follow-up question 'who was next to legislate on transfer pricing?' is still not the United States of America, we now turn to define the issue of transfer pricing.

DEFINING THE ISSUE

1.12 When two (or more) related companies trade with one another, the price agreed between them is typically referred to as a 'transfer price'. There is a concern amongst governments that, due to the special relationship between related parties, the transfer price might be different from the price that would have been agreed between two unrelated parties. Whilst the overall pre-tax profit realised by the MNE on a global basis remains unchanged, the use, by accident or design, of non-arm's-length pricing could lead to different profit being recognised in each country than would have happened if the parties were not related to each other.

1.13 Why might this matter? Put simply, because there is no single global tax system. It is often said that different tax rates and rules between states provide a perceived incentive for MNEs to manipulate their transfer prices. Recognising lower profits in one jurisdiction (the one with the higher tax rate) will reduce the total tax burden on the MNE, as compared to the position between unrelated parties, which means that the MNE will have more resources available to compete, or to return to its shareholders. In the absence of a rule, there is little or no incentive for businesses to focus attention on their inter-company prices beyond what they need to run their business. All tax authorities are concerned with the protection of their tax receipts, within the laws that are enacted in their country, so transfer pricing has developed as the means by which a tax authority can both require and check that a fair amount of profit is declared for taxation in their country, commensurate with the activities undertaken and assets owned by a business in that country.

1.14 It is fair to say that there was a time when the countries with transfer-pricing rules were few in number and these rules were based on anti-avoidance measures rather than self-assessment. However, times have changed.

1.15 In the mid- to late twentieth century, many MNEs appeared to be relatively indifferent about the legal entity or country in which they recognised profit. Whilst there have been some examples of deliberate manipulation, the matter of profit location generally received genuine inattention. MNEs were managed by their board on the basis of what would now be called the profit-before-tax line of the accounts on a global basis and not by reference to earnings per share (which includes the effect of taxes paid) or by reference to individual entity profitability. The legal entity in which profit before tax arose was of little (or no) consequence to the commercial team; the key question was whether a particular product or product line was both profitable and contributing to the group's overall level of profitability.

1.16 Tax authorities, however, take a very different view as they want to see the global profits split by country on a fair basis; as a result, transfer-pricing rules the world over apply to individual legal entities. The rules are

applied to ensure that, where there is profit-generating activity in a territory, an appropriate return on that activity is subject to tax.

1.17 By the end of the twentieth century, management focus had moved on and businesses were managed by reference to earnings per share. Taxation took a place at the boardroom table and in business planning discussions. MNEs began to manage themselves by looking at the after-tax return and differing corporate tax rates concentrated the attention of management on the question of where to locate activities, risks and assets. Businesses change constantly, and locating value-generating functions and risks in a higher tax rate jurisdiction will mean that the associated profit is both recognised and taxed at a higher rate. This reduces earnings per share, which in turn may have negative consequences for an MNE's share price, or its ability to compete. Locating those same functions and risks in a lower-tax rate jurisdiction will have the opposite effect. MNEs may be in a position to consider carefully where to locate functions, assets and risks and choose (all other factors such as local costs, skills, language, legal protection etc being equal) to locate in lower-tax rate jurisdictions. This can lead to an outflow of functions and risks from high tax rate countries and into low tax rate countries together with the associated jobs, personal taxation, etc.

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

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

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

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

ensures single taxation while protecting against double taxation. To do so would require at least the following:

- global agreement to use the method in the first place;
- global agreement on how to measure the global tax base of an MNE group;
- global use of a common accounting system; and
- global agreement on the apportionment formula(e), including the weighting of the various constituent parts.

Without these it would be impossible, should one country make a transfer-pricing adjustment, to tell who was the counterparty and who, as a result, should give a corresponding adjustment. There might indeed be a number of possible counterparties, all of whom might be candidates for giving some measure of relief.

2.17 Likewise, without a broad consensus on how to apply the method, one could imagine taxable profits dropping quietly between the cracks of one country's interpretation and another's, thus rendering the idea impotent in dealing with the very matter for which currently it is being actively promoted by some – the elimination of non-taxation of MNE profits.

2.18 It is worth noting that global formulary apportionment has a certain superficial attractiveness. There are, however, issues; differences in accounting systems (movement towards international accounting standards might offer an answer here) and measuring the global tax base. Perhaps the real point is that a broad international consensus is needed to preserve the benefits of fair, single taxation and no double taxation. The arm's-length principle has achieved that consensus where nothing else has.

2.19 It is worth pausing to consider how easy it would be to succumb to the superficial attractiveness of global formulary apportionment. An approach sometimes put forward is 'contribution analysis'. The idea behind this approach is that it is possible to look at each aspect of the business and to assign a profitability to it, such that the entire profit of the enterprise is allocated to each part of the business. Though it is possible to undertake this exercise whilst abiding by the arm's-length principle – by analysing profit contribution by reference to third-party activities and profits – the analysis is sometimes undertaken in the form of a purely econometric exercise which applies human judgement and economic theory to allocate profit to different parts of the enterprise. Without reference to the actions and profits of third parties, with due comparability, the fundamental requirement of the arm's-length principle is not met. (Note that contribution analysis can, with appropriate reference to third-party actions and profits, form part of the work in a profit split approach, as described in the Guidelines at paras 2.119–2.120.)

2.20 It is possible that a purely econometric approach to contribution analysis might have a place in some transfer-pricing circumstances (eg a bilateral advance pricing agreement (APA), where both tax authorities and the taxpayer agree that there is no potentially comparable data and that a departure

from the arm's-length principle is required), if the transfer-pricing law of both territories will accommodate such a departure. However, without the explicit agreement of all potentially interested parties, this is a dangerous road to walk.

SETTING PRICES VERSUS TESTING PRICES

2.21 It remains a mystery to the author why there is any doubt on this point at all, but doubt there is in the minds of some. Often one reads of, or hears, assertions that 'the OECD Guidelines require associated companies to set prices in the way they would have been agreed upon by independent parties acting at arm's length'. They do not. The OECD Guidelines do not tell businesses how to set their transfer prices. OECD pricing methodologies are there to test, for tax purposes only, the outcome of MNEs' pricing policies. The commentary on Article 9(1) of the Treaty (quoted in **2.2** above) says this clearly enough:

> '... its paragraph 1 provides that in such cases the taxation authorities of a Contracting State may *for the purpose of calculating tax liabilities* ...' (emphasis added)

This does not mean that hindsight can be used by tax authorities or MNEs. Transfer prices frequently will be determined ahead of time by reference to best available forecasts; this is fine, and it is not appropriate to require transfer-pricing adjustments computed in the light of actual, unforeseen (later) events.

2.22 Perhaps the mistake arises because, in many instances, MNEs do indeed use OECD methodologies to calculate their transfer prices ahead of time – the idea being that conformity with OECD principles at the price-setting and planning stage is a sensible way of ensuring (as far as possible) conformity with OECD principles at the tax return filing and subsequent tax authority audit stage. There are advantages to this approach. For example, in most jurisdictions transfer-pricing adjustment of a tax return is possible only to increase the tax due. Failure to trade with an associated business using arm's-length prices would lead to an imbalance of profit between them, and only the under-rewarded business might be able/required to adjust its tax return. The over-rewarded business might be required to pay tax based on the excess profit that it has reported in its accounts, leading to double taxation of the group which would be dealt with through a claim for relief, if available, under an appropriate bilateral Double Taxation Agreement or a multilateral convention such as the EU Arbitration Convention. The cost and time required to pursue such a claim can be avoided by trading at arm's-length prices in the first place and thereby not suffering a transfer-pricing adjustment at all.

2.23 So, in summary, it really does not matter how prices have been set – the MNE may have just 'guessed' a price (although we certainly do not recommend that as a course of action!); what we test is the price and, if the MNE was 'lucky' and chose the correct arm's-length price, there is no transfer-pricing adjustment. Although many intra-group services are priced on a cost-plus basis, and software licence rates are set by reference to comparable uncontrolled prices, and so forth, this does not alter the fact that MNEs have considerable

transaction. This is a subject to which we will return in Chapter 6, where we consider the transfer pricing of intangibles.

2.43 Finally on this subject, one of the key parts of the recent Australian judgment in *Chevron Australia Holdings Pty Ltd v COT (No 4)* [2015] FCA 1092 concerned the interpretation of 'consideration' in the Australian transfer-pricing legislation, specifically whether the consideration given by the company for the funds borrowed could be taken to encapsulate more than just the price (ie the interest rate). The Australian court found that adjustments can be made to other factors in the loan terms (such as security and financial covenants) which have an impact on the arm's-length pricing of the loan. The finding that such other factors would have been present in the *Chevron* case meant, in that case, that the interest rate applied was deemed excessive when considering what would have been agreed between independent parties dealing at arm's length.

2.44 This could have important consequences for multinational corporations (MNCs) when analysing whether their internal financing arrangements are 'at arm's length', and the idea is certainly not limited to financing transactions. It also re-emphasises the importance of finding appropriate comparables, bearing in mind all factors considered in arriving at the terms of a loan. We await the output from the OECD on the transfer-pricing aspects of Action 4, due at the end of 2016, to see whether a similar approach is adopted for the revised OECD Guidelines. It will also be interesting to see whether commentary is forthcoming on the question of whether the approach taken in *Chevron*, to effectively 're-write' some of the terms of the loans to arrive at an arm's-length pricing, is simply re-pricing (as found in that case) as distinguished from re-characterisation.

Evaluation of separate and combined transactions

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

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

Use of arm's-length range

2.47 This is a familiar concept, supported by observation, common sense and the Guidelines (see paras 3.55–3.59). A range of arm's-length prices generally exists because inefficiencies in the market, good and bad deals and a variety of other factors mean that competitors in the same market do not generally have the same price or the same profit. There is simply no single 'right price'.

2.48 The Guidelines are clear: where a taxpayer's pricing is within range there should be no adjustment (see para 3.60). Where pricing is outside the range and cannot be justified on the grounds of special circumstances, then the recommendation in the Guidelines is to adjust to the most appropriate part of the range. There is a compelling argument to move to the upper or lower reach of a consistently reliable range, whichever is nearer. However, local transfer-pricing law or customary practice may provide differently.

Multiple year data

2.49 Again it is standard practice and common sense (but not a systematic requirement) to look at the position over a number of years before concluding that any given result is out of line. Reviewing performance over a number of years gives insight into market and product cycles, launches and other exceptional circumstances and allows a view to be taken on profitability on the contract over time.

Losses

2.50 An independent enterprise would be incapable of sustaining losses forever, but independent data shows that there can be circumstances in which losses are sustained for a number of years. An associated enterprise will often find its transfer-pricing policy under scrutiny if it is consistently making a loss, particularly where the group as a whole is making a profit. If the losses arise because of an obligation to make or sell all group products, even though some are incapable of realising profits in that market, then this arguably may be a service provided to the group (or to particular members of it) requiring compensation by way of a service fee. This argument has often been used in the United Kingdom, where it is not unusual to find distributors returning

bearing full risk exposures and using internally developed product intangible property (Figure 3.1B). From a transfer pricing perspective, the amount of profit to be allocated to the manufacturer depends on the operational model employed by the multinational group, in other words, how the multinational conducts its business between the various group companies, sharing functions and risk between them. The analysis of functions, risks and assets to answer this question is called a 'functional analysis'. This process is fundamental to transfer pricing. A functional analysis provides the information for determining the tested party and provides the information on comparability for the selection of evidence of third-party transactions from which the arm's length nature of inter-company prices can be tested. This can be illustrated by considering the position for the type of manufacturing entity at each end of the spectrum, starting with the operation which adds least value.

Contract or toll manufacturer

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

3.13 The level of reward would be driven by the functions, assets and limited risks borne by the contract manufacturer and would reflect the depreciation of fixed assets employed. These are, in effect, the opportunity costs of providing the contracted service. In testing, or indeed setting, the price to be charged by such a manufacturer – and so the reward that it makes – the most likely approach is a benchmarking exercise in which comparison is drawn between the return on costs achieved by the group company and that of a sample of independent, but otherwise comparable, manufacturing companies operating (as far as data availability permits) in the same territory. Care does need to be taken in assembling and using such samples because publicly available data rarely discloses the nature of the relevant contractual arrangements. There will, as a result, always be some doubt as to whether

like is being compared with like. One answer lies in making adjustments in respect of relevant items such as inventory carried, capital employed, debtor days and such like so that, for example, where the group company is a toll manufacturer, all risk and expense related to inventory ownership is factored out of the comparable set.

Complex manufacturer

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

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

Centralised business model

3.16 On occasions, both manufacturing and sales companies will be regarded as 'complex'. That is set out in Figure 3.1C above. We can use both of the methodologies applied to Figure 3.1A and C to reward both the manufacturing and sales entities to leave an appropriate reward (the residual profit or loss) for the entrepreneur. We look at how to proceed in such cases at **3.38** below.

3.17 Where different manufacturing plants undertake different stages of the manufacturing, or finishing and packing are carried out by the reseller, the situation becomes more complicated. It is important to conduct a comprehensive functional analysis to ascertain the correct transfer pricing method to be used in the benchmarking process.

indeed to set, prices? Must the charge be made directly, or are indirect methods permissible? Each of these is discussed in turn in the sections which follow.

4.16 Further, according to paragraph 7.29 of the Guidelines, the arm's-length nature of the consideration has to be considered from the viewpoint of both provider and recipient.

What OECD method?

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

4.18 CUPs are relatively rare as there are generally no requirements for the public filing of service agreements. Unless the company also performs similar services for, or purchases similar services from, unrelated parties, it is difficult to use the CUP method to benchmark services. CUPs tend to pop up in specific areas such as debt factoring, where there is a wealth of information available (eg on the internet) and there is a reasonable degree of comparability between third-party and in-house infrastructures. This latter point on infrastructure is very important when proposing the use of, or examining, apparent CUPs in areas such as management consultancy and tax advice. While it is possible to obtain details of hourly or daily rates, these can vary wildly depending on the structure of the organisation providing services. Factors such as layers of delegation and quality control, the need to obtain new business, training, downtime, risk of litigation, guaranteed utilisation and so forth are all potential differentiating factors to be taken into account. Nonetheless, it is sometimes the case that the recipient of a service could have gone out to his (or her) local market and obtained the service on more competitive terms, especially if the provider is in a higher cost location than the recipient. The new paragraphs 1.142 and 1.143 of the Guidelines stress the importance of looking at local market comparables. In such cases, if it is clear that the local substitute for the group service provider could have provided the right kind and quality of service, then the local CUP is indeed a CUP and will drive the price down. This can result in the group service provider making a loss on the transaction.

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

4.20 In many cases, an 'all costs plus' or 'fully loaded costs' method, which is really a form of TNMM, is used. This would be particularly so in the case of

small service providers where the distinction between direct and indirect costs is neither easy to make nor especially meaningful.

4.21 Occasionally a high value-added service or management fee will be calculated as a percentage of turnover. This is not the same as allocating a finite pot of costs by reference to third-party turnover (see **4.24** onwards below). Here we are talking about paying out (say) 2% of sales, such that a bumper year means a higher management charge.

4.22 There is somewhat oblique coverage of this in paragraphs 7.17 and 7.18 of the Guidelines. These deal with paying fixed amounts by way of 'retainers' for (say) legal fees or IT support – what the Guidelines describe as services provided 'on call'. The payment of a fixed percentage of turnover would seem to fall into this category. The sort of justification it would be wise to put together would include difficulty in calculating the charge any other way, an uneven call for the services in question from one year to the next and a direct link between the service and sales performance. Suppose a group member can call on marketing support, legal services, tax advice or computer support whenever, and to whatever extent, they want. One year they might be launching a new product line, be embroiled in litigation, suffer repeated computer problems threatening key supplier and customer records and be faced with a massive tax authority enquiry into a range of difficult technical areas. In the following two years they may require a rather lower level of support. It might well be commercially justified to commit a substantial amount of money each year just to keep such supplies on tap.

4.23 Having said that, it is quite hard to get fixed percentages of turnover past the tax authorities if the amounts are substantial. Tax authorities will usually measure the amounts paid out over a number of years by reference to some other method (eg cost-plus). If the answer is sensible over time they may well concede, but if overall they appear to be losing, they will not. They will be particularly unimpressed if it appears that there is no need to have the services on standby at all either because the potential need for such services is remote, or other sources of supply are readily available. The other difficulty with the example given above is that not all the services have an obvious direct link with sales (eg tax advice). This weakens the methodology and increases the prospect of tax authority challenge.

Direct or indirect charging? Tracking time, use of allocation keys, identifying the cost base

4.24 A direct charge is one made for a particular service to a specific affiliate, whilst an indirect charge is one that is imputed through other means (such as where charges are allocated across all group entities on the basis of an appropriate metric – for example, share of group turnover). A direct charge has the advantage of providing greater transparency to the tax authorities, in that the time and costs associated with supplying the service will normally be straightforward to identify.

5.5 These points all make for an interesting and challenging environment. Therefore, transfer-pricing practitioners must take into account the full context of territories and tax laws involved and the nature of the transactions themselves. They must consider the arm's-length nature of the form of financing, the terms of the financing (term, security, etc), the amount of financing, and the interest rate applied. And to make things even more interesting, the deductibility of interest is an area that has been of particular focus as part of the recent OECD developments in relation to BEPS, as we will detail further in this chapter.

WHAT ARE TYPICAL INTER-COMPANY FINANCING TRANSACTIONS?

5.6 Inter-company financing transactions arise for a variety of commercial reasons where a company requires access to funds. The reasons behind the financing transaction are important, not only in relation to non-transfer pricing tax laws but also because they can have a substantial impact on the types of transfer-pricing questions that arise and the correct approach to dealing with them. It is important at this juncture to consider some of the reasons for inter-company financing which set the context for transfer-pricing approaches that are discussed in the rest of this chapter.

5.7 At the highest level, funding provided to a group subsidiary for the acquisition of shares in a target company or significant business assets might take the form of debt or equity. Immediately this raises a question of the relative levels of debt compared to equity (ie the capitalisation of the subsidiary) once the funding is in place. This mix of equity and debt should be considered against evidence showing the ratio of debt and equity that would be appropriate for an independent entity to fund such an acquisition. This point has to be addressed before one can consider the appropriate rate of interest that should apply to the debt portion of the funding, as changes to the debt/equity ratio also have an impact on the interest rate that would be paid by an independent entity on the debt that remains; more debt leads to a lower credit rating and to higher interest rates because of the increased risk to the lender. Acquisition scenarios might see external group borrowings at parent company level being pushed down to the subsidiary making the acquisition. In that case it is appropriate to consider the relationship between the terms for the external debt and those for the internal debt. For example, the parent company may give security to the external lender that often cannot be replicated by the subsidiary when it borrows from the parent. One should also consider the question of what should happen to the fees incurred in arranging this external funding and in securing committed further funding, which are often substantial; should they (at arm's length) be passed on to the ultimate borrower?

5.8 For most MNEs, acquisition financing transactions are relatively infrequent and large scale. For that reason the transfer-pricing issues are carefully considered. If they are not, and the level of and pricing of debt is not dealt with appropriately, it will typically prove to be difficult to fix the problems when they are unearthed later on.

5.9 The ongoing operations of subsidiaries also require funding. Unless the subsidiary finances itself entirely from its own operations, funding is likely to be partly by way of share capital and partly by way of debt (which may be borrowed from an affiliate). This might be the same group entity that injects share capital, but frequently it is not, as many MNEs have a specialist group finance company through which intra-group loans are provided. Again, the question of the arm's-length mix of equity and debt funding may arise, although less frequently and with less potential for significant error when compared to the large, one-off transactions considered in **5.7**. However, the MNE will still need to determine an arm's-length price for any loans. As these transactions are likely to occur much more frequently within groups it is advisable, as with other areas of transfer pricing, for the MNE to have a transfer-pricing policy in place to address this kind of debt. This should combine the need to determine the arm's-length mix of equity and debt in the borrower, with the need to determine and apply the arm's-length nature of the interest rate. The additional catch here arises from the practicalities of determining the arm's-length nature of multiple loans in differing currencies and with differing terms to borrowers with different credit ratings. As a result of changes proposed by Action 4 of the BEPS project at OECD, it is likely that intra-group lending will increase, compared to current levels, at the time of writing. The proposed limitations to interest deduction are 'relatively blunt' and, where external debt is concentrated into a parent, it is likely that not all of that cost will be deductible in computing taxable profits once the new rules are adopted. MNEs will therefore wish to push down debt to subsidiaries, proportionate to their ability to obtain a tax deduction, and ensure (if they can) that the full quantum of interest paid to external lenders is deductible for tax purposes. Of course, there are other – non-transfer pricing – rules that might restrict or prevent the push-down of debt that must be considered on a country-by-country basis.

5.10 On a short-term basis, subsidiaries within a group may either have surplus cash or require additional cash to fund day-to-day operations. From a treasury management perspective, it can be most efficient for the MNE to have a form of cash pool in place. This mechanism for managing short-term balances has its own subset of issues regarding transfer pricing which will be discussed shortly.

5.11 For both long- and medium-term debt, the transactions described above are based on the concept of a central borrowing of external debt, some part of which is pushed down to subsidiary members of the group. A MNE might take a different approach, where the subsidiary borrows funds directly from a third-party bank with the assistance of a guarantee from, usually, its parent or the ultimate group parent. This approach changes the transfer-pricing question because the MNE group must now consider how much should be paid by the subsidiary in return for the guarantee. That question is addressed through a variety of quantitative and technical approaches (see below).

5.12 Aside from these most common forms of loan transactions an MNE has a variety of other options to finance its operations and manage its balance sheet. These include issuing bonds, factoring receivables, entering into finance leases or sale-and-lease-back transactions and hybrid debt instruments. Finally,

upon giving the guarantee, but it has taken on a potential liability contingent upon the default (or not) of the borrower. In that sense it might be possible to consider the cost of an alternative transaction – an insurance transaction – as a means to assessing the arm's-length nature of the guarantee payment. This is not re-characterisation of the transaction as an insurance payment (which is rejected in all but the most extreme circumstances, see Section D2 of the OECD's 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations') but a potentially acceptable methodology in accordance with the OECD Guidelines.

5.58 The provision of a guarantee can be viewed as an intra-group service. In this case, many of the principles set out in Chapter VII of the OECD Guidelines discussed earlier should be applied. The OECD Guidelines state at paragraph 7.13:

> '... an associated enterprise should not be considered to receive an intragroup service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed. For example, no service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were not affiliated, but an intragroup service would usually exist where the higher credit-rating were due to a guarantee by another group member ... In this respect, passive association should be distinguished from active promotion of the MNE group's attributes ...'

The OECD Guidelines provide some insight into the definition of 'incidental benefits' in paragraph 1.158:

> '... the term incidental refers to benefits arising solely by virtue of group affiliation and in the absence of deliberate concerted actions or transactions leading to that benefit. The term incidental does not refer to the quantum of such benefits or suggest that such benefits must be small or relatively insignificant. Consistent with this general view... when synergistic benefits or burdens of group membership arise purely as result of membership in an MNE group and without the deliberate concerted action of group members or the performance of any service or other function by group members, such synergistic benefits of group membership need not be separately compensated or specifically allocated among members of the MNE group.'

5.59 The diagrams below provide examples of how group affiliation can impact loan pricing in practice. Figure 5.1 assumes that a third party lender ('3P' in the diagram) would allocate a credit rating of 'A' to S, which is higher than S's standalone credit rating of 'Baa' due to the fact that its parent, P, is rated 'AAA'. P is not providing any formal guarantee to the third party lender and it should be assumed that it is also not carrying out any other concerted actions or transactions that have resulted in this 'A' rating. So, in line with the OECD Guidelines, the difference between S's 'Baa' standalone rating and the 'A' rating allocated by the lender should be considered an incidental benefit. This is on the basis that the benefit that S is receiving is purely as a result of S being a member of a more creditworthy group.

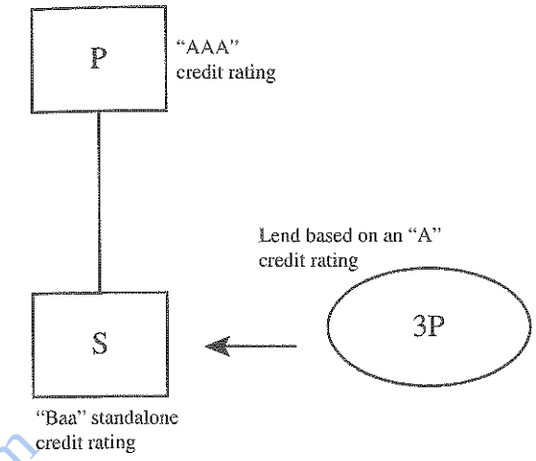

Figure 5.1

5.60 The same facts are reflected in Figure 5.2, with the exception that P is now providing a guarantee to the third party lender. The provision of the guarantee has increased the rating at which the third party was prepared to lend from 'A' to 'AAA'. This additional increase in credit rating is due to P's deliberate action in providing a guarantee, and so S should pay a guarantee fee to P. However, this guarantee fee should only be based on a proportion of the benefit provided by the guarantee itself (ie the difference between 'A' and 'AAA', and not between 'Baa' and 'A'). The difference between 'Baa' and 'A' is still an incidental benefit.

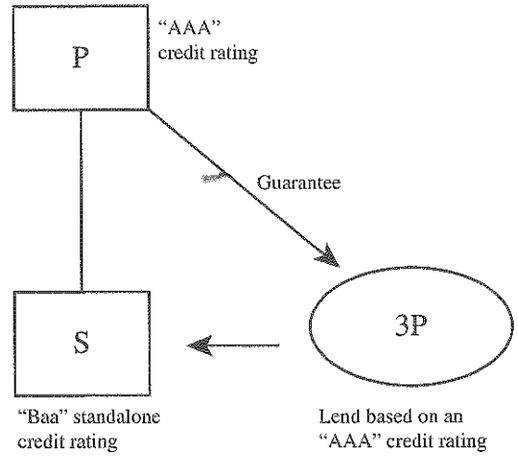

Figure 5.2

- the arm's-length principle (Chapters I, II and III) applied equally to intangible property;
- it was important to understand, and to take into account, the value of the intangible property to both licensee and licensor; and
- the contribution of both parties to the creation or value of the intangible property had to be taken into account in setting the arm's-length pricing to be agreed between them.

6.7 There is nothing in the old guidance against which we can complain, but it was not actually helpful in any practical way. The new material builds on the core principles identified by the old Chapter VI, and highlights the following:

- the alignment of intangibles-related returns with the important functions related to the development, enhancement, maintenance, protection and exploitation of intangibles (more-easily defined as the 'DEMPE' functions);
- the importance of the parties' actual conduct in determining the ownership of intangibles, including the principle that the legal ownership of an intangible asset, by itself, does not confer any right ultimately to retain the intangibles-related return (a complicated idea, to which we will return following these bullet points);
- the risk-associated return, including the concept that economic control must be exercised over the risks, and the financial capacity that must be available in order to assume the risks; and
- the consideration and appropriate remuneration of the contributions of each party to the transaction (ie a two-sided analysis).

The transfer-pricing practitioner should keep in mind here that, rather confusingly, the revised OECD Guidelines often consider where the 'return' associated with the intangible should rest, as distinct from who has the right to receive income from an intangible. This may be a hang-over from earlier rounds of debate at the OECD, when the focus of some meetings that the author attended had been on redirecting the income stream arising from an intangible away from the 'owner' towards another party who had contributed, in some meaningful way, to the creation of value in the intangible. Thankfully, that approach was recognised to be incorrect; intangibles that are 'owned and controlled' (in the terms of the revised guidance) are a form of monopoly created by the law of the country concerned, and the payment for use is, in reality, a payment for the non-exercise of that monopoly right. Looked at in this way (ie taking a commercial view, as we are intended to do under the arm's-length standard), it is clear that the income arising from an intangible will always flow to the party that has the right to enforce the monopoly – by which we mean the 'legal owner'. Therefore, others who have contributed in a meaningful way to the creation value in the intangible must get their reward from the legal owner by way of a separate transaction. What the Guidance now tells us is that, *net of that additional transaction*, the rewards that can be

reaped from an intangible will mainly rest with those who have contributed in a meaningful way to value in the creation, enhancement, maintenance, protection or exploitation of the intangible.

6.8 In response to past criticisms that the brevity of the current Chapter VI meant that it did not address, or provide guidance for addressing, the more fundamental areas of the transfer pricing of intangibles, the new material includes a six-step framework for analysing intangible transactions between associated enterprises, and provides detailed guidance on the application of each step.

6.9 The six-step framework for analysing transactions involving intangibles, as prescribed by the new material, is as follows:

(i) Identification of intangibles – what intangibles are being used or transferred, and by whom are the associated DEMPE functions undertaken?

(ii) Contractual arrangements – determining legal ownership of intangibles, based on the terms and conditions of legal arrangements.

(iii) Identification and analysis of the parties performing functions, using assets and managing risks related to the DEMPE functions of the intangibles.

(iv) Confirmation of the consistency between the contractual arrangements and the associated risks undertaken by the parties.

(v) Delineation of the controlled transaction to determine the DEMPE functions performed in relation to the intangibles.

(vi) Determination of the arm's-length prices for these transactions consistent with each party's contributions of functions performed, assets used and risks assumed.

Each of these six steps is discussed in the remainder of this chapter.

6.10 In the experience of the author, problems with the transfer pricing of intangibles are frequently traced to a lack of understanding of what intangibles are, who owns them and how third parties transact in them. Even the most difficult intangibles transfer-pricing case can be dramatically simplified when the two sides reach agreement on whether or not an intangible exists, who owns it and what rights that intangible actually gives to the owner. The six-step framework quite rightly places this first; it would be a waste of time for everyone involved to argue about contributions to the development of simple know-how when simple know-how (ie falling short of a 'business secret') is unprotectable under the law of the country concerned, and therefore it is not 'owned and controlled' and hence is not an intangible for the purposes of the revised Chapter VI. The existence of an intangible, precisely what it is and who the legal owner is (who exercises the monopoly rights) can be ascertained by following the arm's-length standard (ie looking at how unrelated parties deal with each other). The same is true when dealing with every element of the six-step framework outlined above. After all, it would be a breach of the arm's-length standard if, for example, we found that related parties outsourced

without it), it is not intellectual property because the knowledge of how to lay bricks cannot be protected by ABC. For 'know-how' to be intellectual property, it must be protectable. This can only be achieved if the know-how is a trade secret.

6.32 Trade secrets are a particular type of confidential information which, in the possession of departing employees, can still be protected by their former employer. There is no limit to the information that can become a trade secret, but there is no automatic protection. A business must take steps, contractually and practically, to protect the information that it believes should be secret, so that courts will recognise and uphold that protection.

6.33 The United States has a codified approach set out in the Uniform Trade Secrets Act. In the US, a trade secret is information that derives independent economic value by virtue of its being secret and is the subject of reasonable efforts by the business to keep it secret. Most US States follow this approach. The Seventh Circuit Court of Appeals considered the steps that a business must take to make mere know-how into a trade secret. See *Fail-Safe LLC v A. O. Smith Corporation* No 11-1354 (29 March 2012), which held that, where information was shared without any contractual restriction being in force to require that information to be kept secret, and it was not used for any purpose other than that for which the information was disclosed, there is no trade secret to protect.

6.34 Trade secrets or 'secret know-how' are, therefore, protectable by law and can qualify under the three-part test set out in **6.12–6.17** above. One difficulty that might be highlighted by transfer-pricing professionals, particularly those attempting to create guidelines that can be applied to both sides of a transaction and thereby spanning (at least) two jurisdictions, is that IP law varies from country to country. Perhaps minor differences might be tolerated, as we tolerate minor differences in local transfer-pricing legislation because the core principle remains, but the difference in protection offered to trade secrets is anything but minor. In fact, the variation in levels of protection offered to trade secrets is so large, even within Member States of the EU, that in March 2011 the Commission appointed the law firm Hogan Lovell to identify these differences with a view to harmonising protection throughout the EU.[1]

6.35 This significant variation in the level of protection is the actual landscape that unrelated parties operate within and so, as the arm's-length principle requires that we assess related-party transactions against third-party transactions for transfer-pricing purposes, this does not so much pose a problem for transfer-pricing professionals and the drafting of effective Guidelines, as provide a real and pre-existing framework within which to test group transactions.

1 Available at http://ec.europa.eu/internal_market/iprenforcement/docs/parasitic/201201-study_en.pdf.

6.36 When know-how falls short of being a trade secret, it is not intellectual property as it fails the three-part test set out in **6.12–6.17** above. That does not mean that know-how has no value; rather, it is merely a factor to be identified in the functional analysis and taken into account in considering the comparability of third-party data used to test the transfer price applied.

Soft intangibles

6.37 Let us now apply these tests to so-called 'soft intangibles' by considering a hypothetical example based around a business restructuring of the type contemplated by Chapter IX.

6.38 Suppose that a US-parented global multinational finds that its European business is under-performing. Compared to competitors, management realises that their business is slow to make and implement decisions, has duplicated functions throughout Europe and has an inefficient logistical chain. Management decides that, to retain market position, it has to reorganise and adopt a new, more efficient, business model. It selects a 'European principal' business model, using 'commissionaire' sales entities in several countries as the preferred business model option.

6.39 The US parent effects this change by serving notice on existing subsidiaries, giving notice of its intention to terminate existing licences to use its intellectual property, principally the right to sell in their own name using the parent's brand and trademark. In the United Kingdom, the sales business has historically been operated by a fully-fledged distributor, UK Co, which is offered and accepts the opportunity to become a sales agent.

6.40 The multinational then conducts a transfer-pricing exercise to assess the level of commission to be paid to UK Co going forward. It identifies potentially comparable companies who are independent, operate in the same economic environment and industry, have almost no stock on their balance sheets (or describe themselves as commissionaires or commission agents) and act in a sales capacity. Let us assume that this shows the range of arm's-length commission to be 0.5% to 2% of sales, and 1.5% sales commission is selected as the appropriate target rate.

6.41 In considering whether the pricing is at arm's length, a question may be raised as to whether or not the transaction would have happened in this form in a third-party situation or, alternatively, whether the commission payable should be significantly higher as the 'soft intangibles' (such as business experience, workforce in place or customer relationships that have been generated by UK Co from its historical operations) would give it the ability to earn a higher reward than is being offered.

6.42 The starting point for this analysis must be that those 'soft intangibles' do not give rise to any intangible property as they are not owned, controlled and transferable separately from another asset such as the business. This is not to say that these intangibles are not adding value to the business, which they clearly are; but, rather than being intangible property in their own right, these

6.61 **The economic answer:** Taking an econometric approach, IPE had been paid for its services on an arm's-length basis. The cost and the risk of developing the software therefore fell squarely on MIS; from this, one might conclude that MIS is the economic owner of all future licence income.

6.62 **The arm's-length answer:** The facts used in the example are taken from a commercial dispute heard by the UK Court of Appeal in 2008: *Meridian International Services Ltd v Richards & Ors* [2008] EWCA Civ 609. Copyright arises to the author, which in the case of the subcontracted work was IPE. The failure of MIS to include a requirement for IPE to transfer any copyright in its work to MIS was neither rectified by any 'implied' need to do so because of the sub-contract nature of its relationship with MIS, nor by reference to any agreement that MIS purported to have made with GSK. The 'economic' answer given above is not what happens between unrelated parties; transfer of copyright in the new software would be a factor in testing the arm's-length nature of the reward for the sub-contracting activity, not in deciding ownership of the copyright. Neither would it be appropriate to assert that MIS and IPE 'would have' agreed to transfer the copyright, as it is clear that unrelated parties do not only contract on the basis that ownership of IP would transfer from the contractor to the party engaging the contractor.

6.63 This approach to ownership is closer to what has in the past been considered to be a 'legal test', which is unsurprising since 'intellectual property' is a legal concept in any case. However, this does not mean that the party having legal title to the intellectual property will always get all of the income which the IP generates. In short, the party named on any register of IP is not conclusive proof that they 'own' all of the rights in the IP. Consider the example in the following paragraphs.

6.64 **The facts:** DLN manufactures agricultural crop covering in the UK under the registered trade name 'Gromax'. GPL holds the sole UK distributorship for Gromax and, over the years, GPL has been solely responsible for building the UK client base. In addition, GPL has provided valuable feedback to DLN concerning customer needs and suggested improvements to the product. GPL has also provided suggestions for sourcing raw materials from which the product is made and took steps to ensure the finest quality of product. Over years of trading, GPL has developed a strong reputation as a knowledgeable and helpful supplier of Gromax crop cover. Subsequently the parties fell out with each other and terminated their business relationship. This has led to a dispute about ownership of the trade name 'Gromax' which had been registered by DLN.

6.65 **The question:** Should DLN, holding the registered title to the trade name 'Gromax', be entitled to the goodwill associated with that name, or should GPL, the party that developed all customer relationships, be entitled to that goodwill?

6.66 **The answer:** Starting from first principles, it is accepted under UK law that where a licensee uses a valid trade name or mark then the goodwill accrues to the licensor and not the licensee. The licensee acquires no interest in the name or mark and must cease to use it on termination of their licence.

Provided that the licence is valid, it does not matter that the licensee may be held out as the provider of the goods and may, in fact, be primarily responsible for their character or quality.[4] However, there may yet be special circumstances in which the actions of the licensee go beyond that expected of a licensee, and thereby the licensee becomes simultaneous part owner of the goodwill associated with a trade name or mark. In this example, the 'sole' nature of the distributorship and the actions of GPL in creating a customer base, passing on customer suggestions and being interested in the quality of the product do not cross that bright-line test. However, the sourcing of raw materials is an example of the line being passed. In this case, the trade name registration is not overturned, but GPL would be allowed to use the goodwill associated with the trade name (by using the trade name itself without paying a royalty) for a short time.

6.67 Again, in the example above, the facts are drawn from an existing settled commercial dispute: *Gromax Plasticulture Ltd v Don & Low Nonwovens Ltd* [1999] RPC 367. Where the activities of a licensee go beyond that expected of a licensee, either qualitatively or quantitatively, then the right to enjoy the value of the IP might be shared between the licensor and the licensee. This 'bright line' test has echoes in some tax cases, notably the Indian case of *Maruti Suzuki ('Maruti' Suzuki India Ltd v Additional Commissioner of Income Tax Transfer Pricing Officer New Delhi* WP(C) 6876/2008 (High Court of Delhi at New Delhi, 2010)) and the US case of DHL (*DHL Corp*, TC Memo 1998-461, RIA TC Memo). What is clear is that the party who is entitled to the income is the party to which a court would award the income if the parties were to dispute that point before a competent court. The primary rule is that this will be the party that holds legal title to the intellectual property and that rule will be set aside only if there are circumstances so special that a so-called 'bright line' is crossed, in which case the parties can become simultaneous joint owners of the IP.

6.68 As the law giving rise to each kind of IP is different (patent law is not the same as copyright law, and so on), ownership of intellectual property is governed by the law and the facts relevant to that particular case. Each case must therefore be tested on its own merits and according to the appropriate law and commercial practice.

6.69 The importance of following this process to understand who, as between unrelated parties, would be entitled to enjoy the financial benefit cannot be understated. Let us consider one more example of how a court has decided which of two unrelated parties is entitled to the rights in, and therefore the financial benefit of, IP to reinforce the point.

6.70 Computer programs represent valuable IP in many businesses and the legal form of protection for a computer program is copyright. Copyright has been understood to concern the actual written code, the source code and the object code of the program, rather than providing any protection for its

4 See C. Wadlow *The Law of Passing Off* (2nd edition, 1995, London: Sweet & Maxwell), para 2.62.

available to the licensee, absent a licence, and apportioning them between the licensor and the licensee.'

7.4 This confirms that what a commercial court seeks (the value of a licence between willing licensors and licensees) and what transfer-pricing practitioners seek (the licence that would have been agreed between unconnected parties) is actually the same. Hence these commercial courts provide insight into how a court might view a transfer-pricing case, which valuation methodologies are acceptable and which fall short of evidential quality. The excerpt quoted above confirms both a preference for using comparable licences and, where they are not available, the appropriateness of the profit split methodology for determining a reasonable royalty for the use of intangible assets in case of dispute between unconnected parties.

7.5 The minimum standards agreed as part of the BEPS Final Reports on transfer pricing reduce the possibility of using inappropriate comparable uncontrolled price (CUP) or comparable uncontrolled transactions (CUT) for the transfer pricing of intangibles by stressing the need to show comparability. Consequently the use of profit split for pricing intangible asset transactions is likely to continue and, indeed, increase.

7.6 The driver for selecting an appropriate methodology for transfer-pricing purposes is the functional analysis; the analysis of the relevant contribution to the value of the transaction by each party. There is no industry or transaction type where profit split cannot potentially be the most appropriate transfer-pricing methodology. For example, this method may be used in situations as diverse as insurance arrangements where control over risk is shared, or for pricing the sharing of savings generated by centralised activities such as procurement.

7.7 At the time of writing, the OECD's Working Party 6 is undertaking further work to provide additional guidance on when and how the profit split method may be used by taxpayers and tax authorities. A Discussion Draft setting out this additional guidance is expected late in 2016 and final guidance is anticipated by June 2017.

OVERVIEW OF PROFIT SPLIT

7.8 The profit split method seeks to test the arm's-length nature of pricing by determining the overall profit from a transaction and its division between the parties, based on what unconnected enterprises would expect to realise from engaging in those transactions.

7.9 Under the current OECD Guidelines, the profit split is considered to be an appropriate method where:

- the roles of the associated enterprises in a transaction are so interrelated that they cannot be evaluated separately; or
- both parties to a transaction make unique and valuable contributions such that third parties might set up a joint venture or partnership and agree to some form of profit split based on their contributions.

7.10 Where both parties make unique and valuable contributions to a transaction, a 'one-sided' transfer-pricing analysis, such as cost-plus or the transactional net margin method (TNMM), does not take into account the balance of risk and contribution between the parties. It would therefore be inappropriate to treat one of the transacting parties as the 'tested party', receiving a relatively 'fixed' remuneration; it would be more likely that, in these circumstances, unrelated parties would share in the profits (or losses) of the venture. Hence a profit split approach, which explicitly considers both transacting parties (ie a two-sided analysis), would be more likely to be an appropriate method.

7.11 There are many circumstances in which profit split might be considered an appropriate methodology for transfer-pricing purposes. Some examples are provided below but this list is by no means exhaustive:

- Where there is insufficient reliable data to analyse comparability so as to determine an arm's-length outcome by any method other than profit split.
- Where the nature of the business arrangements means that both parties to a transaction are performing highly valuable functions and bearing significant risks such that appropriate comparables cannot be identified to price one end of the transaction.
- Where there are a variety of transactions (eg transfers of tangible assets, the licensing of intangible assets and the provision of services) between the associated enterprises, some of which may involve overlaps, and there are no comparables for the combination of transactions. In these cases, profit methods may be a more reliable way to set or review the transfer pricing used in the dealings between the associated enterprises, or to check the findings made using traditional methods if there is doubt about the reliability of the data used or the outcome produced.
- Where the supply chain is highly integrated and the parties to the transaction share the key risks or provide the key intangibles. This situation may arise, for example, where product development risk is genuinely shared between associated manufacturing entities, one of whom supplies highly specialised components to another group company.

7.12 Care should be taken to record the reasons why profit split (or, indeed, any chosen method) is selected as the most appropriate transfer-pricing methodology. The reasons, and the recording of those reasons, should be undertaken in a manner that would be considered to be 'evidential'. Referring to another UK case, *General Tyre & Rubber Co v Firestone Tyre & Rubber Co Ltd* [1975] WLR 819, the judge commented that it is for the plaintiff to adduce evidence which will guide the court. The ruling notes as follows:

'This evidence may consist of the practice, as regards royalty, in the relevant trade or in analogous trades; perhaps of expert opinion expressed in publications or in the witness box; possibly of the profitability of the invention; and of any other factor on which the judge can decide the measure of loss.'

	Total Available Profit Split	Residual Profit Split
Calculation of the split	There can be third-party evidence, or evidence, of how the econometric split should be performed. A split based on pure econometric principles can be acceptable if the above are not available	Third-party evidence is less likely to be found and econometric split is commonly used, based on pure economic principles
Tax audit risks	Limited to the calculation of profit and to the split applied	Calculation of overall profit, the routine activity identification and cost analysis, the reward for routine activity, and the split applied to the residual profit
How commonly used?	More common in unrelated party transactions Less common in related party transactions	Less common in unrelated party transactions More common in related party transactions

Step 3: Split the profit

7.25 Once the most appropriate form of profit split has been selected and the appropriate profit calculated, the next step is to split this profit between the licensor and the licensee. Some of the common approaches are discussed below. In practice, it is often better to use more than one approach so that there is an element of corroboration in the results of the analysis.

Case law

7.26 Guidance relevant to a total profit split analysis can be found in commercial court cases, available in the public domain; cases which attribute the profits generated by intangible assets between a licensor and a licensee. These are examples of what arm's-length behaviours would be in circumstances where a court is asked to split profits arising from the use of an intangible between a 'willing licensor and a willing licensee'.

7.27 Analysis of case law shows that the split appropriate in any situation will depend on its own fact pattern; the relative values and costs of contributions by each party along with the value-impact of the transaction under examination. Thus, when reading third-party cases, even though an analysis of the actual split found in each case would provide material from which one might create an 'industry average', this would not meet the requirements of the arm's-length principle. Analysis of these cases is therefore appropriate to understand the

methodology of the profit split and the factors which influenced the actual split; this can be applied to the facts and circumstances of the particular transfer-pricing case.

7.28 That approach is fully consistent with the arm's-length principle and it accords with the need to produce work of evidential quality. The need for transfer-pricing valuations to be evidential in case of any dispute brought before a court is illustrated in the US case of *Daubert v Merrell Dow Pharmaceuticals Inc* 113 S.Ct 2786 (1993) and the UK court's approach in *General Tyre & Rubber Co v Firestone Tyre & Rubber Co Ltd* [1976] RPC 197 (HL). In the latter case, it is worth considering the following statement which was made in relation to a claimed CUT valuation:

> 'Before a "going rate" of royalty can be taken as the basis on which an infringer should be held liable, it must be shown that the circumstances in which the going rate was paid are the same, or at least comparable, with those in which the patentee and the infringer are assumed to strike their bargain.'

7.29 Under the profit split methodology, the determination of the split ratio is chosen based on hypothetical negotiations. The case law in some countries, such as the UK, indicates that this exercise can start from an assumed split which is then adjusted for the specific facts and circumstances of the case by the application of 'scientific, technical, or specialized knowledge … based on scientific and technical grounding'.[2] Thus, this approach will alter the starting estimate to arrive at an appropriate profit split, given the specific facts and circumstances.

7.30 The case law in other countries, such as the US, rejects that idea and requires the analysis to proceed from first principles; however, it is arguable that this is simply to start at a different assumed ratio, either 0:100 or 100:0. It is not clear that the two approaches would lead to a different answer, as cases in both countries apply precisely the same factors to determine the profit split.

7.31 In practice, as the transfer-pricing analysis has to be acceptable to the tax authority responsible for auditing each end of the transaction, it is likely to be appropriate to take the more conservative approach of analysing the factors and concluding on an appropriate split of the profits, rather than assuming an initial split and then adjusting (based on the same analysis) to reach the same split. The result may actually be the same, but the ease of explaining it to both tax authorities may well be different.

7.32 In terms of ascertaining the factors to take into account in determining an appropriate split, a seminal court case in the US is *Georgia-Pacific Corp v US Plywood Corp* (318 F Supp 1116 (SDNY 1970)) (the '*Georgia-Pacific*' case). It concerned the infringement of intellectual property and led the courts

2 *Uniloc*, 632 F 3d at 13315 (citing J. Weinstein & M. Berger, Weinstein's Evidence, para 702[2], 1988).

for its role on an arm's-length basis. This final point requires consideration of the economic significance of the risk, which is a function of three things, the second two being intimately inter-related:

- the costs of taking on, mitigating and managing the risk;
- the cost of the risk if it turns into a liability; and
- the chance of that risk turning into a liability.

If the potential cost of a risk that turns into an actual liability is small and the chance of it becoming an actual liability is small, then the financial reward for handling this risk will be similarly low, over and above the service value of managing the risk. If the potential cost of a risk, if it turns into an actual liability, is large, then even if the chance of it so doing is small, the financial reward will reflect that position over and above the service value of managing the risk. Therefore, the transfer-pricing work should review the potential cost of any risk that might materialise and consider evidence to show the chance of that event arising.

8.24 Finally on the topic of business risk, the transfer-pricing method adopted for testing the arm's-length nature of related-party transactions cannot affect the allocation of risk between the parties. However, the important point in the last sentence is 'tested'. The pricing method agreed in a contract to set prices can (and, in some cases, does) affect the risk allocation between the parties (see paras 9.45 and 9.46 of the OECD Guidelines).

Part II: Arm's-length compensation for the restructuring itself

8.25 The restructuring event gives rise to transfer-pricing questions concerning the potential right of an entity to compensation for the impact of the restructuring, and for the costs of restructuring. There are three circumstances in which compensation might be due and three types of cost to consider.

The three circumstances in which compensation might be due for the restructuring are:

- where assets belonging to the entity are transferred;
- where local law or the contract provides a legal right to compensation; or
- where the cooperation required of the entity is such that an unrelated party would most likely negotiate payment for that cooperation.

8.26 The three types of cost that we need to consider are:

- Expenditure in the period prior to termination of the old business model – is this expenditure arm's length in the light of the decision to terminate?
- Expenditure incurred to get out of the old business model – should this fall on the entity or on someone else?

- Expenditure incurred to get into the new business model – who should bear that cost?

We will look first at the question of compensation and then turn to consider costs.

8.27 Before going any further on the topic of compensation, it is important to note that there is no automatic right to compensation simply because there has been a restructuring, or because a restructuring results in a reduction in the profitability of an entity (see para 9.65 of the OECD Guidelines). This might appear to be an obvious statement but, between unrelated parties, similar claims have been made and litigated in the UK, with the same result. The UK Court of Appeal decision in *Baird Textile Holdings Limited v Marks & Spencer plc* [2001] EWCA Civ 274 is instructive in this matter, as the business of the claimant was intertwined with Marks & Spencer to a degree that would not be unfamiliar within an MNC group. However, compensation would be due if, as between unrelated parties, compensation would be paid, so we must consider why unconnected parties might conclude that compensation should be due.

Compensation for restructuring

Assets transferred

8.28 The most obvious reason for payment to be made to the restructured entity is that it has transferred an asset that it owns to someone else. This might relate to the whole business, or to an asset of the business depending on the circumstances of the parties and the way in which the restructuring is effected. Transfers of particular assets are easier to recognise and price. A full functional analysis of the business pre- and post-restructuring is one of the best ways to identify assets that have been transferred. As part of the functional analyses, care should be taken when defining any transferred intangible assets, applying the language in the new Chapter VI of the OECD Guidelines; if an intangible is not capable of being 'owned or controlled' (eg if a product goes off-patent), there may be no requirement for compensation on transfer. See **8.43** for an illustration of this point.

8.29 Intangible assets, particularly marketing intangibles such as goodwill, often cause the most disagreement, but reference to the position of independent parties should provide the answer. Intellectual property is 'property' and can be transferred only by contract; members of a sales force in a distributor will always interact with customers and will generate 'goodwill'. The sales force that remains can exploit 'existing' goodwill while serving a new master without transferring it, even if they do not build 'new' goodwill (which is the case for an entity moving, say, from being a distributor to being an agent).

8.30 Whilst this book does cover the creation of permanent establishments (PEs), it is worth noting that one of the changes brought about by the OECD's BEPS project has led to a revision of the definition of a PE under the model double tax treaty. One example concerns *commissionaires* and similar undisclosed agency arrangements (see Chapter 4), which will soon be regarded

being a function of national laws and practice, the broad structure is likely to require:

- identification of the related parties;
- a description of the business;
- identification of the related-party transactions;
- a functional analysis of those transactions to show how entities add value to that transaction; this will draw out the information relevant to pricing the inter-company transactions (including the characteristics of the property or services provided or received, the contractual terms between the parties, the business strategies adopted by the entity, a functional analysis which outlines the functions performed, the risks assumed and the assets used by the entity and the underlying economic circumstances which may include an analysis of the industry in which the entity operates); and
- the application of an economic analysis to support the pricing applied.

9.4 Transfer-pricing documentation should generally be 'look back' in nature. That is, it is a document to test an actual result of an arrangement with a related party, and whether it is in accordance with the arm's-length principle. This can be contrasted with a policy document which describes beforehand the rationale for setting a pricing policy for the arrangement. Multinationals often try to trade at arm's-length prices because they wish to have arm's-length prices reflected in their statutory accounts, as this reduces the risk of either suffering double taxation or incurring additional costs to deal with double taxation when it arises. In practice, however, all of the work performed for a policy document can be very useful in preparing documentation for a particular financial year, requiring only that the actual financial results and the underlying facts and circumstances of the year are incorporated into the 'policy' material to update (or replace, if needed) the material. This step is vital because the arm's-length standard is not met simply by setting a target margin based on the budget for the year; we are required to test the actual results of the year, and not just the intention. Where the actual results depart from the intended policy, the documentation will then also include an explanation of facts, circumstances or events that brought this about. The objective of this is to identify the party that should take ownership of the variance, according to the application of the arm's-length principle.

9.5 With increasing levels of documentation requirements introduced in different countries and the implementation of proposals under BEPS, as we will see, there is likely to be an increasing focus on the form and content of any documentation. But firstly we will examine in more detail the purpose of preparing documentation.

THE PURPOSE OF TRANSFER-PRICING DOCUMENTATION

9.6 The OECD, in its revised wording for Chapter V of the Guidelines, gives three objectives for producing documentation (see paragraph 5 of Chapter V):

(i) 'To ensure taxpayers give appropriate consideration ... in establishing prices ... between associated enterprises and in reporting the income derived from such transactions in their tax returns';

(ii) 'To provide tax administrations with the information necessary to conduct an informed ... risk assessment'; and

(iii) 'To provide tax administrations with useful information to employ in conducting an appropriately thorough audit ... although it may be necessary to supplement the documentation with additional information as the audit progresses'.

9.7 While the form, content and sometimes even the preparation of transfer-pricing documentation is not mandated in all countries, having comprehensive, contemporaneous transfer-pricing documentation allows the taxpayer to be on the front foot when supporting its tax return, particularly in the case of an audit by a tax authority. By having a position documented, the company is in a better position to push the burden of proof back onto the tax authority to show that the position taken is incorrect.

THE CURRENT STANDARD – A LOCAL APPROACH

9.8 The number of countries that have effective documentation requirements is significant (as can be seen in the 2016 Transfer Pricing Country Guide, referred to in Appendix B to this book). However, currently there is little consistency in the requirement to prepare documentation, the information required to be presented within the documentation, the timing of when such documentation is required to be prepared, whether or not the documentation is required to be submitted to the tax authority along with the tax return, and the penalties imposed for non-compliance.

9.9 While there are many standard components that would be considered necessary to include within transfer-pricing documentation, the specific requirements vary from country to country. Some countries provide a list of what information is required to be presented in the transfer-pricing documentation before it can qualify for penalty protection purposes. While some countries will accept an OECD-style transfer-pricing report, it is not unusual for local requirements to be more prescriptive and require additional information to that suggested in the OECD Guidelines, Chapter V. For example, in Australia, newly introduced transfer-pricing legislation requires a comprehensive analysis of local reconstruction provisions before the transfer-pricing documentation can qualify for penalty protection.

9.23 The OECD recommends that the Master File should be finalised by the filing date for the tax return of the group parent company, and that it is delivered (in conjunction with the Local File) directly to local tax administrations, when requested, by each member of the MNE group.

Local File

9.24 Unlike the Master File, the Local File is intended to provide specific details relating to inter-company transactions between a local company and a related party, to demonstrate that the local taxpayer has complied with the arm's-length principle.

9.25 The Local File, when read in conjunction with the Master File, is meant to allow a tax authority to undertake a risk assessment to assess whether the related-party transactions entered into by the local entity are consistent with the arm's-length principle, and therefore to decide whether to start a transfer-pricing audit.

9.26 The information suggested by the OECD to be presented in the Local File is described in the table below:

Category	Information required
Local entity	• Management structure and local organisational chart • Description of the business and business strategy • Key competitors
Controlled transactions	For each material category of controlled transactions: • Description of the transactions and context • Amount of intra-group payments and receipts • Identification of related parties and relationship • Copy of material intercompany agreements • Comparability and functional analysis of taxpayer and related party • Selection of most appropriate transfer-pricing method and reasons for selection • Selection of tested party and reasons for selection • Important assumptions made in applying the selected method • Reasons for performing a multi-year analysis

Category	Information required
	• Description of selected comparable uncontrolled transactions, if any, financial indicators for independent enterprises used in the transfer-pricing analysis and search strategy • Explanation of any comparability adjustments performed • Rationale for concluding on arm's-length pricing • Summary of financial information used • Copy of existing APAs or other tax rulings related to the transactions (where local entity is not a party)
Financial information	• Local audited financial statements if available, or else existing unaudited statements • Reconciliation between financial data used in applying the transfer-pricing method to the financial statements • Summary of financial data for comparables and source of data

(OECD *BEPS Action 13: 2015 Final Report*, Annex II to Chapter V, page 27.)

9.27 The OECD recommends that the Local File is reviewed annually, to ensure that the facts are appropriately updated, and that the analysis remains relevant. If the business has not materially changed, the OECD notes, in its revised guidance, that it should be unnecessary to undertake a benchmarking study annually. It is suggested that a benchmarking search is refreshed once every three years, although financial data relating to parties chosen as comparables should be updated each year, to reflect the latest position.

9.28 As the documentation should present the most reliable information available, the revised guidance notes that it is often (but not always) the case that local comparables should be used instead of regional comparables, if available. The guidance states that, where transfer-pricing documentation is prepared for various countries in the same geographic region, this may be a situation where it is appropriate to conduct a regional benchmarking study. It is also noted that, while there are clear benefits in reducing the number of benchmarking studies required (such as lower time investment and professional fees), we are warned that 'trying to simplify compliance processes should not undermine compliance with the requirement to use the most reliable information' (OECD *BEPS Action 13: 2015 Final Report*, para 46). In practice, for many countries it is difficult to obtain local comparables in sufficient quantities, and so the reality is that many multinationals use regional comparables.

Country-by-Country report

9.29 The third tier of the transfer-pricing documentation proposed by Action 13 is the Country-by-Country report. The guidance suggests that