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Chapter 1

Transfer pricing: What is it?

WHAT IS TRANSFER PRICING?

1.1 The term 'transfer pricing' is now embedded in our vocabulary, but what does it really mean? As a transfer-pricing professional, with some 30 years of experience in international taxation, the author considers Winston Churchill's famous statement 'It has been said that democracy is the worst form of government except all the others that have been tried' could be adapted for transfer pricing and the arm's-length principle. Whilst this is not particularly helpful as a definition, it does ensure the right mind-set to learn about transfer pricing.

1.2 Put simply, transfer pricing is the amount that is charged between related parties, when they transact. One way to understand transfer pricing is to think of an organisation's global business profits as a pie which needs to be divided up between different countries who have contributed to its making and that division should be undertaken in a principled and justifiable manner. This exercise must be undertaken because taxation of business profits continues to be based on the national laws of each country, whilst business becomes increasingly global in nature. Whilst the internal objectives of the globalised business might be best served by minimising the importance of corporate and national boundaries, tax law is based on the clear recognition of those same boundaries. Transfer pricing might, therefore, be considered to be the 'oil' that lubricates the coexistence of these opposing starting points.

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1.3 To begin, though, it is necessary to review some history.

WHERE DID TRANSFER PRICING COME FROM? THE GROWTH OF WORLD TRADE

1.4 Economic historians cite the fifteenth and sixteenth centuries as the origins of the multinational enterprise (MNE). This period saw the emergence of large companies predominantly based in what were then the superpower countries, trading large amounts of commodities in the colonies of their home countries. Yet it was not until early in the twentieth century that the manufacturing concepts of one country came to be exported to subsidiaries abroad. This growing interest in production accelerated markedly after the Second World War as developed countries began to invest heavily in the rebuilding of their economies. Many historians maintain that it was this period that laid the foundations for the current shape of the global economy.

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1.5 *Transfer pricing: What is it?*

1.5 The MNE established itself as a driver of global production and trade in the post-war years but the process has accelerated in more recent years. The most significant growth in the number of enterprises conducting business in more than one country has been seen in the closing years of the twentieth century, years in which the growth in world exports has consistently been greater than the growth in world Gross Domestic Product. Even though the early years of the twenty-first century have been affected by a financial crisis and global slowdown, the importance to business of trading in more than one country has not diminished. There is limited data on trade transactions between related parties (despite growing attention from policymakers), but available evidence suggests that intra-firm trade represents a significant share of world trade.[1]

1.6 There are numerous reasons for the increased growth in world trade over time, ranging from the desire of MNEs to access cheaper labour costs for production, to the increased demands from developing nations for a wider range of goods and services. Yet even at the start of the twentieth century there was little perceived need for the concept of transfer pricing. The reason for this was simply that differences, or potential for differences, between the territorial nature of taxing legislation and the actual behaviour of multinational enterprises remained small. As little as 100 years ago 'international trade' still meant loading things onto a train, wagon or ship to export. As MNEs began to expand their manufacturing abroad they did so by a 'replication' process whereby an individual or management team was identified to run a business overseas which was a standalone copy of the parent's business but which operated in its local market. In this business model, related-party transactions were few in number and low in value, so the potential for local business profits to be affected by related-party transactions was small.

1.7 What changed? In short, the revolution in communications and logistics allowed businesses to become more efficient and consequently more profitable. Reducing the cost of manufacturing, speeding the entry of new products to market, cutting the value of stock held in warehouses and taking a single product to several markets are all steps that increase profitability. Improvements in logistics and information systems allowed product manufacturing to consolidate around single factories, and improved communication allowed management to consolidate around a single location. These step-changes in business efficiency drove up the number and the value of related-party transactions and moved (globalised) business further and further away from mirroring (territorial) taxing legislation. This separation increased the risk that related-party transactions could have a substantial impact on the amount of profit on which an entity was subject to tax in each territory of operation, with a real or perceived preference, from the business point of view, to have the larger share of the profits taxed in the territories with the lowest tax rate. As this risk

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1 See Lanz, R. and S. Miroudot (2011), 'Intra-Firm Trade: Patterns, Determinants and Policy Implications', *OECD Trade Policy Papers*, No 114, OECD Publishing. Available at: http://dx.doi.org/10.1787/5kg9p39lrwnn-en.

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increased, so did the awareness within tax authorities of their need to regulate their potential exposure to a loss of tax.

WHERE DID TRANSFER PRICING COME FROM? THE GROWTH OF TRANSFER-PRICING RULES

1.8 If you ask the question 'Which country first introduced transfer-pricing rules?' you will most often be given an incorrect answer, typically the United States of America.

1.9 Transfer-pricing rules were first tried (unsuccessfully) in the United Kingdom in 1915. The UK tax authority lost a court case, *Stanley v The Gramophone and Typewriter Ltd [1908] 2 KB 89 CA* and had to accept that not all of the profits made by a UK-based group could be taxed in the UK. For the first time the UK tax authority began to fear that cross-border tax opportunities were emerging. In those days many UK companies with overseas operations acted through branches and, where local subsidiaries were established, the subsidiary would often be managed and controlled by a UK board, so were tax-resident in the UK. In this business model there was little tax risk for the UK tax authority from incorrect transfer pricing. However, there was concern that non-UK resident companies might set up subsidiaries in the UK to do their selling for them and these UK companies might be charged inflated prices, hence reducing their overall exposure to UK taxation.

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1.10 This fear led to legislation in the *Finance Act 1915, s 31(3)* which effectively said that if it appeared that the conduct of the business had been arranged to leave the UK resident company with less than the ordinary profit which might have been expected to arise from that business, then the non-resident would be chargeable to tax in the name of the resident (what we now know as an agency permanent establishment). It is also interesting to note that this pragmatic approach was confined to cases of abuse, not self-assessed, a subject to which we will return shortly. In the event, *Finance Act 1915, s 31(3)* was of little value. Later court decisions cast doubt on the suitability of what was a 'machinery provision' (in the way that UK tax legislation works, legislation can give rise to a charge – a charging provision – or deal with how that charge is administered – a machinery provision – as a way to impose a charge to tax). The rule was abandoned and it was not until the 1950s that there was sufficient concern about the potential loss of tax from transfer pricing for legislation to return.

1.11 Departing historical fact for a moment, though returning to consider the history of global legislation again at **1.22** to reveal that the answer to the follow-up question 'who was next to legislate on transfer pricing?' is still not the United States of America, we now turn to define the issue of transfer pricing.

DEFINING THE ISSUE

1.12 When two (or more) related companies trade with one another, the price agreed between them is typically referred to as a 'transfer price'. There is

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will mean that the associated profit is both recognised and taxed at a higher rate. This reduces earnings per share, which in turn may have negative consequences for a MNE's share price. Locating those same functions and risks in a lower-tax rate jurisdiction will have the opposite effect. MNEs may be in a position to consider carefully where to locate functions, assets and risks and choose (all other factors such as local costs, skills, language, legal protection etc being equal) to locate in lower-tax rate jurisdictions. This can lead to an outflow of functions and risks from high tax rate countries and into low tax rate countries together with the associated jobs, personal taxation, etc.

THE ARM'S-LENGTH STANDARD – WHAT AND WHY?

1.18 Tax authorities are concerned that the price of transactions between related parties might be incorrectly reported to their disadvantage and many have reached the conclusion that legislation is required to protect against the potential loss of tax. The generally adopted solution is to require MNEs to calculate their taxable profits based on the transactions and prices that would have been entered into and agreed between unrelated parties. The underlying economic assumption is that all independent parties to a business transaction seek to maximise their own profit and, through this process, a deal is struck.

1.19 In this way the intention is that a fair profit is achieved by each party, commensurate with the functions they perform, the assets they employ and the risks that they assume. This is the basis of the need to review the functions, assets and risks in a related-party transaction and to ensure that the reward earned by each party is similar to that which would have been achieved by unrelated parties. The outcome of this process is therefore referred to as 'arm's-length pricing'.

1.20 The need to understand functions, assets and risks is fundamental to the theory and practice of transfer pricing and requires a 'functional analysis' to be performed for the entities involved in a related-party transaction. This enables the MNE to understand the role that each entity plays and use this understanding to determine a fair pricing. Economic theory suggests that companies should receive a basic return on their assets at the very least, or they would not enter into transactions in the longer term, but this does not always imply that companies making losses or lower than basic returns are not pricing on an arm's-length basis. Also, as the arm's-length principle is applied on an entity-by-entity basis, this does not necessarily mean that if a group is profitable overall then each entity should be profitable, or vice versa.

1.21 If an MNE is operating in a country or industry that is in recession, or if micro-economic pressures result in the company making a loss, then such a situation may still accord with the arm's-length principle. However, the company will need to evaluate its position and determine that unfavourable economic conditions are driving the loss, rather than losing money through non-arm's-length transfer pricing. Any such determination should include evidence of expected recovery and a recovery plan. Most tax authorities will, quite appropriately, not accept a situation where companies in their jurisdiction are persistently only breaking even (or making a loss) without justification.

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A SPREADING FIRE – TRANSFER-PRICING LEGISLATION AROUND THE WORLD

1.22 In paragraph **1.9,** it was noted that the first attempts at transfer-pricing legislation by the United Kingdom, were ineffective and that the level of transactions within MNEs were not sufficient to drive the development of effective legislation. As the importance of MNEs grew, so did the consciousness of governments of the potential for loss of tax. When tax authorities returned to the legislative process, their first response was to invoke powers to stop abusive transactions (i.e. to regulate transactions with tax havens). The United Kingdom again was first to move, enacting short and simple legislation in the form of *section 37* of the *Finance Act 1951*, which survived as *section 770* of the *Income and Corporation Taxes Act 1988* until 1999 when the UK and other jurisdictions starting taking this area much more seriously following a significant development in the United States in 1994.

1.23 The US government first introduced legislation in the late 1960s to combat the perceived erosion of the US tax base through transfer-pricing manipulation. It was not dissimilar to the UK legislation enacted in 1951, being in the nature of an anti-abuse rule. However, in the mid-1980s, transfer pricing became a hot topic for the US Internal Revenue Service (IRS) and tax audits revealed that many companies could not justify their inter-company prices, let alone provide documentation to support them. The IRS reached the conclusion that a number of MNEs had formulated their transfer-pricing strategies to minimise their US tax burden.

1.24 As a result, in 1994, the US government updated its transfer-pricing legislation and became the first to impose a greater compliance burden on MNEs. The new US rules required MNEs to produce contemporaneous documentation demonstrating that their transfer-pricing policies satisfied the arm's-length principle and introduced penalties for non-compliance. The new legislation meant that the financial reporting of MNEs with foreign operations came under increasing scrutiny: transfer pricing, as we know it today, was born.

1.25 Running parallel to these developments, international cooperation at the Organisation for Economic Co-operation and Development (OECD) resulted in the creation and continual updating of their 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' (the Guidelines). The first comprehensive version of the Guidelines was published in 1979, but the developments mentioned above helped to create the pressure for an updated version to be issued in 1995. The OECD has continued to update, and add to, the Guidelines ever since, with Chapter IX (Business Restructurings) being added in 2010 and Chapter VI (Intangible Property) being updated at the time of writing. The Guidelines were and remain pivotal in standardising the approach of tax authorities in many countries. As each country either introduced or updated its transfer-pricing legislation, the impact of the comprehensive US rules was also a factor to take into account. There was a fear that transfer-pricing compliance could cause MNE profits to be skewed in favour of countries with costly penalties – just to be safe. The development of legislation became commonplace as country after country adopted legislation

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similar circumstances. This requires a rigorous description and analysis of the business framework within which the transaction takes place. It also requires identification of third-party trading strategies and models that show similar approaches to functions and risks.

1.30 As well as self-assessment of a business's compliance with arm's-length pricing, it is also important that evidence of the third-party nature of related-party transactions is retained, as during tax audits, tax authorities will seek to understand the commercial purpose of business transactions.

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Chapter 2

OECD

BACKGROUND TO ARTICLE 9 AND THE TRANSFER-PRICING GUIDELINES

2.1 Chapter 1 introduced the arm's-length standard – or arm's-length principle – as a fundamental of transfer pricing. Economic theory postulates that unrelated parties dealing at arm's length with each other will seek to maximise their own profit. When dealing with a related party it is possible that other considerations might influence behaviour and disrupt the economic balance between them. Noting this, the OECD has adopted the arm's-length principle as the basis for pricing related-party transactions undertaken by multinational enterprises.

2.2 This idea first took shape in 1963, though the thinking has roots that go back to the 1927 League of Nations. The first paragraph of Article 9 of the OECD Model Convention on Income and Capital, otherwise known as the OECD Model Treaty, reads:

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

2.3 The commentary on this paragraph notes:

> 'This Article deals with associated enterprises (parent and subsidiary companies and companies under common control) and its paragraph 1 provides that in such cases the taxation authorities of a Contracting State may for the purpose of calculating tax liabilities re-write the accounts of the enterprises if as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that State. It is evidently appropriate that adjustment should be sanctioned in such circumstances, and this paragraph seems to call for very little comment.'

The basic concept is straightforward, but there are significant difficulties when it comes to applying the idea in practice: first ascertaining whether or not true taxable profits have been influenced by the 'special relations' of the parties and second, if so, how to recalculate those profits to regain the proper balance.

2.4 The importance of testing inter-company pricing has grown steadily until, at the time of writing, it is one of the most relevant tax questions on the minds of finance directors responsible for multinational companies. For many

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years the OECD has been the key organisation to comment on the question of how to assess arm's-length pricing, publishing their 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations'. Over the years this has been subject to update, expansion and revision; at the time of writing we are using the version published in 2010. Throughout this book we refer to them simply as 'the OECD Guidelines', 'the transfer-pricing Guidelines' or just 'the Guidelines'. These Guidelines have been adopted as a guide by many countries and incorporated into the domestic legislation of some, including the United Kingdom, to provide the definitive standard by which MNEs should benchmark their inter-company prices. Other countries follow OECD guidance in transfer-pricing matters even if it has not been specifically brought into their law.

2.5 The 2010 Guidelines consist in part of new material (eg Chapter IX on Business Restructuring) and in part of a revision and expansion of the guidance in an earlier OECD report, the 1995 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations', which in turn updated the 1979 publication 'Transfer Pricing and Multinational Enterprises'. They also capture, but do not completely replace, material contained in two other OECD reports, namely 'Three Taxation Issues' (1984) and 'Thin Capitalisation' (1986). No doubt there will be future additions and updates (an update of Chapter VI (Special Considerations for Intangible Property) is considered later in this book) and this constant review process does raise an interesting question; which version of the guidelines should one be guided by?

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WHICH VERSION OF THE GUIDELINES?

2.6 The OECD has improved, updated and revised its transfer-pricing guidelines on several occasions and will continue to do so in the future. That poses the question: which version of the Guidelines should be used when considering the arm's length nature of a particular transaction? Unfortunately, the answer is not as simple as the question if one takes a strict and statutory approach. However, as we will see, in practical situations – including cases that have proceeded to a court hearing – there is often less confusion in the matter.

2.7 To understand the statutory position, the first point to consider is whether you are complying with local legislation or with the associated enterprises article of a double tax treaty based on the OECD Model Treaty. This is because the status of the Guidelines as an aid to interpretation can be different. For example, UK transfer-pricing law requires the interpretation of UK rules in a way that 'best secures consistency' with 'the effect which, in accordance with the transfer-pricing guidelines, is to be given, in cases where double taxation arrangements incorporate the whole or any part of the OECD model, to so much of the arrangements as does so' (see *TIOPA 2010, s 164(1)(b)*) For the purposes of UK legislation, the transfer-pricing guidelines are defined (see *TIOPA 2010, s 164(4)*), at the time of writing as set out below, but the use of 2010 OECD material was actually brought into UK law only in 2011 (see *Finance Act 2011, s 58(1)*) and applies only to accounting periods for

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corporation tax beginning on or after 1 April 2011. Prior to that, OECD material up to 1 May 1998 was the reference point for interpreting UK legislation:

'(a) the version of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations approved by the Organisation for Economic Co-operation and Development (OECD) on 22 July 2010, or

(b) such other document approved and published by the OECD in place of that (or a later) version or in place of those Guidelines as is designated for the time being by order made by the Treasury,

including, in either case, such material published by the OECD as part of (or by way of update or supplement to) the version or other document concerned as may be so designated.'

2.8 Therefore, when considering a transfer-pricing question under UK domestic law one would consult the Guidelines which were specified in relation to the tax accounting period under consideration, as UK 'transactional based' legislation looks to the payment or receipt that arises in a tax year. In other countries the Guidelines may have more, or less, force.

2.9 When considering the question of arm's-length pricing under an OECD-based tax treaty the interpretive value of the Guidelines is less clear. In some territories the Guidelines are indicative of what might have been in the mind of the parties when the treaty was negotiated. In that case the most recently published version of the Guidelines, at the time the treaty was concluded, would be the Guidelines that might have been in the minds of the negotiating parties; versions of the Guidelines issued later would not have been available. However, jurisdictions use the Guidelines in other ways (eg some follow a process of continuous ambulatory interpretation). This approach will adopt any new or changed meaning as the Guidelines are revised.

2.10 In practice, things are a little more blurred.

2.11 There is a tendency for the latest version of the Guidelines to be applied with no regard to when the actual transaction under audit took place. This could lead to difficulties if there has been a change in the Guidelines; even if that is not appreciated when agreeing a position, it may still come to light during a claim for relief of double taxation that arises from any transfer-pricing adjustment when the second jurisdiction considers the claim.

2.12 More importantly, for the most part, the revisions and improvements to the Guidelines do not actually change their meaning; they improve the clarity of the existing Guidelines. In so far as that is the case, the use of an incorrect version of the Guidelines does not cause any unfairness. For example, a 2013 decision of the Finnish Administrative Court (KHO 2013:36) concerning 'location savings' decided that assistance could be drawn from Chapter IX of the Guidelines (published as new material in 2010) in deciding the correct transfer pricing for a transaction that took place years before; the reasoning being that this material simply explained the arm's-length position which had always applied.

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THE ARM'S-LENGTH PRINCIPLE

2.13 The OECD Guidelines set out, in paragraph 1.8, why the arm's-length principle is the preferred method of pricing related-party transactions. This majors on parity of treatment between associated and independent enterprises, and states:

> 'Because the arm's length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment.'

2.14 Having made this brave claim, the Guidelines do go on to recognise that there are difficulties applying the arm's-length principle, notably in the following circumstances:

- when there are no readily available comparable transactions, such as when the cross-border business in question is in highly specialised goods or services, or unique intangibles;
- when MNEs engage in transactions that would simply not be entered into by independent parties. The example cited is of the sale or licence of intangibles, which groups might feel more able to contemplate when buyer/seller or licensor/licensee are related rather than third parties, or where the seller or licensor may well jib at the loss of control of the intangible;
- when an MNE has to justify its pricing to a tax authority years after the event;
- when relevant comparable data is very hard to find; and
- when it is clear that an MNE group is enjoying advantages simply not available to independents, for example economies of scale or the benefits of business integration.

2.15 Having acknowledged these problems, the Guidelines conclude that the arm's-length principle is better than any other approach, such as global formulary apportionment. It is fair to say that there is usually some form of proxy and/or some practical economic model that can be used to overcome even the hardest pricing problems. If a transaction can credibly be entered into, it can also be priced.

2.16 The arm's-length standard was adopted as the OECD Committee on Fiscal Affairs felt that there were no realistic alternatives. The one non-arm's-length approach that has sometimes been mooted is global formulary apportionment. Formulary apportionment has been used by some local tax jurisdictions, most notably the US state of California; it is still put forward from time to time both in the United States and in Europe as a way of resolving the problems of transfer-pricing documentation requirements and double taxation. Under global formulary apportionment, total consolidated profits would be allocated among associated enterprises in different countries according to a

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THE HEART OF TRANSFER PRICING: COMPARABILITY

2.24 Before beginning to unpick the various OECD pricing methods in detail, it is essential to pause to consider comparability. In the first edition of this book comparability warranted '… a few words …' but over the years – and with increasing pace – comparability has become a significant issue not only for transfer-pricing practitioners and tax authorities, but also for the OECD. In response to this, more detailed consideration is given to this area in this edition.

2.25 Comparability has always been at the very heart of all of the OECD methodologies to test the arm's-length nature of the transfer pricing of an MNE. At its simplest – and at the same time at its most profound – transfer-pricing justification is being able to point to the behaviour of third parties and say, 'this is how they do it, and therefore so can I'. For that statement to be true, however, the third parties must be involved in a transaction that is sufficiently similar, in economic terms, for their behaviour to be relevant as a benchmark against which to test related party behaviour. It is necessary to test that similarity, demonstrate that comparability exists and thereby show that the third-party data is evidence against which the related-party pricing can be measured and tested.

2.26 Where transactions between associated enterprises and independent parties are not identical, transactions that are sufficiently similar can nevertheless provide evidence against which transfer prices can be measured and tested. To use data from transactions that are not identical, all economically relevant differences that might affect the transfer price must be examined and, where possible, adjusted for. These adjustments serve to align the comparable with the transaction under review, and so create a benchmark.

2.27 It is important to appreciate that the application of the arm's-length principle is far from an exact science. Judgment must be exercised to determine the comparability of transactions, so that accurate adjustments can be made to reflect any differences. A record should be included in the transfer-pricing report evidencing the basis on which that judgment has been made.

2.28 In determining comparability and making adjustments to data, the OECD Guidelines indicate that a number of general factors should be taken into account.

- *Characteristics of property and services* – for example, the quality, volume, and reliability of goods, the nature and extent of services and, in the case of intangible property, the nature of the property, the form of the transaction, and the anticipated level of profitability.
- *Functional analysis* – compensation paid between third parties usually reflects the functions performed, assets employed and risks assumed by each party to the transaction. So, to work out whether third party and intra-group transactions are comparable, a functional analysis is needed, the purpose of which is to identify and compare economically significant activities and responsibilities taken on by the third party and associated enterprises. The same analysis should cover risk, since reward is intimately linked with risk. In broad terms the more limited the exposure to risk, the more limited will be the reward (though this limited reward is

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likely to be steadier than the fluctuating returns associated with the assumption of more and higher risk).

- *Contractual terms* – an analysis of contractual terms is really part of the function and risk analysis outlined above. Where there is no contract or other written agreement, terms can be inferred from the behaviour of the parties and general principles; where there is a written contract, it is important that there is a good match between what the contract says and how the parties behave in practice.
- *Economic circumstances* – by which the Guidelines mean market conditions: geographic location of market, size, competition, availability of alternatives, government regulation, costs of labour and land and so forth. Differences in any of these will put a dent in comparability.
- *Business strategies* – businesses will very likely approach their markets in different ways, with varying degrees of innovation and risk taking. The adoption of a market penetration scheme can also have a significant effect on a transfer price. Contentions that an MNE is following a market penetration strategy should be carefully thought through, as tax authorities usually regard them with a degree of scepticism. Market penetration strategies will always involve one or more parties taking something of a hit in early years in the expectation of profits later. So the contract and other evidence of the parties' relationship must be consistent with this. Cases have been found where a distributor agrees to incur marketing expenditure on such a scale that it cannot make a profit during the lifetime of the contract which, it is arguable, is a contractual position that no third party would agree to. Credible projections (and not just 'projections') of growing profits over a reasonable timescale will be required, as will evidence of lower end prices and/or higher marketing spend and effort.

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2.29 It can be seen from this that establishing true comparability is a serious matter that is often far from straightforward. Nevertheless, however difficult it may be, the process must be gone through by both MNEs when testing their prices for their tax returns and the tax authorities auditing them. In this respect the final sentence of paragraph 1.16 of the Guidelines is illuminating: 'In no event can unadjusted industry average returns themselves establish arm's length conditions.' It is probably right to say that all tax authorities use industry-average data as a diagnostic tool in choosing MNEs for audit; one can understand that. However, that is the rough and ready beginning of the dialogue with the taxpayer, not the end of it.

2.30 In the preceding paragraphs there is a concept that has not always been appreciated in transfer-pricing work to date, one that has led to inaccurate work and irrelevant arguments. The process outlined so far is intended to ensure that the comparable data is as closely aligned with the economics of the tested transaction as possible. Therefore the process should not be applied blindly, but with considerable thought. Differences between the tested party and third-party data have to be 'economically relevant' to require adjustment, not simply differences. The author has seen transfer-pricing reports that identify

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'differences' between the tested party and third-party potential comparables and go on to claim adjustments for them without demonstrating that these differences are economically relevant. A simple example is to consider the process to compile a comparable data set from a database source to evidence the pricing of the toll-manufacturing service provided by an associated enterprise based on a measure of the return achieved on total cost base of the manufacturing entity. (There are other ways to measure the arm's-length nature of the return achieved by a toll manufacturer, but this example was drawn to make a particular point.)

2.31 A database search for 'toll manufacturing' is unlikely to generate any results as businesses involved in toll manufacturing do not have a distinct industry code or business description. Hence there will be a general search for manufacturing, then it's necessary to screen for matters that may result in economic differences and reject companies that fail the screen; independence, business start-up, different industries, turnover, a very low level of employees (removing owner-managed small businesses), etc. When the process is complete, there will be a manageable number of independent businesses concerned with manufacturing in the same industry who have broadly similar levels of turnover, intangibles and staff. Should any business that holds significant levels of raw materials or stock now be screened out as the comparables are sought for a toll-manufacturing activity?

2.32 There may be a knee-jerk reaction to take such action because of an emotional reaction to the difference between a manufacturer that buys raw materials in its own name and one that does not. When that step is taken, suppose that it's found that the data set now contains so few companies that a comparable range cannot be established; the typical reaction is to relax one of the earlier screens – typically the industry screen – to boost the number of companies. The step missed out in this example was to analyse and conclude whether stock holding is actually an economically significant difference when considering the profit achieved as a function of full cost. If it was not economically significant, then the additional screening introduced a step not warranted by the OECD Transfer Pricing Guidelines. This, then, caused the data issues and led to the relaxation of another, earlier, screen criteria that may have been economically significant and therefore required.

2.33 Suppose that instead the reaction to the question of stock holding had been to follow the OECD Transfer Pricing Guidelines. It is relatively simple to test whether it is necessary to screen the manufacturing data set for stock holding, by plotting stock holding against profit margin as a function of full cost to see if stock holding is a profit driver for this index. In a real case dealt with by the author, the result of that test plotting net cost plus against stock-holding is shown in **Figure 2.1** below.

2.34 As can be seen, there is no correlation between the holding of stock and the profit achieved by a manufacturer when expressed as a function of full cost in this case. Therefore, there is no justification for removing stockholding companies from the comparable data set in the report being prepared, based on full-cost plus.

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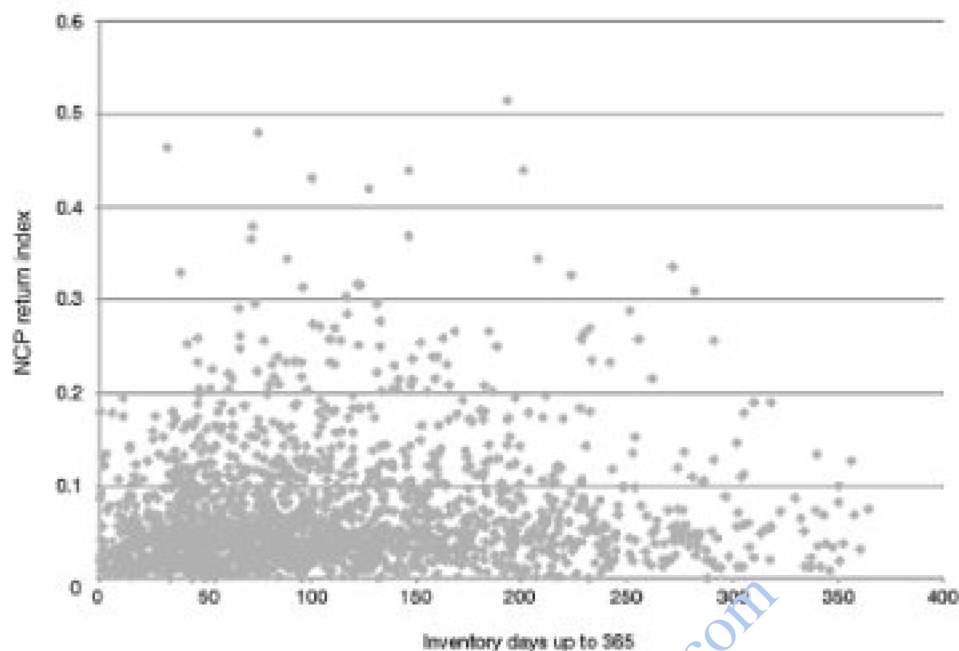

Figure 2.1 – Net plus cost vs stock-holding

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2.35 The example above does not illustrate that stockholding is not a profit generator for a business; the activity of stockholding most certainly is a source of profit for the enterprise. What the example shows is that when considering one particular index (full-cost plus) there is no economic difference (in that specific industry) between the margin earned by stockholding and non-stockholding enterprises.

2.36 The particular difficulties of comparability and 'industry average' data are returned to in CHAPTER 6, dealing with intangible property.

OTHER PRACTICAL ISSUES

2.37 The Guidelines highlight a number of other issues that should be taken into account in applying the arm's-length principle. These are all practical issues that should be observed both by MNEs in analysing and documenting transfer-pricing arrangements and by tax authorities in auditing them.

Transaction undertaken

2.38 In paragraph 1.64 of the OECD Guidelines there is a clear statement to the effect that the transaction actually undertaken should be respected by the tax authorities, with disregard or substitution of the transaction for tax purposes being permitted in only exceptional circumstances. Some regimes, notably the United Kingdom, have specifically adopted the Guidelines into their domestic law, yet arguments have arisen as to whether UK transfer-pricing rules permit the re-characterisation of transactions without reference to the OECD

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Guidelines. Paragraph 1.65 of the OECD Guidelines permit only two circumstances in which a tax authority may, exceptionally, re-characterise the actual transaction undertaken for tax purposes. These are:

- where the economic substance of a transaction differs from its form. The classic example of this is thin capitalisation: investment in an associated enterprise by way of interest-bearing debt that exceeds the amount that could have been borrowed at arm's length and therefore has the economic substance of equity; or
- when the arrangements made differ from those which would have been adopted by those acting in a commercially rational manner *and* the transaction is structured in such a way that it is impossible to price it. The example given is of a sale up front for a lump sum of intellectual property rights arising from future research to be carried out under a long-term contract. Such a lump sum could not sensibly be determined before the work had been carried out, and therefore it would be more appropriate to regard the contract as a continuing research agreement.

Other than these, there are no instances where the Guidelines permit either MNEs or tax authorities to replace transactions actually undertaken with ones that they prefer.

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2.39 It is important that transactions are governed by legal agreements and are documented. Where exceptionally it is permitted, any recharacterisation has to be consistent with the physical activities performed.

Evaluation of separate and combined transactions

2.40 This is another important point meriting careful thought by both taxpayers and tax authorities. The Guidelines acknowledge that while it would be ideal to evaluate each transaction separately, there are times when a number of transactions are so closely linked or continuous that they are bundled together and should be priced in aggregate rather than individually (see paragraph 3.9). Examples include pricing a range of closely linked products, and intangible property. Should bundled grants of rights to know-how, patents, trademarks, designs etc be separated – and, if so, would the constituent parts add up to a different value from the whole? In many cases it is impractical to unbundle and price in this way. There is a value in having the whole package together that is different from the value of the various parts, hence it is neither possible (nor appropriate in view of the overriding arm's-length principle) to fragment a bundle of rights that, in reality, cannot be used independently and scatter them among a number of associated parties simply to reduce their total value (and hence the amount of income that they might be capable of generating).

2.41 Paragraph 3.11 of the Guidelines does talk of the need to unpack some rights bundles, but the examples given are of rights that are quite different in character (eg patents, know-how and trademarks bundled in with the provision of services and the lease of facilities). This does not constitute permission to disaggregate the various intellectual property rights. Nor does it sanction the breaking out of franchise fees into intangible and service elements. A true

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Government policies

2.47 Government intervention such as price control, subsidies, anti-dumping duties and exchange controls may all have a bearing on the price attached to an uncontrolled transaction and should be taken into consideration as factors that may affect comparability. The Guidelines (see paragraphs 1.73 ff) note that these are all factors that will affect independent companies doing business in the same market. One would expect these to be taken into account when prices are set along the supply chain.

2.48 The Guidelines recognise that, sometimes, governments take an asymmetrical approach to certain intra-group transactions. For example, one jurisdiction might expect a royalty of x% and the other might block payment of part or even all of it. The Guidelines comment that where the same asymmetry is not applied to transactions between third parties, there is no simple solution.

Intentional set-offs

2.49 Where an associated enterprise has provided goods or services in return for goods or services from an associate, such set-offs need to be considered as if the trade had occurred between independent parties. The Guidelines find it easier to countenance set-offs where the flows are similar in character to one another than a general agreement between parties to balance out quite different kinds of business. However, as long as the individual flows can be priced with some confidence, there is no reason why such set-offs should be rejected out of hand.

2.50 Recognition by tax authorities of intentional set-offs is normally limited in practice to transactions between the same two legal entities and does not extend to cases in which three or more companies in different tax jurisdictions net off the effect of a number of transactions in which they are all involved.

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Use of customs valuations

2.51 The Guidelines openly encourage cooperation between customs and tax authorities to prevent taxpayers from using one valuation for customs purposes and another for direct tax.

USE OF TRANSFER-PRICING METHODS

2.52 Introducing the chapter on methods and methodologies, the Guidelines (see paragraphs 2.1 to 2.11) make some fairly open-minded comments on how such methods should, in broad terms, be used. The key point is that the method selection should always be aimed at finding the 'most appropriate method' for a particular case.

2.53 Tax authorities are reminded not to make small or marginal adjustments and not to be so overly rigid in the standard set for comparability that they close the door on useful and illuminating information. Moreover,

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MNEs are permitted to use just one method and should not be expected to prove why they did not use others. At the same time, in difficult cases, the use of several methods in conjunction is encouraged as a practical way of resolving what might otherwise prove to be uncertain and problematic valuations.

2.54 These remarks do need to be seen against the backdrop of Chapters II and III of the Guidelines as they were originally drafted. In earlier versions of the Guidelines there was a clear hierarchy of the various methods, which to some extent limited these opening observations. Nonetheless, even then, the warning against too narrow-minded an approach was a welcome reminder that transfer pricing is, in the end, as much an art as a science. In the 2010 amendments to the Guidelines, much of that hierarchy has been swept away (see **2.58**). Though there is a clear preference for Comparable Uncontrolled Price, once it is established that this method cannot be used there is now more leeway to apply the most appropriate methodology. This does not mean a move away from science and reason to pure artistry, rather it means that transfer-pricing practitioners must be 'professional' in their selection of a methodology and must record the evidence which led them to conclude that the chosen methodology was indeed the most appropriate one.

TRANSFER-PRICING METHODS

2.55 The point was made in **2.23** above that, subject to company law or practical constraints, MNEs can use any method or mechanism when setting inter-company prices. However, most tax authorities now require taxable profits and allowable losses to be calculated as if intra-group business had been carried out on arm's-length terms. Testing conformity with the arm's- length principle in this way may be possible using only one method, but where there are different transaction types that may not be possible. In most cases, the variety of goods, services, debt and intangibles that are transacted by an enterprise with one or more associated enterprises requires the use of more than one of the methods set out in Chapter II of the OECD Guidelines.

2.56 The Guidelines group the approved methods into two categories:

- traditional transaction methods (Chapter II, Part II); and
- transactional profit methods (Chapter II, Part III).

Notice the emphasis on transactions – the OECD's intention is always to track the return on a particular transaction or group of transactions, not overall results however achieved and of whatever component parts composed.

2.57 Within the first group – the traditional transaction methods – there are three methods comparing prices or gross margins. These methods are:

- comparable uncontrolled price (CUP) method, which offers a direct price comparison; and
- resale price and cost-plus methods, which make comparisons at gross margin level.

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Transactional profit methods compare the profit arising from controlled transactions with that generated by transactions between third parties.

2.58 Until the 2010 edition of the Guidelines there was a clear expression of a preference for traditional transaction methods, in particular, the CUP method. However, even then the Guidelines recognised that shortage of data may render traditional transaction methods ineffective. As such, they stated (as does the current version of the Guidelines) that, in exceptional circumstances, transactional profit methods or other methods not described in the Guidelines (see paragraph 2.9) may be used to establish a transfer price, as long as they provide the best basis for applying the arm's-length principle.

2.59 Let us look first at the traditional transactional methods.

The CUP method

2.60 This offers a direct comparison between an intra-group transfer price (otherwise known as the price of a 'controlled transaction') and the price charged for the same or similar property or services transferred between third parties. There are two possible types of comparison:

- *Internal CUP* – the comparison is between the price charged in the controlled transaction and that charged in a transaction between one of the parties to the controlled transaction and an independent enterprise.
- *External CUP* – the comparison here is with a transaction between two third parties, neither of whom is a party to the controlled transaction.

The use of an internal CUP will almost always be favoured since, all other things being equal, the circumstances of the controlled transaction will more closely mirror those of the uncontrolled transaction.

2.61 Reliable application of the CUP method will usually require either that there are no differences in the transactions being compared, or that the effect on price of any differences that do exist can be accurately accounted for by way of an adjustment. (The OECD Guidelines discuss comparability in relation to comparable uncontrolled transactions in paragraph 3.24ff of Chapter III 'Comparability Analysis'). In the open market, even a small change in the circumstances of a transaction may have a material impact on price. As such, the overall effectiveness of the CUP method depends on the nature and reliability of any adjustments made to take into account the differing circumstances of transactions.

2.62 Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable transfer-pricing method; therefore in such cases the OECD considers it preferable over all other methods. Product comparability is absolutely key, in particular physical features such as size, weight, appearance, along with volume, reliability, storage requirements, regulatory requirements, and the like. Also significant are other contributors to the overall economics of the deal such as the market, delivery and payment terms, etc. Where an independent enterprise buys or sells the same product as is supplied in the controlled transaction and sufficient data on the uncontrolled transaction is readily available, the CUP method will

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always be the most suitable method of applying the arm's-length principle. Examples of situations in which the CUP method may be used include:

- the interest rate charged on a loan between related parties;
- industries where CUPs are more prevalent, for example, the software industry where products are often licensed to third parties; or
- the price charged for the transfer of a homogenous item, such as a traded commodity.

Often, however, adjustments cannot be made for differences in transaction terms or market cycle and, consequently, the CUP method will not provide a reasonable basis for comparing transactions. Furthermore, in a large number of cases it is simply impossible to identify third-party pricing information to derive a CUP. In such circumstances the most appropriate method, depending on circumstances, may be the resale price method or the cost-plus method.

2.63 These two methods operate at one step removed from a direct price comparison; which one might be used in any given circumstance depends on the nature of the transaction.

2.64 A brief word on terminology: in the United States the terms 'comparable uncontrolled transaction' (CUT) and 'comparable uncontrolled financial transaction' (CUFT) are used in specific and limited circumstances. CUFT speaks for itself, but it is worth pointing out that CUT is used more narrowly in US transfer-pricing legislation than it is in the OECD Guidelines, and tends to refer specifically to comparable prices for intangible property (usually royalty rates).We return to the CUP method to review comparability for transactions in intangible property in **CHAPTER 6**.

The resale price method (RPM)

2.65 The Resale Price Method (RPM) takes the price at which a product is resold to an independent entity after being initially purchased from an associated entity and reduces it by an appropriate gross margin: the 'resale price margin'. The resale price represents the amount of income out of which the reseller in the open market would seek to cover its direct and indirect costs, in addition to making an appropriate level of profit. It takes into account risks assumed, assets utilised and functions performed by the reseller. Subtraction of the resale price margin and adjustment for other costs associated with the purchase of the product (eg customs duties) leaves the arm's-length price, as would be charged between independent parties.

2.66 The reference to making an appropriate level of profit (see Guidelines, paragraph 2.21) has led to a long, occasionally heated and sometimes tedious debate as to whether the RPM is really some form of thinly disguised profit method. It is fair to say that some tax authorities have certainly appeared to think so, focusing on the bottom line and not appearing to care about a good match at gross level if there are no operating or net profits to be had. Probably the right way to look at this is that no business will put up with losses for a long period of time: it will either give up trying, or be forced to close down. A reasonable gross margin should offer the chance of a decent profit over time;

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2.84 Perceived strengths of the profit split method include:

- less reliance is placed on comparability with observed third-party transactions, and so the method remains useful even if no such transactions can be found; though there must still be a reference to observable third-party behaviour at some level; and
- both parties to the arrangements are examined, and so profit is unlikely to be allocated in such a way as to leave one or other in an extreme or improbable profit position.

2.85 Perceived weaknesses include:

- the external market data used to identify the contributions of the parties is not so closely linked to the relevant transactions as is the case with other methods. Operating at one remove, as it were, gives an air of greater subjectivity to the application of the method in practice;
- safe application of the method requires the production of considerable data from more than one jurisdiction, so there may be issues of availability;
- certainty is required that revenues and costs have been reported on consistent bases by all parties to the arrangements. This might mean special efforts being made by the parties to re-state their books, or to modify their internal systems appropriately; and
- it can be challenging to remain true to the arm's-length principle and measure, at some level, the profit split by reference to the transactions of unrelated parties.

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The Transactional Net Margin Method (TNMM)

2.86

This was originally intended to be the method of absolute last resort but, in practice, it became almost overnight the most popular and frequently used of all the OECD methods (in some jurisdictions, but not all – see below). Perhaps its popularity stems, at least in part, from the fact that for years before the Guidelines finally got round to accepting it, great numbers of people had been using it anyway. The United States called it the Comparable Profits Method (CPM) – they still do; CPM is not, of course, officially the same as TNMM, since CPM cuts straight to the bottom line, however complex or multi-faceted the businesses of the comparables and tested party might be, in a way that the OECD finds frankly distasteful. TNMM, by contrast, is a method of greater taste and refinement and there is something akin to elegance in the way in which it – well – cuts to the bottom line.

2.87 The point is that in a large number of cases data reliable enough to permit the safe application of one of the other methods is simply not available, and so for years before the acceptance of TNMM, both MNEs and tax authorities had been solving difficult cases on the basis of profitability, usually over a number of years. So, for example, solutions were found under which distributors might take a few years to start up and then would make an operating

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margin in the region of 2%. The United States were honest about this and called it CPM; everyone else played a game of simultaneously sneering at the US by solving the problem with reference to operating profits or all costs plus.

2.88 The TNMM examines the operating profit (ie the profit after direct and indirect costs) from controlled transactions as a percentage of a base such as sales, costs, or assets. Ideally the operating profit should be established by reference to profits earned by the same taxpayer in comparable uncontrolled transactions. However, if that is not possible, comparable transactions between wholly independent entities can be used. Comparability between controlled and uncontrolled transactions should be established, as ever, through a functional analysis.

2.89 The TNMM should consider only the profits attributable to the transactions under review. This might necessitate separating the profit and loss account into streams where the company engages in a variety of different controlled transactions. By the same token, comparables must be selected carefully to retain only companies whose business is homogeneous and whose transactions are the same as, or similar to, those under review.

2.90 Advantages of the TNMM include:

- use of it is common, as previously described;
- as the TNMM focuses on only one party to a controlled transaction it is a relatively simple method to apply. There is, for example, no need to ensure that all parties' books are stated on a consistent accounting basis; and
- an operating margin is likely to be less susceptible to functional differences in comparing transactions than are the gross margin studied in the resale price method and the price in the comparable uncontrolled price method. It is an observed fact that different businesses might show a wide range of gross margins but be broadly similar at operating level.

2.91 Weaknesses include:

- for many years, not all OECD countries accepted it, even though it had been sanctioned by the Guidelines for many years. This led to a certain amount of creativity on the part of MNEs in those jurisdictions in dressing up what is really a TNMM to look like another method – and not just in those jurisdictions, of course, but in other countries which are the counterparty to transactions involving those jurisdictions, to maximise the chance of obtaining competent authority relief in the event of double taxation. This point has become less of a problem over time, but there are still one or two examples left;
- a comparison made after operating expenses might fail to account for relevant factors that have nothing to do with gross margin or particular prices, such as operational inefficiencies, a redundancy programme, fluctuating marketing spend, etc;

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- it might be difficult to be certain that the operating profit has been calculated consistently, (ie that items such as depreciation, reserves, provisions, other operating income, etc have been treated in the same way); and
- there may be difficulties in identifying the counterparty or parties for the purposes of making corresponding adjustments to relieve double tax. This would be so where the company sits in the middle of the group supply chain, or where it buys from or sells to a number of group companies.

Cutting to the bottom line does not do away with the need to consider many of the factors affecting comparability already mentioned, for example threat of new entrants, competitive position, management efficiency and strategy, availability of substitute products, maturity or otherwise of the business, differing cost structures, and so forth. Adjustments will have to be made to account for such differences. Sometimes it is argued that the use of a range takes care of this, but it should be obvious that for the purist this cannot be so. A range does not in itself take account of unique features (start-up phase, innovative strategy decisions, etc). What it does offer is a spread of possibilities which can be of use in resolving a tax authority audit. How? Information on comparables is limited, so it is hard to decide whether or not the enterprises chosen as comparables face the same issues as those being debated in the audit, and so the range can be said statistically to lay off the risk of reaching a demonstrably wrong conclusion. It is worth noting that this risk is reduced further if multiple year data is used, since this will enable proper account to be taken of any short-term economic factors.

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Comparable profits method

2.92 This was referred to in our discussion on TNMM. Is the TNMM, when it comes right down to it, essentially the same as the US comparable profits method? Strictly, no it is not. The CPM benchmarks the profitability of companies as a whole, rather than on a transaction-by-transaction basis as the TNMM does. Sometimes, by accident rather than by design, the two methods would reach the same answer because the comparable sets chosen consist of companies with either homogeneous or one-product businesses. But often this is not so, and the CPM has incurred the wrath of the Guidelines and of many individual OECD countries. However, as a practical matter, it can be observed that, when it comes to resolving double taxation issues arising from transfer-pricing adjustments, competent authorities, especially those in mature transfer-pricing jurisdictions such as the UK, do try to reach pragmatic solutions without getting hung up on mere labels.

RECENT OECD DEVELOPMENTS

2.93 There is a tremendous amount of activity at OECD in the transfer-pricing arena right now. This section looks briefly at some OECD developments that, at the time of writing, were reasonably hot. It is only briefly, because time

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hurries on and it is likely that soon after publication these sections will be out of date. These developments are:

- Intangibles
- Timing issues
- Bilateral safe harbours
- Base erosion and profit shifting (BEPS).

Intangibles

2.94 Briefest mention of all here for intangibles as they are dealt with in detail in **Chapter 6**. However, this is an area of considerable interest at OECD at the time of writing both because of the need to provide additional guidance in the area of intangibles and because of the role this topic might play in the BEPS discussion, dealt with below.

Timing issues

2.95 Arising out of the work on intangibles but then extending more widely, the OECD is also considering timing issues, looking at (i) the time that comparable information is available to taxpayers in assessing whether their prices are arm's length; (ii) tax authority acceptance of year-end adjustments; (iii) the use of post-transaction date information to assess reasonableness; and (iv) specific issues in respect of the valuation of highly uncertain intangibles.

Bilateral safe harbours

2.96 The OECD is considering amendments to guidance on the use of safe harbours and is proposing to remove the 'somewhat negative tone' that does not reflect the practice of OECD member countries (particularly in respect of smaller taxpayers and less-complex transactions). In particular, the OECD is looking to encourage countries to agree 'bilateral' safe harbours given the potential advantages of simplicity and ease of administration, which avoids some of the downsides of providing unilateral safe harbours with no reciprocal treatment in counterparty jurisdictions.

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BEPS

2.97 The Fiscal Affairs committee of the OECD has formed a working party to consider Base Erosion and Profit Shifting. The committee intends to produce changes that will be implemented by 2015, which is a very short timescale for what could potentially (although it is very early days at the time of writing) include significant reform of the concepts of international taxation. The underlying concept behind this review is that the fundamental principles of international taxation and the OECD Model Tax Convention were founded at a time (actually, in 1927 by the League of Nations) when international trade was characterised by business activity significantly different to the globalised, digitised business world of today. Given recent public and political pressure on the amount of tax paid by multinationals, it is time to look again at these

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fundamental principles to assess whether they are appropriate to business as it exists today. This will include a review of six major areas, taking into account that the international tax system will need to be considered holistically rather than on an issue-by-issue basis:

- hybrid instruments and hybrid entities leading to mismatches of tax treatment between jurisdictions;
- application of treaty concepts to profits from digital goods and services (including permanent establishment questions);
- intra-group interest and captive insurance companies;
- transfer pricing, particularly of risk and intangibles and transactions that are rarely seen between third parties;
- the effectiveness of anti-avoidance measures such as GAARs, CFC, thin capitalisation and anti-treaty abuse rules; and
- the availability of harmful preferential regimes.

The transfer-pricing review will be comprehensive, including consideration of whether the arm's-length principle continues to be the appropriate standard to apply. The BEPS working group are also keenly interested in the conclusions of the Working Party 6 review of intangibles transfer pricing as the potential ease of relocating intangibles by MNEs is a concern to the BEPS working group.

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THE REST OF THE BOOK

2.98 It is worth setting out at this stage the basic format for the rest of this book together with an explanation of how this corresponds with the format of the OECD Guidelines.

2.99 Chapters I, II and III of the OECD Guidelines set out the underlying principles in relation to transfer pricing, being the arm's-length principle, transfer-pricing methods and comparability analysis respectively. These have been discussed already. Chapters VI to IX of the OECD Guidelines look at the application of the theory from Chapters I to III in a number of different circumstances (eg Chapter IX (which was newly incorporated into the 2010 Guidelines) deals with business restructuring). This book takes a slightly different approach by exploring the application of transfer-pricing principles on a transaction-by-transaction basis, dealing with tangible goods, services, financing and intangible property in turn within the following four chapters.

2.100 Chapter IV of the OECD Guidelines sets out administrative approaches to avoiding and resolving transfer-pricing disputes and Chapter V sets out guidance as to the content of transfer-pricing documentation that tax payers should hold on file. These two chapters are dealt with in this book in **CHAPTER 8** on the subject of 'Implementation and Monitoring'.

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Chapter 3

Types of transaction: Tangible goods

INTRODUCTION

3.1 At the very highest level there are four types of transaction that members of the same MNE might enter into with one another or, indeed, with any unrelated enterprise. They can transact in:

- tangible goods;
- services;
- financing; and/or
- intangible property.

The next four chapters introduce these types of transaction and the consequences for transfer pricing them in turn. This chapter looks at tangible goods.

3.2 To begin with there are some definitions to set out: the terms 'supply chain', 'contract manufacturer', 'toll manufacturer' and 'widget'.

3.3 For some reason international tax specialists have decided that the codename to be used when trying to explain anything to do with tangible goods is 'widgets'. The term 'widget' originates from engineering and means 'a small mechanical device or control', though 'widget' has since been appropriated into other spheres such as software engineering where it clearly means something else entirely. In the world of tax and economics the term is used to mean a physical object, unlike a service, a loan, or a licence.

3.4 We are indebted to the world of business consulting for the term 'supply chain'. It means the channel of distribution beginning with the supplier of materials or components, extending through a manufacturing process to the distributor and retailer and, ultimately, to the consumer. It is convenient as a term first because, it is much shorter to say 'supply chain' than to describe the flow through a business, and secondly because 'supply chain' carries a high score if you are playing 'Buzzword Bingo' in business meetings. That said, this term is borrowed for the remainder of this book.

3.5 A 'contract manufacturer' is a specialised form of manufacturing entity where the hiring firm approaches the contract manufacturer with a design or formula. The contract manufacturer will quote based on processes, labour, tooling, and material costs. Unrelated hiring companies would usually request quotes from multiple sources and then buy on price and other factors, such as reliability or capacity to deliver. The contract manufacturer acts as the hiring firm's factory, producing and shipping units of the design on behalf of the

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hiring firm. A contract manufacturer does not own intangibles in the product that is produced and makes to order which means it has little inventory risk. Sometimes the production process is well known (there are no process intangibles owned by the contract manufacturer) and sometimes the hiring firm provides its production intangibles. Occasionally the contract manufacturer may use its process intangibles but the reward for this is usually a slightly higher margin on a similar unit price. Unrelated parties use contract manufacturers in aerospace, defence, consumer goods, and automotive to name just a few but they are commonly found in many industries.

3.6 A 'toll manufacturer' is slightly more specialised in that it does not purchase the raw materials used to make the widgets, though it will often purchase consumables required in the manufacturing process (eg electricity, oil and spares for the machines used in production). Toll manufacturers typically bid for work just like contract manufacturers but they play no part in, and enjoy no reward from, sourcing and holding raw materials. Toll manufacturing is less common between unrelated parties but it does happen. In transfer-pricing terms, the value added by the manufacturing entity in either contract manufacturing or toll manufacturing is quite close and so, unless there is an overwhelming reason to choose toll manufacturing in an intra-group scenario, it is often best avoided; there can be significant complexities to raw material procurement in a toll manufacturing structure and customs duty, import licences and other controls are particularly important.

3.7 In a simple (though not untypical) business model, a group involved in the production and sale of tangible goods might organise and carry out its business by separating manufacturing operations from sales operations. This can be for several reasons, the most obvious of which being that perhaps they manufacture in a small number of jurisdictions but sell in many. A business model utilising specialist manufacturing companies yet making sales to third-party customers through dedicated reselling and marketing companies must provide for the transfer pricing of goods as they pass through different associated companies along the supply chain.

3.8 There are many variations in the ways that a multinational might structure its business model and supply chain which vary in complexity; potentially involving invoicing companies (eg for the management of currency risk) or agents acting as intermediaries in the sale of goods. To aid this discussion, three examples of a supply chain for tangible goods transactions are set out in **Figure 3.1** below. As will be demonstrated, the transfer-pricing issues surrounding the trade in tangible goods centre on the allocation of key functions and risks among the various group companies along the supply chain.

MANUFACTURING

3.9 All types of manufacturers apply processes to raw materials to create a 'widget' (in this example). This is true from simple contract or toll manufacturing (see **Figure 3.1A**) through to complex manufacturing operations bearing full risk exposures and using internally developed product intangible property (**Figure 3.1B**). From a transfer-pricing perspective, the

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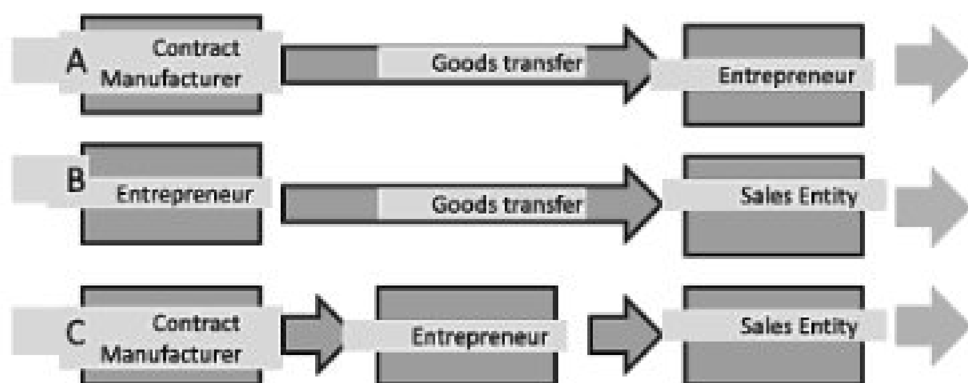

Figure 3.1

amount of profit to be allocated to the manufacturer depends on the operational model employed by the multinational group, in other words, how the multinational conducts its business between the various group companies, sharing functions and risk between them. The analysis of functions, risks and assets to answer this question is called a 'functional analysis'. This process is fundamental to transfer pricing. A functional analysis provides the information for determining the tested party and provides the information on comparability for the selection of evidence of third-party transactions from which the arm's-length nature of inter-company prices can be tested. This can be illustrated by considering the position for the type of manufacturing entity at each end of the spectrum, starting with the operation which adds least value.

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Contract or toll manufacturer

3.10 The supply chain for this type of business relationship is illustrated in **Figure 3.1A** above. A typical contract or toll manufacturer would be employed by the business entrepreneur to undertake well-defined widget manufacturing or assembly processes. The only difference between contract and toll manufacturing is their involvement in procuring raw materials that will form part of the finished goods or packaging but the transfer-pricing methodology that is most applicable to this business model is not affected by that. It is likely that a contract manufacturer will not bear any risks associated with currency, inventory or selling the finished goods. Payment terms would likely be based on budgets which, quite rightly, allow the manufacturer to be more, or less, profitable depending on how well they have performed (perhaps with a year-end adjustment to actual, though as this verges on a non-commercial licence to spend, it is not the model most commonly advised), and the risk of unfulfilled orders would lie with the purchaser rather than the manufacturer. Other than possibly some process know-how, the contract manufacturer will not own or develop any valuable intangibles. Transfer prices would often be set on a 'per unit' fee, or a return on assets or a return on costs. Even the risks associated with fixed costs may be ameliorated with long-term contracts and guaranteed volumes.

3.11 The level of reward would be driven by the functions, assets and limited risks borne by the contract manufacturer and would reflect the

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depreciation of fixed assets employed. These are, in effect, the opportunity costs of providing the contracted service. In testing, or indeed setting, the price to be charged by such a manufacturer – and so the reward that it makes – the most likely approach is a benchmarking exercise in which comparison is drawn between the return on costs achieved by the group company and that of a sample of independent, but otherwise comparable, manufacturing companies operating (as far as data availability permits) in the same territory. Care does need to be taken in assembling and using such samples because publicly available data rarely discloses the nature of the relevant contractual arrangements. There will, as a result, always be some doubt as to whether like is being compared with like. One answer lies in making adjustments in respect of relevant items such as inventory carried, capital employed, debtor days and such like so that, for example, where the group company is a toll manufacturer, all risk and expense related to inventory ownership is factored out of the comparable set.

Complex manufacturer

3.12 Like a contract manufacturer, a complex manufacturer would typically own fixed assets for the widget production process and carry out manufacturing or assembly work. However, it would also bear inventory, product and other risks. It is also likely to carry out research and development and own its intangible property and it is this element in particular that adds to its complexity. From the perspective of benchmarking transfer prices, it is far more difficult to test the arm's-length return for this type of manufacturer, particularly where embedded intangible asset development and ownership is significant. Here, costs and tangible assets employed are not the only value drivers in play, so payment by reference to them is likely to miss the mark. How to proceed, then?

3.13 A common structural model for multinational groups is the separation of manufacturing and sales/distribution activities. This is set out in **Figure 3.1B** above. Where the manufacturer is complex, the sales entities would, by definition, be relatively simple with the manufacturer bearing most of the risks of the overall activity. In this case, allocating an arm's-length reward to the sales entities and allowing all the residual – whether profit or loss – to fall to the manufacturer would be the most appropriate approach. This relies on the premise that if prices paid by the sales entity are at arm's length, then the balance received by the manufacturer, whatever it might be, is also arm's length. As ever, care must be taken to ensure that an accurate analysis of the functions of the tested party have been undertaken, as any omissions here will lead to an under-reward for the tested party and the 'mistake value' will augment the residual return.

Centralised business model

3.14 On occasions, both manufacturing and sales companies will be regarded as 'complex'. That is set out in **Figure 3.1C** above. We can use both of the methodologies applied to **Figures 3.1A** and **3.1C** to reward both the

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on to ensure close comparability with the sample of third-party resellers selected for benchmarking.

WHOLESALERS AND MARKETERS

3.24 This type of distributor is discussed briefly at paragraph 2.29 of the OECD Guidelines, namely a reseller which does not add substantially to the value of the product resold (such enhancements might be in the form of further processing, packaging or in the creation and/or maintenance of an intangible asset, such as brands underpinned by a trademark and trade name). The OECD Guidelines do not refer to such distributors as stripped and indeed they might not be; they may well be marketing and reselling vehicles whose function and risk profile puts them somewhere between the stripped buy/sell and the fully fledged distributor. For convenience we will call these wholesalers and marketers.

3.25 Wholesalers and marketing-type entities take title to the goods for resale, carry out marketing functions and often handle transportation of the product. They typically bear market risk (ie risk on their operating expenses) but do not own intangibles related to the products sold. Again, the most typical benchmarking approach here is usually the resale price method, with the transactional net margin method as a fallback if needed.

3.26 As with all transactions, there is no clear hierarchy of methods in the OECD Guidelines and the most appropriate method should be used. That being said, there is still a preference towards transactional methods over profit-based methods where both could be applied equally reliably, and within the transaction-based methods there is a preference for the CUP method if data is available.

3.27 However, in general, external CUPs can rarely be found. Internal CUPs occur more frequently and can be available in some industries, such as software licensing, although they are still relatively rare in practice as multinationals often employ captive distributors to centralise the supply of their products to a particular geographic market.

3.28 As outlined above, in the absence of CUPs, the resale price method is usually the preferred method to apply to distributors. Economic theory suggests that a distributor would only accept a purchase price that would leave sufficient margin to cover its operating costs in delivering the product to third parties over the long term. The OECD Guidelines agree (see paragraph 2.21). However, if companies use the resale price method to set their inter-company prices, there is a risk that if the market price for their goods deteriorates, losses can be generated in the short term. Nevertheless, proper application of the resale price method ensures that both the manufacturer and the distributor in a transaction chain will share the downside (or upside) of any market fluctuation.

3.29 Where applying the resale price method accurately would be impossible, the transactional net margin method is typically used. In practice it is frequently impossible to apply the resale price method with sufficient accuracy, the prime reasons all revolving around non-uniformity of reporting

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conventions and paucity of publicly available detail. There are no established rules as to what should be reported in the cost of goods sold as opposed to operating expenditure, for example. Again, publicly available financial statements do not reveal enough about the size and constitution of sales forces, terms under which companies buy goods from suppliers, whether they own or lease warehouses, and so forth. The transactional net margin method can, therefore, legitimately be used in such circumstances to provide a respectable solution.

3.30 A further issue that arises is the variation between different types of distributor in their gross profit margin and operating expenditure profile. The interesting observable phenomenon is that almost any sample of rigorously chosen independent distributors will show an operating margin of something like 2% to 6%, no matter what their gross margin or their level of operating expenditure. It seems that the market knows what such operators deserve, and acts to keep gross margin and operating expenses in synch so that whether the reseller is moving high-margin low-volume goods or the reverse, it makes a bearable but modest return and no more.

3.31 Often, therefore, a sample of potentially comparable independent resellers will show homogeneity at operating margin level but not at gross margin. Can high gross margin resellers be used to benchmark low gross margin and vice versa? One simple answer is no, not at gross margin level, but yes at operating margin level. So the transactional net margin method is often used to provide an answer here. This might be perceived to be somewhat rough and ready, but it is actually quite hard to find cost-effective alternative answers. Those that have been found, such as the Berry ratio (the ratio of gross profit to operating expenditure), tend to be variations on a single quite simple theme, namely that the market will in general keep distributors of all types in check so that operating margins are a constant with the variables being gross margin and operating expenditure.

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Fully-fledged distributors

3.32 Fully-fledged distributors perform the same core activity as the sales entities described above but take on more risk. They typically perform value-added activities such as post-sales services and support and, importantly, can be expected to contribute to the creation and maintenance of intangible assets such as a brand underpinned by a trademark or trade name. In terms of valuing the distribution function, the analysis and issues discussed earlier in this section apply. However, the impact of risks assumed and extra functions performed should be considered in detail when seeking third party comparable data as these factors have a considerable influence on profitability.

3.33 Sometimes there is no requirement to benchmark such entities because the other party to the transaction performs a simple function such as contract manufacture. The same is true where there are several other group companies involved but they all act as service providers to the reseller, such as providers of research and development, back offices services, and the like. The

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problems come when there is more than one complex entity involved, for instance when the counterparty is a complex manufacturer.

3.34 Such structures are not susceptible to straightforward benchmarking of one side or the other, with the residual all going to one party. A useful approach here is to begin by splitting out all the functions performed by either party, and identifying those that in standard parlance would be considered 'routine'. These can be benchmarked and a 'routine' return assigned to them in the normal way. Best practice is to eliminate in this way as many functions and allocate as much profit (or loss) as possible. There then remain the 'complex' functions and risks, associated mainly with the creation and contribution of intangible property, to which can be assigned the residual profit or loss. How that residual might be allocated has been covered in **2.78** ('profit split'); briefly the relative contributions of the parties will be weighted or scored in some way, or some kind of observable third-party behaviour be found in the market place and an allocation derived from it. Each party will then have been assigned a mixture of routine and residual returns. The sum of all these should equal the total available to be split in the first place; whether it is sufficient simply to add up the amounts allocated to each party in these various exercises, or whether some further refinement is needed to take account of discounts or premiums to be applied because the value of the aggregates is different from the sum of the component parts, is a matter of judgment.

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Chapter 4

Types of transaction: Intra-group services

4.1 Intra-group services are generally not the most exciting part of transfer pricing. In the transfer-pricing world, for many multinationals, intra-group services can be the kind of thing that you just can't avoid – like attending the wedding celebrations of a cousin whom you hardly ever see and don't actually like very much. It is your duty, as a good family member, to make the effort.

4.2 The most common kind of intra-group services simply cover the kind of backroom activity that could (if you had chosen that option) have been outsourced to a third-party provider: things like IT, HR, accounting, legal, finance etc. which are neither integral to, nor drive the profits of, the business. Yet, even for this kind of service, there will often be audits from the tax authorities: just how many days did it take to install that new accounting system? Have the costs of preparing consolidated accounts really been excluded? There are a number of reasons for this. For a start, no specific industry knowledge is required of a tax inspector to examine intra-group services. Experience from around the world shows that a lot of tax authority audits start with intra-group services – such audits are often the way in which jurisdictions with new transfer-pricing rules or new inspectors within mature regimes learn their trade. Apart from anything else, therefore, paying due attention to this issue will improve an MNE's chance of an audit being closed quickly and not extended into other more critical areas.

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4.3 It is also true to say that some unlikely sounding claims are made in respect of payments for services, and tax authorities know this. How often has a multinational group acquired a stand-alone overseas company or group and immediately it transpires that the subsidiary group cannot get by without spending hundreds of thousands of pounds a year on management services? How likely is it that this is really the case?

4.4 There are three essentials to bear in mind when considering intra-group services:

- Is there a benefit to the recipient company? This is usually considered in terms of service provision vs shareholder costs;
- How should a charge be made? This breaks down into selecting the most appropriate OECD method to use and whether the charge should be 'direct' or 'indirect'; and
- At cost or at a profit? This is most relevant when a cost-based charge (either direct or indirect) is made.

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It is important to look at these three essentials from the viewpoint of the recipient as well as the provider. While it is true that many audits will be carried out by the provider's tax authority, it is equally true that many audits will be conducted into payments made for services by the recipient, with the attendant risks of a disallowed expense and double taxation.

IS THERE A BENEFIT? SERVICES VS SHAREHOLDER COSTS

4.5 Under the arm's-length principle, the question of whether an intra-group service has been rendered depends on whether the activity provides economic or commercial value which enhances a company's commercial position (ie whether the recipient company has received economic benefit from the services). Paragraph 7.6 of the Guidelines sets out the main test for deciding whether or not a service has been provided:

> '… whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself. If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle.'

There are some activities for which a recharge should not be made. These include what the Guidelines call 'shareholder activity' and the costs of duplicate services.

4.6 Some attempt is made at paragraph 7.10 of the Guidelines to identify typical shareholder costs. These might include:

- meetings of the shareholder parent;
- issues of shares in the parent;
- costs of the supervisory board;
- costs relating to the parent's reporting requirement, including consolidation of reports; and
- costs of raising funds for its own new acquisitions (as opposed, for example, to fund acquisitions to be made by subsidiaries).

It is possible to think of others, such as the costs of a tax authority audit of the parent, to the extent that this did not spill over into the activities of any subsidiary.

4.7 Some of these are open to challenge, if on no other grounds than lack of clarity. What, for example, does 'costs of the supervisory board' mean? It may be that some benefit to the operations of a subsidiary are derived from particular board meetings. The key point to consider is whether or not the activity is one which the recipient would have carried out for itself. Would it have paid for a third party to carry out the operation if there had been no in-house provider?

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4.8 Duplicate services are often found. For example, a recharge might be made for a central human resources function, but subsidiaries also employ human resources personnel. There may be no overlap, but frequently there is.

4.9 Despite the ban on deducting duplicate costs, tax authorities should nonetheless accept that some temporary duplication may be valid (eg during a reorganisation; likewise, it is not duplication to seek a second opinion before making an important business decision).

4.10 The Guidelines make interesting comments on when an incidental benefit not amounting to a service is received. Paragraph 7.12 considers situations where services (eg restructuring or acquisitions) relate only to some group members, though incidentally provide benefits to others; such benefits may involve realising synergies or achieving economies of scale. The Guidelines consider that no payment is due in this instance, as an independent enterprise would not ordinarily be willing to pay for these benefits. A distinction is also drawn between a benefit derived from specific activity and one attributable solely to being part of a larger concern ('passive association'). So, for example, enjoying a higher credit rating by reason of affiliation should be distinguished from enjoying a higher credit rating by reason of a parental guarantee. Similarly, basking in the reflected glory of marketing or PR campaigns by another group member (activity that is not intended to benefit other entities) should not be treated in the same way as if specific marketing expenditure had been laid out on campaigns for specified local markets.

4.11 The Guidelines also warn against double charging (eg raising a separate service fee when adequate recompense is already received by way of a licence fee or the spread on a loan).

4.12 To balance the apparent concentration on what is not a service, paragraph 7.14 of the Guidelines also lists a number of activities that would normally amount to a service, because the recipient would have been willing to pay for them, or perform them itself. These include:

- Debt factoring.
- Contract manufacturing.
- Contract R&D.
- Administration of intellectual property.
- Legal services.
- Accountancy.
- Market research.
- Auditing.
- IT support.
- Raising finance.
- Central purchasing.
- Exchange risk management.

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- Recruiting.
- Training.

These are all services which a subsidiary could readily make use of in conducting its own business. Paragraph 7.9 of the Guidelines also identifies 'detailed planning services for particular operations, emergency management, technical advice (trouble shooting) or, in some cases, assistance in day-to-day management'.

4.13 The mention of contract R&D is interesting. Tax authorities often contend that such activities are so valuable that they cannot be rewarded on a cost-plus method or, if they are, the 'plus' must be somewhere up in the stratosphere (eg 15 or even 25%). Paragraph 7.41 of the Guidelines looks at this and, while not concluding on the right price (one could hardly expect them to), they do make some pertinent comments on points to be taken into account. The Guidelines state that 'the additional functions of identifying commercially valuable areas and assessing the risk of unsuccessful research can be a critical factor in the performance of the group as a whole'. At this point, many tax authority officials will be right on board, waiting eagerly for the justification of their investigation and the franking of a huge adjustment. What comes next is this:

> 'However, the research company itself is often insulated from financial risk since it is normally arranged that all expenses will be reimbursed whether the research was successful or not. In addition, intangible property deriving from research activities is generally owned by the principal company and so risks relating to the commercial exploitation of that property are not assumed by the research company itself. In such a case a cost plus method may be appropriate …'

The correct approach to pricing contract R&D activities will be driven by the facts of the case and understanding in this area is developing as a result of the current review by OECD Working Party 6 of Chapter VI of the Transfer Pricing Guidelines, which deal with intangible property. In some cases a cost-plus approach will be appropriate, but it is possible to envisage circumstances in which the reward for contract R&D would be more reflective of the later value created by the fruits of the R&D. For example, where a business asks a university to conduct fundamental research, the fee structure might include a variable element dependent on the future profitability of any commercial applications of the research.

HOW SHOULD A CHARGE BE MADE?

4.14 As with all transfer pricing, the key is that any charge made must satisfy the arm's-length principle. How a charge should be made can be broken down into two sub-parts: What OECD method might be used to test, or indeed to set, prices? Must the charge be made directly, or are indirect methods permissible?

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What OECD method?

4.15 There is no clear hierarchy of methods for pricing services, following the adoption of the 'most appropriate method' principle (as set out in **Chapter 2**). However, there is still a preference towards transactional methods over profit-based methods and within the transaction-based methods, there is a preference for the CUP method if data is available. In practice, three OECD methods are used in testing or setting the price of services: CUP, cost plus and TNMM.

4.16 CUPs are relatively rare as there are generally no requirements for the public filing of service agreements. Unless the company also performs similar services for, or purchases similar services from, unrelated parties, it is difficult to use the CUP method to benchmark services. CUPs tend to pop up in specific areas such as debt factoring, where there is a wealth of information available (eg on the internet) and there is a reasonable degree of comparability between third-party and in-house infrastructures. This latter point on infrastructure is very important when proposing the use of, or examining, apparent CUPs in areas such as management consultancy and tax advice. While it is possible to obtain details of hourly or daily rates, these can vary wildly depending on the structure of the organisation providing services. Factors such as layers of delegation and quality control, the need to obtain new business, training, downtime, the risk of litigation, guaranteed utilisation and so forth are all potential differentiating factors to be taken into account. Nonetheless, it is sometimes the case that the recipient of a service could have gone out to his (or her) local market and obtained the service on more competitive terms, especially if the provider is in a higher cost location than the recipient. In such cases, if it is clear that the local substitute for the group service provider could have provided the right kind and quality of service, then the local CUP is indeed a CUP and will drive the price down. This can result in the group service provider making a loss on the transaction.

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4.17 Some form of cost plus is much more commonly used, both to set and to test intra-group service pricing. Sometimes a recharge is made of direct costs only (plus a mark up), for example in the case of a contract manufacturer. In this case, one would expect the recharge to be sufficient to cover indirect as well as direct costs, even though only the latter have been built into the pricing formula.

4.18 In many cases, an 'all costs plus' or 'fully loaded costs' method, which is really a form of TNMM, is used. This would be particularly so in the case of small service providers where the distinction between direct and indirect costs is neither easy to make nor especially meaningful.

4.19 Occasionally a service or management fee will be calculated as a percentage of turnover. This is not the same as allocating a finite pot of costs by reference to third-party turnover (see **4.22 onwards** below). Here we are talking about paying out (say) 2% of sales, such that a bumper year means a higher management charge.

4.20 There is somewhat oblique coverage of this in paragraphs 7.17 and 7.18 of the Guidelines. These deal with paying fixed amounts by way of

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4.27 One special instance of passing on costs without a mark up is mentioned in paragraph 7.36 of the Guidelines. It is not normally appropriate to mark up directly the cost of contracted-out or bought-in services, such as external consultancy services (ie 'pass through' costs). For example, an MNE hires an external consultant to undertake a worldwide project that benefits each member of a multinational group. In this situation, when reallocating the costs of the project to each member of the group, a mark-up should not be applied. The profit margin of the external consultant is already included in the cost and to mark-up the cost again is inconsistent with the arm's-length principle. To the extent that one member of the MNE group coordinates or manages this activity, its coordination costs should be recharged with a suitable mark-up.

4.28 Finally, in a concession to the US IRS's stated policy of only looking for a mark-up on the costs of providing integral services (ie services that are integral to the business of the provider or the recipient), paragraph 7.37 of the Guidelines states that on pragmatic cost–benefit grounds, charging cost only with no mark up might be accepted where the effort of adding a mark-up is simply not worth it. This concession is unlikely to be made by tax authorities where the provision of a service is a principal activity of the service provider, where the profit element is relatively significant, or where it is possible to make a direct charge.

Calculating an arm's-length consideration

4.29 According to paragraph 7.29 of the Guidelines, the arm's-length nature of the consideration has to be considered from the viewpoint of both provider and recipient. What are the provider's costs? What profit might an unrelated party expect to realise? What is the value of the service to the recipient? What would he be prepared to pay an independent party for the same service?

Types of transaction: Intra-group services

4.30 As a matter of practice, prices are most often set by reference to the mark-up on costs achieved by independent providers of comparable services. There is an argument as to what comparables should be used: should they come from the territory of the provider or of the recipient? Normal practice is to draw comparables from the country where the service is performed. The philosophical support usually given for this is that although the recipient would most likely go to his (or her) local market if minded to look for alternative providers, the group service provider is likely to be best placed to offer the service and thus is not in real competition with any putative local providers. In other words, no viable alternative and therefore no CUPs can be found, so we should look to what margin the provider would expect to earn in its market.

DOCUMENTATION

4.31 As a minimum, documentation should include formal agreements between the related parties and details of:

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- What services are provided.
- The basis of charging (ie direct or allocation key, and if the latter, what key).
- The identification and justification of the costs to be charged.
- How the mark-up(s) have been derived – this is usually with reference to comparable data.

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