Section 1.02[A][1] discusses how to identify intercompany transactions within an organization, and the general guidelines for pricing such transactions.

[1] *Identifying Intercompany Transactions for Analysis*

The planning phase consists of identifying the relevant intercompany transactions within the organization, understanding the roles and responsibilities of the parties to the transactions, and prioritizing the company's risks related to those transactions.

[2] *Types of Intercompany Transactions*

When attempting to identify all of the intercompany transactions that exist within an organization, it is helpful to think about potential transactions by type of transfer. Transfer pricing transactions generally fall into five broad categories: tangible; intangible; services; financing and insurance; and cost contribution arrangements.

[a] *Tangible Property Transactions*

Tangible property transactions are generally easy to identify and monitor. Most companies already have invoicing procedures designed for these types of intercompany transactions. Tracking systems are also likely in place due to customs and value added tax (VAT) requirements. Beyond knowing what physical goods are crossing borders within the intercompany supply chain, the tax department should be aware of the following about each transaction type:

- general description of goods being transferred;
- state of goods transferred (whether they are raw materials, inputs or finished goods);
- transaction volume;
- current intercompany pricing policy;
- payment terms between entities;
- existence of intercompany agreements corresponding to these transfers; and
- end markets/customer types for the goods transferred.

All of these factors will be important when determining the potential transfer pricing risks associated with these transactions and in establishing an appropriate transfer pricing policy.

[b] *Intangible Transactions*

The question, what constitutes an intangible, is common in transfer pricing. The scope of property to be considered 'intangible property' was revised for the 2017 version of the OECD Guidelines. Specifically, the term 'intangible property' 'is intended to address something which is not a physical asset or a financial asset,[32] which is capable of

32. Financial assets include, but are not limited to, bonds, bank deposits, stocks, shares, forward or futures contracts, and swaps.

being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.'[33] This definition of intangible property is a broader evolution from the definition established in previous versions of the OECD Guidelines. Some of the categories of intangibles listed in the OECD report include brands; rights under contracts and government licences; licences and rights to intangibles; goodwill and ongoing concern; group synergies; and market specific characteristics. The finalized report is important to consider when assessing future or current intercompany transactions involving intangible property.

As defined under the US transfer pricing rules under section 482-4, an intangible includes any asset that comprises any of the following items and has substantial value independent of the services of any individual:[34]

- patents, inventions, formulae, processes, designs, patterns, or know-how;
- copyrights and literary, musical, or artistic compositions;
- trademarks, trade names, or brand names;
- franchises, licences, or contracts;
- methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
- other similar items. An item is considered similar to those listed above if it 'derives its value not from its physical attributes but from its intellectual content or other intangible properties'.

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With regards to the outbound transfer of IP, there are other specific rules prescribed in IRC section 367. The definition of intangible property outlined in IRC section 367(d)(4) also includes workforce in place, goodwill (both foreign and domestic), and going concern value as well as the residual category of 'any similar item', the value of which is not attributable to tangible property or the services of an individual. In 2018, section 482 was revised to codify the use of an aggregation approach for the valuation of the intangible property being transferred when this approach achieves a more reliable result than an asset-by-asset approach.[35]

Identifying transfers of intangibles can be more difficult than identifying transfers of tangible property since it is often possible for subsidiaries to 'use' certain rights without ever having documented any licences or transfers in the form of an intercompany agreement, invoice, or other traceable item. However, there are a number of potential sources of information available within an organization that can guide the tax department in identifying intangible property transfers. Table 1.1 lists some of these sources and how they can be used.

33. OECD Guidelines, para. 6.6.
34. Treas. Reg. 1.482-4(b).
35. Heimert, Mike, and Jill Weise, Douglas Fone, and Shiv Mahalingham; 'Transfer Pricing Times: IRS Issues New LB&I Directives'; Duff & Phelps, LLC; 6 February 2018.

Table 1.1 Sources of Information Available to Identify Intangible Property Transfers

Source	*Use*
Intercompany Agreements	Obtain copies of all intercompany agreements and separate those that involve rights to intangible assets as defined by the relevant transfer pricing regulations. In some cases, rights to intangibles may be granted as part of distribution agreements or other types of transactions. It is often helpful for companies to create a matrix of all intercompany agreements and create a list of transfers included in each agreement.
Tax Returns	Forms 5471 and 5472 in the US, and equivalents in other countries, require that intercompany royalty payments be disclosed separately. Obtaining the work papers for these forms can provide insight on where payments for intangible property are currently being made within the organization.
Controllers	To the extent that insufficient detail is available in tax-return work papers, and in cases in which it would be too cumbersome to examine numerous intercompany invoices for potential payments for intangible property, dialogue with foreign controllers can be productive. In addition, the use of brief surveys can increase efficiency even further for large multinationals with a multitude of legal entities. Discussions with controllers can also identify potential transactions that are undocumented. As such, they represent an important source to consider when identifying intangibles.
10Ks, Annual Reports, Company Website	Information in these sources will often have a section that discusses a company's patents, brand names and other intangibles. The tax department should have a detailed understanding of which entities are the legal and economic owners of each of these categories of intangibles, and it should identify through the functional analysis process how the rest of the legal entities use or are affected by such intangibles. To the extent an entity uses intangibles that it does not own, this is usually an indicator of the fact that some sort of payment should be made.
Functional Analyses	Interviews with business executives are very useful in identifying intangible property transactions. The following departments are commonly relevant in this context: Research and Development, Engineering, Design, Technology, Marketing, Advertising, and Legal.[36] Of course, which of these departments if relevant will depend on the nature of the potential intangibles owned by the company.

[c] *Services Transactions*

Intercompany services transactions can be difficult to identify since, with the exception of expatriates or other travelling professionals, there is often no transfer of physical material across borders that signal the existence of such transactions. However, with

36. Note that the legal department can be especially helpful as it will likely maintain records of trademark registrations, patent filings, and other lists of protected intangible property items by country.

the nature of many OECD countries' economies shifting to service-oriented industries, these activities can comprise a significant majority of a firm's intercompany dealings.

As will be discussed in Chapter 2, the OECD Guidelines do not specifically define a service, per se, other than by alluding to administrative, technical, financial and commercial services, including management, coordination and control functions.[37] Rather, the Guidelines articulate the manner in which a company should determine whether an intra-group service has been provided.

To identify intercompany services, it is usually best to take a cost-centre based approach. In other words, through discussions with accounting/finance and business personnel and a review of all of the cost centres of a particular entity, one can separate the costs that represent activities that are: (1) not attributable to other types of intercompany transfers; and (2) potentially beneficial to other legal entities.

Action Item 10 released by the OECD provided proposed modifications relating to intra-group services. The proposed modifications include refined definitions of certain shareholder and duplicative activities and introduce a simplified approach for low value-adding services. The simplified approach provides insights on computing charges on a cost-centre based approach and establishes a safe harbour profit markup for low value-adding services. The OECD plans to provide additional clarification regarding the safe harbour provisions as part of the follow up work on implementation.

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[d] *Financing and Insurance Transactions*

There are a number of financing transactions that can occur between related parties that companies must consider. Three of the most common are transactions for which pricing is unsupported, transactions priced by the treasury department without guidance from the tax authority, and financing transactions for which no compensation is paid.[38] Unsupported pricing transactions are especially easy for tax authorities to target due to the lack of analysis support. Intercompany loans are generally easy to identify because they are often accompanied by contracts on file in a company's treasury department or legal department. Such contracts outline principal amounts, interest rates and payment schedules applicable throughout the duration of the loan. However, most companies' treasury departments are not bound by the same standards required by most countries' transfer pricing regulations. In addition, it is important to note that financing transactions are also subject to additional rules for compliance, including Treasury Regulations section 385 and US Code section 163(j) in the US as well as the thin capitalization legislation determined by the OECD and various other tax authorities. These rules aim to determine whether a particular financial instrument is to be considered as debt or equity, which carry differing tax implications.

Intercompany guarantees and guarantee fees can be more difficult to identify, as guarantees exist in both implicit and explicit forms. Subsidiaries often have standalone credit ratings that are less favourable than their parent company's credit rating. As such, subsidiaries will often approach the parent company about entering into a transaction

37. OECD Guidelines, para. 7.2.
38. Johnson, Michelle & Kumar, Sheetal. 'Intercompany Financial Activities Under BEPS Action 13: A Primer for Compliance With New Disclosure Standards.' *Bloomberg BNA*. 12 Nov. 2015.

in which the parent agrees to pay the subsidiary's obligations to its creditor in the event the subsidiary defaults. The guarantee allows the subsidiary to borrow funds at a lower interest rate, that is, the rate at which the parent company would be able to borrow. In certain instances, the subsidiary may pay a portion of the spread between the two interest rates to the parent company as a 'guarantee fee'.

Explicit guarantees, by definition, are spelled out in agreements, which make them easier to track. Implicit guarantees reflect situations in which a subsidiary may receive credit support from its parent or another related party, even though such support is not required by an explicit credit guarantee.[39] Generally, the best way to understand whether a guarantee fee is required is by performing functional analysis interviews. These interviews focus on the legal entity's ability to secure better terms with third party financial institutions, customers, or other organizations due to its relationship with other members of the multinational group. More information about performing effective functional analysis interviews is presented in §1.02[A][4].

Insurance transactions are generally easy to identify. Most intercompany insurance transactions occur between a company's operating entities and a captive insurance company that has been set up by the parent. As such, any intercompany insurance transactions will be well documented in the insurance company's normal course of business.

[e] Cost Contribution Arrangements

Cost Contribution Arrangements (CCAs) (under the OECD Guidelines) and Cost Sharing Arrangements (CSAs) (under the US regulations) allow related parties to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from the individual exploitation of the interests in such intangibles. Buy-in transactions[40] are payments intended to compensate entities that contribute pre-existing intangible property to such CSAs or to compensate previous participants in an active CCA for a transfer of interests generated by the entry of a new participant.[41] Such arrangements and payments generate intercompany transactions that must be properly evaluated and priced. These transactions are generally large and require the involvement of the tax department. For these reasons, identification of such transactions is usually straightforward. Whether a transaction should have occurred but did not (perhaps new intangible property is acquired and made available without an appropriate buy-in) can become a concern when these types of arrangements are implemented. It is recommended that similar steps to identifying intangible property transactions are relied upon to identify if there are any contributions made to the cost sharing arrangement.

39. Van der Breggen, et al. 'Does Debt Matter? The Transfer Pricing Perspective', *BNA Tax Management Transfer Pricing Report.* 16 Transfer Pricing Report 200. 11 Jul. 2007.
40. Also referred to as Platform Contribution Transactions (PCT) under the final cost sharing regulations issued by US Treasury on 16 Dec. 2011 (s. 1.482-7(a)(2)).
41. Note that specific guidance about what constitutes a CSA, CCA or buy-in/PCT payment is provided in the US regulations and the OECD guidelines.

[3] How to Prioritize Risk Areas

Once a company determines it strategic goals with respect to transfer pricing, and identifies its intercompany transactions, it may be beneficial to spend time prioritizing risk areas. In other words, assuming a company has a limited budget to dedicate to transfer pricing issues, it will want to make sure that it spends its budget in ways that will be most effective for achieving the firm's goals.

A useful framework for prioritizing risks is a transaction inventory matrix. Such a matrix will summarize all global intercompany transactions for open audit periods as well as factors for assessing the potential risk or opportunity related to each transaction, as determined by the company's strategic goals. Factors that tend to be important in this exercise include the materiality of the transaction, the nature of local country requirements, the applicability of penalties or interest, and the quality of support or documentation already in place. Information presented should consider both 'sides' of a transaction (i.e., the perspectives of all relevant taxing authorities), and should also include transactions that perhaps do not exist but could or should be executed.

Note that similar information may have already been collected for a company's ASC 740 analysis or for other purposes. The company may want to leverage work already completed rather than perform this exercise from scratch. Table 1.2 provides an illustration of the types of information that may be collected in assessing potential transfer pricing risk.

Once such information is summarized, the company can make informed decisions about what intercompany transactions to focus on, and what transfer pricing initiatives to give priority to. As a company's goals change, and as the facts and circumstances

Table 1.2 Sample Transaction Inventory Matrix

Item	*Transaction 1*	*Transaction 2*
Provider/licensor (entity)	US entity name	US entity name
Jurisdiction of provider/licensor	US	US
Receiver/licensee (entity)	Foreign entity name	Foreign entity name
Jurisdiction of receiver/licensee	Foreign country	Foreign country
Tax Year	2017	2017
Transaction size (USD)	USD 2,500,000	USD 150,000
Type of agreement	Trademark licence	None
Status of audit year	Open	Open
Transaction	Intangible Property	Corporate management services
Could penalties be applicable?	Yes	No
Most recent TP analysis	FY 2016	None
Most recent functional analysis	FY 2014	None
Most recent comparables update	FY 2016	None
Quality of most recent TP documentation	High, reviewed by Independent Experts	NA

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surrounding the firm's transfer pricing framework change, priorities will evolve. For this reason, companies frequently will want to update any such matrix and reassess their priorities annually.

[4] *How to Conduct Functional Analysis Interviews*

A functional analysis is a key component of the transfer pricing planning process, as it is imperative to understand key facts about the business before developing transfer pricing policies. The term 'functional analysis' describes a method of identifying and organizing facts about a business in terms of its functions, risks, and assets, to present their allocation among the legal entities within a multinational group. Although some information can be gleaned through analyses of financial documents or publicly available information on the company, the best way to obtain such information is generally through 'functional analysis interviews'. These interviews are typically performed with personnel who are responsible for key, relevant functions within the organization.

Because it usually requires a significant amount of time and effort to schedule such interviews, companies want to identify the appropriate personnel to ensure that the most pertinent information is collected, so that they can avoid having to complete multiple follow-up requests. In addition, a company may need to perform high-level interviews during the planning process and then obtain much more detail for purposes of preparing transfer pricing documentation. Below are some best practices for conducting effective interviews:

- Distribute information to the interviewees in advance to help them prepare. Such information may include a brief description of the purpose of the meeting, an agenda for the discussion, a list the tax years under review, the legal entities involved, and any summarized information already prepared that the company may want the interviewee to confirm or augment.
- Avoid providing the interviewee with lists of specific questions in advance. When lists of questions are given out in advance, the interviewee may respond to the questions in written form in place of an interview, which limits the ability to ask follow-up questions and obtain all relevant information.
- Ensure questions are focused on the intercompany transaction at hand, not on the entity's overall operations. For example, a legal entity might perform only sales functions with respect to tangible goods purchased from related parties, although it may perform many different functions related to products purchased from third parties. In this situation, questions should be focused on the intercompany sales activities.
- A transfer pricing analysis is concerned only with the functions, risks and assets related to the intercompany transaction, so it is important that the information received from the interview accurately represents this perspective.
- Obtain multiple perspectives when possible, especially on key issues. Individuals' perspectives frequently differ, particularly about the importance of a certain department, function or location to the overall value chain of the company. Hearing all sides allows maximum opportunity to ascertain the true nature of

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the intercompany relationships, and to determine the most appropriate transfer pricing policy to fit the circumstances.

A primary objective of the functional analysis is the ability to objectively characterize each relevant entity based on its functions, assets and risks. Additionally, with the guidance issued under OECD BEPS Action Item 13, an examination of a company's global value chain and how the functions, assets and risks of individual entities interact is now seen as a critical component of the functional analysis. The global value chain ensures a detailed understanding of how each function fits within the worldwide operations and how it impacts the overall profitability of the global organization. While there is not universal agreement on how entities should be characterized, some examples of possible characterizations for manufacturing and sales entities are provided in Tables 1.3 and 1.4:

Table 1.3 Characterizing Manufacturing Entities[42]

Contract Manufacturer	*Full-Fledged Manufacturer*
Does not own technology	Owns technology
Minimal risk	Full risk of manufacturer (e.g., product liability, warranty)
Minimal discretion in production scheduling	Performs all production scheduling
Does not totally control equipment selection	Selects own equipment and vendors
Quality control usually dictated by customer	Direct control over quality
Usually manufacturing high volume, mature Products	Manufacturing products at all stages of product life cycle

Table 1.4 Characterizing Distribution and Selling Entities[43]

Manufacturer's Representative (Agent)	*Limited Distributor*	*Distributor*	*Marketer/ Distributor*
Does not take title No credit risk	Takes title Credit risk minimal/parent controls policy	Takes title Credit risk	Takes title Credit risk
No inventory risk	Inventory risk minimal	Inventory risk	Inventory risk
No marketing responsibility	Marketing responsibility limited	Marketing responsibility limited	Full marketing responsibility
No foreign exchange risk	No foreign exchange risk	May or may not bear foreign exchange risk	May or may not bear foreign exchange risk

42. *Ibid.*
43. Source: Boone, Patrick. 'Building A Transfer Pricing Defence: A Practical Guide'. *BNA Transfer Pricing Report.* 14 Transfer Pricing Report 3. 18 Jan. 2006.

[5] Determining How to Price Intercompany Transactions

Once a company has identified the form and substance of its intercompany transactions, the next phase in the planning process is to price those transactions. This includes selecting appropriate methods for analysing and pricing the transactions and understanding the rules and requirements in the jurisdictions in which it operates.

Although virtually all tax jurisdictions follow the arm's-length standard and prescribe to similar methods of analysis, the application and interpretation of each country's rules vary. As such, taxpayers and practitioners must understand each relevant tax jurisdiction's perspective and then develop transfer pricing policies that are sensitive to each country's unique requirements. In addition, the policies must be sufficiently flexible to ensure a defensible tax position in each jurisdiction. Because of the divergent views of varying tax authorities, even the most vigilant and savvy taxpayers are likely to encounter situations in which the requirements of the various tax jurisdictions in which it operates are at odds. In such instances, a taxpayer may be subject to an income adjustment in one or both of those jurisdictions.

Tax authority-initiated income adjustments are typically imposed several years after the company has closed its financial books. As such, income adjustments often lead to double taxation (i.e., taxable income is increased in one jurisdiction without a corresponding decrease in income in the jurisdiction on the other side of the transaction). The taxpayer can choose to either pay the double-tax or seek relief through Competent Authority proceedings (if the other party to the transaction is located in a tax treaty country), appeals, litigation, or other alternative dispute resolution processes that are discussed later in the book.[44]

To avoid these types of scenarios, taxpayers should be aware of the differing requirements in each of the jurisdictions in which they operate so that they can work to mitigate their risk of adjustment. It is important that taxpayers begin addressing any potential conflicts in the planning stage of a transfer pricing project. To assist taxpayers with this process, the following subsections address a number of key issues for companies to consider.

[6] Selecting Transfer Pricing Methods

The first step in establishing an arm's-length price is to determine the most appropriate method for analysing the transaction. The OECD Guidelines outline three traditional transaction methods and two transactional profit methods for pricing intercompany transactions. The traditional transaction methods include the:

(1) Comparable Uncontrolled Price (CUP) Method.
(2) Resale Price Method.
(3) Cost Plus Method.

The transactional profit methods include the:

(1) Transactional Net Margin Method (TNMM).[45]

44. *See* Section 1.8 for more detail on alternative dispute resolution mechanisms.
45. The TNMM is similar to the Comparable Profits Method (CPM) under the US regulations.

(2) Profit Split Method.[46]

With some exceptions, virtually all countries allow for the use of these five methods (or iterations of these methods) in pricing intercompany transactions. However, there are a number of tax jurisdictions that express a preference for the use of the traditional methods (and the CUP method, in particular) over the transactional profit methods. In such instances, a taxpayer must consider the use of the traditional transaction methods before defaulting to a transactional profit method approach. This can create challenges for companies, particularly when comparability standards differ between jurisdictions.

[a] Prioritization of Methods of Analysis

The OECD Guidelines, as well as many local country transfer pricing regulations, express a preference for the use of the CUP method over other methods of analysis when it can be applied reliably.[47] Specifically, the OECD Guidelines note 'Where it is possible to locate comparable uncontrolled transactions, the CUP Method is the most direct and reliable way to apply the arm's-length principle.[48] Consequently, in such cases the CUP Method is preferable to all other methods.'

The US regulations state that:

> The results derived from applying the comparable uncontrolled price method generally will be the most direct and reliable measure of an arm's-length price for the controlled transaction if an uncontrolled transaction has no differences with the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made.[49]

Not surprisingly, the determination of whether a particular CUP transaction is 'reliable' enough for comparison purposes is highly subjective, and thresholds for considering a transaction a reliable CUP vary significantly from jurisdiction-to-jurisdiction (and even from practitioner-to-practitioner). For instance, it is generally understood and accepted among tax practitioners that the reliability standards for the use of the CUP method are more stringent in the United States than they are in many foreign tax jurisdictions.

Similarly, US taxpayers and practitioners, unlike certain of their European and Asian counterparts, do not apply the Resale Price and Cost Plus methods as frequently because of practical issues associated with the application of those methods. The Resale Price and Cost Plus methods can be applied using 'internal' or 'external' transactions. In describing the application of the Resale Price method,[50] the US regulations state:

> If possible, appropriate gross profit margins should be derived from comparable uncontrolled purchases and resales of the reseller involved in the controlled sale,

46. Each of these methods is described in detail in Ch. 2.
47. OECD Guidelines, para. 2.3.
48. OECD Guidelines, para. 2.15.
49. Section 1.482-3(b)(2)(ii)(A).
50. The Resale Price method evaluates whether the amount charged in a controlled transaction is at arm's-length by reference to the gross margin realized in comparable uncontrolled transactions. The Resale Price method is most often used for distributors that resell products without physically altering them or adding substantial value to them.

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> because similar characteristics are more likely to be found among different resales of property made by the same reseller than among sales made by other resellers. In the absence of comparable uncontrolled transactions involving the same reseller, an appropriate gross profit margin may be derived from comparable uncontrolled transactions of other resellers.[51]

The availability of internal comparable transactions is often limited. As such, the application of the Resale Price (or Cost Plus) method generally relies on the use of external comparable uncontrolled transactions (typically comparable companies). Because both the Resale Price and Cost Plus methods rely on profitability measures at the gross profit level, this presents a unique set of challenges. As described in §1.482-3(c)(3)(ii)(B):

> The reliability of profit measures based on gross profit may be adversely affected by factors that have less effect on prices. For example, gross profit may be affected by a variety of other factors, including cost structures (as reflected, e.g., in the age of plant and equipment), business experience, (such as whether the business is in a start-up phase or is mature), or management efficiency (as indicated e.g., by expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

Because of the difficulty of accounting for all of these potential differences, it is far more common among Western European practitioners versus US practitioners to use these methods (or modifications of them) in their analyses because of the expressed preference for their use in many Western European jurisdictions.

The OECD Guidelines also acknowledge that there can be practical difficulties in applying these methods. For instance, the OECD Guidelines highlight the need to account for any inconsistencies in accounting practices between the comparable companies and the tested party. In practice, taxpayers and practitioners may not have enough information from the financial statements of the comparable companies to determine whether or not such differences exist, or whether adjustments have to be made to account for those differences. As such, all taxpayers and practitioners must be aware of these potential issues.

In the United States, however, taxpayers and practitioners can be too quick to default to the use of the transactional profits methods for the aforementioned reasons. This can be a mistake, especially when the regulations of the jurisdiction on the opposite side of the transaction express a clear preference for the use of the traditional transaction methods and hesitation to rely on one-sided profit based methods like the TNMM or CPM. Further, several recent high-profile transfer pricing cases involving Veritas, Amazon, and Medtronic have indicated that the use of the CUP (or CUT in the US Transfer Pricing Regulations) method, even if imperfect, may be preferable to use a one-sided method or other alternative. Guidance from the OECD on profit splits issued in December 2014 suggests that a transactional profit split using the best available transactional data may be preferable to more one-sided methods. While nothing has been issued with respect to further guidance from the OECD, China issued modifications to their transfer pricing guidelines in June 2016 that require taxpayers to perform a value

51. Section 1.482-3(c)(3)(ii)(A).

chain analysis as part of their documentation.[52] These methods may not align with the results identified under a one-sided approach. As such, taxpayers (and the practitioners that assist them) should thoroughly investigate the potential use of each method of analysis when performing a transfer pricing analysis, and build strong arguments for either accepting or rejecting the use of each of those methods.

One clear way to address this issue is to seek a convergence of results between methods. Specifically, both the OECD Guidelines and the US transfer pricing regulations acknowledge that the use of multiple methods can be useful for demonstrating that, regardless of the method used (e.g., the CUP method or the profit split method), the results are arm's length.[53] As such, if a company has a CUP transaction that it feels may not fully satisfy the comparability requirements under the US transfer pricing regulations, but it is likely to be relied upon by a non-US tax authority, the taxpayer might want to consider using the CUP method as the primary method of analysis and a second method as a confirming method, assuming the results converge. Similarly, if the results of an application of the Resale Price method and the TNMM show a similar result, a taxpayer might want to consider including both analyses in its documentation. Of course, the potential downside of this strategy is that the results of the analysis may not always converge in future years, requiring the taxpayer to explain why results under the methods diverged when compared to prior years.

It is important to note that the IRS issued a directive[54] in January 2018, which places a higher burden on the IRS examination team when arguing for a change in transfer pricing method. Specifically, it directs the exam team to obtain approval from a review board, the Treaties and Transfer Pricing Operations ('TTPO') Transfer Pricing Review Panel, before making a change in the taxpayer's selected best method under Treas. Reg. §1.482 in contemporaneous transfer pricing documentation or an Advanced Pricing Agreement ('APA') application.[55]

[7] *Identifying Comparable Companies*

The use of the TNMM requires the identification of third party comparable company benchmarks. Comparable company searches are typically performed for the first time during the planning stage of a transfer pricing project, and then updated on an annual basis for documentation purposes.

Transfer pricing practitioners spend a significant amount of time identifying comparable companies for use in their analyses. In addition, many taxpayers choose to perform comparable company searches in-house. This section serves as a guide for taxpayers and practitioners in thinking about some of the most important practical considerations when performing comparable company benchmark analyses.

52. At https://www.pwc.com/gx/en/tax/newsletters/pricing-knowledge-network/assets/pwc-TP-China-SAT-issues-TP-compliance-requirements.pdf, accessed 7 Apr. 2017.
53. *See* s. 1.482-1(c)(2)(iii) of the US regulations and para. 2.12 of the OECD Guidelines.
54. LB&I-04-0118-005: Memorandum for Large Business and International Division Employees (12 Jan. 2018).
55. Heimert, Mike, and Jill Weise, Douglas Fone, and Shiv Mahalingham; 'Transfer Pricing Times: IRS Issues New LB&I Directives'; Duff & Phelps, LLC; 6 February 2018.

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[a] Comparability Considerations

Different methods place different weights on various comparability criteria. For instance, the CUP method places a particular emphasis on the similarity of the products being transferred in the controlled versus uncontrolled transactions.[56] The Resale Price and Cost Plus methods emphasize the importance of functional comparability between the controlled and uncontrolled transactions, and require less stringent product comparability,[57] while the TNMM requires only broad functional comparability (a less rigorous standard than the functional comparability criteria under the Resale Price and Cost Plus methods).[58,59]

In practice, the functional comparability criteria under the TNMM provide taxpayers and practitioners with a considerable amount of flexibility when selecting comparable companies. For example, a taxpayer that is looking to benchmark the activities of a distributor of household appliances (e.g., refrigerators and stoves) is unlikely to be able to identify a set of comparable companies that is comprised exclusively of distributors of household appliances. Rather, the taxpayer will need to consider loosening its comparability criteria to include companies that perform similar functions, but operate in slightly different industries or distribute different types of products. In this instance, the comparable company set might include distributors of household electronics, hand tools, heating and ventilation equipment, or other consumer durables. Although the product lines differ, the taxpayer might consider the functions and risks of these companies to be similar to the functions and risks of the entity being benchmarked. In addition, the taxpayer might determine that these companies operate in industries with similar characteristics and would therefore be likely to be affected similarly by changes in the economic environment.

It should also be noted that transfer pricing analyses typically focus on benchmarking the activities of the party to the transaction that has the least complex functions and risks. In many instances, the 'tested party'[60] is a business segment within a larger legal entity that performs a variety of functions. For this reason, competitors of the overall company are frequently not used as reliable comparables. Consider the following hypothetical scenario. A US sportswear company wholly owns a Singapore subsidiary that manufactures garments on a contract basis for the US Parent (USP). USP provides the product specifications to the Singapore manufacturer, specifies the production volume, and is legally obligated to purchase all of the output produced by the Singapore entity. USP is also responsible for the development (and funding) of the garment's trademarks and other marketing intellectual property. In determining whether the Singapore entity

56. OECD Guidelines, para. 2.13.
57. OECD Guidelines, paras 2.21 and 2.39.
58. OECD Guidelines, para. 2.58.
59. See the local country reports in Part IV of this book for a more detailed description of the comparability requirements of each of the methods.
60. 'Tested party' is a US term, however, the concept of a tested party is applied globally. Under profits-based methods (i.e., the CPM and TNMM), the tested party is '. . . the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments . .' (s. 1.482-5(b)(2)(i)).

earned an arm's-length return for its activities, USP benchmarks the financial results of the Singapore subsidiary against the financial results of USP's competitors.

Such a comparison would likely be inappropriate for a number of reasons. First, USP's competitors operate as full-fledged manufacturers and distributors of a broad range of products including apparel, footwear, and other sports equipment. Second, these entities own valuable intangible property, including product and manufacturing technology and marketing intangibles (e.g., trademarks, trade names and customer relationships). As such, these entities have significantly different functional and risk profiles than the Singapore subsidiary.

In determining what types of companies would provide an appropriate comparison for the Singapore subsidiary's operations, there are a number of practical issues that should be taken into consideration. If the comparable companies are independent enterprises, they may have a significantly different risk profile than the party being benchmarked. In this instance, it will be difficult to identify independent, public companies that operate purely as contract manufacturers. Rather, independent manufacturers might have their own sales and marketing functions, brand-related intangible property, and manufacturing intangibles.

Taxpayers and practitioners must use their best effort to identify comparable companies that have functional and risk profiles that are as similar as possible to the functional and risk profile of the tested party. Since differences are still likely to exist, a practitioner must determine whether adjustments can be made to increase the reliability of the results of the analysis. A transfer pricing analyst might find it appropriate to perform asset intensity adjustments to adjust the financial results of the comparable companies to reflect the level of accounts receivable, inventories, and accounts payable held by the tested party.[61] These adjustments would increase the reliability of the comparison by adjusting for various risk factors that could not be addressed otherwise.

[b] Geographic Differences

Tax authorities generally prefer that comparable companies operate in the geographic market in which the controlled party operates, and most jurisdictions express a preference for the use of local country comparables when they are available. This is because the comparable companies would be subject to the same market conditions as the controlled party and they would be subject to the same accounting standards. Thus, the comparison of the financial results of the controlled and uncontrolled parties would be more reliable than if they were operating in different jurisdictions.

In practice, however, it might be difficult (or even impossible) to identify robust sets of comparable companies in certain jurisdictions. There are two primary reasons for this. First, certain jurisdictions do not require companies to publicly report their financial results (or only require the disclosure of limited information) and data is

61. Asset intensity adjustments were primarily a US concept and have not had the tradition of being widely accepted by other tax jurisdictions. However, Ch. III of the 2010 OECD Guidelines include an example explaining an instance in which working capital adjustments would increase the reliability of the analysis.

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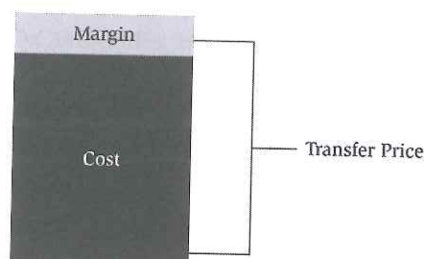
an appropriate markup. The CPLM 'is most useful where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services'.[5]

In determining whether cost plus is an appropriate method, it is important that the functions between the related and unrelated parties be comparable. Data on the costs and the appropriate markup have to be reliable in order for the application of the method to be successful.

[a] CPLM: Application

Paragraph 84 of IC 87-2R illustrates a typical example of the CPLM (*see* Figure 7.2).

Figure 7.2 Transfer Price under Cost Plus Method



Canco, a Canadian company, manufactures specialized stamping equipment for arm's-length parties in the manufacturing industry using designs supplied to them by the arm's-length parties. Canco realizes its costs plus a markup of 10% on this custom manufacturing. Under the arm's-length agreements, costs are defined as the sum of direct costs (i.e., labour and materials) plus 50% of the direct costs. The additional 50% of direct costs is intended to approximate indirect costs, including overhead.

Canco also manufactures stamping machines for its United States subsidiary, Usco, using designs supplied by Usco. Under the Usco agreement, costs are defined as the sum of the direct costs plus the actual indirect costs, including overhead. It is assumed that the transactions between Canco and the arm's-length parties are functionally comparable to the transactions between Canco and Usco.

Canco has calculated its indirect costs and has allocated them to the various projects based on the direct labour hours charge to each project. Based on Canco's calculations, indirect costs including overhead to be charged to each project is equal to 45% of the direct costs. The cost base of the comparable transactions must be restated to determine the appropriate markup.

5. OECD Guidelines, para. 2.32.

Calculation of markup under the arm's-length agreements	*In CAD*
Direct costs	1,000
Indirect costs (50% × CAD 1000)	500
Total costs	1,500
Markup 10%	150
Price	1,650

Calculation of markup under the arm's-length agreements using restated costs	*In CAD*
Direct costs	1,000
Indirect costs (45% × CAD 1,000)	450
Total costs	1,450
Price established above	1,650
Markup based on restated costs (CAD 1,650 – CAD 1,450)	200
Gross markup based on restated costs (CAD 200/CAD 1,450)	13.8%

Calculation of the arm's-length transfer price	*In CAD*
Canco's direct costs related to Usco contract	900
Add:	
Indirect costs (45% × CAD 900)	405
Markup (13.8% × (CAD 900 + CAD 405)	180
Transfer price	1,485

The objective of the CRA's example is to emphasize that the cost base of the transaction of the tested party is calculated in the same manner as the cost base of the comparable transactions (i.e., if the comparable party includes a particular item as an operating expense, while the tested party includes the item in its COGS, the cost base of the comparable must be adjusted to include the item).

The CPLM is applied to only one party (the tested party) of the group participating in the transaction. Therefore, this method generally produces the most reliable results where the functions performed by the tested party are the least complex, and the tested party does not contribute valuable or unique intangible assets.

[4] Resale Price Method

The RPM can be employed to determine the arm's-length consideration to be earned by the related purchaser in an intercompany transaction when the purchaser, in turn, resells to unrelated parties.

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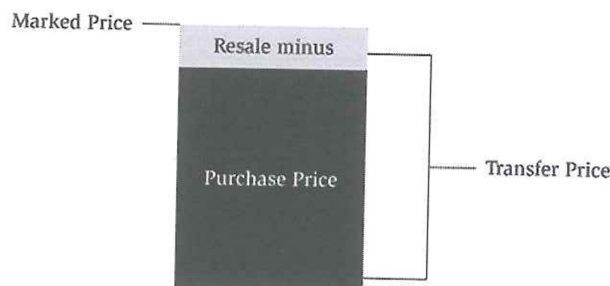
[a] *RPM: Application*

Paragraph 75 of IC 87-2R illustrates a typical example of the RPM (*see* Figure 7.3).

Figure 7.3 Transfer Price under Resale Price Method



Canco distributes widgets in Canada for its United States parent, Usco. Salesco, a Canadian company operating at arm's-length to Usco, distributes gadgets, a product similar to widgets, in Canada for Usco. The key functional differences, other than the minor differences in product, between the controlled transactions and the uncontrolled transactions are:

- Usco bears the warranty risk in the uncontrolled transaction, and Canco bears the warranty risk in the case of the controlled transaction.
- Usco provides samples and promotion materials to Salesco for free, while Canco produces its own samples and promotional materials and bears the related costs.

The widget and gadget markets are similar in Canada. Salesco earns a commission of 15% of gadget sales net of discounts and allowances.

Calculation of sales commission:	*In CAD*
Canco's net sales of widgets to arm's-length parties	4,000
Arm's-length sales commission rate 15%	600
Adjustments for function and risk differences:	
Promotion costs	10
Warranty costs	22
Total adjustments	32
Adjusted sales commission	632

Calculation of transfer price:	*In CAD*
Canco's net sales of widgets to arm's-length parties	4,000
Less adjusted sales commission	632
Transfer price	3,368

This method is most appropriate where the seller adds relatively little value to the goods. The greater the value-added to the goods, the more difficult it will be to determine an appropriate resale margin. This is especially true where the contribution pertains to the creation or maintenance of an intangible property (i.e., marketing intangible).

The RPM is applied to only one party (the tested party) of the group participating in the transaction. Therefore, this method generally produces the most reliable results where the functions performed by the tested party are the least complex, and the tested party does not contribute valuable or unique intangible assets.

[b] *Profit Split Method*

The PSM seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction. Under this method, the profits of the related parties are combined, and then divided on the basis of the contribution of value of each party to the transaction. It is most useful where transactions are highly integrated and cannot be evaluated on a separate basis, or where more than one party to the transaction possesses significant intangibles.

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[i] PSM: Application

Paragraph 102 of IC 87-2R illustrates a typical example of the PSM. Canco, a Canadian company, has developed and manufactures a unique computer chip. The chip is considered to be an innovative technological advance. Usco, a United States subsidiary of Canco, has developed and manufactures a computer which incorporates the new chip and technology developed by Usco itself. The success of the computer is attributable to both companies for the design of the computer and the computer chip.

Canco supplies Usco with the computer chips for assembly in the computers. Usco manufactures the computers and sells the computers to an arm's-length distributor.

In light of the innovative nature of the chip and computer, the group was unable to find comparables with similar intangible assets. Because they were unable to establish a reliable degree of comparability, the group was unable to apply the traditional transaction methods or the TNMM. However, reliable data are available on chip and computer manufacturers without innovative intangible property, and they earn a return of 10% on their manufacturing costs (excluding purchases).

The total profits attributable to computer and chips are calculated as follows:

	In CAD
Sales to the arm's-length distributor	1,000
Deduct	
Canco's manufacturing cost	200
Usco's manufacturing cost	300
Total manufacturing costs for the group	500
Gross margin	500

	In CAD
Deduct	
Canco's development costs	100
Usco's development costs	50
Canco's operating costs	50
Usco's operating costs	100
Subtotal	300
Net profit	200
Canco's return to manufacturing (CAD 200 × 10%)	20
Usco's return to manufacturing (CAD 300 × 10%)	30
Subtotal	50
Residual profit attributable to development	150
Based on proportionate development costs:	
Canco's share of residual profit [CAD 100 / (CAD 100 + CAD 50)] × CAD 150	100
Usco's share of residual profit [CAD 50 / (CAD 100 + CAD 50)] × CAD 150	50

Canco's transfer price is calculated as follows:	*In CAD*
Manufacturing costs	200
Development costs	100
Operating costs	50
Routine 10% return on manufacturing costs	20
Share of residual profit	100
Transfer price	470

The key difference between the PSM and the TNMM is that the PSM is applied to all members involved in the controlled transaction, whereas the TNMM is applied to only one member.

[5] Transactional Net Margin Method

The TNMM examines the profit that is earned by one of the parties to the transaction (as opposed to the profits of the transacting companies as a whole) to determine the transfer price. 'The transactional net margin examines the net profit relative to an appropriate base (e.g., costs, sales, assets) that a taxpayer realizes from a controlled transaction. The net profit margin of the taxpayer from the controlled transaction should be established by reference to the net profit margin that the same taxpayer

earns in comparable uncontrolled transactions.'[6] If no similar transactions with third parties exist, the OECD Guidelines allow comparable transactions of an independent enterprise to serve as a guide.

There are two significant requirements that must be met to qualify to use the TNMM. First, comparables must meet strict standards of comparability that go beyond product and functional similarity. In fact, the OECD prescribes comparability adjustments to be made for factors which are unrelated to transfer pricing such as management efficiency, cost of capital and phase of business cycle. Secondly, the TNMM can only be applied to particular transactions, not on a company wide basis. In obtaining the comparable net margin from independent enterprises, the net margin should exclude other similar transactions as well as any controlled transactions of the enterprise.

According to Canadian practice, the TNMM should only be applied when other recommended methods do not produce a reasonable or more appropriate estimate for arm's-length prices. As a result, the TNMM will be used when there is insufficient system profit to reliably apply the profit-split method. The TNMM is applied from the perspective of the least complex party in the transaction.

[a] TNMM: Application

Paragraph 108 of IC 87-2R illustrate a typical example of the TNMM. Canco, a Canadian company, produces a liquid product for itself and three foreign subsidiaries of its Swiss parent. Canco and the foreign subsidiaries own the rights to the liquid product formulae for sales to their respective countries. Although Canco has no internal comparable transactions, it has been able to locate data relating to an arm's-length party who performs custom formulations for arm's-length purchasers using formulae supplied to them by those purchasers. Given the absence of valuable or unique intangibles, Canco has been able, after the appropriate functional analysis, to verify that the custom formulator is comparable. However, Canco cannot obtain the relevant information at the gross margin level. Therefore, it is unable to apply the CPLM. The arm's-length formulator realizes a net markup of 10% on the custom formulations.

The transfer price of the liquid product is calculated as follows:	*In CAD*
Canco's cost of goods sold	1,000
Canco's operating expenses	300
Total costs	1,300
Add:	
Net markup (10% × CAD 1,300)	130
Transfer price	1,430

6. OECD Guidelines, para. 3.26.

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When relevant information exists at the gross margin level, taxpayers should apply the cost plus or RPM. It is also recommended that tax payers follow a four-step approach in their search for external comparable transactions under the TNMM:

(1) Select entities with similar industry classifications to the tested party.
(2) Eliminate the entities that do not have comparable transactions as the tested party, based on the financial information available.
(3) Review in detail the entities selected in Step 1 and not screened out in Step 2 to determine if the information indicates that they could be considered to have comparable transactions.
(4) Material differences may affect comparability; therefore, make appropriate adjustments where possible and eliminate any entities for which necessary adjustments cannot reasonably be made.

[6] Application of Transfer Pricing Methods

[a] Method Selection for Intra-Group Services

The CRA's guidance in IC 87-2R and TPM-15 in applying the arm's-length principle to intra-group services follows the OECD's two-step test. The first step is the determination if an arm's-length entity would be willing to pay for the activity, or undertake the activity themselves, and whether the activity confers a benefit of economic or commercial value. The CRA typically disallows the deduction of the service fee if this test is not passed.

The second step is the determination of the amount of the charge. The transfer pricing methods recommended by the CRA are CUP and cost plus. However, based on CRA practice, there should be no markup on cost of the intra-group services where the intra-group services are offered as a convenience to the group and not as an ordinary and recurrent activity. More specifically, if the activity is administrative in nature and is centralized to gain efficiencies, then the CRA generally disallows a markup. However, markups in intra-group services are acceptable if the services are operational in nature.

The CRA accepts the use of both the direct and indirect charge methods in the determination of intra-group service charges, but in TPM-15 reinforces its preference for the direct method. Under the direct charge method, a specific charge is established for each identifiable service. Under the indirect charge method, an allocation to a particular entity of the cost of a service provided to more than one entity is made by referring to a basis or allocation key that indicates the share of the total value of the service attributable to the particular entity.

The CRA prefers the direct charge method over the indirect charge method. However, the indirect charge method is acceptable where a service has been provided to a number of non-arm's-length parties and the portion of the value of the service directly attributable to each of the parties cannot be determined. Under these circumstances, a taxpayer can use the indirect charge method.

The CRA, in IC 87-2R, recommends that when choosing an allocation key (e.g., sales, gross or operating profits, units used/produced/sold, number of employees, or capital invested), the taxpayer should consider the nature and use made of the service. For example, when allocating centralized resource costs, consider using proportionate

head count as the allocation key, and when allocating centralized marketing costs, consider using proportionate sales.

In the case where a Canadian taxpayer is located in the province of Ontario, and the taxpayer is a recipient of intra-group services, an additional 5% withholding tax is assessed on management fees paid or payable to a related non-resident person. In order to be exempt from the add-back (i.e., the additional tax), the taxpayer must demonstrate that the management fee constitutes a reimbursement of costs incurred on its behalf.

[b] Method Selection for Transfers of Intangible Property

The CRA generally follows OECD guidance in applying the arm's-length principle to transfers of intangible property. However, the CRA's interpretation of the arm's-length principle in respect of intangible property as outlined in IC 87-2R, may lead to results that vary from the OECD guidelines. First, the CRA assumes that in most cases, both the supplier and the recipient share the risks and the benefits associated with using an intangible. For this reason, the CRA suggests that arm's-length pricing for the transfer of intangible property must take into account the perspective of both the transferor of the property and the transferee. From the transferor's perspective, the CRA recommends a cost recovery plus a reasonable profit. While from the transferee's perspective, the CRA recommends an expected benefit (additional profits) perspective. IC 87-2R states that the overall expected benefit to the recipient is usually a key, however in practice, the CRA often defers to the cost-recovery perspective, especially for Canadian in-bound transfer of intangible property.

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Similar to transfers of other property or services, the CRA recommends the CUP or the resale method, and suggests that the TNMM would not be appropriate. In circumstances where the intangible property is highly valuable or unique and generates significant excess profits, the residual PSM is recommended, ensuring that both the transferor and the transferee share the excess profits.

In establishing royalty rates for the right to exploit intangible property, the following items should be considered:

- prevailing industry rates;
- terms of the agreement, including geographic limitations, time limitations, and exclusivity rights;
- singularity of the invention and the period for which it is likely to remain unique;
- technical assistance, trademarks, and know-how provided along with access to any patent;
- profits anticipated by the licensee; and
- benefits to the licensor arising from sharing information on the experience of the licensee.

The CRA's position in IC 87-2R is that transferees of intangible property that do not own trademarks or trade names, and undertake marketing activities, should share in the returns attributable to marketing intangibles. More specifically, the Canadian position is that distributors who bear the costs of marketing activities would usually expect to share in the return from the marketing intangibles. Also, distributors who

bear marketing costs in excess of those that an arm's-length distributor with similar rights to exploit the intangible would incur would expect an additional return from the owner of the trademark or trade name. The actual marketing activities of the distributor over a number of years should be given significant weight in evaluating the return attributable to marketing activities.

The use of hindsight in the determination of the value of intangible property is not appropriate. Under the arm's-length principle, an agreement that is, in substance, the same as one into which arm's-length parties would have entered, would not usually be subject to adjustment as a result of subsequent events. Thus the CRA typically does not make an adjustment solely on the basis that income streams or cost savings differ from those initially estimated by the parties. However, the CRA may consider factors that a reasonable person with some knowledge of the industry would have taken into account at the time the valuation was projected.

The CRA generally accepts business transactions as they are structured by the parties. However, the CRA would consider the re-characterization of a transaction where there is a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to intangible property arising as a result of future research. Generally, the CRA will review any long-term agreements between non-arm's-length parties for the right to use intangibles to ensure that they are consistent with the arm's-length principle and subject the transaction to re-characterization if they determine that:

- A long-term sale of intangible property would not have been entered into between persons dealing at arm's length.
- The sale was not entered into primarily for bona fide purposes other than to obtain a tax benefit.

Under the OECD's BEPS project, further work is being done to provide guidance on the use of profit splits. This work is expected to continue through 2016 and into 2017. The likely result of the work will be increased application of the PSM, supporting the OECD's focus on value creation. In turn, the use of one-sided methods such as the TNMM will likely be discouraged as the value creating activities of all entities involved in the transaction will need to be considered. Historically, the PSM has been rarely used and relatively difficult to apply, increasing the burden on taxpayers to implement as well as on tax authorities to enforce.

[c] *Methods to Price QCCAs*

QCCAs provide a vehicle to share the costs and risks of producing, developing or acquiring any property, or acquiring or performing any services. The costs and risks should be shared in proportion to the benefits that each participant is reasonably expected to derive from the property or services as a result of the arrangement. Where a participant's contribution is not consistent with its share of expected benefits, a balancing payment may be appropriate.

Similar to the OECD guidance and most other countries, if the QCCA develops property such as an intangible, each participant in a QCCA is not required to be a legal

owner of the property, but each participant must enjoy substantially similar rights, benefits, and privileges as a legal owner (effective or beneficial ownership).

QCCAs are typically used for the joint development of intangible property, with each participant being assigned an interest in the developed property. However, Canadian guidance provides for the use of QCCAs for participants to pool their resources to acquire any type of centralized services (e.g., accounting, computer technical support, human resources, or the development of an advertising campaign common to the participants' markets).

The arm's-length principle is used as the basis to determine each participant's contribution. That is, the contribution must be consistent with that which an arm's-length party would have agreed to contribute under comparable circumstances given the benefit it would have reasonably expected to derive from the arrangement. Therefore, only persons who can reasonably be expected to derive a benefit from the results of a QCCA can be considered participants in that QCCA. The requirement of an expected benefit does not impose a condition that the subject activity in fact be successful. The application of the arm's-length principle should take into account, among other things, the contractual terms and economic circumstances particular to the QCCA. The arm's-length principle also applies to capital contributions of tangible or intangible assets to a QCCA.

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Generally, each participant's share of the benefits may be determined by estimating the anticipated additional income or cost saving that each participant is expected to gain as a result of its participation in the arrangement. The CRA suggests certain allocation keys, including:

- sales;
- units used, produced or sold;
- gross or operating profit;
- number of employees; or
- capital invested.

It is critical that the allocation method takes into account the relationship between the allocation key and the expected benefits.

It is important to note that contributions and allocations are treated as though they were made outside the scope of the QCCA to carry on the activities that are the subject of the QCCA. More specifically, the deductibility of the costs allocated to a Canadian taxpayer is determined in accordance with the Act. The fact that a charge for the costs is itself justified for the QCCA does not automatically make the costs deductible under the Act.

Where a participant's contribution to a QCCA is not consistent with its share of the expected benefit, a balancing payment may be required between the participants to adjust their respective contributions. For tax purposes, the balancing payment is treated as an addition to the cost of the payer and as a reimbursement of costs to the recipient. Where the balancing payment is more than the recipient's expenditures or costs, the excess will be treated as a taxable amount.

The costs subject to allocation would be net of other QCCA receipts (i.e., royalties from licenses or proceeds from the sale of research assets). Costs subject to allocation for Scientific Research and Experimental Development (SR&ED) tax credits carried out in Canada under a QCCA will be calculated before deducting any tax incentives (i.e., SR&ED tax credits) earned with respect to the SR&ED, but after deducting subsidies granted by a government, unless there is evidence that arm's-length parties would have done otherwise.

Under the arm's-length principle, participants in a QCCA that transfer a part or all of their interests in the results of prior QCCA activities (such as intangible property, work in-progress, or the knowledge obtained from past QCCA activities) to a new participant should receive arm's-length compensation from the new participant for that property (a buy-in payment). The amount of a buy-in payment should be determined, based on the price an arm's-length party would have paid for the rights obtained by the new participant. This determination would take into account the proportionate share of the overall expected benefit to be received from the QCCA.

For tax purposes, a buy-in payment is treated as if the payment was made outside the QCCA for acquiring the interest in the rights being obtained (e.g., an interest in intangible property already developed by the QCCA, work in progress, or the knowledge obtained from past QCCA activities).

Similar issues arise when a participant to a QCCA disposes of part or all of its interest in a QCCA. The effective transfer of property interests should be compensated according to the arm's-length principle (a buy-out payment). However, taxpayers should exercise care in the event of either a buy-in or buy-out because the very nature of any intangibles in a QCCA may often make the buy-in or buy-out valuation difficult. This valuation is particularly difficult where the intangibles developed by a QCCA are valuable or unique. Buy-in and buy-out payments, in particular when a low-tax jurisdiction is involved, are often challenged by the CRA.

[d] *Methods to Price Intercompany Loans*

There is no published specific guidance by the CRA with respect to determining the arm's length interest rate for intercompany loans. The method selection would be the most appropriate method under the circumstances with due consideration to the availability and reliability of potentially comparable third-party loan agreements. It should be noted, however, that the CRA does consider the impact of implicit parental support to be significant in assessing the subsidiary borrower's credit risk. Accordingly the CRA would, in most cases, look to pricing the intercompany loan at an interest rate similar to that which the subsidiary's parent would have been charged. However, the impact of implicit parental support, if it can be determined to exist in a specific case, is still difficult to quantify with regard to how an arm's length lender would price the loan. There is no market pricing evidence that implicit parental support would result in a member of a multinational group, that does not have the same credit rating as the parent, obtaining the same loan pricing as the parent.

[B] Comparables Selection

The CRA closely follows the OECD Guidelines sections that emphasize the importance of comparability factors in evaluating compliance with the arm's-length principle; that is, the greater the degree of comparability, the greater the assurance that the results meet the arm's-length principle. Comparability is judged not only by product similarity but also by functions performed, risks undertaken, contractual terms, economic circumstances and business strategies.

The arm's-length standard is generally based on a comparison of the prices or margins used by non-arm's-length parties with those used by arm's-length parties engaged in similar transactions. Therefore, the selection of comparable uncontrolled transactions is crucial in the application of the arm's-length standard. To consider uncontrolled and controlled transactions to be comparable, there should either be no differences between the transactions which would materially affect the price in the open market, or in the case that differences do exist, reliable adjustments should be made to eliminate the material effects of such differences.

While, IC 87-2R (paragraph 51) suggests that multiple years of data for the taxpayer and the comparables may be taken into consideration when determining comparability, TPM-16 clearly states the CRA's preference for single-year (and the same single year) data for the purpose of assessing the arm's-length nature of the transfer price.

The CRA's interpretation is also consistent with paragraph 1.15 of the OECD Guidelines, and the application of the arm's-length principle is generally based on a comparison of the prices or margins used or obtained by non-arm's-length parties with those used or obtained by arm's-length parties engaged in similar transactions.

In IC 87-2R, the CRA also states that for such price or margin comparisons to be useful, the economically relevant characteristics of the transactions being compared must be at least sufficiently similar so as to permit reasonably accurate adjustments to be made for any differences in such characteristics. Transactions between other non-arm's-length parties should not be used for purposes of these comparisons, because the terms and conditions may not be arm's length. It is the term 'sufficiently similar' that distinguishes the Canada from OECD countries. It is generally thought that Canada has a higher standard of comparability than most OECD countries.

The CRA follows paragraphs 1.19 through 1.35 of the OECD Guidelines in identifying factors that may influence the degree of comparability of transactions. These factors include:

- the characteristics of the property or services being purchased or sold;
- the functions performed by the parties to the transactions (taking into account assets used and risks assumed);
- the terms and conditions of the contract;
- the economic circumstances of the parties; and
- the business strategies pursued by the parties.

The CRA recognizes that transfer pricing is not an exact science and the selection of the most appropriate transfer pricing method depends largely on the assessment of the comparability of transactions. As a result, the application of the most appropriate

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TPM may produce a range of results. The CRA relies on the facts and circumstances of the case to determine a range, or the point in a range, that is the most reliable estimate of an arm's-length price or allocation. Taxpayers should exercise care in assessing the reliability of each comparable transaction used to establish a range. Based on the CRA's position, it is not atypical to see fewer comparables within the range of acceptable results when compared to other OECD countries.

The CRA accepts that business strategies are factors that can affect comparability because they influence the price that arm's-length parties would charge for a product. IC 87-2R provides the following example:

> Where an arm's-length party attempts to introduce a product into a new market or increase its market share, it may be reasonable for that party to temporarily charge a price lower than it would otherwise charge in an attempt to establish that market or market share. This assumes that an arm's-length party would have estimated the potential long-term benefits of such a strategy. It is unlikely, however, that an arm's-length party would maintain such a strategy for an extended period of time.

§7.04 DEVELOPING SUPPORT FOR ACTUAL PRICING

[A] Transfer Pricing Documentation Requirements

CRA's Transfer Pricing Memorandum TPM-09 *Reasonable Efforts under section 247 of the ITA*, dated 18 September 2006 (TPM-09), provides guidance as to what constitutes reasonable efforts to determine and support arm's-length terms and conditions. This Memorandum provides a number of examples on how to present and incorporate specific aspects of documentation. It also provides insightful examples of taxpayers who received transfer pricing penalties for not satisfying the reasonable efforts standard.

Documentation has to be prepared on a contemporaneous basis, and a reasonable effort has to be made. Although the term 'contemporaneous documentation' is not defined in the ITA, the respective CRA administrative policy is found in paragraphs 190 and 191 of IC 87-2R.

- In light of the obligations set out in subsection 247(4), taxpayers will generally produce or obtain the required documentation at the time the transaction is entered into.
- Taxpayers may, after a transaction has occurred but before the filling due date, recognize that the transfer price recorded for that particular transaction does not represent an arm's-length price.

The reference to subsection 247(4) of the ITA states that the taxpayer must make or obtain, on or before the taxpayer's documentation-due date for the taxation year or fiscal period, certain records or documents.

A reasonable effort means the degree of effort that an independent and competent person engaged in the same line of business or endeavour would exercise under similar circumstances. What is reasonable is based on what a reasonable business person in the taxpayer's circumstances would do, having regard to the complexity and importance of the transfer pricing issues that arise in the taxpayer's case. The determination of

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whether a taxpayer has made reasonable efforts to determine and support arm's-length terms and conditions is a question of fact. The CRA will consider taxpayers to have made reasonable efforts if they have taken all reasonable steps to ensure that their transfer prices or allocations conform with the arm's-length principle.

The reasonable efforts test is contained in subsection 247(4) of the ITA.

The reasonable efforts test provides that the taxpayers must make reasonable efforts:

- to determine arm's-length transfer prices or arm's-length allocations; and
- to use those prices or allocations.

TPM-09 raises this point a number of times to ensure that reasonable efforts are made to follow the policies that have been established through use of reasonable efforts. In two examples, cited in the Appendix of TPM-09, taxpayers received penalties due in part to inconsistencies in applying established transfer pricing policies.

Pursuant to subsection 247(4), a taxpayer is deemed not to have made reasonable efforts unless the taxpayer makes or obtains, on or before the documentation-due date, records or documents that provide a description that is complete and accurate in all material respects of:

- the property or services to which the transaction relates;
- the terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the participants in the transaction;
- the identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into;
- the functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction;
- the data and methods considered and the analysis performed to determine the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction; and
- the assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction.

This is similar to the type of documentation suggested by the OECD Guidelines, and it is consistent with the type of information required by other countries, including the United States. For each subsequent taxation year in which the transaction continues, the taxpayer must review the existing documentation and update it for material changes in fact and/or circumstance.

[B] Relationship between Fulfilling Documentation Requirements and Protection from Penalties

See section §7.02[C], 'Transfer Pricing Penalty Framework' for a discussion of these issues.

[C] Sufficiency of Compliance Reports for Purposes of Applying Penalties

Contemporaneous documentation must provide complete and accurate descriptions of the following:

- the property or services to which the transaction relates;
- the terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the participants in the transaction;
- the identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into;
- the functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction;
- the data and methods considered and the analysis performed to determine the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction; and
- the assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction.

This is similar to the type of documentation suggested by the OECD Guidelines, and it is consistent with the type of information required by other countries, including the United States. For each subsequent taxation year in which the transaction continues, the taxpayer must review the existing documentation and update it for material changes in facts and circumstances.

The TPRC is responsible for reviewing all cases where a transfer pricing penalty may be assessed due to threshold levels being reached, to evaluate whether reasonable efforts have been made and to ensure fair and consistent application of the law. Each submission to the TPRC by the CRA Transfer Pricing Auditor is examined on a case-by-case basis. *See* the CRA's TPM-13 *Referrals to the Transfer Pricing Review Committee*.

When the TPRC is evaluating whether a taxpayer has made reasonable efforts to determine and use arm's-length terms and conditions, the TPRC will first review if the deeming provision contained in subsection 247(4) applies. That is:

(1) whether the documents obtained or prepared contain a description that is complete and accurate in all material respects of the items listed in subsection 247(4);
(2) whether the documents were prepared or obtained by the documentation-due-date; and
(3) whether the documents were provided within three months of a written request to do so.

A number of different factors are then considered, including but not limited to:

- Compliance versus accuracy.
- Demonstrated efforts.
- Administrative burden.

[1] Compliance versus Accuracy

A taxpayer has complied with contemporaneous documentation requirements if the documentation is prepared within the required timeframe while the accuracy of the pricing generally refers to extent of any adjustment made by the CRA. However, taxpayers have to take reasonable steps to search for arm's-length data, apply adjustments to the arm's-length data, select the transfer pricing methods, apply the selected methodology and ensure that the method followed is current with changing facts and circumstances of the taxpayer.

The CRA recognizes that data may be available at the time of a transfer pricing audit that was not available when the terms and conditions were established. The TPRC assessment of the penalty is not solely based on the ultimate accuracy of the transfer price but on efforts that a taxpayer makes to determine arm's-length terms and conditions. That is, a transfer pricing penalty would likely not be imposed on a taxpayer for failing to consider data to which the taxpayer did not have access, or for failure to apply a transfer pricing method that would have required data that was not available to the taxpayer when the access to or availability of the data was beyond the taxpayer's control.

The CRA is less likely to accept documentation if the taxpayer has not made reasonable efforts to consider applying a recommended TPM in accordance with the natural hierarchy of recommended methodologies referred to in IC 87-2R. The CRA may assess a penalty for transfer pricing on a taxpayer that made an insufficient effort to apply available arm's-length transactional data, even though significant effort was expended in the support and application of a profit based method, assuming the transfer pricing adjustment exceeds the threshold.

The CRA has stated that less effort to find detailed comparable information may be acceptable to support relatively small controlled transactions. The term 'small controlled transactions' refers to the size of the business. However, the degree of compliance effort must also be assessed against the size of the controlled transactions. Thus, it would be reasonable for taxpayers to devote proportionally more effort to find comparables for larger controlled transactions, regardless of their relative importance in the taxpayer's business. The ninth memorandum provides an example of a Canadian taxpayer that had relatively insignificant revenues compared to the worldwide operations. The taxpayer, was assessed a transfer pricing penalty for not making reasonable efforts, including not preparing a transfer pricing study. In essence, the taxpayer was not held to a lesser standard due to relatively lower revenues compared to its global operations.

[2] Demonstrated Efforts

TPM-09 states that the most effective way for taxpayers to demonstrate that they have made reasonable efforts to comply with the arm's-length principle is through the use of proper documentation. The term 'proper documentation' is not defined but it is understood to mean documentation that is complete and accurate in all material respects. The taxpayer should maintain sufficient documentation to establish that the taxpayer reasonably concluded that, given the available data and the applicable pricing

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methods, the method and the application of the method, provide an arm's-length result. The steps taken to ensure compliance with the arm's-length principle also need to be explained within the documentation.

The list of documents in subsection 247(4) of the ITA is not intended to be an exhaustive list of the documents necessary to substantiate that a taxpayer has made reasonable efforts to determine and use arm's-length terms and conditions for their related party transactions. IC 87-2R explains that the documentation should include:

- the general organization and description of the business;
- the selection of a particular TPM, including an explanation of why the selected method is more appropriate than any higher-ranking methods;
- the projection of the expected benefits as they relate to the valuation of an intangible;
- the scope of the search and criteria used to select comparables;
- an analysis of the factors determining comparability, including a review of the differences and attempts made to make adjustments; and
- the assumptions, strategies, and policies as they relate to the tangible property, intangible property, and services being transferred.

The CRA cautions against inconsistencies in methods, data and factual representations, as these can undermine the reliability of the documentation, and affect the CRA's consideration of whether reasonable efforts have been made.

[3] Administrative Burden

The CRA's view on the appropriate administrative burden is consistent with paragraph 5.28 of the OECD guidelines:

> . . . the extensiveness of this process [compliance to arm's-length] should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. Moreover, the need for the documents should be balanced by the costs and administrative burdens, particularly where this process suggests the creation of documents that would not otherwise be prepared or referred to in the absence of tax considerations. Documentation requirements should not impose on taxpayer's costs and burdens disproportionate to the circumstances. . . .

§7.05 HOT TOPICS/SPECIAL CONSIDERATIONS IN CANADA CONCERNING TRANSFER PRICING

[A] Range and Multiple Year Data Issues

The CRA recognizes that a taxpayer's transfer pricing analysis may provide for a range of acceptable results. The CRA's position is that the full range does not necessarily reflect an arm's-length result due to potential comparability defects between the comparable transactions, however, as stated in TPM-16, the interquartile range is not a preferred statistical adjustment. As a result, the CRA expects taxpayers to rely on the facts and circumstances of the case to identify a narrow range or point within a range that provides the most reliable estimate of an arm's-length price or allocation. Thus the CRA, unlike the IRS for example, does not believe that the application of an interquartile range to

determine an arm's-length range enhances reliability of the comparable data considered in producing a range. The CRA's general position is as follows:

- Results from independent transactions that have a relatively high degree of comparability with the targeted transaction's key economic characteristics are preferred.
- Secondary evidence, such as unique characteristics of the target that are not present in the comparable transaction, can assist in judging the impact of comparability defects that could not be removed via screens or adjustments.
- Consider employing the residual PSM if the comparables for implementing a one-sided methodology (cost-plus, resale price and transactional net margin) are not sufficiently comparable.

The CRA's policies in regards to use of ranges, adjustments within a range, and use of multi-year data originate from an article released at the 2002 Canadian Tax Foundation Conference by the then existing Chief Economist of the International Tax Directorate,[7] and were recently updated in TPM-16. Unfortunately, the guidance has and continues to cause conflict between the CRA and other tax jurisdictions. This use and application of ranges in Canada is fairly unique and may cause a taxpayer concerns if they attempt to prepare documentation to satisfy multiple tax authorities including Canada.

The CRA prefers that taxpayers use single-year comparable data in the construction of the comparable range when estimating arm's-length prices or allocations. As a result, the averaging of comparable multi-year year data used in many jurisdictions is not endorsed. The CRA's believes that the use of multi-year data may not be reliable due to difficulties in determining the appropriate period over which to average and the variability by which averaging can be performed. Until TPM-16 was recently issued, neither IC 87-2R nor the Transfer Pricing Memoranda series addressed the issue of multi-year averaging versus a single-year's results. The CRA relied on the Simkover paper for their position on this issue, and will now rely on TPM-16.

The CRA's single-year approach places a significant burden on taxpayers. For example, a taxpayer over a three year period may be profitable in two of those years but incur losses in a particular year that are not related to transfer prices. The taxpayer could be subject to a reassessment in that particular year if the taxpayer uses the TNMM and the comparable companies are profitable, even though the taxpayer's results meets the arm's-length standard over the three-year period.

Although the CRA has a preference for using a single-year for comparative purposes, Canadian transfer pricing legislation provides opportunities for taxpayers to deviate from using a single year's comparative information. Subparagraph 247(4)(a)(vi) of the Act requires transfer pricing documentation to be complete and accurate and include the following:

> The assumptions, strategies, and policies, if any, that influenced the determination of the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, for the transaction.

7. See Ron I. Simkover, Transfer Pricing: Acceptable Arm's-length Prices within the Range, Canada Tax Foundation, 2002 Conference Report, Ch. 17.

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§12.03 LOCAL COUNTRY ADMINISTRATIVE PRACTICES

[A] Advanced Pricing Agreements

An APA is an agreement between the DGT, the taxpayers and the tax authority(ies) of another country(ies) to determine the pricing of transactions between related parties. The following regulations govern the APA process in Indonesia:

- Article 18 of the 1983 Income Tax Law;
- Government Regulation No. 80/2007 regarding the Implementation Procedures on Taxation Rights and Obligations based on General Tax Provisions and Procedures Law as amended by Government Regulation 74 of 2011;
- PER-69;
- Article 23 of PER-32; and
- PMK-7.

[1] APA Application Process

(a) *Preliminary evaluation:* The application, background information and documents submitted are subject to an initial evaluation by the DGT.

(b) *Analysis*: Once the necessary data is collected, selection and evaluation of the comparable transactions, assets employed, other adjustments, applicable methods, terms of agreement and other central factors follow.

(c) *Acceptance or Rejection of Agreement*: Upon the completion of required analyses, the DGT may accept the taxpayer's application as it is, may accept upon the condition that certain changes are made or reject the application.

(d) *Renewal of Agreement:* The taxpayer may request the renewal of an APA under the same terms upon its expiration. In this case, the taxpayer should apply to the DGT within 9 months prior to the expiration of the agreement.

(e) *Termination of Agreement:* If the DGT determines that the taxpayer's conduct is not in accordance with the terms of the agreement, or the conditions surrounding the agreement no longer apply, or information, assumption and documentation submitted by the taxpayer is incomplete, inaccurate or deceptive, the current agreement can be terminated by the DGT unilaterally and retroactively.

[2] Other Significant Provisions in the APA guidelines

(a) An APA is valid for a maximum of three years from when the APA is agreed. An APA that has expired after the original three-year term is subject to renewal upon approval from the authority;

(b) An APA can apply to tax years before the APA was agreed provided:
- The tax years to which the APA applies are clearly stated in the APA;
- No audit has been conducted for those years;

- No objection or appeal has been submitted by the taxpayer; and
- There is no indication of tax-related criminal activity.

(c) The taxpayer is required to submit an annual compliance report.

The development of an active APA program is to be encouraged as it would provide a useful way for taxpayers to achieve some certainty of treatment as far as transfer pricing is concerned.

[3] Types of APAs

(a) Unilateral (Taxpayer + One Tax Authority): Where the APA process in Country A does not involve or require agreement with the tax treaty partner or involves a country with which Country A does not have a taxation treaty, the arrangement between the taxpayer and the tax authority of Country A is referred to as a unilateral APA, as shown in Figure 12.05 below. A unilateral APA is concluded between the tax authority of Country A and a taxpayer under the tax authority's power of general administration of the income tax legislation but does not guarantee the agreement of the tax treaty partner(s).

(b) Bilateral (Taxpayer + Two Tax Authorities): A bilateral APA is an arrangement between the tax authority of Country A and a tax treaty partner concerning the transfer pricing of international related party dealings. It is concluded under the Mutual Agreement Procedure (MAP) Article of the relevant taxation treaty, as shown in Figure 12.06 below. A bilateral APA is binding on the tax authority of Country A and tax treaty partner and therefore provides certainty for taxpayers seeking to avoid double taxation. Each treaty partner confirms the terms of the APA in a letter or similar document with their resident taxpayer.

Figure 12.05 Unilateral APA

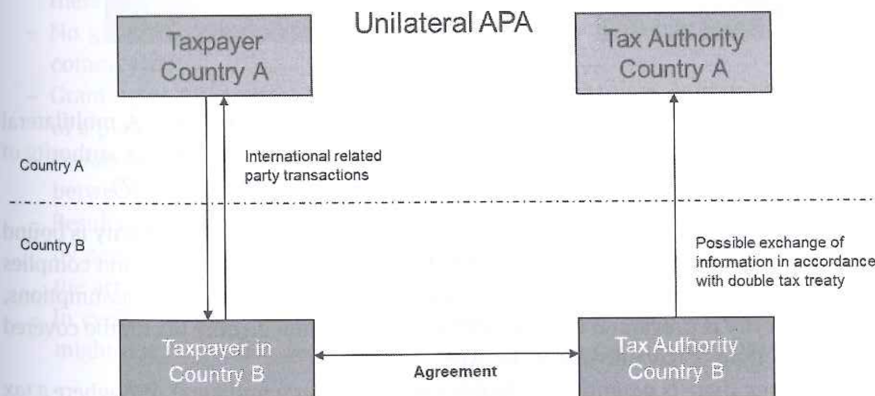

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Figure 12.06 Bilateral APA

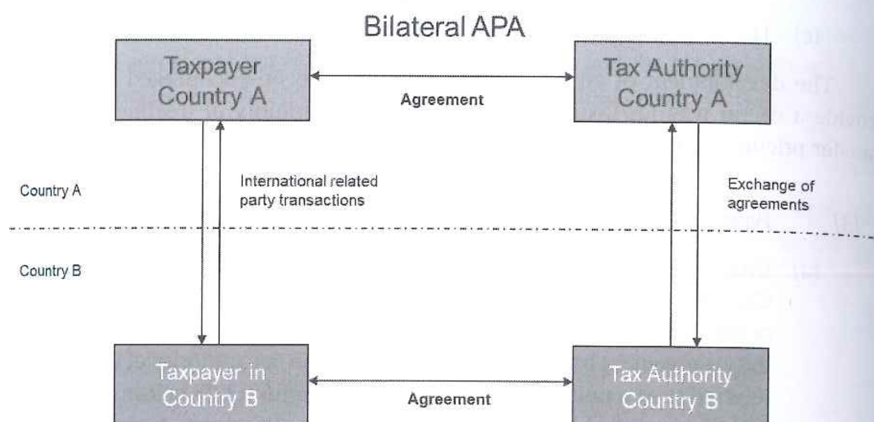
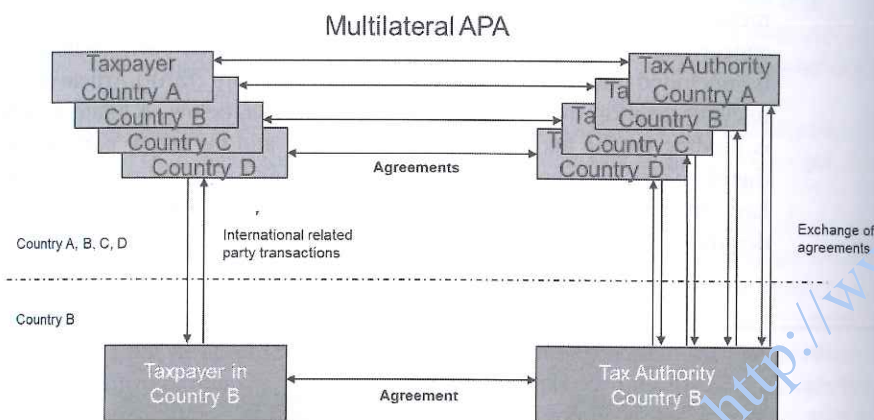


Figure 12.07 Multilateral APA



(c) Multilateral (Taxpayer + Three or More Tax Authorities): A multilateral APA is an arrangement between the relevant taxpayers, the tax authority of Country A and more than one tax treaty partner (Figure 12.07).

The general position is that once the APA comes into effect, the tax authority is bound by the terms of the APA. Therefore, provided that the taxpayer agrees to and complies with the terms of the APA, and there have been no breaches of the critical assumptions, the tax authority is prevented from imposing any additional income tax on the covered transactions than is payable under the APA.

However, there is potential for double taxation under a unilateral APA where a tax treaty partner forms a different view as to the application of the arm's-length principle to the transactions covered by the APA.

[4] *Advantage and Disadvantages of APAs*

The OECD Guidelines describe the possible advantages and disadvantages of APAs, but it is clear that each case should be viewed on its own merits.

[a] *Based on the OECD, the advantages of an APA include, among others:*[2]

- Cooperative instead of controversial atmosphere;
- Creates legal certainty;
- Increases planning security;
- Avoidance of legal conflicts;
- Reduction or avoidance of double taxation, and time- and cost-intensive audits;
- From tax authority perspective: deeper insight in business models of taxpayers; and
- Protection from penalties.

The multinationals and tax authorities through the tax avoidance instrument of an APA try to create a win-win situation, in most cases by balancing their conflicting interests. Multinationals strive for elimination of tax risks, while tax authorities strive to achieve more (upfront) certainty on future tax revenues.

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[b] *Based on the OECD Guidelines, the disadvantages of an APA include, among others:*[3]

- Risk of double taxation;
- No legal claim for adjustments by the other country;
- In case of unsuccessful APA negotiations, use of inside information by the tax authorities to launch transfer pricing audits;
- Costs for the APA procedures: human resources and financial costs may be burdensome;
- Not all countries are well equipped with staff, regulations and know-how;
- Limited reduction of the documentation burden by APAs in general: in many cases, there may only be a time difference;
- No guarantee of an agreement being reached once the application process is commenced;
- Granting of APAs might influence the market mechanism, introducing elements of a planned state economy;
- Dictation of prices by one or more countries versus autonomous price negotiations between independent parties;
- Results of APAs might diverge from the arm's-length principle, since deals reached by negotiation between MNEs and tax authorities may not still accurately reflect the arm's-length principle; and
- In cyclical markets and in economic downturns, the pricing clauses in an APA might not reflect the 'real economics'. In trying to capture a complex economic

2. Source: OECD Guidelines 2017 paras. 4.153 up to and including 4.157.
3. Source: OECD Guidelines 2017 paras. 4.158 up to and including 4.168.

process into an APA, this might limit the flexibility of either the MNEs or the tax authorities to adjust prices and margins in line with changes in the economic circumstances and/or changes in the business models of MNEs.

[B] Mutual Agreement Procedures

In the event that taxpayers do suffer double taxation as a result of a transfer pricing adjustment, the guidelines have specifically confirmed that it is possible to seek relief in accordance with the terms of the MAP article of the applicable double tax treaty. The following regulations govern the MAP process in Indonesia:

- PER-48; and
- PMK-240.

A MAP could be sought when there is an action of the contracting state that results or will result in taxation that is not in accordance with the provision of a tax treaty. In practice, a taxpayer could initiate a MAP procedure upon the issuance of notification of tax audit letter. Also, it is possible to initiate a MAP when the taxpayer is in the process of litigation (i.e., tax appeal/filing an objection) of the case against the tax authority in court. The taxpayers cannot seek MAP after the tax court has concluded the court proceedings.

Nevertheless, termination of MAP is possible if the tax court makes a decision on an appeal case. Regardless of whether or not the taxpayer requests a MAP, any MAP request does not postpone obligations of the taxpayer to pay the assessed tax if the taxpayers have received the notice of assessment. The DGT may also initiate a MAP if it finds it necessary to do so.

[1] MAP Application Process

(a) Initiation: The MAP can be filed and initiated by the following parties:
  - An Indonesian resident taxpayer through the DGT;
  - The DGT; or
  - The competent authority (CA) from a treaty partner country.

(b) Application and submission: Formal administration requirement and supporting documents for submission of an application letter in writing in Indonesian to the DGT must have been signed by the taxpayer or its legal representative.

(c) Evaluation: The taxpayer will be informed by the DGT in the case of submission of incomplete information and required to resubmit to the DGT for disposition in thirty days.

(d) Acceptance or rejection of the application: Upon the completion of required information, the DGT may accept the taxpayer's application, or reject the MAP application.

(e) Termination of a MAP: The DGT may decide to terminate or even to reject a MAP application due to the below events:
  - Taxpayer (the requestor) does not or cannot provide complete documentation or information requested by the DGT. Therefore, the DGT is not able to collect all of the documents required in order to conduct the consultation for MAP assessment;
  - MAP application submitted after the time limit;
  - The MAP will not result in an agreement based on the DGT's judgment;
  - Withdrawal of MAP application by taxpayer;
  - The Taxpayer, Citizen or related taxpayer or Permanent Establishment in Indonesia disagrees with the draft MAP agreement; or
  - The Tax Court issues its verdict on the tax dispute before the MAP is agreed.

[2] Competent Authority

According to PMK-240, the DGT is the CA that handles MAP applications for the Government of Indonesia. The division within the DGT responsible for MAP applications is the Director of Tax Regulation II.

[3] Other Significant Provisions in the MAP guidelines

(a) In the case where the related taxpayer is also proposing the same APA to the DGT, a MAP requested by a Treaty Country on APA can also be processed by the DGT.

(b) Regardless whether the taxpayers file an objection or apply for reduction or cancellation of the tax assessment, the DGT will amend the tax assessment letter in cases where the MAP results in a mutual agreement after the issuance of a tax assessment.

(c) Under PMK-240, the implementation of a MAP carried out through discussion with the tax authority in the tax treaty partner country may take a maximum period of three years commencing from the first discussion.

[4] Expectation from a successful MAP application

In the event of a successful MAP application, the DGT is to issue one of the following, but most likely will amend the following years' assessments, if any, provided that there are no significant changes in the taxpayer's business environment.

(a) Assessment letter from the DGT;
(b) Decree of revision of assessment letter;
(c) Decree of cancellation of assessment letter (in the case of cancelation); or
(d) Decree of tax penalty deduction/reduction.

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[5] *Disadvantage of MAP*

There are a number of potential problems with MAP:

- The process of seeking relief under MAP may be costly and time-consuming for taxpayers, as the amount of information and analysis requested by the DGT to assist in the MAP discussions with the opposing tax authority is likely to be significant.
- Transfer pricing adjustments may be made with respect to transactions with related parties in non-treaty countries, in which case MAP would not be available to that extent. There is no guarantee the DGT and the overseas tax authority will be able to reach an agreement that resolves the double taxation.
- Once an adjustment is made for one year of assessment, it often provides a precedent for future years of assessment, with the result that the taxpayer may ultimately be faced with multiple MAP procedures to deal with. So far, the DGT has limited experience in the conduct of MAP cases, so the MAP process is likely to take longer in practice and there may be difficulties encountered along the way.

§12.04 OTHER TRANSFER PRICING ISSUES

MoF Regulation 39/PMK.03/2017 (PMK-39) was issued on March 6, 2017 to govern the procedures on EOI based on International Agreements including the following:

- Bilateral and multilateral competent authority agreements (BCAA and MCAA);
- Tax Information Exchange Agreements;
- The Convention on Mutual Administrative Assistance in Tax Matters;
- Double taxation agreements;
- Intergovernmental agreements; and
- Other bilateral and multilateral agreements.

According to PMK-39, the implementation of EOI can be done by the way of a specific request, automatically or spontaneously submitted by the CA.

The introduction of PMK-39 indicates that DGT may request and have access to the financial-related information not only from Indonesian taxpayers but also from partner countries through the implementation of EOI. As such, taxpayers from various jurisdictions that belong to a global business group will be scrutinized strictly using a multi-jurisdictional approach by various tax authorities across the globe compared to the earlier one-sided jurisdictional approach.

§12.05 DETERMINING THE APPROPRIATE INTERCOMPANY PRICE

[A] Method Selection

Earlier, PMK-43 strictly required taxpayers to apply the Comparable Uncontrolled Price (CUP) method if at all possible, followed by the resale price (RP) method or the cost-plus (CP) method if possible, followed by the profit split (PS) method if possible, with the TNMM allowed as a method of last resort only.

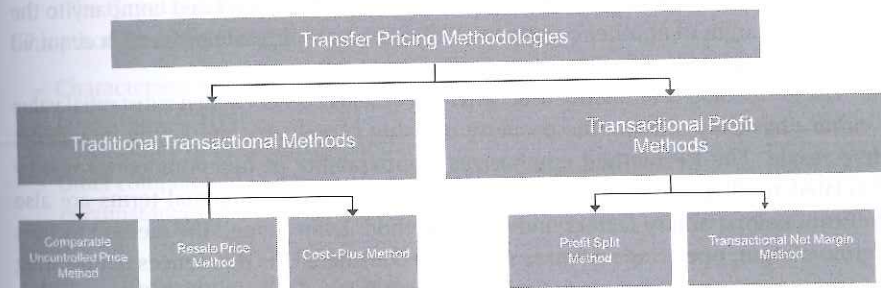
However, the PER-32 has abandoned this requirement and has adopted the most appropriate method approach, having regard to all relevant factors including:

- The strengths and weaknesses of the methods;
- The appropriateness of the method, considering the nature of a controlled transaction, which is determined in particular through a functional analysis;
- The availability of reliable information; and
- The degree of comparability between controlled transactions and uncontrolled transactions, including the consideration of the possibility and accuracy of adjustments that could be made to eliminate material differences identified.

However, taxpayers may have been applying the TNMM on a whole of entity basis with little attempt to apply other more direct methodologies, which would not be acceptable to the DGT. In practice, tax auditors have been arguably too keen to apply the CUP or RP/CP methods using internal data, for example, when the third-party transactions are clearly significantly different, such as type or quality of product or significant functional differences, so that any number of attempted adjustments is unable to produce a reasonable and reliable standard of comparability.

Taxpayers are therefore advised to consider each related party transaction separately at first, and consider each transfer pricing methodology in detail. Detailed reasons should be provided in the transfer pricing documentation for the rejection of methods (Figure 12.08).

Figure 12.08 Summary of Transfer Pricing Methodologies in Indonesia



[1] *Comparable Uncontrolled Price*

The CUP method "compares the price 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."[4] Comparability requires that there be no differences that would materially affect the open market price, or that

4. Source: OECD Guidelines 2017 Para. 2.13.

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reasonably accurate adjustments can be made to reflect any differences between the controlled and uncontrolled transactions.

The Circular Letter SE-50 provides the following considerations prior to selecting CUP method in performing the comparability analysis for both direct and indirect comparison:

- Characteristics of goods or services;
- Functional analysis; and
- Other comparability factors (e.g., contractual terms, business strategy and economic circumstances).

The Circular Letter SE-50 acknowledges the extent and reliability of the necessary quantitative adjustments will affect the relative reliability of the CUP analysis.

[2] RP Method

The RP method is "based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is then reduced by the appropriate resale price margin [. . .]. What is left after subtracting the resale price margin from the resale price can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated enterprises."[5]

In essence, the RP method determines an arm's-length price for the sale of tangible property by reference to the gross profit margin realized in comparable transactions between unrelated companies. The method compares the gross profit of a reseller on its resale to an unrelated company of property it acquired from a related company to the gross profit margin of another company on that company's resale property it acquired and sold to unrelated companies.

The RP method is ordinarily used when the reseller has not added substantial value by either physically altering the property or using its valuable marketing intangibles before resale. The RP method emphasizes comparability of functions performed by the related reseller and the unrelated reseller. Risks and contractual terms are also significant comparability factors under this method. Even though the method focuses on gross margin, operating expenses should be considered, as differences in operating expenses may reflect differences in functions performed and risk assumed. Comparability is less dependent on physical similarity of property than it is under the CUP method but substantial differences in property may indicate significant differences in functions performed.

The Circular Letter SE-50 provides the following considerations prior to selecting RP method in performing the comparability analysis:

- Characteristics of goods or services;
- Functional analysis;
- Consistency of accounting standards;

5. Source: OECD Guidelines 2017 Para. 2.27.

- Significant value(s) added on product;
- Possible intangible(s) created;
- Exclusive rights; and
- Other comparability factors (e.g., contractual terms, business strategy and economic circumstances).

[3] CP Method

The CP method "uses the costs incurred by the supplier of property or services in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction. This method probably is most useful where semi-finished goods are sold between associated parties, where associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements or where the controlled transaction is the provision of services."[6]

Comparability under the CP method requires that no differences exist that would materially affect the CP markup in the open market or that reasonably accurate adjustments can be made to reflect any differences. The method focuses on the circumstances of the transaction and does not require that the property or services being sold in the uncontrolled transactions be essentially identical to the property or services in the controlled transaction. The extent and reliability of the adjustments will affect the relative reliability of the analysis.

The Circular Letter SE-50 provides the following considerations prior to selecting CP method in performing the comparability analysis:

- Characteristics of goods or services;
- Functional analysis;
- Consistency of accounting standards;
- Other comparability factors (e.g., contractual terms, business strategy and economic circumstances).

[4] Transactional PS Method

The PS method "identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged then splits those combined profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length."[7] The contribution of each entity is determined by performing a functional analysis and valued by reference to reliable external market data.

6. Source: OECD Guidelines 2017 Para. 2.45.
7. Source: OECD Guidelines 2017 Para. 2.114.

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The Circular Letter SE-50 introduces procedural steps for selecting PS method as comparability analysis as below:

- Combine net profits of related parties as one whole entity;
- Determine simple functions and unique functions of each related party that contribute to net income;
- Identify availability of external data for simple functions carried out by each related party without considering the unique functions;
- Carry out a weighting of the simple function without considering the unique functions to determine the PS percentage for each related party;
- Allocate the residual profit based on the contribution of each related party; and
- Determine the arm's-length profit.

[5] Transactional Net Margin Method

The TNMM "examines the net profit margin relative to an appropriate base (e.g., costs, sales and assets) that a taxpayer realizes from a controlled transaction. The net margin should ideally be established with reference to the margins achieved in comparable uncontrolled transactions. Where it is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise may serve as a guide."[8]

The Circular Letter SE-50 introduces procedural steps for selecting TNMM as comparability analysis as below:

- Enhance the comparability analysis through search criteria and manual selection, multiple-year data and transactional or aggregated approach; and
- Select the most appropriate Profit Level Indicator (PLI).

The table below introduces the PLIs recognized under the PER-22 in the application of the arm's-length principle:

Profit Level Indicator	*Definition*
Gross margin	[Gross profit/sales] × 100%
Gross markup	[Gross profit/cost of goods sold] × 100%
Return on sales/Operating margin	[Operating profit/sales] × 100%
Return on total cost/Net CP markup	[Operating profit/(cost of goods sold + operating expenses)] × 100%
Return on assets	[Operating profit/Total Operating Asset] × 100%
Return on capital employed (ROCE)	[Operating profit/(average total assets less cash and cash equivalents less current liabilities)] × 100%
Berry ratio	[(Sales − cost of sales)/operating expenses]

8. Source: OECD Guidelines 2017 Para. 2.64.

[B] Comparability Factors

The PER-32 outlines five key comparability factors that should be taken in to account when applying transfer pricing methods as below.

[1] Characteristics of Property or Services

Differences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market. Therefore, comparisons of these features are relevant in determining the comparability of controlled and uncontrolled transactions. In general, similarity in the characteristics of the property or services transferred is most relevant when comparing prices (e.g., using a CUP method) and less when comparing gross and operating margins.

[2] Functional Analysis

In transactions between two independent parties, the compensation typically reflects the functions performed, risks assumed and resources employed by each party. An evaluation of the degree of comparability between controlled and uncontrolled transactions, therefore, requires a "functional analysis" which examines the economically significant activities undertaken by the parties to the transaction, and considers the risks assumed and resources employed in conjunction with performing those activities. The functions carried out (taking into account the risks assumed and assets used) will determine, to some extent, the allocation of risks between the parties, and, therefore, the conditions each party would expect in an arm's-length transaction.

Generally, the functions that should be identified and compared include: design, manufacturing, assembling, research and development (R&D), servicing, purchasing, distribution, marketing, advertising, transportation, financing and management. Risks that should be considered in every functional analysis include: market risk (e.g., input cost and output price fluctuations), risks of loss associated with the investment in and use of assets, risks associated with the success or failure of investments in R&D; financial risks (e.g., fluctuations in the foreign currency rates of exchange and interest rates), credit risks.

Factors pertaining to the resources employed include: (i) the type of assets used (e.g., plant and equipment); (ii) the use of valuable intangibles; and (iii) the nature (e.g., age, market value, location, property right protections available) of the assets used.

[3] Contractual Terms

Between independent parties, contractual terms normally define how responsibilities, risks and benefits are allocated. Related parties have a similar need to govern their relationship and it is therefore relevant to examine contractual terms. This will often be part of the functional analysis, in particular in respect of risks.

Sources of information concerning contractual terms include written contracts, correspondence between the parties and actual conduct of the parties. An example of

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actual conduct of the parties that can reveal contractual terms is the currency used for invoicing—that will generally determine who bears the currency risk.

[4] *Economic Circumstances*

Because arm's-length prices may vary across different markets even for transactions involving the same property or services, one comparability factor is "economic circumstances."

Therefore, to achieve comparability for transfer pricing purposes requires that the markets in which the independent and associated enterprises operate are comparable and that differences do not have a material effect on price or that appropriate adjustments can be made.

In the Asian market, in contrast to Western Europe, there are significant differences between developed economies such as Japan and Australia with developing economies including Indonesia, Thailand and China.

[5] *Business Strategies*

Business strategies are also relevant in determining comparability because they can have a significant impact on, for example, pricing. Companies selling the same products have the option to pursue a variety of strategies in order to position themselves in the market. For example, one company might opt for competing on price in order to gain market share, whereas another company would opt to provide additional services or warranty on a similar technical product and perhaps even spend money on establishing a brand name and/or gain market share in order to be able to achieve a price premium.

Business strategies can take into account many aspects of a company, including: innovation and new product development, degree of diversification, risk aversion, assessment of political changes, alliances, the choice of channels to the market place.

One business strategy that is extensively addressed in transfer pricing regulations is the market penetration strategy. A multinational that is seeking to enter a market or to defend or increase its market share might temporarily lower its prices or incur higher marketing expenditure.

Whether or not a market penetration strategy is reflected in the transfer price depends on which party in the intercompany transaction bears the costs of the pricing strategy. In any case, the effect of a market penetration strategy on an intercompany transaction will be taken into account only if it can be shown that an unrelated party is engaged in a comparable strategy under comparable circumstances for a comparable period of time, and the taxpayer provides documentation that substantiates the following:

- The costs incurred to implement the market penetration strategy are borne by the related party that would obtain the future profits that result from the strategy, and there is a reasonable likelihood that the strategy will result in future profits that reflect an appropriate return in relation to the costs incurred to implement it;
- The market penetration strategy is pursued only for a period of time that is reasonable, taking into consideration the industry and product in question; and

- The market penetration strategy, the related costs and expected returns, and any agreement between the controlled taxpayers to share the related costs, were established before the strategy was implemented.

[C] Comparables Selection

[1] *Internal Comparables*

Under the PER-32, taxpayers must make every attempt to identify comparable transactions with third parties from internal sources, as these are recognized by the DGT as the most reliable sources of information. If the internal data is not available, information from external sources may be used.

In an application of any methodology, it is recognized that internal data is likely to be the most reliable source of information, if such data is found to exist. However, for many multinationals, the nature and terms of transactions entered into with related parties differ significantly to the nature and terms of transactions with third parties, such that adjustments are not possible to be made to enable the use of the transactions with third parties to benchmark the related party transactions.

[2] *External Comparables*

Both the Circular Letter SE-50 and PER-32 acknowledge that external comparables could be used if such comparables sufficiently satisfy the comparability factors stipulated in the PER-32, provided that it is not possible to identify any internal comparables. If it is necessary to carry out a benchmarking study using external comparables, taxpayers need to search for independent comparable companies operating in Indonesia.

[3] *Foreign Comparables*

If it is not possible to identify sufficient comparables of reasonable quality solely from the Indonesian market, the ASEAN region and then the broader Asian region (possibly excluding Japan and Korea) may be considered. In any case, simple reliance on European or US benchmarks is not an acceptable approach unless it can be shown that an extensive search of the financial databases for Indonesian or ASEAN/Asian companies yields no or insufficient numbers of independent and reasonably comparable companies.

However, the application of external foreign comparables has triggered comparability issues which led to challenges from the DGT.

[4] *Secret Comparables*

The DGT has a database of secret comparables that it has obtained through tax return data. In the event of a tax audit, in the absence of internal comparables, the DGT has used these secret comparables to raise audit adjustments, even though the OECD Guidelines 2017 states at paragraph 3.36 that this practice is unfair to taxpayers:

> "Tax administrators may have information available to them from examinations of other taxpayers or from other sources of information that may not be disclosed

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to the taxpayer. However, it would be unfair to apply a transfer pricing method on the basis of such data unless the tax administration was able, within the limits of domestic confidentiality requirements, to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard judicial control by the courts."

The DGT has issued several regulations relating to benchmarking based on the secret comparables obtained from the tax return data. These benchmarking regulations are classified based on the type of industry and include a number of PLIs.

It is mentioned that these benchmarking ratios may be used by the DGT to monitor the taxpayer's performance and to assist the DGT in the selection of taxpayers for investigation. However, they should not be confused with a real benchmark for transfer pricing adjustment purposes.

[5] *Database*

Once a pricing methodology is chosen, the arm's-length prices and/or margins need to be determined for new transactions and/or validated for existing transactions. To do this it is necessary to look for quantitative reference material, which could assist the multinational in determining the most appropriate level of compensation to the group companies involved in the specific intragroup transaction.

Both the PER-22 and PER-32 acknowledge that external comparables sourced could be collected from domestic or foreign publicly available data, commercial databases and other databases, provided that the comparables from these databases are publicly assessable and satisfy the comparability factors.

A major deficiency in the use of databases, so far, has been the presentation of the results of a database search without (a) proper industry analysis, (b) an adequate design of a transfer pricing system and its implementation and (c) some level of documentation of what each of the group companies is actually doing (i.e., functional analysis description).

[6] *Timing in Carrying Out the Comparability Analysis*

There is no specific guidance or provision provided in Indonesia in particular to the timing in carrying out the comparability analysis. However, PMK-213 stipulates the requirement of preparing and documenting transfer pricing documentation based on the data and information that are available when the transaction is executed. The taxpayer is expected to have a robust transfer pricing documentation on a contemporaneous basis and use an ex-ante perspective based on comparable data that is available before or during transactions.

Clearly, the taxpayer should take note that the ex-ante price-setting approach (i.e., prior to the beginning of a new financial year/prior to entering any related party transactions) is always being positioned as a more prudent approach as compared to price-checking approach (i.e., during the relevant financial year/after entering any related party transactions).

While the PMK-213 requires the taxpayer to prepare a "Statement Letter," to be signed by the preparer of the transfer pricing documentation, to declare when the

transfer pricing reports were "available," the taxpayer is also required to submit an additional form along with the tax return—this form requires the taxpayer to confirm whether the Master File and Local File contain the required elements, and the date on which each of these reports were available, as declared on the Statement Letter.

§12.06 SIGNIFICANT TRANSFER PRICING LITIGATION

The Indonesian transfer pricing landscape has witnessed a tremendous makeover since 2009. Although the DGT has introduced an aggressive program of transfer pricing scrutiny, recently there has been decrease in the number of tax disputes filed for resolution in the Tax Court in 2017 by 5.6% (i.e., 9,579 applications) compared to the number of tax dispute applications in 2016 (i.e., 10,153 applications).[9]

Indonesia has a self-assessment system under which the taxpayer is required to calculate, pay and report their own taxes in accordance with prevailing tax laws and regulations. As such, in a tax audit context, the burden of proof lies with the taxpayer to prove that the related party transactions have been priced on an arm's-length basis.

[1] *Transfer Pricing Audit—The DGT*

During the audit process, the taxpayer being audited is required to provide documents and information (e.g., transfer pricing documentation) requested by the tax auditors within one month of the request letter date. The tax audits may be conducted through desk or field reviews by the tax authorities.

At the end of a tax audit, the tax auditors will issue to the taxpayer a written notification of the tax audit findings containing their proposed tax audit adjustments. In the case of disagreement regarding the tax audit findings, the taxpayer must respond to the notification in writing within seven working days and also to attend a closing conference with the tax auditors as a final discussion to conclude the case.

Further to the disagreement with the letter of Final Discussion Audit Result on the tax assessment decided by the tax auditors, the taxpayer is to submit the Objection letter to the DGT within three months from the date of issue of the assessment letter. The DGT must issue a decision on the objection within twelve months of the filing date of the objection by the taxpayer. If no decision is issued by the DGT within twelve months, the objection is automatically deemed approved by the DGT.

[2] *Tax Court*

The taxpayer who does not accept the DGT's decision can file an appeal with the tax court within three months of the receipt of the DGT's objection decision. The tax court will typically decide on an appeal within twelve months. Nevertheless, there is no consequence stipulated in the regulations when the time line of twelve months has elapsed.

9. Direktorat Jenderal Pajak Kementerian Keuangan – Statistik "Hasil Penyelesaian Sengketa 2012–2017 dan Jumlah Berkas Masuk 2012–2017."

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[3] Supreme Court

Upon a tax court decision, it is considered to be a final decision with full legal force. However, a taxpayer who is not satisfied with the tax court decision may further seek judicial review of a transfer pricing adjustment in the Supreme Court. Such judicial review request must be made by the taxpayer within three months from the tax court decision. The Supreme Court will typically decide on an appeal within six months. Nevertheless, there is no consequence stipulated in the regulations when the time line of six months has elapsed.

[4] Litigation Cases

The following cases are some examples for the taxpayer to consider on the fundamental aspects of transfer pricing legislation and its implementation. It is worth nothing that there are many cases whereby the courts decide in favor of the taxpayer. Other than the Indonesia regulations and guidelines, OECD Guidelines are widely being referred to in the court as part of the defense in any law cases.

[A] Putusan Pengadilan Pajak Nomor: Put-46787/PP/M.IV/15/2013

The tax authority conducted an audit on an Indonesian resident taxpayer with business operations, classified as a full-fledged manufacturer under two distinct business units. The case was focused on the application of the TNMM for segmented income statement to determine the arm's-length price.

Since the taxpayer's financial statements submitted were not prepared on a segmented basis, the tax authority produced the profit margin of the taxpayer from a company-wide basis. This resulted in the taxpayer's profit margin to fall below the arm's-length range obtained from a search carried out by the DGT of the BvD ORIANA database.

The taxpayer subsequently managed to produce an internal segmented income statement clearly differentiating the two distinct business units from each other—different functions, assets and risks and, as such, argued that it was not valid for the tax authority to consolidate both business units as a whole for the purpose of this case.

The panel of judges called for the decision that the application of the TNMM for segmented income statement to determine the arm's-length price was justified and that the adjustment proposed by the tax authority was therefore not upheld. Also, the panel of judges made reference to paragraph 2.84 of the OECD Guidelines 2017 for the consideration of the reality that the taxpayer operated its business operations under two distinct business units.

[B] Putusan Pengadilan Pajak Nomor: Put-65598/PP/M.IIIB/15/2015

The case focused on the selection of comparables by the DGT. The Indonesian taxpayer is a subsidiary of a Swedish-based multinational company that is engaged in the manufacturing and distribution of industrial steel and in assembly work and providing services. The taxpayer entered into multiple sales transactions with related party companies and the tax authority challenged the profitability of the taxpayer on the basis that the sales transactions were mispriced.

The taxpayer selected a total of seven comparable in its transfer pricing documentation but the tax authority only selected one comparable company (more profitable) in its TNMM analysis. The taxpayer argued that a single comparable in a TNMM analysis is not practically possible, and quoted support from comments in paragraph 3.43 of the OECD Guidelines which state that quantitative and qualitative criteria should be used to include or reject potential comparables.

The tax court concurred with the taxpayer's arguments and decided in favor of the taxpayer on the basis that the use of a single comparable implies that the comparable must be perfect, and there is no such thing as a perfect comparable in transfer pricing.

[C] Putusan Pengadilan Pajak Nomor: Put-63637/PP/M.XIA/15/2015

The case focused on the application of an appropriate transfer pricing method for a related-party transaction, involving a member company of a Japanese-based multinational manufacturing consumer electronic products. The tax authority challenged the application of TNMM by the taxpayer and used the CPM for the transfer pricing analysis for the financial year 2008.

In addition, the tax authority used reference materials available at the time of the dispute although the dispute was related to 2008. In this case, the panel of judges stated that the later reference materials were valid under the principle of "lex posterior derogate legi priori" (a later law repeals an earlier law).

The taxpayer further argued that subsequent interpretation materials issued by the OECD Guidelines to the effect that the application of CPM is difficult due to the comparability issues should also be taken into consideration. Also, the taxpayer further convinced the tax court that CPM was not the appropriate method by presenting other countries' experience of the CPM to the tax court.

During the audit and objection stage, the taxpayer documented that its entity characterization was a contract manufacturer. However, the taxpayer changed its position and stated that it should be characterized as a full-fledged manufacturer in the tax hearing process.

Subsequently, the tax court decided to accept this change and agreed with the taxpayer's method to be used—the TNMM.

§12.07 LIST OF ABBREVIATIONS

APA	Advance Pricing Agreement
BCAA	Bilateral Competent Authority Agreement
BEPS	Base Erosion and Profit Shifting
CA	Competent Authority
CBC	Country-by-Country
CFO	Chief Financial Officers
Circular Letter SE-50	DGT Circular Letter SE-50/PJ/2013
CP	Cost Plus

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