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NOTE:
This chapter is written prior to the issuance of the 2010 Revised OECD Guidelines.

1 WHAT IS TRANSFER PRICING AND WHY DOES IT EXIST?

In a rapidly globalising economy, multinational enterprises (MNEs) are expanding their operations into an increasing number of countries around the world. This expansion has resulted in a growing number of intercompany transfers of tangible goods, intangible property, services, and financial instruments across international borders. The price at which these transfers occur has an effect on the taxable income reported by the legal entities involved in the transaction and the overall effective tax rate of the consolidated organisation. These internal prices are called 'transfer prices'.

Transfer pricing regimes (e.g., the arm's length standard discussed later in this chapter) provide the conceptual framework for pricing intercompany transactions and ensuring an appropriate allocation of income between the various tax jurisdictions in which a multinational company operates. Transfer pricing for tax purposes is governed by local country tax authorities, many of which have issued formal rules regulating transfer pricing practices. In most instances, the regulations are accompanied by documentation requirements and penalty provisions for non-compliance.

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1.1 Transfer Pricing Example

The impact of transfer pricing on taxable income can be seen in the following examples. Consider the case of a manufacturer that sells all of its product to a related-party distributor located in another tax jurisdiction. Assume that the distributor does not sell any third-party manufactured products, and that it sells everything it buys from the manufacturer instantly, so that its cost of goods sold (COGS) entirely consists of the purchases from its related-party manufacturer during the relevant period. See Figure 1.1 (the related-party transactions in the following are shown with arrows and, for purposes of this example, all figures are in US dollars).

In Scenario 1, the manufacturer charges the distributor $100 for the goods. If the manufacturer has total costs of $85 (COGS of $75 and operating expenses of $10), it will have $15 of taxable income. The tax rate in the country in which the manufacturer is incorporated is 10%, resulting in $1.5 in taxes paid.

Figure 1.1: Scenario 1 – Tangible Transaction

Manufacturer —$100→ Distributor | Consolidated

	Manufacturer	Distributor	Consolidated
Revenues	$100	$120	$120
COGS	75	100	75
Operating Expenses	10	5	15
Taxable Income	$15	$15	$30
Tax Rate	*10%*	*40%*	
Taxes Paid	$1.5	$ 6	$ 7.5 (25% ETR)

The distributor's profit and loss statement is made up of $120 in third-party revenue, $100 in related-party COGS, and an additional $5 in operating expenses. In total, the distributor earns $15 of profit. After applying the 40% tax rate, the distributor pays $6 in taxes.

In Scenario 1, the consolidated group pays a total of $7.5 in taxes. Since the total taxable income of the group is $30, this represents an effective tax rate of 25%. Now consider Scenario 2, shown in Figure 1.2.

Figure 1.2: Scenario 2 – Tangible Transaction

Manufacturer —$110→ Distributor | Consolidated

	Manufacturer	Distributor	Consolidated
Revenues	$110	$120	$120
COGS	75	110	75
Operating Expenses	10	5	15
Taxable Income	$25	$ 5	$30
Tax Rate	*10%*	*40%*	
Taxes Paid	$2.5	$ 2	$ 4.5 (15% ETR)

In Scenario 2, the manufacturer charges the distributor $110 for the goods rather than the $100 charged in Scenario 1. The change in price has a significant impact on total taxes paid because of the varying tax rates in the two jurisdictions. Specifically, because the manufacturer now receives $110 in revenue rather than the $100 it earned in Scenario 1, its taxable income increases by $10, to $25. Applying the 10% tax rate results in $2.5 in taxes paid. On the other side of the transaction, the distributor's taxable income has decreased by $10 as a result of the increase in its COGS. This results in taxable income of $5, which, after applying the 40%tax rate, results in $2 in taxes paid by the distributor.

On a consolidated basis, the company's revenues, COGS, operating expenses, and taxable income remain identical to the corresponding amounts in Scenario 1. However, because profit has been shifted from the higher tax jurisdiction into the lower tax jurisdiction, the company has saved $3 in taxes ($7.5 less $4.5), and the company's overall effective tax rate has been reduced from 25% to 15%.

This simple example illustrates how taxpayers with material intercompany transactions can manipulate their financial results to reduce their overall effective tax rates. It also shows how the amounts collected by individual tax authorities are affected by transfer pricing practices. Not surprisingly, tax authorities around the world have adopted formal rules and regulations that limit taxpayers' ability to either understate or overstate their transfer prices, and the rules grant the tax authority the right to adjust the taxable income of a taxpayer that is not in compliance with the country's transfer pricing laws.

1.2 Arm's Length Standard

The fundamental concept behind pricing intercompany transactions is the arm's length standard. The arm's length standard has become the basis for evaluating transactions between members of a controlled group in virtually all tax jurisdictions. The concept was first introduced in the United States, was subsequently adopted by the Organisation for Economic Co-operation and Development (OECD),[1] and has since been adopted by virtually all tax

1 The OECD is comprised of thirty member companies that work together, in part, to coordinate domestic and international policies. The OECD has issued specific guidelines on transfer pricing which are discussed in detail in Chapter 2.

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authorities in major market countries. To understand its status as the global standard for transfer pricing matters, it is helpful to examine its origins.

The first regulatory initiative addressing transfer pricing was made just four years later in the War Revenue Act of 1917, which required corporations to file consolidated returns where necessary to 'equitably determine the invested capital or taxable income'.[2] This brief mention of transfer pricing was expanded in the Revenue Act of 1921, in which Congress declared:

> In any case of two or more related trades or businesses ... owned or controlled directly or indirectly by the same interests, the commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses.[3]

Subsequent to the Revenue Act of 1921, numerous laws were passed which expanded the ability of the Commissioner to reallocate gross income or deductions in order to 'clearly reflect the income' or prevent the 'milking' of profits of US-based entities. However, the definition of the proper or 'accurate' allocation of income remained quite vague until the promulgation of the Revenue Act of 1934. In section 45 of the Revenue Act of 1934, the arm's length standard as it is known today became explicit:

> The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer ... The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.[4]

Since the passage of the Revenue Act of 1934, subsequent legislation has adhered to and advanced the arm's length principle, solidifying it as the basis for testing intercompany transactions in the United States. Although the arm's length principle first emerged as a formal concept in the United States, it has since spread to countries throughout the world. The principle was included in the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines) in 1979. As a result,

2 War Revenue Act of 1917, §1331(a).
3 Revenue Act of 1921, §240(d).
4 Revenue Act of 1934, §45.

OECD member countries and countries outside the organisation have largely built their transfer pricing regulations around the arm's length principle, making it the key global transfer pricing standard.

1.2.1 Arm's Length Standard Defined in the US Transfer Pricing Regulations

The United States has adopted the arm's length principle as the general standard behind the laws and regulations that govern intercompany pricing for multinational companies. The current definition of the arm's length standard is contained in section 1.482-1(b)(1) of the treasury regulations that were finalised in 1996, as follows:

> In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realised if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result).

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1.2.2 Arm's Length Standard Defined in the OECD Guidelines

The OECD Guidelines provide an international standard for companies located in both member countries and non-member countries to price their intercompany transactions. Within the current OECD Guidelines, approved by the OECD Council in 1995, the arm's length standard is described as follows:

> [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.[5]

1.2.3 Exceptions to the Arm's Length Standard

There are jurisdictions that do not follow the arm's length standard. Brazil is the most notable example. Brazil's transfer pricing regulations deviate

5 OECD Guidelines, para. 1.6.

significantly from the OECD Guidelines when transactional methods are not applied in that, in the absence of such methods, they employ fixed-margin methods that have no direct link to observed arm's length results. Under Brazil's regulations, intercompany transactions must be documented under the transactional methods or by applying fixed statutory profit margins (which are generally not consistent with the arm's length principle). In addition, the regulations do not require the functional or industry analyses that are generally incorporated into transfer pricing studies for other countries, but they do require that each Brazilian entity document tangible and intangible intercompany transactions to ensure that they comply with at least one of Brazil's statutory transactional methodologies (i.e., Comparable Uncontrolled Price (CUP), Resale Price, or Cost Plus).

1.3 Importance of Transfer Pricing to Today's Multinational Companies

Transfer pricing has, for many years, been cited as the most important international tax issue (and often, more broadly, as the most important tax issue) facing MNEs.[6] If an MNE operates in jurisdictions with widely varying tax rates, different transactional structures and intercompany pricing policies can have major implications on its global tax burden. Even in the absence of tax-rate variation, the potential for double taxation could have a material adverse impact on the financial well-being of a multinational corporation. One need only consider the $3.4 billion payment that Glaxo Smith Kline made to the Internal Revenue Service (IRS) in 2006[7] to settle a transfer pricing dispute to understand the potential impact that transfer pricing can have on reported profits (along with cash flows, stock prices, and other important variables). With that magnitude of dollars potentially

6 See, for instance, Ernst & Young's 2009 Global Transfer Pricing Survey available at <www.ey.com/Publication/vwLUAssets/2009_Global_transfer_pricing_survey/$FILE/Ernst%20&%20Young%202009%20Global%20transfer%20pricing%20survey.pdf>.

7 The IRS and Glaxo Smith Kline were engaged in a dispute over intercompany transactions associated with certain 'heritage' products. The dispute was, at its core, a disagreement over the value of marketing contributions made by the US GSK group vis-à-vis the value of product intangibles and trademarks owned by its UK parent. This settlement was made to settle transfer pricing disputes with the IRS for years 1989 to 2005, and it generated the largest single payment made to the IRS to settle a tax dispute. For further detail, see IR-2006-142 available at <www.irs.gov/newsroom/article/0,,id¼4162359,00.html>.

at risk, it is not surprising that transfer pricing is a key concern for many corporate tax departments and other stakeholders.

1.3.1 Who Cares About Transfer Pricing?

Transfer pricing policies permeate many facets of an MNE's business. A number of key internal and external stakeholders have a vested interest in the development, implementation, and defence of an MNE's transfer pricing policies. Key internal stakeholders include tax departments, Chief Financial Officers (CFOs), operations personnel, accounting departments, and legal counsel.[8] Key external stakeholders include government authorities, independent auditors, and tax planning and compliance advisors.

The interests of each of these stakeholders are described in detail in the following sections.

1.3.1.1 Tax Departments

The tax department's objectives are most directly affected by transfer pricing. Meeting tax compliance objectives requires that the tax department:

- understand the transfer pricing regulations in the jurisdictions in which the company operates;
- set transfer pricing policies that it can demonstrate are in compliance with those regulations;
- for some countries, compile documentation reports demonstrating that compliance; and
- in some cases, file additional disclosures or statements with tax authorities associated with intercompany transactions.[9]

Poor execution at the compliance level increases the likelihood of adjustments being sustained upon audit by tax authorities. Furthermore, in many countries, failure to meet these requirements can result in substantial tax penalties.

8 Legal counsel may be internal or external.

9 One example of this would be the cost sharing statement that is required under US Treas. Reg. §1.482-7T(k)(4).

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In the tax department of MNEs, transfer pricing plays a central role in tax planning. Companies undergoing tax and business restructurings can maximise tax efficiency (and therefore returns on reorganisation efforts) by optimising intercompany transactional flows and pricing. Optimising flows and pricing should yield (at least on an expected basis) lower global tax burdens for MNEs. Centralising ownership and management of intangible property in lower tax jurisdictions, for instance, is one tool that MNEs frequently use to help minimise their global tax burden.

In addition to compliance and planning efforts, tax departments may find themselves devoting substantial internal and external resources to resolving transfer pricing controversies with tax authorities. Given the importance of transfer pricing to the revenue base available to tax authorities within a particular jurisdiction, it is not surprising that over time, tax authorities all over the world have become increasingly focused on the transfer pricing practices of the MNEs that operate within their jurisdictions.

1.3.1.2 Chief Financial Officers

In addition to the obvious concern transfer pricing creates for CFOs, given that they typically oversee the tax responsibilities within companies, transfer pricing also affects CFO's financial reporting and cash-management responsibilities and objectives. Regardless of whether an MNE is headquartered in a country with a territorial tax system (i.e., a system in which earnings generated abroad are not subject to domestic tax) or in a country with a foreign tax-credit system which defers taxation in the parent company country until the earnings of foreign subsidiaries are repatriated, transfer pricing can have a material impact on its overall taxes paid (and therefore its available cash) in any given period.

Transfer pricing can also have an important impact on reported earnings due to its impact on income tax expense recognised for financial reporting purposes. Under US generally accepted accounting principles (GAAP) (specifically, APB 23), companies are permitted to exclude deferred US taxes on the earnings of their foreign subsidiaries as long as those earnings are expected to be permanently reinvested outside the United States (rather than being repatriated back as dividends). Therefore, for MNEs in this situation, the effect of transfer pricing on the global cash tax burden may carry through to reported tax expense for financial reporting purposes. The question of whether an MNE may recognise tax benefits associated with

profits earned in lower tax countries can be incredibly complex, and could require a thorough evaluation of the merits of all of its transfer pricing positions (such as would be required under US GAAP by Financial Accounting Standards Board (FASB) Interpretation No. 48 (FIN 48)/ Accounting Standards Codification 740 (ASC 740)).

For MNE's headquartered in a country with a tax-credit system, transfer pricing policies will have potentially important cash-management implications on an entity-by-entity basis since movement of cash across entities in the form of dividends may trigger undesirable tax and financial reporting consequences.

1.3.1.3 Operations

Transfer prices must meet the tax regulatory requirements (in most cases, some version of the arm's length standard). The tax department's objectives (insofar as they relate to setting transfer prices) are to select the transfer prices that are defensible under these requirements, while at the same time yielding the lowest overall tax burden (obviously optimising the trade-offs between these two sometimes contrary objectives).

However, transfer prices within firms also serve purposes beyond the tax compliance and planning objectives discussed thus far. Since transfer prices also determine the level of profits recognised by each subsidiary (and each division within each subsidiary), transfer pricing can play a critical role in many managerial objectives, including:

(1) providing proper incentives to employees who receive performance-related compensation; and
(2) the evaluation of business unit profit potential for purposes of making capital allocation decisions.

These objectives may not be met if companies use the same transfer pricing system for 'managerial' purposes as for tax purposes. Many MNEs impose such a constraint because it simplifies their accounting processes (i.e., there is no need to keep separate books using two different transfer pricing systems) and because the presence of multiple transfer pricing systems could potentially weaken the company's defence of its tax transfer prices should those prices become the subject of litigation. For companies that impose this constraint, managerial objectives have to be considered in the determination of their transfer prices (along with tax compliance and

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efficiency). In many instances, the transfer pricing system that maximises overall post-tax profit (including managerial effects) is not going to be the same, in isolation, as the transfer pricing regime that would minimise taxes and optimise managerial performance.[10]

1.3.1.4 Accounting Departments

Accounting departments' concerns also intersect in multiple ways with transfer pricing concerns. In addition to the financial reporting issues discussed above, accounting departments are vital players in ensuring that the intended transfer pricing policies are correctly implemented (and that reporting systems are set up to capture the necessary information in the necessary format). Companies that do not carefully monitor the implementation of their policies (and the results derived from that implementation) run the risk of needing to make substantial transfer pricing adjustments at year end (or worse, finding themselves in situations where adjustments cannot be made to bring actual results in line with the intended policy). Accounting departments are also crucial to the success of any transfer pricing analysis since they determine what information is and is not available for purposes of performing the analysis.

1.3.1.5 Legal Counsel

Transfer pricing concerns an MNE's internal and external legal counsel for several reasons. In many cases, intercompany transactions are conducted in accordance with intercompany agreements. An MNE's legal counsel plays a critical role in ensuring that these agreements are constructed appropriately. This is particularly important for intercompany transfers of intellectual property, where poorly drafted agreements might weaken a company's ability to protect its intellectual property against threats from outside of the enterprise.

10 See Reichelstein, Stefan, Tim Baldenius & Nehun Melumad. 'Integrating Managerial and Tax Objectives in Transfer Pricing', *The Accounting Review* 79 (July 2004): 591–616. This tension derives from the fact that in the absence of taxes, the optimal transfer price would be set equal to the marginal cost of production of the supplying division. To the extent that tax objectives would seek to charge a price in excess of that marginal cost, tax and managerial objectives will necessarily be at odds.

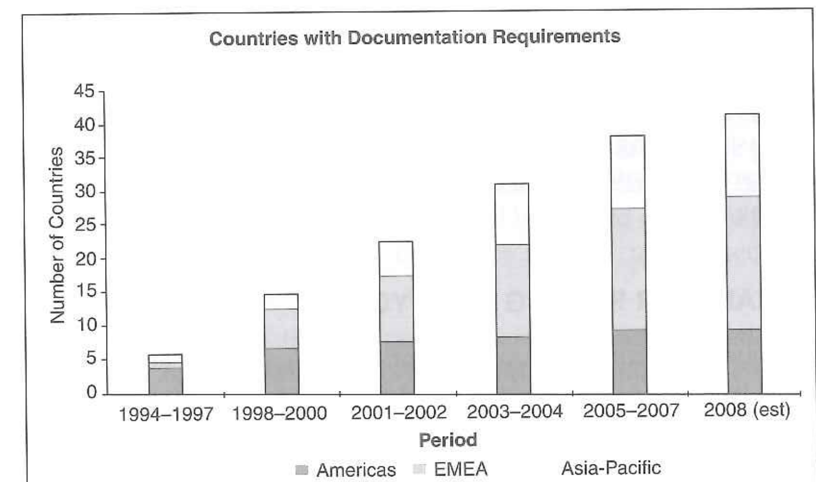
An MNE's legal counsel can also be an important source of information for the tax department when it is conducting transfer pricing analyses. Transactions between a company and third parties often serve as an important source of information that must be considered when evaluating intercompany transactions against the arm's length standard. The legal department is often the most complete source of information regarding agreements that might serve as transactional comparables.

Finally, legal counsel will likely become involved in any transfer pricing disputes that arise, because such disputes could eventually develop into litigation.

1.3.1.6 Government Authorities

Given the direct and obvious impact that transfer pricing has on their revenue base, governments are increasingly focused on the transfer pricing practices of taxpayers with operations within their borders. Figure 1.3 provides a clear illustration of this concept. In the mid-1990s, countries with documentation requirements could be counted on a single hand. That figure has grown rapidly over the years.

Figure 1.3: The Increase in Transfer Pricing Documentation Requirements[11]



11 Ernst & Young LLP. Precision Under Pressure: Global Transfer Pricing Survey 2007–2008 (Ernst & Young, 2007), 9. <www.ey.com/Global/assets.nsf/International/EY_Tax_TPSurvey_2007/$file/Tax_TPSurvey_2007.pdf>, accessed 12 Feb. 2009.

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taxpayer, its day-to-day operations, and its internal accounting and financial management systems. In addition, although transfer pricing practitioners are often hired to assist a company with developing transfer pricing policies, a taxpayer is often left to its own devices to implement that policy. The implementation process can be complex and arduous, so it is important for a company to have well thoughtout procedures in place for implementing new transfer pricing policies.

This section describes key implementation steps, provides guidance on some of the most common implementation issues, and discusses best practices for taxpayers when navigating through the implementation process.

2.2.1 Key Implementation Steps and Timeline

Once a company has established its transfer pricing policies, the company enters the implementation phase. The implementation phase typically consists of the following five broad steps:

- Step 1: Communicating transfer pricing policies to key stakeholders
- Step 2: Drafting and executing intercompany agreements
- Step 3: Determining internal pricing mechanisms
- Step 4: Monitoring results
- Step 5: Developing transfer pricing policy manuals or guides.

Each of these steps is described in detail below.

2.2.1.1 Step 1: Communicating Transfer Pricing Policies to Key Stakeholders

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Generally, the tax department is responsible for transfer pricing compliance, identifying transfer pricing planning exposures/opportunities and amending existing transfer pricing policies as needed as the taxpayer's business evolves. Therefore, the tax team bears the responsibility of communicating its objectives to the key internal stakeholders. This is to ensure that the tax objectives are well aligned with the company's broader corporate and operational objectives. The key stakeholders include: (1) local country tax personnel; (2) senior management (such as the CFO); (3) relevant operations personnel; (4) the IT, accounting, and finance department

personnel who will be responsible for the back office support related to the implementation effort; (5) the legal department; and (6) the company's tax planning and compliance advisors.

2.2.1.1.1 Local Country Tax Personnel

Transfer pricing policies are often implemented on a global level, and changes to transfer pricing policies are commonly initiated by headquarters. For the headquarters of any company, this means that it must clearly communicate its objectives to the local country tax personnel to ensure that the company's global tax objectives do not conflict with its local country tax objectives.

In addition, headquarters personnel may rely on the local country tax personnel to communicate a change in policy to key local country operations personnel.

2.2.1.1.2 Senior Management

When implementing changes, the tax department will usually need buy-in from senior management. This likely includes the CFO and Controller, but may also include other executives such as the chief executive officer (CEO) and chief operations officer (COO), depending on the size of the organisation and the materiality of the transfer pricing issue.

Generally, buy-in from senior management is critical for several reasons. First, it is important to ensure that the objectives of the tax department are well aligned with the company's overall corporate strategy. Second, there are times when changes in transfer pricing policies can have unintended effects that require attention from senior personnel.[54] It is therefore is critical that upper management is well informed of any material changes in pricing policies so they are not caught off guard if issues arise. In addition, if there is opposition from any of the stakeholders during the implementation process, senior management may be able to help push through the desired changes.

54 For instance, a change in a transfer pricing policy could have the unintended effect of altering the incentive/compensation structure of an employee or a group of employees.

To get buy-in, the tax department should ideally involve management personnel early in the planning process. Typically, management personnel will be able to assist with identifying any potential pitfalls and may also have thoughts on how to communicate the policy changes to other internal stakeholders.

When approaching the CFO, Controller, or other senior management about a change in transfer pricing policy, it is important to be able to clearly communicate

(1) the reasons for the change;
(2) the expected tax implications of the change (transfer pricing and other);
(3) any identified risks; and
(4) the anticipated tax and financial statement impact, as applicable.

In addition, the tax department representative should compile a comprehensive list of all of the potential internal issues that may arise from the change in policy, and walk through any key items with upper management.

2.2.1.1.3 *Operations Personnel*

From an operations perspective, the most common issue that arises during the implementation phase is related to employee incentive structures. In many instances, employee incentive structures are tied to the performance of business units – either through some measure of revenue generation, cost savings, or profitability, among others. Since a change in transfer pricing will affect the performance of a business as reported on its legal entity financial statements, a company that does not keep separate management financials (or whose managerial books are tied to the legal entity financials) may unintentionally alter its employee incentive structure.

Consider the following hypothetical example. The bonus of a manager of a Canadian company, the Canada Company, is tied to the annual profitability of her business unit. Specifically, she receives a bonus equal to 0.25% of the operating profit earned by her business unit.[55] In 2010, her business unit

55 Note that in this case, her 'business unit' is the entire legal entity of the Canada Company.

earned an operating margin of 20% on CAD 200 million in sales. As such, her bonus was CAD 100,000 (CAD 40 million times .025%). In 2011, due to the implementation of a new transfer pricing policy, the business unit earns an overall operating margin of 12% (see Table 1.6).

Table 1.6: Hypothetical Example of the Potential Impact of a Change in Transfer Pricing Policy on an Employee Incentive Structure

(in CAD)	2010	2011	Increase/(Decrease)
Revenues	200,000,000	200,000,000	–
Cost of goods sold			
Third-party	60,000,000	60,000,000	–
Related party	27,500,000	51,000,000	85%
Gross Profit	**112,500,000**	**89,000,000**	
Operating expenses	50,000,000	42,500,000	(15%)
Depreciation and amortisation	22,500,000	22,500,000	–
Operating profit	**40,000,000**	**24,000,000**	**(40%)**
Operating margin	**20%**	**12%**	
Manager's bonus	100,000	60,000	(40%)

In the Canada Company example shown in Table 1.6, revenues, the third-party COGS, and depreciation and amortisation expenses held steady between 2010 and 2011. However, in 2011, Canada Company's operating expenses decreased by CAD 7.5 million or 15%. Let's assume this decrease was attributable to the fact that the business unit manager was able to identify CAD 7.5 million in operating expense – related cost savings for re-negotiating the lease terms on its office space and storage facilities, finding a less expensive supplier of marketing materials, and eliminating four redundant positions within the accounting and finance departments. Despite the fact that the manager was able to reduce operating costs in her business unit by approximately 15%, her bonus was reduced from CAD 100,000 to CAD 60,000, solely because of the increase in the price charged by its related party. Theoretically, this scenario could have been avoided if the manager's bonus had been determined based on a cost savings-based metric or on a pre-intercompany basis.

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ways to find mutually satisfactory solutions to transfer pricing cases, thereby minimising conflict among tax administrations and between tax administrations and MNEs and avoiding costly litigation. The Guidelines analyse the methods for evaluating whether the conditions of commercial and financial relations within a MNE satisfy the arm's length principle and discuss the practical application of those methods. They also include a discussion of global formulary apportionment. OECD Member countries are encouraged to follow these Guidelines in their domestic transfer pricing practices, and taxpayers are encouraged to follow these Guidelines in evaluating for tax purposes whether their transfer pricing complies with the arm's length principle. Tax administrations are encouraged to take into account the taxpayer's commercial judgment about the application of the arm's length principle in their examination practices and to undertake their analyses of transfer pricing from that perspective.[1]

1.2 Authority of the OECD Transfer Pricing Guidelines

One of the OECD's goals is to encourage global acceptance of the principles pertaining to international transfer pricing transactions. The OECD has attempted to issue modifications and clarifications to the OECD Transfer Pricing Guidelines by engaging both governments and business representatives to participate in policy formulations.

The OECD has a Centre for Tax Policy and Administration which is responsible for issuing documents, such as the transfer pricing guidelines. At the same time, a separate and distinct organisation called the Business and Industry Advisory Committee (BIAC) to the OECD is made up of representatives from the private sector who advise OECD policymakers on the business concerns and the issues concerning policy opinions that are under discussion at the OECD. While the decisions or advice of the OECD or the BIAC are not binding on any government authority, the policy recommendations of these organisations are generally based on a joint business-government consensus. As such, governments often take heed of OECD policy issuances.

1 OECD Transfer Pricing Guidelines, Preface 15 and 16.

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At present, there are thirty-two member countries of the OECD. In order to be accepted into the OECD, a country's policies, including transfer pricing, are reviewed by the OECD, and the OECD imposes conditions for acceptance. It should be noted that because the OECD Transfer Pricing Guidelines are widely accepted by many countries many non-member countries often accept or modify the OECD Transfer Pricing Guidelines when they enact their own transfer pricing regulations.

1.3 Contents of the OECD Transfer Pricing Guidelines

The OECD Transfer Pricing Guidelines contain nine chapters. These chapters are:

(1) 'The Arm's Length Principle': This chapter establishes the standard against which international related-party transactions are measured. It includes technical sections pertaining to the factors that need to be considered in determining appropriate comparisons to assess an intercompany transaction.

(2) 'Transfer Pricing Methods': This chapter discusses the different transfer pricing methods and replaces the hierarchy of transfer pricing methods with the principle of the selection of the 'most appropriate method to the circumstances of the case'.

(3) 'Comparability Analysis': This chapter discusses the importance and requirements of a comparability analysis.

(4) 'Administrative Approaches to Avoiding and Resolving Transfer Pricing Disputes': This chapter provides a variety of comments and recommendations regarding how MNEs and tax authorities should examine intercompany transactions, and the studies that are performed to assess the intercompany transactions. There is also discussion on the procedures required to involve the OECD in a multinational transfer pricing dispute, called the mutual agreement procedure (MAP). This section covers all the legislative and administrative issues pertaining to tax audits, and provides guidelines for an efficient and effective system.

(5) 'Documentation': This chapter provides recommendations for member countries on the appropriate level of documentation required for assessing intercompany transactions.

(6) 'Special Considerations for Intangible Property': This chapter deals specifically with the use and sale of intellectual property between entities of a MNE.

(7) 'Special Considerations for Intra-Group Services': This chapter deals with intra-group service charges, and provides guidelines as to which services should be charged, and the appropriate methodologies for charging for services.

(8) 'Cost Contribution Agreements': This chapter provides information and guidelines on a MNE's sharing of intangible property.

(9) 'Transfer Pricing Aspects of Business Restructurings': This chapter discusses how transfer pricing principles should apply to business restructurings.

1.3.1 Arm's Length Principle

The arm's length principle is the standard on which the OECD Transfer Pricing Guidelines are based. The arm's length principle is defined in Chapter I of the OECD Transfer Pricing Guidelines ('the Guidelines') as:

> The international standard that OECD Member countries have agreed should be used for determining transfer prices for tax purposes. It is set forth in Article 9 of the OECD Model Tax Convention as follows: where 'conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.'

Broadly speaking, the arm's length principle may be defined as the amount charged by one related party to another for a given product, asset or service and that this charge must be the same as if the parties were not related. An arm's length price for a transaction is therefore the price of that transaction in an open market situation. The Guidelines discuss the arm's length principle at length and even note some of its flaws, such as the fact that third parties often do not interact in a similar manner to a MNE.[2] For example, the Guidelines note that for a MNE, different commercial circumstances

2 OECD Transfer Pricing Guidelines Chapter I para 1.11.

arise due to the interactivity of related entities that cannot be replicated in a third party situation.

Nonetheless, the OECD reaffirms the position of its member countries that the arm's length principle is sound in theory since it provides the closest approximation of the workings of the open market when property is transferred or services are rendered between associated enterprises. The Guidelines recognise that while the arm's length principle may not always be straightforward to apply in practice, it does generally produce adequate levels of income between members of MNE groups, acceptable to tax administrations. Further, 'A move away from the arm's length principle ... would threaten international consensus, thereby substantially increasing the risk of double taxation.'[3]

1.3.1.1 Determination of the Arm's Length Nature of Intercompany Pricing

Because international transactions between related parties are often complex, an array of different issues are addressed from the outset by the Guidelines in order to ensure the appropriate assessment of the arm's length price. First and foremost is the issue of how to assess what third-party transactions are comparable to the related-party transaction.

The Guidelines state that there are five factors[4] to determine comparability, including an assessment of the functions performed by the related and unrelated entities, the contractual terms, the business economic circumstances of the comparative transactions, the business strategies involved in the comparative transactions, and the type of property or services involved.[5]

It is important to note that, generally speaking, the Guidelines offer more flexibility for the assessment of an arm's length price. Given that the OECD needs to consider concerns of both tax administrations and business entities, the result is that the Guidelines provide general recommendations, which in many cases, are modified by tax administrations in their own transfer pricing legislation. Such modifications generally are stricter than the Guidelines.

3 OECD Transfer Pricing Guidelines Chapter I paras 1.14 to 1.15.
4 OECD Transfer Pricing Guidelines Chapter I para 1.36.
5 OECD Transfer Pricing Guidelines Chapter I para 1.38 to 1.63.

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Chapter I also contains a discussion of a non-arm's length approach called the global formulary apportionment. Global formulary apportionment allocates the global profits of a MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula. The Guidelines note that generally speaking there would be three essential components to applying a global formulary: determining which entities within the MNE group should comprise the global taxable entity, accurately determining the global profits, and establishing a viable formula for allocating the global profits.[6]

The Guidelines then outline the reasons that proponents of global formulary apportionment see it as an alternative to the arm's length principle. These reasons include:

(1) It provides administrative convenience and certainty for taxpayers, as they know in advance the formula, and can then easily assess the taxes to be paid with no risks of a tax audit.

(2) It could be deemed to better represent the economic realities of a multinational company. This argument is based on the assumption that it is extremely difficult to assess the separate operating entities of a multinational and accurately portray each of these entities' contribution to the overall multinational's profits and sales.

The Guidelines state that OECD members do not accept the idea of global formulary apportionment. One of the primary reasons provided is that this method cannot adequately provide protection against double taxation. It is argued that each jurisdiction would desire to compute its formulary apportionment based on a different set of factors, and as such, different results would be yielded by different jurisdictions. The second critique is that a formulary approach is deemed to be arbitrary. It has, according to the Guidelines, no true relationship to economic reality. A number of other reasons are also provided, including difficulties in making the formulary apportionment and taking into account exchange rate differences, and difficulties in allocating value amongst entities when there are transactions involving intangible goods. In the end, the Guidelines reject the global formulary approach, and argue that it does not provide a reasonable means of assessing an arm's length price between two related parties.

6 OECD Transfer Pricing Guidelines Chapter I paras 1.16 to 1.18.

1.3.2 Transfer Pricing Methods

The 1995 Guidelines distinguished between traditional transaction methods (i.e., the comparable uncontrolled price method or CUP method, the resale price method and the cost plus method) and transactional profit methods (i.e., the transactional net margin method and the profit split method) and suggested that the CUP method was preferred, followed by the other traditional transaction methods and finally by the profit based methods.

Even though the 1995 Guidelines expressed an explicit preference for the traditional transaction based methods, in practice, due to the inherent problems of lack of information, many taxpayers resorted to the use of the profit based methods. The most significant change to the Guidelines in 2010 came about with the replacement of the hierarchy of methods with the principle of the 'most appropriate method to the circumstances of the case.'[7] Considerations to be taken into account in determining the most appropriate method to apply include:

- The strengths and weaknesses of the various methods;
- The nature of the controlled transaction, determined through a functional analysis;
- The availability of reliable information;
- The degree of comparability; and
- The reliability of comparability adjustments.

The OECD explained in a clarifying document[8] that in the selection and substantiation of the most appropriate method under the circumstances of the case there is 'no requirement to perform a detailed analysis and rejection of all alternative methods; usually some methods will be easily eliminated as not being the most appropriate based on simply a high level analysis of the comparability factors.'

However the Guidelines do to some extent maintain a hierarchy of methods as it states that the traditional transaction method is to be preferred to the profit based methods when they are 'equally reliable.' Further, where the

7 OECD Transfer Pricing Guidelines Chapter II para 2.2.
8 Response of the Committee on Fiscal Affairs to the Comments Received on the September 2009 'Draft Revised Chapters I-III of the Transfer Pricing Guidelines', issued 22 July 2010.

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CUP and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred.[9]

1.3.2.1 Traditional Transaction Methods

There are three traditional transaction methods. The first traditional transaction method is the Comparable Uncontrolled Price (CUP) method. This method '... compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.'[10] The CUP is deemed, if it can be employed, to be the most direct and reliable way of measuring the arm's length nature of intercompany transactions. It is noted, however, that the level of comparability of the third party prices to those of the related party prices needs to be high. Any differences that exist need to be adjusted for, or it needs to be shown that such differences have no material effect on the price itself.

Table 2.1 provides an example of the CUP discussed in the Guidelines.

Table 2.1: Comparable Uncontrolled Price Example

	Comparability Issues (Intangibles)	Comparability Issues (Volume, Characteristics)	Comparability Issues (Timing, Market Level)	Comparability Issues (Business Circumstances)
Columbia Coffee beans related transaction	Unbranded			
Independent Columbia coffee beans	Unbranded	Same type, quality and quantity	Occur at same time, stage in production/ business chain	Occur under similar conditions
Brazilian coffee beans		Does source of beans have material effect on price?		

9 OECD Transfer Pricing Guidelines Chapter II para 2.3.
10 OECD Transfer Pricing Guidelines Chapter II, para. 2.13.

As is seen in Table 2.1, the comparison with the independent Columbian coffee beans is likely going to be a valid CUP analysis since all the factors are deemed to be comparable. While the Guidelines do not state outright that this CUP is valid, they compare this example to a CUP with Brazilian coffee beans in which there may be differences that invalidate the use of the CUP. The Guidelines also provide other examples, and note other factors that are important to consider in a CUP, such as the volumes of transactions and the transportation terms.

The second method described is the Resale Price Method (RPM). This method measures the gross profit earned on the resale of goods. As such, this method is usually relied on for entities involved in sales and marketing activities.

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The RPM also requires that adjustment be made for any differences between the controlled and uncontrolled transactions that would have a material effect on the gross margin. Because the RPM generally relies on relatively close product comparability, and because the gross margin is a measure of the sale of all similar types of products (though not identical), the level of comparability for the RPM analysis is less strict than it is for the CUP. Further, small differences in the comparability of the products will likely not have to be adjusted for.

In using the RPM, it is important to make an assessment of the functions performed in the controlled and uncontrolled transactions, to ensure that the gross profit recompense covers the same activities and risks in both transactions. The Guidelines stress that the functions and risks incurred in the controlled and uncontrolled transactions have to be similar for the RPM to be a valid comparison. If the functions and risks differ, then the gross margin will need to be adjusted. A number of different examples are provided, each of which highlights the use of the RPM. The first example compares the gross margin on the sale to a related party to the gross margin on the sale of the same product with the same brand name to an unrelated party. The related party provides a warranty while the unrelated party does not. In this situation, the distributor providing the warranty charges a higher price, and therefore extracts a higher gross margin. To ensure that the comparison is comparable, it is necessary to adjust for the value of the warranty.

A second example is provided in which a MNE sells a product to five different distributors in different countries. These distributors merely market and sell the product. The MNE also sells the same product to its

subsidiary distributor, but this subsidiary provides other services, such as technical support, and it sells the MNE's product exclusively. The Guidelines recognise that the only way to make an accurate comparison through the use of the RPM is to account for the services provided, and for the effect of exclusivity. Note that there is no conclusion regarding whether exclusivity of a product will increase or decrease the gross margin.

Indeed, one of the issues with the Guidelines is that they are very general in nature, and technical issues such as what the normative effect of various adjustments that are described are not considered. It can equally be argued, for example, that having an exclusive agreement enables a distributor to earn higher gross margins as it has no competition for its product. By contrast, in other situations, it could be argued that the exclusivity reduces the gross margin, as the distributor needs to sell more volume of the only product it can sell in order to cover its fixed selling costs.

The Cost Plus (CP) Method is the third traditional transaction method discussed. The CP is relied on in situations where there is value added to a product. Circumstances in which the CP is applied include the sale of semi-finished goods between related parties, where related parties have concluded joint facility agreements or long term buy-and-supply arrangements or where the controlled transaction is the provision of services.

The same general conditions described above for the RPM, that is, to make an assessment of the functions performed in the controlled and uncontrolled transactions, to ensure that the gross profit recompense covers the same activities and risks in both transactions, are valid for the CP. However, the CP measures the gross profit as a percent of the cost of sales. If different entities have different cost bases, as in the case where one entity is leasing equipment and the other owns equipment, there may need to be adjustments to one of the two cost plus markups for these cost basis differences. Adjustments to the cost base are needed in the following cases:

- if the expenses reflect functional differences (taking into account assets used and risks assumed) which have not been taken into account in the original markup; or
- if the expenses reflect additional functions that are distinct from the activities tested by the method.[11]

11 OECD Transfer Pricing Guidelines Chapter II para 2.45.

The most critical issue for the CP method is the cost base. The Guidelines highlight the various types of costs, and discuss the need to ensure that there is a comparable comparison not only of functions and products, but also of the costs. It defines three distinct groupings of costs: direct production costs or service costs such as the costs of raw materials, indirect production costs (e.g., the costs of a repair department), and the operating expenses of the entity such as supervisory, general and administrative expenses.

The Guidelines then define two distinct types of cost plus markups – the first is a gross markup on the first two groupings of costs, and the second is a net markup on all three groupings of costs. Either type of assessment is appropriate, but the comparison between the related party and the uncontrolled entities needs to be accurately made. It is also noted that the appropriate cost base needs to be assessed according to the specific situation, as there are circumstances when perhaps not all costs should be included. For example, when production represents marginal production, then only variable cost of sales should be included.[12]

1.3.2.2 Transactional Profit Methods

Transactional profit methods are methods that assess the profits that accrue from transactions between associated enterprises. The two methods noted are the Transactional Net Margin Method (TNMM) and the Profit Split (PS) method.

The TNMM measures the net profit to a given base (sales, costs, and assets) that an entity earns from its related party transactions. The Guidelines suggest that the TNMM is unlikely to be reliable if both parties to the transaction make valuable, unique contributions, but it may be applied where only one of the parties makes all the unique contributions.[13] The Guidelines go on to distinguish the case when both parties make contributions but only one of them makes unique contributions or even where there are no unique contributions involved at all and clarify that although the TNMM may be applied, the absence of unique contributions involved in the transaction does not necessarily imply that the TNMM is the most appropriate method.[14]

12 OECD Transfer Pricing Guidelines Chapter II para. 2.51.
13 OECD Transfer Pricing Guidelines Chapter II para 2.59.
14 OECD Transfer Pricing Guidelines Chapter II paras 2.60 to 2.61.

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As with the RPM and CP methods, a functional analysis needs to be performed when applying the TNMM. The TNMM measures the arm's length price based on a transactional approach, rather than a total company net profit on all activities approach (i.e., the Comparable Profits Method approach in the U.S. transfer pricing regulations). Significant discussion is provided pertaining to the strengths and weaknesses of the TNMM. Table 2.2 highlights the strengths and weaknesses[15] of the TNMM as noted in the Guidelines.

Table 2.2: Strengths and Weaknesses of the TNMM

Strengths	Weaknesses
Less affected by differences in functions and transaction price	Net result can be affected by factors other than transfer price
One-sided method (typically tests the less complex entity)	Information may not be available at the time of the assessment
	Determining an appropriate corresponding adjustment

An example illustrating the sensitivity of gross and net profit margin indicators is found in Annex I to Chapter II of the Guidelines.

The conclusion regarding the TNMM is that while it may provide a 'practical solution' to otherwise 'insoluble transfer pricing problems', it must be relied on circumspectly and appropriate adjustments need to be made to account for differences.

The Guidelines go on to provide detailed guidance on the selection of the profit level indicators (PLIs). Guidance is provided on the most commonly used PLIs such as the return on sales, return on cost and return on assets as well as the Berry ratio.[16] The Berry ratio is equal to the gross profit divided by operating expenses. The Guidelines endorse the use of the Berry ratio in limited circumstances. It contains numerous cautions on the use of the Berry ratio measure for purchase and resale (i.e., distribution) transactions but recognises that this ratio can be useful for intermediary activities.

15 OECD Transfer Pricing Guidelines paras 2.62 to 2.67.
16 OECD Transfer Pricing Guidelines paras 2.90 to 2.102.

The Guidelines explain that the PS method is appropriate where both parties to the transaction make unique and valuable contributions[17] or where the transaction involves highly integrated operations for which a one-sided approach would not be appropriate.[18] This method would not be appropriate where one party perform only simple functions and does not make any significant unique contribution.

Profits or losses should be allocated when possible based on how independent parties would have split the combined profits or losses in comparable transactions.

Table 2.3 highlights the strengths and weaknesses[19] of the PS method as noted in the Guidelines.

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Table 2.3: Strengths and Weaknesses of the PS method

Strengths	Weaknesses
A two-sided approach which can offer a solution where there are highly integrated operations or where both parties contribute unique and valuable contributions	Difficulty in application – it may be difficult to measure combined revenue and costs for the parties
Offers flexibility by taking into account specific, unique facts and circumstances which may not be present in independent enterprises	
Less likely that either party to the transaction will be left with an extreme and improbable result	

The Guidelines provide guidance[20] for the application of the PS method and state that the determination of the combined profits to be split and the splitting factors should:

- Be consistent with the functional analysis;
- Be consistent with what would have been agreed between independent parties;
- Be consistent with the type of profit split approach;
- Be capable of being measured in a reliable manner.

17 OECD Transfer Pricing Guidelines para 2.59.
18 OECD Transfer Pricing Guidelines para 2.109.
19 OECD Transfer Pricing Guidelines Chapter II paras 2.109 to 2.114.
20 OECD Transfer Pricing Guidelines Chapter II para 2.116.