unclear how the relationship between the Platform and the Inclusive Framework will operate in practice.

As a result, despite this rather odd tension between the international organizations in dealing in a concerted manner with transfer pricing policy legislation and enforcement, a number of the major countries and regions representing the emerging economies of this world followed their own path in managing their domestic transfer pricing practices.

The next paragraphs will then address how Brazil, China, India, and some relevant economies from the Africa region took a position vis-à-vis the above-mentioned initiatives of such prominent international organizations in the area of transfer pricing.

2 SIGNIFICANT TRANSFER PRICING DEVELOPMENTS IN THE COURSE OF 2017: THE IMPACT OF PART D OF THE 2017 UNITED NATIONS MANUAL

Brazil, China, and India present certain similarities as well as certain differences when it comes to transfer pricing enforcement. Recent years of tax policy in these countries witnessed the circumstance that the approach to the interpretation and implementation of the arm's length principle is very much related with the economic policy considerations of each country's foreign policy.

In order to understand the magnitude of the discussion, it is necessary to focus on the economics at stake to realize why they achieved such prominence from a tax and transfer pricing standpoint.

First, China and India are cumulatively home to 40% of the world's population.[5] In 2014, China had the world's largest number of middle-class households, standing at 112 million, and the number is expected to reach 137 million by 2030.[6] Craving lucrative opportunities, investors are entering into the emerging markets. As a result, the global economy has observed a huge influx of FDI into these markets.

In this regard, looking at the BRICS countries, China and Brazil are amongst the most popular countries in which foreign investors are more willing to have their businesses in place. At a global level, the FDI inflow of BRICS countries in total accounts for almost 10% of the global FDI from 1970-2016.

In this regard, while all three jurisdictions were featuring themselves as capital importing countries, in the last five to ten years, such a trend reversed, particularly for China and India.[7] China somehow replaced India as the major funder of foreign direct

5. *See* US Central Intelligence Agency (CIA), World Factbook, 2015 statistics.
6. *See* Middle-class consumers are defined as those with 75.0%-125% of the median income. The source of data is Euromonitor International, *Top 5 Emerging Markets with the Best Middle Class Potential*, which can be assessed at: http://blog.euromonitor.com/2015/09/top-5-emerging-markets-with-the-best-middle-class-potential.html.
7. In this regard, the circumstance that China somehow surprised investors by issuing three new transfer pricing regulations during 2016 and 2017 that can be considered as some of the OECD BEPS Action Plan's international front-runners is significant. The newly introduced regulations, namely, Bulletins 42, 64 and 6, were issued related to the reporting of related-party transactions,

investment in the region of South-East Asia because of its significant donation of surplus capital to invest and started a very aggressive economic foreign policy campaign known as the "Belt and Road Initiative" (or BRI). India as well started to characterize itself as a capital exporter and a number of significant acquisitions by Indian conglomerates of foreign targets, which simply were unthinkable years ago, became a reality in recent years.[8]

From a purely transfer pricing standpoint, however, there is an underlying aspect that the above-mentioned countries share and is given by the slightly diverging interpretation of the arm's length principle as endorsed both at the OECD and at the United Nations levels.

It is not a case, indeed, that in the 2017 update of the UN Transfer Pricing Manual, part D on "Country Practices" entailed the existence of doubts as to whether Brazil, India and China wanted to clearly distance themselves from the arm's length principle.

In this regard, the 2017 version of the UN TP Manual expressly stated such diverging positions[9] when, by referencing to the foreword to the first edition of the UN TP Manual, it held the view that "[..]*While consensus has been sought as far as possible, it was considered most in accord with a practical manual to include some elements where consensus could not be reached, and it follows that specific views expressed in this Manual should not be ascribed to any particular persons involved in its drafting. [Part D] is different from other chapters in its conception, however. It represents an outline of particular country administrative practices as described in some detail by representatives from those countries, and it was not considered feasible or appropriate to seek a consensus on how such country practices were described. [Part D] should be read with that difference in mind.*" (NdR: emphasis added).

Based on the above premise, the following features represent, in the author's view, some of key elements where the countries listed below take their own views when it comes to transfer pricing policy design and implementation, namely:

(i) **Brazil**: being one of the first countries in South America that introduced transfer pricing legislation, despite its full involvement in the BEPS project, reiterated that the comparability analysis under the arm's length principle

the administration of APAs and rules for improving the administration of special tax investigations, and adjustments and MAPs, respectively. Dr Liao Tizhong, Director of the International Tax Division in the State Administration of Taxation (SAT), notes that China is increasingly eager to become an active participant in the international tax reform process. Such a position is in line with China's flourishing development of its transfer pricing regulations, in particular from the issuance of its first APA rule in 1998 to the latest Bulletin of 2017. Along the way, China has actively engaged in APAs and MAPs and produced significant results, as it had signed 51 bilateral APAs and made 43 transfer pricing corresponding adjustments by the end of 2015. Furthermore, during its Five-Year Plan (2011–2015) period only, the SAT eliminated international double taxation exposures of RMB 18.7 billion for MNEs. *See also* https://economictimes.indiatimes.com/news/international/business/china-expected-to-become-worlds-largest-importer-in-5-years-investment-firm/articleshow/61919413.cms.

8. For an example of such a trend, *see* the 2008 completion of the acquisition by Tata Motors of the Jaguar Land Rover businesses from Ford Motor Company for a net consideration of US $2.3 billion. For further information, *see* http://www.tatamotors.com/press/tata-motors-completes-acquisition-of-jaguar-land-rover/.
9. *See* Foreword, page V, of the 2017 Manual.

falls short of achieving market results. Therefore, it adopts methods with predetermined profit margins as well as rejecting the possibility of performing corresponding adjustments under its tax treaties in the same way that this is recommended by Article 9(2) of the OECD Model Tax Convention.[10]

(ii) **China**: the most active of the emerging economies in the field of transfer pricing, its State Tax Administration ("SAT") always stressed the relevance of the market of distribution (and associated proximity to customers) to be treated in a manner akin to an intangible rather than a comparability factor. This views found its expression in the notion of "location-specific advantages" or "location rents where China made it clear that they will construe the recommendations of Actions 8-9-10 of the BEPS Action Plan in a manner consistent to what is reflected in their own domestic administrative practice.

(iii) **India:** the country has always been characterized, more than any other jurisdiction, by a "hypertrophic" production of its courts in the field of transfer pricing. The attention of Indian judges was on every single facet of transfer pricing legislation but, more than any other country, the importance given by its administration toward the notion of intangibles (and an alleged economic ownership notion underlying every distribution activity taking place within its domestic boundaries) as well as the approach to intercompany services stood out when compared to any other transfer pricing issue.

(iv) **Mexico:** like the above-mentioned countries presented earlier, Mexico shares a common goal with these jurisdictions which is securing tax revenues from base erosion and profit shifting phenomena. This situation particularly concerns developing countries and emerging economies which collect the most significant portion of their revenue as corporate income tax from multinational groups. Significant tax noncompliance concerns as well as the political challenge of imposing general indirect taxes in developing countries such as Mexico have forced the latter jurisdiction to revisit its tax collection strategy.

Notwithstanding the above, the BEPS approach to transfer pricing may not necessarily benefit Mexico which—among OECD countries—has the lowest tax to gross domestic product (GDP) ratio (19.5% in 2014, compared to the OECD average of 34.4%).[11]

Because of tax collection pressure, Mexican tax authorities may seek to adhere strictly to the recommendations coming out of the BEPS Final Report to transfer pricing audits that do not necessarily always reflect the principles agreed at the OECD level. In fact, recent experience in transfer pricing audits in Mexico has revealed the potential for differing interpretations of the arm's length principle, although the Mexican SAT generally guarantees a consistent application of transfer pricing provisions. For instance, should the BEPS approach for properly understanding value creation be

10. *See* Oliveira, A. Gomes de; Moreira, F. Lisboa, *The Brazilian Transfer Pricing Regime*, in Bulletin for International Taxation, IBFD, 2017 (Volume 71), No. 6.
11. *See* OECD, Revenue Statistics, available at http://www.oecd.org/tax/tax-policy/revenue-statistics-ratio-change-latest-years.htm.

applied in a way aiming at highlighting, e.g., solely headcount or payroll expenses, such an approach would likely lead to double taxation as developed economies may rely on other value contribution assets (e.g., R&D activities, marketing functions, depending on the circumstances and the industry sector at stake) to justify the attribution of residual margins.

Although Mexico is very well represented in transfer pricing issues by skilled officials at both the OECD and United Nations fora, the reality of transfer pricing audits in the country do not seem to always be reconciled with sound tax policy approaches. For instance, certain foreign-owned MNEs with subsidiaries in Mexico have reported that, during past audit activities, Mexican tax authorities, at times, have requested information in the course of an audit on payroll expenses of the top executives of the Mexican subsidiary and its counterparts.

Such information, on top of the data collected on head counts provided in the country-by-country reporting, might lead to a distortion in profit attribution or to a complete recharacterization of the actual substance of the transactions by Mexican tax authorities. However, such an approach would not be consistent with the arm's length principle and, therefore, could lead to double taxation.

The following paragraphs will review each of these relevant developments in detail. However, the author believes that a significant aspect to focus on in identifying a sound conceptual framework for understanding the transfer pricing approach applied in the above-mentioned countries is how Brazil, China, and India look at the notion of "risk." In particular, the tax administrations of the latter countries generally aim at construing it in a more economical manner vis-à-vis the OECD and UN position as expressed in the notion of risk management and financial capacity to assume risk.[12]

More in detail, markets (and proximity to them) play an indispensable role in the business life of MNEs. MNEs make decisions with regard to which market and in what form they would like to establish their businesses after assessing the relative strengths and weaknesses of them. The consideration of which market to choose in the business setting of MNEs has given rise on how to consider the notion of location-specific advantages (LSAs) in the field of transfer pricing. "Location savings", lacking an official definition, is in transfer pricing parlance often understood both as: (i) (net) cost savings realized by an MNE exploiting price differences in the factors of production between alternative jurisdictions; and (ii) as any extra profits arising thereof.

The discussion of the identification and allocation of location savings in the past was mostly related to the relocation of manufacturing activities from a "high-cost" to a

12. The concepts of "risk management" (embedding within it that of control over risk) and "financial capacity to assume risk" are contained in Chapter I of the 2017 update of the OECD Transfer Pricing Guidelines, in the new Section D2, at para. 1.60 onwards. The above-mentioned concepts lie at the heart of the revamp of the "BEPS" transfer pricing analysis in requiring an accurate delineation of the transaction by going through of a six-step approach to risk allocation. This is where, in the author's view, Brazil, China, and India approach the issue in a substantially different manners in trying to attribute a greater economic premium to the market where profit economically arises.

"low-cost" location and raised interest both from MNEs that were involved in business restructurings and relocation of activities and from tax administrations in both types of countries that were concerned.

Despite the rather significant amounts at stake, the subject appears to have attracted relatively little attention from the transfer pricing community with some exceptions in the nineties but again with little public awareness since then. However, its importance gained prominence again given the explosive growth of Foreign Direct Investments (FDIs) in emerging economies with the BRICS countries (led by China and India) emphasizing the importance of fair treatment (i.e., taxation in the "market country") of location savings in transfer pricing matters.

In this context, the term location savings appears to have a broader meaning and go beyond the situation of relocating a plant from a "high-cost" to a "low-cost" jurisdiction. On the contrary, it relates to any net cost advantage that a company involved in any activity in a certain country may benefit from and the impact it should have on the transfer pricing dealings it has entered into with other related companies.

This entails that, along with the rapid economic growth, emerging countries are big advocates of the concept of LSAs. China and India in particular are known for holding strong views regarding LSAs, but also African countries (e.g., South Africa), Asian (e.g., Vietnam), and some other developing countries are currently considering implementing specific transfer pricing rules regarding LSAs. The emerging markets, in general, contend that the additional profits attributable to LSAs should accrue to the jurisdiction in which the business operations actually take place as they are physically closer to the source of income and, therefore, the associated premium profit margins arising therefrom should be taxable by that very jurisdiction, i.e., the market country.

Notwithstanding the above, it is worth mentioning that LSAs do not involve solely emerging markets but, rather, are a more generic item relevant to all types of economies with regard to transfer pricing, and countries that are more capital importers than capital exporters tend to maintain similar views.

Stated otherwise, it seems that LSA is a notion to be construed as a by-product of the economic argument whereby risks are economically shared irrespective of their "legal segregation" by means of contractual arrangements and, therefore, the economic impact of certain risks is translated at a separate entity level irrespective of their transfer pricing labeling.[13]

For instance, assume that a US MNE active in the automotive business and characterized as a "principal" for transfer pricing purposes experiences a significant crisis in the industry, triggering a dramatic reduction in sales. Such an external factor (i.e., the market demand reduction leads to a contraction of the production capacity at the group level, leading to a business restructuring requiring the closure of

13. Interestingly enough, it seems that such a view is held by the OECD itself in the 2010 Report "Attribution of Profits to Permanent Establishments" that is currently a subject of review by WP6 in the wake of the follow-up work to BEPS Final Report on Actions 8–9–10. In Part I of the Report, it is clearly argued that, in Step 1 of the Authorized OECD Approach, ("AOA") risks—absent binding legal arrangements between the head office and the rest of the enterprise of which it is a part—always follow functions, i.e., can never be separated from the source-generating activities of income.

manufacturing plants due to production overcapacity (and associated increase of inventory costs)). Such an externality would arguably affect the remuneration that is left at the level of both related party or third-party contract or toll manufactures, although such entities are being—in the transfer policy of the group—generally treated as low-risk entities entitled to routine margins. In light of the surge of the LSA argument, the position of the tax administration of BRICS countries is questioning the legitimacy of such a widely accepted notion.

3 BRAZIL

As a capital importing country, Brazil has always imposed measures of protection of its corporate tax base. These measures include limitations on remittances abroad and the deductibility of royalty payments on top of the introduction of the transfer pricing legislation in 1996. In this regard, Brazil was one of the first Latin American countries to enact such legislation, together with its unique worldwide income taxation regime for companies which goes far beyond the usual controlled foreign company (CFC) regimes to include taxing income earned offshore, the concepts of black and grey lists, the application of the concept of beneficial ownership, and thin capitalization rules that incorporate a flat debt-to-equity ratio. From a policy perspective, these rules are Brazil's defense against tax evasion even if they can result in double taxation.

As far as transfer pricing is concerned, Brazil stands out in a category of its own. Almost 20 years after the introduction of Law 9,430/1996, the term "arm's length" was incorporated into the doctrine to denote a principle to comply with in respect of a transaction between related parties under which the parties have to act as if they were independent. According to some literature,[14] the fixed margins introduced by the Brazilian legislator in applying the transfer pricing methods have the following three main objectives, namely: (i) countering tax avoidance; (ii) guaranteeing predictability regarding the attraction of foreign investment; and (iii) assessing the respect of the principle of strict legality. Therefore, there are already two elements which make Brazil's position with respect to transfer pricing different than the internationally accepted standards, namely:

(i) The fact that transfer pricing provisions have been introduced targeting tax avoidance and not a proper allocation of taxable income, in mind; and
(ii) The use of fixed margins and industry weighted averages rather than a proper comparability analysis.

Defining the concept of cost to determine the comparable arm's length price is difficult. Specifically, in transactions between independent parties, it is not the cost incurred on which comparability is based but rather a planned cost that has benefit, sometimes nonmonetary or nondisbursed, which is the basis for third parties to add to their profit margin. Consequently, the predetermined margins adopted by Brazil are an

14. *See* M. Ilarraz, *Drawing upon an Alternative Model for the Brazilian Transfer Pricing Experience: The OECD's Arm's Length Standard, Pre-fixed Profit Margins or a Third Way?*, Brit. Tax Rev. 2, pp. 227–228 (2014).

attempt to capture what the intercompany prices would have been had the transactions in question occurred between independent parties.[15]

In the following, a more detailed description of the recognized transfer pricing methods according to domestic Brazilian legislation is provided:

The *preços independentes comparados* (independent comparable prices, PIC) method is defined as the arithmetic mean of the prices of identical or similar goods, services or rights, ascertained in the Brazilian market with regard to purchase and sale transactions under similar payment conditions. The details of the PIC are contained in Article 18, first paragraph of Law 9,430/1996.

As can be appreciated from its legal definition, the PIC method is a comparison between the transaction conducted by the related party domiciled abroad and a Brazilian, unrelated company or between a Brazilian company and a foreign, unrelated company on the basis that such transactions must be identical or similar in relation to transactions between a related foreign company and an unrelated third party. The related company located outside Brazil must provide the relevant information.

In order for the PIC method to apply, the products compared in the transactions used as standards and the transactions in question must be similar. The definition of similarity for comparability purposes is set out in Article 42 of IN 1,312/2012 and must "have the same nature and function; may be mutually replaced in the function for which they were produced; and have equivalent specifications."

Certain adjustments are possible with regard to transactions arising out of business. These may be physical or content-related in nature. The purpose of this is to make the transactions compatible. If the PIC with the OECD comparable uncontrolled price method ("CUP") are compared, minor differences seem to exist with the internationally accepted guidance reiterated also within the UN Practical Manual on Transfer Pricing for developing countries, although the strict requirement of retrieving information from the entity located abroad may present some difficulties from a strict compliance standpoint.

The *preço de revenda menos lucro* (resale price less profit method, PRL) is defined in Article 18, item II of Law 9,430/1996, as being the weighted arithmetic mean of the resale prices of the goods, services, or rights in Brazil calculated in accordance with a specific method, i.e., a formula, that is intended to compare the participation in the cost of the goods, services, or rights sold of the imported input and apply such a percentage to the sale price of the finished goods, services, or rights.[16]

In general, the PRL is the method applied in most of the situations in which a Brazilian importer has difficulties in obtaining the supporting documentation required

15. Such a position has been argued by L. Schoueri, in *O arm´s length como Princípio ou Standard Jurídico*, in *Estudos de Direito Tributário em Homenagem ao Professor Gerd W. Rothmann*, pp. 203–230 (L.E. Schoueri et al. eds., Quartier Latin 2016).
16. The difference is the profit, which must fall within the appropriate fixed profit margin, which depends on the sector involved. The fixed profit margins are as follows: (1) 40% in respect of pharmaceuticals, tobacco, optical, photographic, and cinema equipment and tools; medical-hospital machinery including dental machinery, equipment and tools; natural gas and oil extraction, and petroleum derivatives; (2) 30% in respect of chemical products, glass and glass products, cellulose, paper and paper products, and metallurgy; and (3) 20% in respect of all the other sectors.

by the tax administration in respect of the other methods, such as the PIC. The PRL has also attracted the most criticism in terms of noncompliance with OECD or UN standards as no value chain analysis is undertaken in determining the minimum profitability required for the Brazilian party in question. In most situations, especially when the Brazilian entity is a limited-risk distributor or a contract manufacturer, it is very complicated to meet even the lower fixed margin of 20%.

In addition, the PRL is the method that has been most scrutinized by the administrative and judicial courts. The relevant discussions date back to the initial years of application of the transfer pricing rules in Brazil. In this context, the original wording of the method was then simpler and stated that the sales price, as adjusted for the unconditional discounts, taxes, and contributions, applied to sales and commissions and brokerage fees paid, less a 20% fixed profit margin, was compared with the import price. However, IN 38/1997 limited the application of the method to straightforward import-resale transactions and did not apply when the imported item was used as stock in the production of other goods, services, or rights sold. This was a limitation only contained in the administrative practices and not in the law.

The *custo de produção mais tributos e lucro* (production cost plus profit, CPL) method is defined as the average production cost of identical or similar goods, services, or rights in the country in which they were originally produced plus the taxes and fees charged on the export operation in the country in question. The CPL contains a profit margin of 20% calculated on the price so determined.

At first sight, the CPL method would appear to be easy to use provided that companies have the necessary information to support it. However, companies can encounter substantial challenges in gathering evidence in respect of the costs incurred abroad by the related party.

In this regard, it should be noted that the local tax administration (*Receita Federal do Brasil—RFB*) is strict in demanding reliable accounting information from abroad, including contacting the companies that wish to keep their price formation data confidential. The CARF has also often held in favor of the tax authorities thereby further hindering the application of the CPL method. As a result, when applying the method, a great deal of documentation and information from the foreign related party is necessary to sustain the application.

The fourth method is the *preço sob cotação na importação* (price under quotation on import, PCI) method and mandatorily applies to goods or rights that are subject to public prices in internationally recognized mercantile and future exchanges as defined in Article 18, sixteenth paragraph of Law 9,430/1996. Although there is no clear definition in law, all of the regulatory rules on the issue refer to its application to commodities traded on internationally recognized exchanges. IN 1,312/2012, which regulates the application of the transfer pricing rules, includes a list of goods in Appendix I, as well as their relevant *Nomenclatura Comum do MERCOSUL* (tariff classification numbers, NCMs) which, if traded on international exchanges, must be subject to the PCI method.

The *preço de venda nas exportações* (export price method, PVEx) is contained in Article 19, third paragraph, numeral I of Law 9,430/1996. The PVEx is defined as the arithmetic mean of the sale prices charged by the company to other customers or by

another national exporter of identical or similar goods, services or rights, in the same income tax calculation period and under similar payment conditions.

For the purposes of the consistent use of the PVEx, the free on board (FOB) price must be used in the comparison. If the transaction is conducted according to the cost, insurance, and freight (CIF) standard, the freight and insurance costs must be excluded. With regard to taxes, the comparability must follow the provisions of Article 19, second paragraph, numeral I of IN 1,312/2012, the price of which, in the Brazilian market, shall be deemed net of any unconditional discounts granted, of ICMS [state VAT], of the Municipal Service Tax (ISS), COFINS and PIS/PASEP.[17]

As far as transfer pricing of intercompany financing is concerned, the domestic provisions regarding intercompany financing transactions have changed over the years. When the first rules were issued in the initial version of Law 9,430/1996, all of the interest paid on intercompany loans was deductible provided that the contract was properly registered with the Brazilian Central Bank.

In its original text, Law 9,430/1996 established the following:

(a) an objective limit in respect of the deductibility of interest where the debtor was a tax resident in Brazil;
(b) a taxable amount where the creditor was resident in Brazil; and
(c) that, with regard to contracts registered with the Brazilian Central Bank, interest should be considered to have been agreed, i.e., a "safe harbor." In practice, as almost the entire loan transactions between Brazilian companies and foreign-related parties were registered with the Brazilian Central Bank, the safe harbor provision applied in almost all situations.[18]

In 2012, with the amendments made to Article 22 of Law 9,430/1996, the express reference to contracts not registered with the Brazilian Central Bank was withdrawn, which established the use of the rate provided for in the registered agreement. In doing so, these changes excluded the use of the "safe harbor" in respect of interest deductibility in Brazil.

Consequently, with regard to *Lei* (Law) 12,766/2012, the limit for deductibility of interest expenses became: (1) a preestablished interest rate; and (2) a spread margin that would be defined by the Ministry of Finance. In particular, the *Portaria* (Edict)

17. There is, nevertheless, a limitation relating to the PVEx. This is that the comparison can only be made with regard to the national company, i.e., the party in question, or any other Brazilian exporter. Such an unrelated Brazilian exporter can sell to other unrelated parties, and this price can be used for comparison despite the fact that it may not be possible to collect data from a foreign company selling to an unrelated third party with regard to the application of the PVEx.
18. The original wording of Art. 22 of Law 9,430/1996 was an effective measure aimed at guaranteeing consistency with the arm's length standard as the registration of intercompany loans was carried out manually and the Central Bank undertook a double-check and/or review of the relevant rate. This persisted until 2007, when the *registro declaratório eletrônico* (electronic registration module, RDE-IED) was set up and the previous verification of the rates was removed from the system. In addition, as the hyperinflation and weak currency that existed prior to 1995 had long past, the rules regarding transfer pricing verification on intercompany loans were in need of revision.

427/2013 establishes a spread margin of 3.5% when the Brazilian party is the borrower and 2.5% when the Brazilian party is the lender. The preestablished interest rate is the interest rate paid by Brazilian sovereign bonds with prefixed rates in US dollars or Brazilian reals or the six-month London Interbank Offered Rate (Libor) rate in respect of other transactions in foreign currency.

Comparing the changes in Brazilian transfer pricing rules introduced by Law 12,766/2012 with the international practice as adopted by the OECD Transfer Pricing Guidelines reveals that the Brazilian legislation is still far from the arm's length principle due to certain fundamental differences such as the lack of commitment to market variables that directly affect the interest rates charged on financial transactions. Stated otherwise, rather than enforcing the arm's length principle adopted by the OECD Model and followed in international practice, the Brazilian transfer pricing legislation attempts to establish a maximum deductibility standard or minimum revenue to be recognized.

With regard to the deductibility limit as set out in Article 22, paragraph 6 of Law 9,430/1996, interest paid or credited to a related party abroad can only be deducted up to the following limits:

- the market rate in respect of Brazilian sovereign bonds issued in the foreign market in US dollars for transactions in US dollars at a prefixed rate;
- the market rate in respect of Brazilian sovereign bonds issued in the foreign market in Brazilian reals for transactions in reals at a prefixed rate; and
- the six-month Libor in all other cases.

The predetermination of the interest rates may also give rise to controversy. Fixed income investments yield an interest rate which may be pre- or post-fixed. The prefixed interest rate is agreed at the time of signing the loan agreement, but the post-fixed interest rate only becomes known on the return of the investment. While the rules established a prefixed interest rate for Brazilian sovereign bonds in US dollars or Brazilian reals or the Libor for transactions in other currencies, they failed to establish a post-fixed interest rate for use in floating rate transactions.

More importantly, Brazil has expressly stated its position of not taking into account corresponding adjustments affecting the other contracting party resulting from the application of transfer pricing rules in the context of a tax treaty. None of the tax treaties that Brazil has concluded contain an equivalent of Article 9(2) of the OECD Model. In this respect, Brazil has stated its reservations on the contents of *OECD Model Tax Convention on Income and on Capital* Article 9(2) but is now attempting to align its laws with Action 14 of the OECD/G-20 BEPS initiative, although it is not possible to say when such measures will be fully implemented by Brazil.

Other interesting transfer pricing areas where Brazil took its own views are those related to services and royalty payments.

According to Article 18, paragraph 9 of Law 9,430/1996, Brazil's transfer pricing rules do not apply to royalties and technical, scientific, administrative, or similar assistance that remain subject to the deductibility conditions stipulated by the current legislation.

With regard to such issues, it is interesting to note that Brazilian tax law contains objective limitations on the deductions of royalties and related technical and/or administrative assistance. In particular, a limit of 5% deductibility for royalty and assistance, i.e., technical, scientific, administrative, and related payments based on the revenues arising from the intangible or technology that is used has been always in place.[19]

Generally, the costs relating to royalties including the technical, scientific, or administrative assistance and rents relating to such royalties should only be deductible when a contract is registered with the *Instituto Nacional de Propriedade Intelectual* (National Industrial Property Institute, INPI), i.e., the Brazilian patent and trademark office, and the Brazilian Central Bank. The deductible amount is established at 1% of the net sales for trademarks or up to 5% of the net sales depending on the economic sector, for patents, industrial processes, and manufacturing formulas and the corresponding technical, scientific, administrative, or similar assistance payments.

In this context, it should be noted that, as an importer of technology, Brazil limits the deductibility of the amounts paid as royalties in order to protect its taxable base. it could be argued that these provisions could fully meet the underlying rationale of the BEPS project, but the objective is achieved at the expense of applying the arm's length principle. As a result, the transfer pricing rules do not apply on such costs/payments for this reason.

Regarding safe harbors, Brazilian legislation covers safe harbors in a simple way with regard to related-party transactions. The first safe harbor applies whenever the average cost of goods sold to related parties in export transactions is equal to or exceeds 90% of the average cost of goods sold in the Brazilian market to unrelated parties. In such circumstances, taxpayers are not covered by the transfer pricing export methods.

The second safe harbor relates to the materiality of the export revenues. This applies when the net export revenues are equal to or less than 5% of the total net revenue of the entity in the period and the relevant documentation is sufficient to prevent any adjustment.

The third safe harbor relates to a stimulus for the exports of Brazilian companies. When the party in question can demonstrate that it has realized a net profit before corporate income tax and social contributions that is equivalent to or greater than 10% of the export revenue, taking the average of the previous two years, and provided that the total export revenues do not exceed 20% of the total net sales of the company, the transfer pricing methods do not apply.

Finally, when the parameter price differs by up to 5% of the actual price or 3% in the case of the PCI or PECEX methods, no adjustment is made.

For the transfer pricing analysis of intercompany services, Brazil approaches as follows: The tax administration has always imposed a high tax burden on the import of services. With regard to intra-group services or the low value-added services between Brazilian companies, it should be noted that, when the centralizing entity consolidates the costs of administrative functions such as accounting, legal, financing, etc., and the

19. *See* BR: Lei (Law) 3,470/1958 of November 28, 1958, Art. 74).

cost is recovered without a markup being applied, the majority position of the doctrine of legal scholars and the prevailing jurisprudence of the courts hold that it should be accepted as the reimbursement of costs or cost recovery.

The recent review of the transfer pricing guidelines promoted by Action 8 to 10 of the OECD/G-20 BEPS initiative prompted a domestic review of how the tax administration should approach the issue of low value-added services. In this respect, such services have a close proximity to the Brazilian concept of *atividade-meio* (ancillary activity) and, as such, could be subject to the reimbursement of expenses.[20] It is not possible to reimburse the costs of operations that represent the main activity of the entity and, in such cases, transfer pricing provisions apply. The treatment of the "importation of services" which is broadly subject to taxation in Brazil at total combined rates ranging from 39.25% to 49.25% should also apply when the Brazilian entity is subject to a cost contribution agreement (CCA) and benefits from services provided abroad.

Based on the above-mentioned analysis, it is possible to conclude that, although inspired by the OECD and the arm's length standard, Brazil's transfer pricing legislation positions itself far from the practices adopted in international taxation. It remains to be seen how the implementation of the BEPS recommendations will be taking place within the country as Brazil is a full member of the OECD "Inclusive Framework."

4 CHINA

In 1991, China introduced its first transfer pricing provisions under the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises which—in a way similar to Brazil- were thought of initially more as an anti-tax avoidance measure.[21]

The emergence of the Chinese transfer pricing provisions was heavily influenced by the phenomenon that more than half of the foreign-invested enterprises reported an operating loss in the 1980s. Indeed, the tax policy in China during that time was strongly pro-FDI with the aim of attracting foreign investments and strengthening the Chinese economy. In the 1990s, the tax incentives provided to foreign-invested enterprises in China were enormous. One of the incentives for foreign-invested industrial enterprises scheduled to operate for a period of ten years or more included exemption from income tax for the first two profit-making years and a 50% tax reduction for the following three years with the possibility to carry forward operating

20. *See*, for further details, E.P. Bifano, *Apuração de Preços de Transferência em Intangíveis, Contratos de Prestação de Serviços, Intragrupo e Cost Sharing Agreements* (L.E. Schoueri ed.) 3 Tributos e Preços de Transferência p. 45 (2009).

21. *See* K.H. Chan & L. Chow, International Transfer Pricing in China (Sweet & Maxwell Asia 1998); K.H. Chan & L. Chow, An Empirical Study of Tax Audits in China on International Transfer Pricing at 83–112, 23 Journal of Accounting and Economics (1997); M. Huang & H. Yu, China: Transfer Pricing at 21–26, International Tax Review (1997); H. Sun, DFI, foreign trade and transfer pricing at 362–382, 29 Journal of Contemporary Asia 3 (1999); J. Li, Transfer Pricing in China at 565–576, 54 Bulletin International Taxation. 11 (2000), Journals IBFD; J. Li, Transfer Pricing Audits in Australia, China and New Zealand: A Developed VS. Developing Countries Perspective at 21–28, 32 Intl. Tax J. 21 (2006); and D.H.K. Ho & P.T.Y. Lau, A Tax Study of Transfer Pricing in China at 62–78, 28 International Tax Journal 62 (2002).

losses at the starting stage for five years. Empowered by the domestic transfer pricing provisions, the Chinese tax authorities can conduct a transfer pricing adjustment when the payment or receipt of charges in transactions between a foreign-invested enterprise and its foreign associated enterprises is not at arm's length, which ultimately results in a tax revenue loss in China.

However, it was not until 2008 that the workload of transfer pricing cases of the Chinese tax authorities had substantially increased. To some extent, the tightened rule toward foreign-invested companies resulted in these companies generating more and more tax revenues in China. The year of 2008 was also a milestone because the State Administration of Taxation (SAT) began introducing transfer pricing concepts, such as LSAs, that were new to the OECD standards and encouraged the local taxation bureaus to explore and apply the concepts in their tax audits.[22]

One year later, the Chinese tax authorities successfully collected the overdue taxes of CNY 544 million (around EUR 74 million) during the fiscal year of 2009 by applying concepts such as location savings, market premiums, etc. in the negotiations of bilateral advance pricing agreements (BAPAs).

Following this line of reasoning, the SAT believed that the notion of LSAs emphasized the advantages of emerging markets, i.e., the purchasing powers and the cheap labor force, the contributions of which should be acknowledged and respected in value creation.

In 2009, China introduced a comprehensive anti-avoidance regime into the legislation—including the transfer pricing articles—for the first time through the "Special Tax Adjustment" provision in Chapter 6 of the Enterprise Income Tax Law and its Implementation Regulation. In 2009 (but retroactively effective from 2008), the SAT released the Implementation Measures of Special Tax Adjustments (Trial Version), better known as Circular 2.[23]

In September 2015, the SAT released the Consultation Draft Circular entitled "Implementation Measures for Special Tax Adjustments" or Draft Circular 2.[24] The latter administrative documents aim at amending and updating Circular 2 by implementing the latest OECD BEPS developments. Throughout Draft Circular 2, the role of location savings, market premiums, and other LSAs in value creation is frequently emphasized. Draft Circular 2 was finalized through three publications, namely: (i) Bulletin 42, "About Improving Reporting and Filing of Related Party Transactions and Contemporaneous Documentation" in July 2016; (ii) Bulletin 64, "Improving the Administration of Advanced Pricing Arrangements" in October 2016; and (iii) Bulletin 6, "Implementation Measures for Special Tax Adjustments and Mutual Agreement Procedure" in April 2017.

The interesting common feature of the above-mentioned documents is that these bulletins show that the Chinese tax authorities are gradually toning down the emphasis

22. *See* Notice of the SAT's Work on the Anti-Tax Avoidance in 2008, Guo Shui Han [2009] 106, March 6, 2009.
23. *See* Implementation Measures for Special Tax Adjustments (Trial), Guo Shui Fa [2009] 2, January 8, 2009.
24. *See* Implementation Measures for Special Tax Adjustments (Draft), September 17, 2015.

on LSAs. Such a reduction in emphasis on the notion of LSAs may be possibly justified by the endorsement by China of the BEPS Inclusive Framework.

However, there are no specific transfer pricing rules concerning LSAs in the domestic legislation even after the finalization of Draft Circular 2. Instead, the Chinese tax officials have made a self-statement in Chapter D.2. of the UN Manual, "China Country Practice," providing input on how the Chinese tax authorities address the issue of LSAs in their tax audits.

Within the country chapter, the Chinese tax authorities adopted a four-step approach on the issue of LSAs, namely: (i) identifying whether an LSA exists; (ii) determining whether the LSA generates additional profit; (iii) quantifying and measuring the additional profits arising from the LSA; and (iv) determining the transfer pricing method for allocating the profits arising from the LSA.

If the Chinese approach on location savings and the OECD position on "local market features" as a comparability factor are compared, certain similarities exist. However, it seems that the OECD's approach is more prescriptive as the determination of the additional profits arising from LSAs should take into account whether the LSAs are passed on to independent customers or suppliers and, if so, to what extent. The thought behind of the OECD's approach is that LSAs may not necessarily generate location rents and, therefore, market premiums to be remunerated.

When determining LSAs and their impact on transfer pricing, the Chinese tax authorities raise two factors in particular for consideration, namely, the industry analysis and the quantitative analysis.[25] However, further information on how to conduct the analyses is missing. In the absence of detailed guidance, taxpayers may face difficulties in practice when dealing with LSAs, especially for the quantitative analysis.

With regard to whether LSAs exist and what they are, the Chinese tax authorities refer to the automotive industry as an example.[26] It is believed that there are six types of LSAs existing in the automotive industry in China, as follows, and that the benefits derived from those LSAs should accrue to the Chinese enterprises:

- the foreign enterprise offering lower prices for the provision of technologies in return for the limited market access opportunities;
- the foreign enterprise charging premium prices in China due to the Chinese consumers having general preferences for foreign brands and imported products;
- a large number of potential customers;
- capacity constraints on the supply of domestically assembled automotive vehicles;
- lower duty savings if imported car parts are assembled domestically; and
- a large supply of high-quality and low-cost parts manufactured by Chinese suppliers.

25. In this respect, *see* 2017 UN Manual, at para. D.2.4.4.
26. *See* 2017 UN Manual, at para. D.2.4.4.7.

1 INTRODUCTION

Comparability is at the center of transfer pricing and the application of the arm's length principle (ALP). The authoritative statement or definition of the ALP as expressed in Article 9 of both the OECD Model Tax Convention on Income and on Capital (OECD MTC) and the UN Model Double Taxation Convention between Developed and Developing Countries reads:

> [Where] conditions are made or imposed between the two [associated or related] enterprises in their commercial or financial relations which "differ" [emphasis added] 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.

The importance of a comparability analysis is well described in the 2017 United Nations Practical Manual on Transfer Pricing for Developing Countries (2017 UN Manual). It states that "a good comparability analysis is an essential step in any transfer pricing analysis in order to gain a correct understanding of the economically significant characteristics of the controlled transactions and of the respective roles of the parties to the controlled transaction. This will assist in the selection of the most appropriate transfer pricing method to the circumstances of the case. [...] In most cases, the application of the selected transfer pricing method will then rely on the identification of uncontrolled comparable transactions."[1]

Of note is that the definition of the arm's length principle does not use the term "transactions" but uses the—in the authors' opinion, broader—terms "relations" and "conditions." As the guidance that is published on transfer pricing also uses the term "transactions," the authors will also refer to this term.

In order to determine the differences between the conditions established between associated or related parties (in the so-called controlled transactions) and the conditions that third parties (in the so-called comparable uncontrolled transactions) agree upon—or would agree upon—it is obvious that one can only do so by "comparing"

1. 2017 UN Practical Manual on Transfer Pricing for Developing Countries—paras. B.2.5.2. and B.2.5.3.

those conditions. In other words, one has to define and analyze the following two terms of an equation:

Conditions controlled transactions $\approx$[2] *conditions comparable uncontrolled transactions*

This equation leads to a two-pronged approach under the so-called comparability analysis: defining the controlled transactions and the search for comparables.

This contribution will explore the recent developments on the comparability analysis in transfer pricing. It will give a brief history of the guidance on comparability since the first OECD transfer pricing guidelines (Transfer Pricing and Multinational Enterprises—Report of the OECD Committee of Fiscal Affairs—1979) were published up to and including the 2017 revision of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. It will also address the recent comparability issues addressed in guidance published by the United Nations, the Platform for Collaboration on Tax, the World Bank, and the EU Joint Transfer Pricing Forum (JTPF). It will also analyze the comparability aspects as they can be deduced from some recent State aid decisions of the European Union Commission (EC). Finally, it will discuss potential pitfalls and address possible improvements in the different reports as well as probable enhancements.

While the time span between the updates in the guidance was quite long in the past, the development in recent years has been continuous. The timeline shown in Figure 6.1 gives an overview of the recent developments and publications of the international organizations in the area of transfer pricing.

2. The symbol $\approx$ is used to indicate that it is not necessary to have an absolute match between the controlled and uncontrolled transactions.

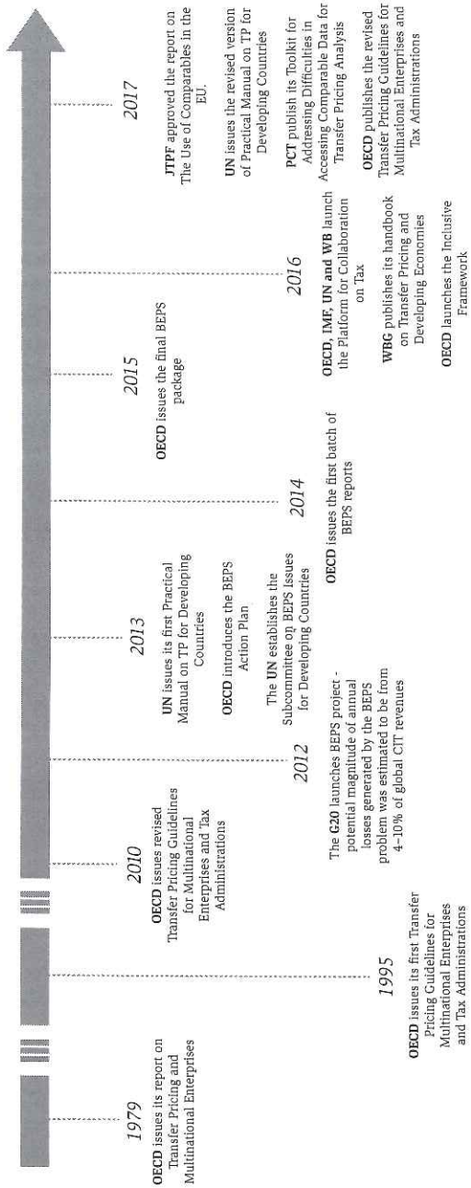


Figure 6.1 Timeline: Publications on Transfer Pricing by International Organizations

2 OECD HISTORICAL DEVELOPMENTS ON STANDARDS OF COMPARABILITY

Over the past decades, the international authoritative guidance on the ALP and the standards of comparability have mainly emerged from OECD work. The following sections briefly outline the historical development of OECD guidance on comparability from the first OECD transfer pricing report published back in 1979 up to and including the 2017 revision of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

2.1 1979 OECD Report: Transfer Pricing and Multinational Enterprises[3]

The 1979 OECD Report of the OECD Committee on Fiscal Affairs—Transfer Pricing and Multinational Enterprises (hereafter, 1979 Report) did not contain detailed guidance on how to perform a comparability analysis except for a short discussion on functional analysis under the General Considerations of the Report.[4] Although the discussion was relatively short, the 1979 Report focused on the importance of analyzing the functions of the various entities in a multinational enterprise (MNE). The 1979 Report already recognized the importance of identifying the first leg of the comparability equation, i.e., defining the controlled transaction.

The concept of "comparability" was, for the first time, cited in the 1979 Report in the context of the application of the ALP. Paragraph 48 of the 1979 Report stated that:

> The comparable uncontrolled price method offers the most direct way of determining an arm's length price. The transfer price is set by reference to comparable transactions between a buyer and a seller who are not associated enterprises [...]. The method requires the uncontrolled transactions to be carefully reviewed for "comparability" [emphasis added] with controlled transactions.[5]

The 1979 Report further cited the need for comparability of: geographic markets,[6] market levels,[7] goods,[8] functions performed and risks assumed by resellers,[9] and other considerations such as product innovativeness, market conditions, custom of the trade, how the MNE is organized, general economic functions, and "all other relevant facts and circumstances of each individual case [...]."[10] Unfortunately, no further guidance was developed at that stage.

3. OECD, *Transfer Pricing and Multinational Enterprises* (Paris: OECD Publishing, 1979).
4. 1979 Report, *supra* n. 3, at para. 17.
5. 1979 Report, *supra* n. 3, at para. 48.
6. 1979 Report, *supra* n. 3, at para. 49.
7. 1979 Report, *supra* n. 3, at para. 50.
8. 1979 Report, *supra* n. 3, at paras. 51–54.
9. 1979 Report, *supra* n. 4, at para. 59.
10. 1979 Report, *supra* n. 4, at para. 55.

2.2 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations[11]

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations were first published in their original version in 1995 (1995 OECD TPG). They were intended as a revision and compilation of previous reports by the OECD Committee on Fiscal Affairs. The 1995 OECD TPG already contained detailed provisions on comparability including a discussion of functional analysis that was applicable to all transfer pricing methods and set forth five factors that can influence the comparability of controlled and uncontrolled transactions for purposes of applying the ALP.[12] These are:

- characteristics of property or services;
- functional analysis (functions performed taking into account assets used and risks assumed);
- contractual terms;
- economic circumstances; and
- business strategies.

In this respect, the 1995 OECD TPG made a significant development regarding the factor on business strategies. The 1979 Report barely recognized the possible effects of business strategies on pricing policy as well as the need to adjust for any difference in business strategies between controlled and uncontrolled transactions. The 1979 Report acknowledged two examples of business strategies that might significantly influence price: (1) a supplier waives payment from a customer "in temporary difficulties in order to preserve a potentially valuable outlet for his goods;"[13] and (2) sellers temporarily lower prices as part of a market penetration or start-up strategy.[14]

The 1995 OECD TPG already contained a nonexhaustive list of business strategies that could influence price including elements such as market penetration, innovation and new product development, degree of diversification, risk aversion, assessment of political changes, and input of existing and planned labor laws.[15] The 1995 OECD TPG cited market penetration schemes as one example[16] and specifically acknowledged that market penetration schemes may fail and gave some guidance on how to approach a strategy where profits are lowered temporarily in return for higher profits in the long run.

11. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD Publishing, 1995).
12. 1995 OECD TPG, *supra* n. 11, at paras. 1.19–1.35.
13. 1979 Report, *supra* n. 3, at para. 40.
14. 1979 Report, *supra* n. 3, at para. 43.
15. 1995 OECD TPG, *supra* n. 11, at paras. 1.31–1.35. Note the phrases "such as" and "could include" when referring to business strategies.
16. 1995 OECD TPG, *supra* n. 11, at paras. 1.32–1.35.

2.3 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

After its publication in 1995, the first significant update of comparability standards of the OECD TPG occurred in 2010.[17] In the 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010 OECD TPG),[18] the general guidance on the comparability analysis described in Chapter I of the 1995 OECD TPG is updated, and the TPG are completed with a new Chapter III containing detailed guidance on how to perform a comparability analysis and an illustration of a possible working capital adjustment to improve comparability, when appropriate. The updated standards of comparability provided in the 2010 OECD TPG thoroughly emphasized the importance of aligning the facts and circumstances with an in-depth analysis of the five comparability factors.

The section that discusses the five OECD comparability factors is expanded with a new paragraph that reflects the need for a balanced approach on how the comparability factors should be assessed. The linkage between the applicable transfer pricing methods and comparability factors is made much more explicit. It states:

> Both the nature of the controlled transaction and the transfer pricing method adopted should be taken into account when evaluating the relative importance of any missing piece of information on possible comparables, [...] If it can be reasonably assumed that the unadjusted difference is not likely to have a material effect on the comparability, the uncontrolled transaction at issue should not be rejected as potentially comparable, despite some pieces of information being missing.[19]

This balanced approach (or reasonableness test) towards comparability factors is further specifically addressed in the discussion around the first comparability factor (characteristics of property or services),[20] the third comparability factor (contractual terms),[21] and the fourth comparability factor (economic circumstances).[22] Furthermore, consideration is also given to the notion of local country comparables versus regional comparables, and the 2010 OECD TPG provides support for reliance upon regional approaches if the facts and circumstances of the MNE are consistent within the defined region.[23]

17. A limited update was made in 2009 primarily to reflect the adoption in the 2008 version of the OECD MTC of a new paragraph 5 of Article 25 dealing with arbitration and of changes to the Commentary on Article 25 on Mutual Agreement Procedures. The 2009 update did not contain updated guidance with regard to comparability and, therefore, is not discussed in this contribution.
18. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD Publishing, 2010).
19. 2010 OECD TPG, *supra* n. 18, at para. 1.38.
20. 2010 OECD TPG, *supra* n. 18, at paras. 1.40–1.41.
21. 2010 OECD TPG, *supra* n. 18, at para. 1.54.
22. 2010 OECD TPG, *supra* n. 18, at para. 1.55.
23. 2010 OECD TPG, *supra* n. 18, at paras. 1.57–1.58.

The 2010 OECD TPG further introduces a new Chapter III dedicated to the analysis of comparability, *inter alia*, with the aim of selecting reliable comparables. Some key changes and items which are, for the first time, endorsed by the OECD are further discussed in the sections below.

2.3.1 *Most Reliable Comparables*

The 2010 OECD TPG introduces the concept of "most reliable comparables" which plays a prominent role in the typical process in performing a comparability analysis established in Chapter III (*see* section 2.3.2). It states that, in principle, the comparability analysis aims at finding the most reliable comparable. The 2010 OECD TPG, however, acknowledges that finding the most reliable comparables does not entail a requirement for an exhaustive search of all possible sources of comparables in view of information limitations and the potentially burdensome nature of a comparables search.[24] This is again an expression that reviewers in transfer pricing must be reasonable in their analysis.

2.3.2 *The Nine-Step Process*

The OECD introduced a nine-step process, as shown in Table 6.1, that could be used when performing a comparability analysis. It explicitly states that such a process is not compulsory as reliability of the outcome is more important than the process itself; and it further continues to clarify that "going through the process does not provide any guarantee that the outcome will be arm's length, and not going through the process does not imply that the outcome will not be arm's length."[25] Most of the steps are relatively straightforward but require thorough factual analysis. The focus of the nine-step process is on finding reliable comparables.

Table 6.1 The Nine-Step Process

1	Determination of years to be covered.
2	Broad-based analysis of the taxpayer's circumstances.
3	Understanding the controlled transaction(s) under examination based in particular on a functional analysis in order to choose the tested party (where needed), the most appropriate transfer pricing method for the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method), and to identify the significant comparability factors that should be taken into account.
4	Review of existing internal comparables, if any.
5	Determination of available sources of information on external comparables when where such external comparables are needed taking into account their relative reliability.
6	Selection of the most appropriate transfer pricing method and, depending on the method, determination of the relevant financial indicator (e.g., determination of the relevant net profit indicator in case of a transactional net margin method).
7	Identification of potential comparables: determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable based on the relevant factors identified in 3 and in accordance with the five comparability factors (characteristics of property and services, functional analysis, contractual arrangements, economic circumstances, and business strategies).
8	Determination of and making comparability adjustments where appropriate.
9	Interpretation and use of data collected, determination of the arm's length remuneration.

24. 2010 OECD TPG, *supra* n. 18, at para. 3.2.
25. 2010 OECD TPG, *supra* n. 18, at para. 3.4.

The guidance further indicates that the process is not a linear one, and there might be a need to repeatedly carry out certain steps.

Each of these steps is then discussed in further detail. The guidance states that the broad-based analysis is an essential step in the comparability analysis including analysis of the industry, competition, economic, and regulatory factors.[26] In reviewing the controlled transaction and choice of the tested party, the 2010 OECD TPG continues to state that the ALP should be applied on a transaction-by-transaction basis. However, a portfolio approach is introduced under which certain transactions can be bundled if the portfolio approach is part of the company's business strategy.[27] Furthermore, the term "tested party" is also introduced which should be the party with the less complex functional analysis.[28] Although not as expressly stated as in the 2017 revision of the OECD TPG, the two legs of the comparability equation (defining the controlled transaction and looking for comparable uncontrolled transactions) are already clearly present in the 2010 OECD TPG.

Reviewing of existing internal comparables is considered a significant step in view of the fact that internal comparables are often overlooked in practice. The 2010 OECD TPG, however, recognize that internal comparables may have a more direct and closer relationship to the transaction under review than external comparables but are not always necessarily more reliable.[29] The use of foreign-source or nondomestic comparables and their relative reliability should be assessed on a case-by-case basis by reference to the five comparability factors instead of default or automatic rejections of nondomestic comparables.[30]

26. 2010 OECD TPG, *supra* n. 18, at para. 3.7.
27. 2010 OECD TPG, *supra* n. 18, at paras. 3.9–3.10.
28. 2010 OECD TPG, *supra* n. 18, at para. 3.18.
29. 2010 OECD TPG, *supra* n. 18, at paras. 3.27–3.28.
30. 2010 OECD TPG, *supra* n. 18, at para. 3.35.

2.3.3 *Comparability Adjustments*

The 2010 OECD TPG contained, at that time, newly developed guidance on comparability adjustments. The guidance also indicated that there should be no presumption that comparability adjustments are always needed or will always improve comparability or its reliability. It is a matter of judgment that should be evaluated in light of the costs and compliance burden.[31] The OECD took the safe route by providing only illustrative guidance regarding working capital adjustments in an Annex to Chapter III. The challenges that are often encountered in practice pertaining to differences in, for instance, volume or operational scale, risks or geographic markets, however, are not really addressed with practical guidance, but the discussion remains theoretical.

2.3.4 *Arm's Length Range*

The 2010 OECD TPG also gives guidance on the use of an arm's length range (and the appropriate point within such a range) and provides consideration for the treatment of extreme results (e.g., eliminations of loss-making comparables if the losses do not reflect normal business conditions) to enhance the quality of the range and minimize error due to unknown facts or defects by using measures of central tendency. For the first time, the OECD endorsed the use of an interquartile range, albeit in terms which do not preclude the use of other statistical approaches that may be appropriate in the particular circumstance of a case. [32]

With the publication of the 2010 OECD TPG, the updated guidance confirmed approaches (such as, for example, interquartile ranges or working capital adjustments) that were already used in practice for a long time. Theory met practice again with the 2010 OECD TPG.

2.4 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

On July 10, 2017, the OECD released its 2017 version of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017 OECD TPG)[33] which further aims at clarifying and strengthening the guidance on the application of the ALP and standards of comparability. In this respect, the OECD has fundamentally redrafted Chapter I, Section D ("Guidance for applying the arm's length principle") of the 2010 OECD TPG, in particular, Section D. 1. which is renamed from "Comparability analysis" to "Identifying the commercial or financial relations."

The 2017 OECD TPG expands the discussion on the comparability analysis, the essential part of application of the ALP, with guidance on the important first leg of the comparability analysis that is now referred to as "accurately delineating the actual

31. 2010 OECD TPG, *supra* n. 18, at paras. 3.47 and 3.52.
32. 2010 OECD TPG, *supra* n. 18, at paras. 3.55–3.66.
33. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Publishing, 2017).

transaction." It requires determining whether a controlled transaction has economic substance and involves a significantly more granular functional and risk analysis. In particular, the granularity and complexity of the analysis may give rise to concerns. In other words, the 2017 OECD TPG expressly indicates the two phases under a comparability analysis:

(1) accurately delineating the actual transaction (or real deal) on the basis of economically relevant characteristics or comparability factors; and
(2) making comparisons between the controlled transaction and uncontrolled transaction on the basis of the economically relevant characteristics or comparability factors in order to determine an appropriate arm's length price or remuneration.

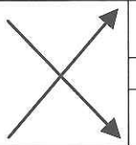
In other words, the first phase determines the real deal between the related parties. The second phase is used to search for comparable uncontrolled transactions or enterprises.

The five-step process outlined below is provided in the guidelines to accurately delineate the transactions. For each transaction, the process involves reviews of:[34]

- the contractual terms of the transactions;
- the functions, assets, and risks of each participant including an assessment of how these relate to the wider generation of value within the group;
- the characteristics of the property transferred or services provided;
- the economic circumstances of the parties and of the market in which the parties operate;
- the business strategies pursued by the parties.

This five-step process corresponds to the five comparability factors set forth in the 1995 and 2010 OECD TPG, albeit the order of the factors being analyzed is slightly adjusted (*see* Table 6.2).

Table 6.2 Comparability Factors

1995–2010 OECD TPG		*2017 OECD TPG*
Characteristics of property or services		Contractual terms
Functional analysis		Functional analysis
Contractual terms		Characteristics of property or services
Economic circumstances		Economic circumstances
Business strategies		Business strategies

34. 2017 OECD TPG, *supra* n. 33, at paras. 1.33–1.118.

The more salient changes that were made to the first two comparability factors ("contractual terms" and "functional analysis") are discussed below. From the order of the comparability factors in the 2017 OECD TPG, it is now made clear that the starting point of the analysis are the contractual terms.

2.4.1 *Contractual Terms*

The 2017 OECD TPG suggests taking written contractual agreements as the starting point for delineation of the transactions between the associated enterprises and the division of responsibilities, risks, and anticipated outcomes.[35] It further states that information from the written contracts should be clarified and supplemented by considering evidence of the commercial or financial relations provided by the other four comparability factors.[36] An analysis of all five comparability factors should provide evidence of the actual conduct of the parties. The 2017 OECD TPG goes further and provides that, when no written contracts or terms exist or the terms of the written contracts are incomplete, delineating a transaction on the basis of the actual conduct of the parties would generally provide results that are more reliable.[37]

2.4.2 *Functional Analysis: In Particular Allocation of Risks*

Newly developed guidance is provided for conducting a functional analysis especially with regard to the allocation of risks to the parties in a transaction.

The guidance of Chapter IX on Business Restructurings of the 2010 OECD TPG already contained a more in-depth discussion on the allocation of risks in an Article 9 context and, in particular, the interpretation and application of the high-level discussion on risks in Chapter I of the 2010 OECD TPG. The authors believe, however, that Chapter I of the OECD TPG is the appropriate place for such in-depth discussion.

Under the new guidance, irrespective of the contractual allocation of risks (and associated expected return), the risks need to be allocated to the parties that have the control over such risks and have the financial capacity to assume such risks. Control over risk is defined as[38]

(1) The capability to make decisions to take on, lay off, or decline a risk-bearing opportunity together *"with the actual performance"* [emphasis added] of that decision-making function (i.e., who makes the decisions and performs the function to take on, lay off or decline risk); and
(2) The capability to make decisions on whether and how to respond to the risk-bearing opportunity together *"with the actual performance"* [emphasis added] of that decision-making function (i.e., who makes the decisions and performs the related functions responding to risk).

35. 2017 OECD TPG, *supra* n. 33, at para. 1.42.
36. 2017 OECD TPG, *supra* n. 33, at para. 1.43.
37. 2017 OECD TPG, *supra* n. 33, at para. 1.49.
38. 2017 OECD TPG, *supra* n. 33, at para. 1.65.

Performance of risk mitigation functions (or day-to-day risk mitigation) is not necessary to have control over the risk, and these functions can be outsourced. When these risk mitigation functions are outsourced, it is still required to have the "end-control" over those functions, for example, hiring, adapting, or terminating the contract with the risk provider or objective setting and control on whether the objectives of risk mitigation are met.[39]

It is needless to say that the analysis of risks and of the functional control of the risks and the financial capacity to assume the risks thus become pivotal elements of the expanded functional analysis.

The 2017 OECD TPG points out the importance of understanding how value is generated by the groups as a whole, the interdependencies of the functions performed, and the contributions that the parties make to that value creation.[40] However, the guidance goes further and states that a functional analysis is incomplete unless the material risks assumed by the parties are identified and considered in the analysis. The new guidance emphasizes the significance of risk allocation in transfer pricing and its interrelation with "human interaction" (i.e., "functions") and presents a six-step process for the arm's length pricing of risks on a transaction-by-transaction basis as illustrated in Figures 6.2 and 6.3.[41]

39. 2017 OECD TPG, *supra* n. 33, at para. 1.64.
40. 2017 OECD TPG, *supra* n. 33, at para. 1.51.
41. 2017 OECD TPG, *supra* n. 33, at paras. 1.56–1.70.