5.4.2 *Transactional Profit Methods*

5.4.2.1 *Transactional Net Margin Method*

Based on the transactional net margin method (TNMM), the net profit margin realized by the tested entity from the tested transaction is computed in relation to costs incurred, sales effected, assets employed, or regarding any other relevant base. The net profit margin realised by the tested entity or by an unrelated entity from a comparable uncontrolled transaction is computed according to the same base. It is adjusted to take into account the differences, if any, between the tested transaction and the comparable uncontrolled transaction or between the entities entering into such transactions that could materially affect the amount of net profit margin in the open market.

The net profit margin thus computed is established to be the same as the net profit margin arising from the tested transaction. The net profit margin is then taken into account to arrive at the arm's length price in relation to the tested transaction.

The TNMM is particularly applied in cases when significant product or functional differences occur.

5.4.2.2 *Transactional Profit Split Method*

Based on the transactional profit split method (TPSM), the combined net profits of the related entities arising from the tested transaction in which the entities are engaged are determined. The relative contribution made by each related entity to the earning of such combined net profit is then evaluated on the basis of the functions performed, assets employed, and risks assumed by each entity. It is also evaluated on the basis of reliable external market data which indicates how such a contribution would be evaluated by unrelated entities performing comparable functions, employing comparable assets, and assuming comparable risks in similar circumstances.

The combined net profit is then split amongst the entities in proportion to their relative contribution. The profit thus apportioned to the entity is taken into account to arrive at the arm's length price in relation to the tested transaction.

Also, it is possible that the combined net profit may, in the first instance, be partially allocated to each entity in order to provide it with a basic return that is appropriate for the type of tested transaction in which it is engaged (with reference to market returns that are achieved for similar types of transactions by unrelated entities). Thereafter, the residual net profit may be split amongst the entities in proportion to their relative contribution. In such a case, the aggregate of the net profit that is allocated to each entity for providing it with a basic return and the residual net profit apportioned on the basis of the relative contribution of each entity shall be considered as the net profit arising from the tested transaction and allocated to that entity.

The TPSM is particularly applied primarily in cases when the tested transaction involves the transfer of unique intangibles or in multiple tested transactions that are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of each single transaction.

6 THE CONSEQUENCES OF A TRANSACTION NOT IN LINE WITH THE ARM'S LENGTH PRINCIPLE

6.1 Primary Adjustments

When an intra-group transaction is determined to not be in accordance with the arm's length principle, tax administrations can adjust the taxable profits that are generated by such a transaction in order to bring them to the level of the arm's length taxable profits. This adjustment, referred to as the 'primary adjustment', should find its legal basis in the national transfer pricing legislation of a country and is not limited by the application of any double tax treaty embedding Article 9(1) in line with the OECD and UN Models.

Example

Company A allows its wholly owned overseas subsidiary, Company B, to use certain equipment at no charge. Based on an audit examination by the tax administrators of Company B, the tax administration assessing Company A determines that the arm's length charge for the use of the equipment is EUR 50,000.

For the year under assessment, EUR 50,000 of income is allocated by the tax administration from Company B to Company A (i.e., the primary adjustment) to reflect an arm's length charge for the use of the equipment. Therefore, the primary adjustment increases Company A's taxable income for the relevant assessment year by EUR 50,000.

A primary adjustment will generate an economic double taxation (in the event of transactions between two related companies) or a juridical double taxation (in the case of transactions between a head office and its PE). Therefore, once the tax administrations of a country have made a primary adjustment to the taxable profits of their taxpayer, the tax administrations of the second country should correspondingly reduce the taxable profits of their own taxpayer in order to eliminate such double taxation. This adjustment is called 'corresponding adjustment' and should find its legal basis either in the national transfer pricing legislation of a country or in any existing double tax treaty embedding Article 9(2) and/or Article 25 in line with the OECD and UN Models.

A corresponding adjustment may be made either by recalculating the taxable profits using the price as revised in the first country (most commonly used) or by letting the calculation remain and giving the taxpayer relief against its own taxes that were paid for the additional tax charged as a consequence of the primary adjustment.[59]

59. OECD TPG, para. 4.34.

Example

In the above example, let us consider Company A's country of residence to be State A and that of Company B to be State B.
Consequent to the primary adjustment made in State A, if State B considers the adjustment to be 'justified both in principle and in regards to the amount,'[60] then a relief to the effect of additional taxes paid in State A (arising due to the increase in income of EUR 50,000 in State A) is to be provided.

Corresponding adjustments, in the absence of a binding arbitration procedure (e.g., in line with Article 25(5) of the OECD Model) are not mandatory.[61] Moreover, some timing issues might be raised when making primary and corresponding adjustments.[62]

Another type of adjustment to the taxable profits of a taxpayer is known as 'compensating adjustment'. Based on this adjustment, a taxpayer might be allowed to report a transfer price for tax purposes that is different than the one actually charged and, therefore, would be allowed to record the difference between the arm's length price and the actual price recorded in its books and records.[63] However, this kind of adjustment is not recognized by most countries.

Example

Company A identifies the arm's length price to be higher than the actual transaction price (in this case EUR 0) in the amount of € 50,000 and accordingly files its return of income reflecting the arm's length price. Company A's actions are based on the rationale that the arm's length price for the transfer of equipment were not identifiable at the time of the actual transfer and were subsequently acknowledged and identified at the time of filing the annual tax return.
However, the filing position is not accepted by State A being an OECD member country based on the principle that tax return should reflect only actual transaction values.

6.2 Secondary Adjustments

A primary adjustment in one country may trigger not only a corresponding adjustment in the second country but also a secondary adjustment in the first country. Indeed, a primary adjustment implies an assessment of extra tax profits in the first country that

60. OECD, *Transfer Pricing, Corresponding Adjustments and The Mutual Agreement Procedure*, 1 Oct. 1984.
61. OECD TPG, para. 4.35.
62. *Ibid.*, para. 4.36.
63. *Ibid.*, paras 4.38–4.39.

results in a misalignment between the actual profits (i.e., the profits shown in the financial statements) and the tax profits. In order to balance this misalignment, some countries' legislations might assert the existence of a constructive transaction whereby the excess profits resulting from the primary adjustment are considered as having been transferred from the assessed taxpayer in some other form and taxed accordingly.

The scope of these constructive transactions is to prevent tax avoidance. In fact, a taxpayer in one country might make an excessive (hence, non-arm's length) payment for the receipt of goods or services to a related company in another country in order to avoid the withholding taxes that would have been levied if that payment would have been, for example, a distribution of profits (typically subject to withholding taxes).

These constructive transactions might take the form of constructive dividends, constructive equity contributions, or constructive loans and could trigger the levying of related withholding taxes (on the related dividends or interest payments) by the country making the primary adjustment.

Example

In the above example, Company B also received a loan of EUR 100,000 from Company A on which it is required to pay 7% interest per annum (EUR 7,000). Upon examination, the company determined that the arm's length interest rate should have been 5% per annum (EUR 5,000). Therefore, Company B determines that it has paid excessive interest of EUR 2,000 to its Company A. Company B, therefore, is required to make a TP adjustment to increase its taxable income by EUR 2,000 in order to account for the excessive interest expense. This will be the primary adjustment.
Further, a secondary adjustment will result in the creation of a deemed dividend in lieu of the amount of EUR 2,000 which will accordingly be subject to dividend tax.

The juridical double taxation related to such withholding taxes might be reduced by means of unilateral measures by the second country (e.g., by means of providing a foreign tax credit) or by internationally agreed measures (e.g., by means of providing relief from the withholding taxes or a related credit under the relevant double tax treaty between the first and the second country).

6.3 Penalties and Interests

Penalties adopted by tax administrations could be categorized as civil or criminal by nature. Criminal penalties are directed towards significant fraud where the burden of proof rests with the tax administration to prove the charges whereas civil penalties are more routine and frequent in day-to-day tax audits.[64] For transfer pricing audits, civil

64. *Ibid.*, para. 4.20.

penalties are levied based on provisions of respective domestic law typically due to reasons such as a delay in the filing of returns of income, an understatement of tax liability based on wilful intent,[65] or failure to provide transfer pricing documentation.[66] The quantum of penalty is based on the nature of compliance failure. Also, different tax jurisdictions could have different means to penalise MNEs for this. This could be in the form of what are termed as 'penalties', 'additional tax' or 'interest' that involve time value of money. Regardless of the forms of punitive actions, the underlying intent of tax administrations in exercising penal provisions remains the same.[67]

Considering the complexity of transfer pricing problems and the quantum of transfer pricing adjustments to taxable incomes, the imposition of a penalty by tax administrations could result in significant impact to the tax position of MNEs.[68] Further, transfer pricing penalties invariably involve two or more tax jurisdictions and, therefore, different rates of penalties in different jurisdictions could potentially trigger tax arbitrage incentives wherein there could be a situation that income is deliberately overstated in one jurisdiction in contravention to Article 9 of the OECD and UN Model.[69]

Therefore, implementation of penalties require consistent application of domestic laws that could encourage compliance by MNEs.[70] Countries are expected to maintain the penalties in proportion to the degree of tax offence based on a tax system aligned with the following considerations:[71]

- When transactions are understated by a certain amount due to error(s) committed in good faith rather than wilful negligence or a concerted intent to evade tax, the penalty could be designed to be less punitive. For example, when tax administrators are convinced that appropriate documentation has been prepared and transfer pricing adjustments to the income is only a result of varying interpretation of the transfer pricing position of the tax administration, the penalties are expected to be relatively lower.[72]
- When a taxpayer demonstrates having taken reasonable efforts to align transactions with the arm's length principle, then the penalty could be designed according to the degree of that effort.[73] For example, when the taxpayer is able to demonstrate that access to data was not possible and, consequently, a particular transfer pricing method could not be applied, then evidence of such practical constraints should to be considered in determining the penalty.

65. *Ibid.*, para. 4.21.
66. UN TP Manual, para, C.2.4.3.1.
67. OECD TPG, para. 4.22.
68. Lohse,T., Riedel, N., *Do Transfer Pricing Laws Limit International Income Shifting? Evidence from European Multinationals*. CESifo, Working Paper No. 4404, p. 14 (September 2013).
69. OECD TPG, para. 4.26.
70. Mehafdi, M., 'The Ethics of Transfer Pricing', *Journal of Business Ethics*, pp. 365–382, (Kluwer: Netherlands).
71. OECD TPG, para. 5.39.
72. UN TP Manual, p. 410.
73. OECD TPG, para. 5.42.

- When considering a situation whereby the Mutual Agreement Procedure (MAP) is sought, payment of an outstanding penalty should not be more burdensome to taxpayers than it would have otherwise been under a normal course of domestic litigation.[74] Therefore, competent authorities are to provide due attention to situations involving penalty.

In most situations, for transfer pricing penalties, documentation plays a key role in defending tax positions and determining whether the burden of proof rests with the taxpayer or tax authorities. In summary, countries are expected to design penalty systems that encourage documentation by MNEs.

6.4 Burden of Proof

The burden of proof in tax litigation refers to the necessity of affirmatively proving the truth of facts alleged by a litigant on a preponderance of evidence.[75] The question of whether the burden of proof rests with the tax administration[76] or the taxpayer[77] could vary depending on the provisions of domestic laws in each country.[78] The characteristic features of both regimes are summarized comparatively below:

Tax Administration[79]	*Taxpayer*[80]
Taxpayer may not have any legal obligation to establish the arm's length nature of transactions and the tax administration makes the prima facie demonstration as to why the transfer prices are not at arm's length. A taxpayer could be asked to furnish necessary information to the tax administration based on request on the basis that the tax administration could establish the need for making an adjustment to arm's length prices. In the absence of furnishing information, the tax administration could determine the arm's length price based on its assumptions.	When the taxpayer demonstrates reasonable efforts to establish the adherence to arm's length criteria, tax administrations may not have the liberty to determine an adjustment to arm's length prices not based in law by ignoring the arm's length principle. Generally, the burden of proof placed on a taxpayer could be shifted legally or de facto to the tax administration in such cases. However, if the taxpayer fails to demonstrate that reasonable efforts have been taken, the actions of the tax administrations may be upheld.

74. UN TP Manual, para. C.2.4.3.7., p. 411.
75. OECD TPG, para. 5.42, p. 364.
76. UN TP Manual: examples include Germany, France, Netherlands, Japan, *paras B.8.6.10–B.8.6.13.*
77. UN TP Manual: examples include Australia, Brazil, Canada, India, South Africa and the United States, *paras B.8.6.4–B.8.6.9.*
78. OECD TPG, para. 4.11.
79. *Ibid.*, para 4.12.
80. *Ibid.*, para 4.13.

The effect of diverging principles of law between countries with regard to the burden of proof could lead to double taxation.[81] In a case when the burden of proof is on the tax administration examining the controlled transaction, the tax administration could determine or re-determine the arm's length price, and such a price could be accepted by the taxpayer. However, the tax administration in the corresponding jurisdiction to the transaction may contradict with the position which could lead to complexities in resolving the standoff. Also, the taxpayer in the second jurisdiction and the tax administration in the first jurisdiction could deviate from the arm's length principle which leads to the question of which parties have complied with the actual arm's length criteria.

Further, in the situation discussed above, when the burden of proof is considered as the guiding behaviour to verify whether the taxpayer has complied with the arm's length criteria, a taxpayer in one jurisdiction (a subsidiary) may not be in a position to provide information about the transaction with the taxpayer in a second jurisdiction (parent company). This will result in the tax administration making an adjustment to transfer prices based on the extent of information available. The corresponding parent company may also not be obligated by domestic law to prove the arm's length nature of the transaction to its tax administration which will lead to conflicts between the two tax administrations.[82]

Considering the above complexities inherent in transfer pricing disputes, taxpayers and tax administrations are expected to tread responsibly on the issue of burden of proof and not consider it as the sole guiding behaviour for verifying deviations from the arm's length principle. Therefore, under the MAP or dispute resolution processes, the tax jurisdiction that proposes the primary adjustment to the transfer price bears the burden of demonstrating to the other State that the adjustment 'is justified both in principle and as regards the amount'.[83] In all conflicting situations, both competent authorities are expected to take a cooperative approach to resolve disputes.

7 CONCLUSIONS

This chapter has discussed the fundamental concept of transfer pricing and its relevance in the backdrop of an international tax system. Transfer pricing has been centred around the arm's length principle. The initial sections have demonstrated how this principle, originally conceived as a legal fiction to allocate business income among different jurisdictions, has soon developed into an economic principle reflecting the economic reality of the transactions.[84] Global formulary apportionment, as an alternative to the arm's length principle, was evaluated, and it was concluded that, based on practical evidence, the approach, as an alternative has never gained global acceptance

81. *Ibid.*, para 4.14.
82. *Ibid.*, para. 4.15.
83. *Ibid.*, para. 4.17.
84. *Supra* n. 23, p. 29.

despite some merits put forth by international tax experts. Therefore, the arm's length principle continues to be the driving principle in a transfer pricing analysis

The application of the arm's length principle is achieved by means of a four-step process commencing with the identification of commercial and financial relations, recognition of accurately delineated transactions, choice of transfer pricing methodology, and application of methodology that is adopted. The chapter then provides a brief overview of the methods and resultant arm's length prices obtained by using such methodologies.

Finally, the chapter enumerates the consequences of transactions that are not aligned with the arm's length principle and the consequent types of adjustments that could be imputed by tax administrations. The role of the burden of proof in the event of a transfer pricing dispute is briefly addressed. Overall, this chapter provides an overview for the detailed discussions on each of the above topics.

1 INTRODUCTION

The assessment of the arm's length nature of an intra-group transaction requires that the terms and conditions of the transaction between the related parties ('tested transaction') are similar to those that would have been entered into by independent parties. This would imply the performance of the following four-step analysis:[1]

- Step 1: Identification of the commercial or financial relations
- Step 2: Recognition of the accurately delineated transaction undertaken
- Step 3: Selection of the most appropriate transfer pricing method
- Step 4: Application of the most appropriate transfer pricing method.

This chapter will provide more details on the first two steps of the analysis. The result of the application of the first two steps of the analysis will ultimately provide an

1. *See* Ch. 1.

answer on whether any compensation for the tested transaction can be chargeable/deductible. This analysis is of outmost importance, as described in section 2.

In order to provide guidance on this relevant topic, both the OECD Guidelines and the UN Manual have included some terminology. Under both documents, in general, the arm's length nature of a transaction should be assessed by referencing the 'transaction actually undertaken by the associated enterprises as it has been structured by them'.[2] However, in some 'exceptional circumstances', tax administrations may adjust the structure of an intra-group transaction and the conditions agreed upon by the related parties. This process leads to the recognition of the accurately delineated transaction undertaken as described in section 3.

Moreover, since the application of the arm's length principle is fundamentally based on a comparison of the conditions in a controlled transaction with those that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances, this chapter will also present the process of performing a comparability analysis in section 4.

2 THE IDENTIFICATION OF THE COMMERCIAL OR FINANCIAL RELATIONS

The identification of the commercial and financial relations is instrumental to two fundamental aims in a transfer pricing analysis:[3]

(i) To identify the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attached to those relations in order to ensure that the controlled transaction is accurately delineated.
(ii) To compare that the conditions and the economically relevant circumstances of the controlled transaction are accurately delineated with the conditions and the economically relevant circumstances of comparable transactions between independent enterprises.

This section will focus on the first of the abovementioned aims while the second aim will be analysed in section 4.

The result of the application of the first two steps of the analysis will ultimately provide an answer on whether any compensation for the tested transaction can be chargeable/deductible. This analysis is of outmost importance. Indeed, without the performance of this analysis, an entity could feasibly deduct expenses that would not have incurred at arm's length. Therefore, the risk of corporate tax base erosion in the country of the entity paying for the tested transaction would radically increase.

2. Paragraph 1.64, 2010 OECD Guidelines; para. 5.4.9.1, 2013 UN Manual.
3. *See* 2017 OECD TPG, *supra* para. 1.33.

Example

Company A, a resident in Country X, and Company B, a resident in Country Y, belong to the Group ABC. Country X's and Country Y's nominal tax rates are 50% and 5%, respectively. Although Company A does not require any service, the Group ABC decides that Company A should pay Company B some fees for intra-group services. In this way, Company A will be able to deduct the service fees at the nominal tax rate of 50% while Company B will be taxed on those service fees at the nominal tax rate of 5%.

However, the incorrect performance of this analysis (whereby either a tested transaction that should be chargeable is ascertained to not be chargeable or a tested transaction that should not be chargeable is determined to be chargeable) could increase the risk of double taxation or less-than-single taxation in the country of the entity paying for the tested transaction.

Example

Company A, a resident in Country X, and Company B, a resident in Country Y, belong to the Group ABC. Company B has provided an intra-group service to Company A. This intra-group service should be chargeable. However, Country X's tax administration incorrectly ascertains that the intra-group service should not be chargeable. As a result, Company A will not be able to deduct the service fees related to the service while, at the same time, Company B will be taxed on the service fees received from it. Ultimately, economic double taxation will arise.

Example

Company A, a resident in Country X, and Company B, a resident in Country Y, belong to the Group ABC. Company B has provided an intra-group service to Company A. This intra-group service should not be chargeable. However, Country X's tax administration incorrectly ascertains that it should be chargeable. As a result, Company A will be able to deduct the service fees related to the service while, at the same time, Company B might be able to avoid taxation on the service fees received from it by proving to Country Y's tax administration that the intra-group service should not be chargeable. Ultimately, less-than-single taxation will arise.

The process of identifying the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances commences with a broad based understanding of the industry sector in which the MNE Group operates and the various factors that influence the performance of the sector as

a whole.[4] The process then continues with an analysis of the MNE Group itself, the ownership structure, and the commercial and financial relationships based on the transactional flow between individual enterprises that require fulfilling the arm's length criteria. The process of identifying the commercial or financial relations between the associated enterprises will result in providing an accurate delineation of the actual transaction that is undertaken between the associated enterprises.

The 1995 OECD TPG[5] first provided various constituents for successful identification of the commercial and financial relations. It contained detailed provisions on comparability wherein a mix of five factors of comparability analysis were identified. These factors were also recognized by other tax jurisdictions such as the US[6] and continue to be the foundations on which the process of identifying the commercial and financial relations rests:[7]

(1) Contractual terms
(2) Functional analysis
(3) Characteristics of property or services
(4) Economic circumstances
(5) Business strategies.

It is also critical to note that the interplay of these factors have undergone changes over a period of time indicating a change to the approach of a comparability analysis in an effort to improve the process (Figure 2.1).

Figure 2.1 Comparability Factors[8]

Historical process		Current process
Characteristics of property or services		*Contractual terms*
Functional analysis		Functional analysis
Contractual terms		*Characteristics of property or services*
Economic circumstances		Economic circumstances
Business strategies		Business strategies

4. *Ibid.*, para. 1.34.
5. *See* OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, (Paris: OECD Publishing, 1995).
6. *See* US Treas. Reg. s. 1.482-1(d)(1).
7. *See* 1995 OECD TPG, *supra* n. 13, at paras 1.19–1.35.
8. *See* Gao, J., Beats.,S; *Recent Developments on Comparability Analysis in Transfer Pricing*, Recent Developments in Transfer Pricing, 2017, Kluwer Tax Law (Vienna: 2018) (*Forthcoming*).

The beginning point for accurately delineating is the evaluation of controlled transactions that are undertaken between related parties. For this purpose, the written inter-group contracts between the transacting parties are the basis for a traditional transfer pricing analysis. However, the coverage of a sound arm's length analysis has expanded considerably to include an evaluation of the economic substance of the transaction. This expanded approach requires taxpayers to ascertain economically relevant characteristics of a transaction.[9] Once obtained, these characteristics help in determining whether the commercial and financial relations of the transacting parties are performed under conditions that could differ from those that would have been agreed upon in an uncontrolled transaction under comparable circumstances.

2.1 Contractual Terms of the Transaction

One of the five economically relevant characteristics (or comparability factors) presented in the OECD TPG to accurately delineate the actual transaction is the contractual terms of the transaction.[10] MNEs use informal arrangements, tacit understandings, etc. to operate with 'relational contracts'.[11] Therefore, an analysis of contractual relations functions as a starting point to the process of a comparability analysis.

An analysis of contracts is associated with the larger arm's length principle since transactions between independent enterprises are typically based on divergence of interest. i.e.: (i) that contractual terms are concluded based on each individual's rational preferences, (ii) the contracting parties will hold each other liable for consequences of deviation from the contract, and (iii) any modification to the contract will be permitted by the parties if it is mutually beneficial. Since associated enterprises could deviate or act in concert, material differences between the contractual terms and actual conduct determine the factual substance and accurately delineate the actual transaction.[12]

2.1.1 Identification of Written Terms

Legal clauses define the functions undertaken and risks assumed by the transacting parties depending on the manner in which the contract is composed. Without an established contract, the actual conduct of parties is left open to interpretations, leading to potential disputes.

This has been further emphasized by the OECD:

> *[w]here a transaction has been formalised by the associated enterprises through written contractual agreements, those agreements provide the starting point for delineating the transaction between them and how the responsibilities, risks, and anticipated outcomes arising from their interaction were intended to be divided at the time of entering into the contract.*[13]

Contractual agreements are critical in evaluating the facts and circumstances underlying a taxpayer's intra-group transactions and form the basis for much of the functional, legal, and economic analyses that support a taxpayer's transfer pricing positions. Therefore, it becomes critical to ensure that the intended substance of the arrangement is reflected in the contractual language as much as possible.[14]

Example

Company P, legally owning a manufacturing technology, provides an exclusive license to Company B to manufacture goods by entering into a legally binding contract. The agreement captures the roles and responsibilities of the parties to the contract.
Further, based on a group transfer pricing policy, Company B and Company A agree on a cost plus 10% remuneration for the activities undertaken by Company B. The contractual agreement includes an appropriate pricing clause explicitly stating the remuneration model adopted by the two companies and also capturing the components of costs on which the mark up is applicable.
Additionally, the agreement includes details of currency of payment, tenure of the contract, collection period, etc. which are factors to be considered in the comparability analysis.

2.1.2 Evaluate Intentions of the Parties

It is recognised that the actual conduct of the parties could vary from what is documented in the contract, and also the information contained may not be sufficient for understanding the circumstances of entering into the transaction, leading to a lack of basis for undertaking a comparability analysis.[15] This is primarily due to the intent of entering into a transaction which may not be fully understood in the contract[16] while tax administrators aim to comprehend the intent from the contract.[17] In this regard, the OECD has recognized the need to take into account the principles of contract interpretation.[18]

9. *See* 2017 OECD para. 1.35, p. 44.
10. *See* 2017 OECD TPG, para. 1.37.
11. *See* Rauterberg, *Contracting Within the Firm, Columbia Law School* (4 May 2005).
12. *See* OECD TPG 1.46.
13. *See* OECD, BEPS Actions 8–10 Final Reports, *supra* para. 1.42.
14. *See* Sharon, A, *Drafting Intercompany Agreements with an Eye on Transfer Pricing*, International Tax, Bloomberg BNA, 28 Nov. 2012.
15. *See* OECD 2017, *supra* para. 1.43.
16. *See* Pichhadze, A., *Exposing Unaddressed Issues in the OECD's BEPS Project: What About the Roles and Implications of Contract Interpretation Law and Private International Law in the Transfer Pricing Arm's Length Comparability Analysis?* World Tax J.1 (2015), at 99, 131–132, Journals IBFD.
17. *See* Canadian Supreme Court in the case of *Manulife Bank of Canada v. Conlin* (1996), para. 79.
18. *See* 2017 OECD TPG, *supra* para. 1.43.

Example[19]

Company X, a manufacturer that has functional currency in US dollars sells to Company Y, an associated distributor in another country having functional currency in euros. The written contract states that Company Y assumes all exchange rate risks arising from the transaction. If, however, the price for the goods is charged by the manufacturer to the distributor in euros, the currency of the Company Y, then the actual conduct is not in accordance with the intention of the contractual arrangement.

2.1.3 Analysis of Substance

2.1.3.1 Source of Evidence

When the actual conduct of the parties is not consistent with economically significant terms that are evident from the contract, further analysis is required in order to identify the actual transaction. In doing so, it is critical to analyse how third-party enterprises could have determined the contractual terms under similar circumstances.[20] If material differences between contractual terms and the conduct of the associated enterprises in their relations with one another exist, the functions actually performed, assets used, and risks actually assumed in relation to the contractual terms should ultimately determine the factual substance and accordingly accurately delineate the actual transaction.[21] The information from written contracts should be clarified and supplemented by considering the evidence of the commercial or financial relations provided by the other four comparability factors.[22]

Example[23]

Company X is the parent company while Company Y is a wholly-owned subsidiary of Company A and acts as an agent for Company A's branded products that have been newly launched in Company B's local market. The agency contract between Company A and Company B is silent about any marketing and advertising activities that are required to be undertaken by Company B.
Based on an analysis, it is identified that Company B incurred significant expenses for creating awareness about the product locally. Further, based on evidence provided by the conduct of the parties, it could be concluded that the written contract did not reflect the full extent of the commercial or financial relations between the parties. Beyond the terms contained in the written contract, the extent of Company B's awareness campaigns is to be ascertained.

19. *Ibid.*, para. 1.89.
20. *Ibid.*, para. 1.46.
21. *Ibid.*, para. 1.47.
22. *Ibid.*, para. 1.42.
23. *Ibid.*, para. 1.33.

2.1.3.2 Control and Financial Capacity to Undertake Functions and Risks

In situations when the parties to the contract do not have the capacity to perform a particular function even if the written contract ordains the role, the actual transaction should be determined only based on an evaluation of the conduct of parties. If the actual functions performed, assets used, and risks assumed by the parties are not in accordance with the written contract, the transaction is determined based on the conduct and not on the written terms.

Example[24]

Parent Company A manufactures products sold by subsidiary Company B according to a licensed agreement. External customers prefer Company B as a joint contracting party along with Company A for administrative convenience while the fee is paid to Company A. Though Company A has given a license to Company B, the control of risks and output of Company B continue to be undertaken by Company A. Therefore, the conduct overrides the contractual assumption of functions, risks, and assets.

In summary, an analysis of contracts helps to delineate in the following circumstances:

(a) When transactions remain unidentified from what is reported or are deducible from the contract due to conduct;
(b) Characteristics of a transaction that are economically relevant are inconsistent with the written contract between the associated enterprises, therefore, requiring a recharacterization of the transaction;
(c) When no written terms exist in the first place, the actual transaction is deduced from the actual conduct that is identified by the economically relevant characteristics of the transaction.

2.1.4 Role of Aggregation of Transactions in Contracts

Analysing contracts for the purposes of delineation helps to identify if a contract contains a number of elements including leases, sales, and licenses all packaged into

24. *Ibid.*, para. 1.48.

one deal.[25] Upon delineation of a transaction, an evaluation is required to determine if a transaction-by-transaction approach is suitable for further comparability analysis stages. If separate transactions are intrinsically linked and continuous, then an aggregation of the transactions is more appropriate. However, accurate delineation of the separate transactions is still necessary and, the question of aggregation of disaggregation comes into focus only upon recognition of the transaction. Functional analysis

The analysis of the contractual terms is followed by the identification of the functions performed, assets used, and risks assumed specifically for the tested transaction. This functional analysis process determines whether a given uncontrolled transaction is relevant for comparison purposes to the related party transaction that is being examined. It examines the specific economic activities that are inherent in the transactions that are being compared. In this manner, a functional analysis acts as a filter for eliminating uncontrolled transactions that are not comparable from a transfer pricing analysis.[26]

Additionally, such an analysis should be 'including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices'.[27] In this context, the performance of a comprehensive global value chain analysis of the MNE will be fundamental.[28] From a transfer pricing perspective, the following steps of a value chain analysis should be relevant:[29]

(1) Mapping out a generic value chain for the industry.
(2) Mapping out an MNE's value chain.
(3) Comparing the generic value chain to an MNE's value chain and analysing the differences that may explain why an MNE has a competitive advantage over its competitors.
(4) Distinguishing between an MNE's main functions and its support functions.
(5) Identifying and understanding which of the MNE's main functions are critical to the success of the organization (i.e., a critical success factor).
(6) Identifying and understanding which activities performed by an MNE add value to the goods and services it produces that may distinguish the MNE from its competitors, i.e., value-adding activities.
(7) Understanding and confirming how the various functions across the value chain are split by the MNE between the various legal entities in the group.

25. *See* United Nations, *Practical Manual on Transfer Pricing for Developing Countries* (New York: United Nations, 2013), para. B.2.3.1.
26. US IRS Reg. 1.482.
27. OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 2010), para. 1.36 (Ch. I).
28. *See* 2017 UN TPM, A3.5.1.
29. *Ibid.*

2.1.5 *Functions Performed*

The analysis of functions that is performed involves tracing the flow of products or services at various stages from the conceptualization to their final sales. The typical components of a functional analysis for transactions involving tangible goods include understanding and documenting the roles of the parties that undertake the following in the transaction flow:[30]

- Research and development;
- Product design and engineering;
- Manufacturing, production and process engineering;
- Product fabrication, extraction, and assembly;
- Purchasing and materials management;
- Marketing and distribution functions including inventory management, warranty administration, and advertising activities;
- Technological developments and marketing analytics;[31]
- Transportation and warehousing; and
- Managerial, legal, accounting and finance, credit and collection, training, and personnel management services.

Generally, the analysis is two-sided, i.e., involving both the transacting parties, and captures the relative strength of each party performing the stated function.

Example[32]

Company B manufactures food products with support from Company A. Company A provides its expertise on market development and undertakes the product development including food technology, composition, and knowhow. Company A also executes the quality control of the manufactured goods. Company B undertakes limited market development functions and has its inhouse R&D team to support Company A. After a detailed analysis, the functional profile of Company A and Company B is summarized as below:

Intensity of Functions	*Company A*	*Company B*
Market Development	X	XXX
Product Development	XXX	X
Manufacturing	None	XXX
Quality Control	XXX	X
Corporate Strategy	XXX	X

30. US IRS Reg. 1.482.
31. *See* 2017 UN TPM B.2.3.2.14.
32. *See* 2017 OECD TPG, *supra* para. 1.48.

Intensity of Functions	*Company A*	*Company B*
Finance, treasury, legal	XXX	X
Human Resource Management	X	XXX

2.1.6 Assets Used

Tangible as well as intangible assets that are utilised in the course of an international transaction or transferred between associated enterprises must be ascertained. Capital assets that are employed such as plant and equipment, intangible assets, financial assets, etc. and their relative usage by the transacting entities also need to be evaluated.[33] An industry analysis (refer to section 4.1.1) determines the level of assets in an industry. In the case of capital intensive industries, the employment of a capital asset such as property, plant, and equipment play a significant role in determining the comparability.

Intangibles for transfer pricing purposes are broader in scope than what is recognized as intangible assets for accounting purposes.[34] Therefore, 'intangible' is intended to address something that is not a physical asset or a financial asset that is capable of 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.[35] Intangibles could be further classified as 'hard' and 'soft' intangibles, 'marketing' and 'trade' intangibles, 'routine' and 'non-routine' intangibles from a transfer pricing perspective.[36] For details on transfer pricing aspects of intangibles, refer to Chapter 11.

List of tangible and intangible assets (not limited to) requiring consideration are as follows:[37]

Tangible Assets	*Intangible Assets*
- Land and buildings; - Plant and machinery; - R&D equipment; - Office equipment; - Furniture and fixtures; - Vehicles;	- Patents - Know-how and trade secrets - Trademarks, tradenames and brands - Rights under contracts and government licenses - Licenses and similar limited rights in intangibles

33. *See* 2017 UN TPM, B.2.3.2.20.
34. *See* 2017 OECD TPG, *supra* para. 6.7.
35. *Ibid.*, para. 6.6.
36. *Ibid.*, para. 6.15.
37. *See* 2017 UN TPM, B.2.3.2.22.

Tangible Assets	*Intangible Assets*
- Computers; and - Testing equipment.	- Goodwill and ongoing concern value - Group synergies - Market specific characteristics

Example[38] (Cont.)

Company B holds a significant number of plants and machines, fixed installations such as warehouses, and premises for the manufacture and distribution of finished products. The technological know-how for Company B's operations are end-to-end provided by Company A. Company B undertakes certain awareness campaigns and customized marketing efforts, establishing certain marketing intangibles apart from the brand already owned legally by Company A. Considering the above, the intensity of risk on brand and technology is attributed.

Intensity of Assets	*Company A*	*Company B*
Tangible assets		XXX
Intangible assests	XXX	None
Technological		
Trademark	XX	X

2.1.7 Risks Assumed

A transfer pricing analysis should involve the identification of risks and subsequently attribute them to the entity that assumes the identified risks. A risk analysis follows the functional and asset analysis, and they cannot be isolated from one another. This analysis results in the identification of the relevant risks and to their allocation, irrespective of which party is responsible in the contract for them, to the parties to the parties that have: (a) the control over such risks and (b) the financial capacity to assume such risks.[39] Control over a specific risk in a transaction focuses on the decision-making of the parties to the transaction in relation to the specific risk arising from the transaction. It is also to be noted that other parties in an MNE's organizational structure could be involved in establishing general policies that are relevant for the assumption and control of the specific risks that are identified in a transaction without such policy-setting itself stipulating decision making.[40]

38. *See* 2017 OECD TPG, *supra* para. 1.48.
39. *See* 2017 UN TPM, B.2.3.2.17.
40. *See* 2017 OECD TPG, *supra* para. 1.76.

2.1.7.1 *Overview of the Risk Framework*

For the purpose of evaluating, the following broad parameters could be considered:[41]

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

The role of the value generated by the MNE groups as a whole, the interplay of functions performed, and the relative contributions of the co-creation of value facilitates understanding the functional profile.[42]

It is also critical to note that, while one party could perform multiple functions, it is the economic significance of the functions in terms of frequency, nature, and value that is to be given importance.[43] The identification of capabilities also helps in determining options that are realistically available to the party before entering into the transaction, demonstrating the rationale adopted by the transacting parties in making the transaction decision.[44]

2.1.7.2 *The Six-Step Process*

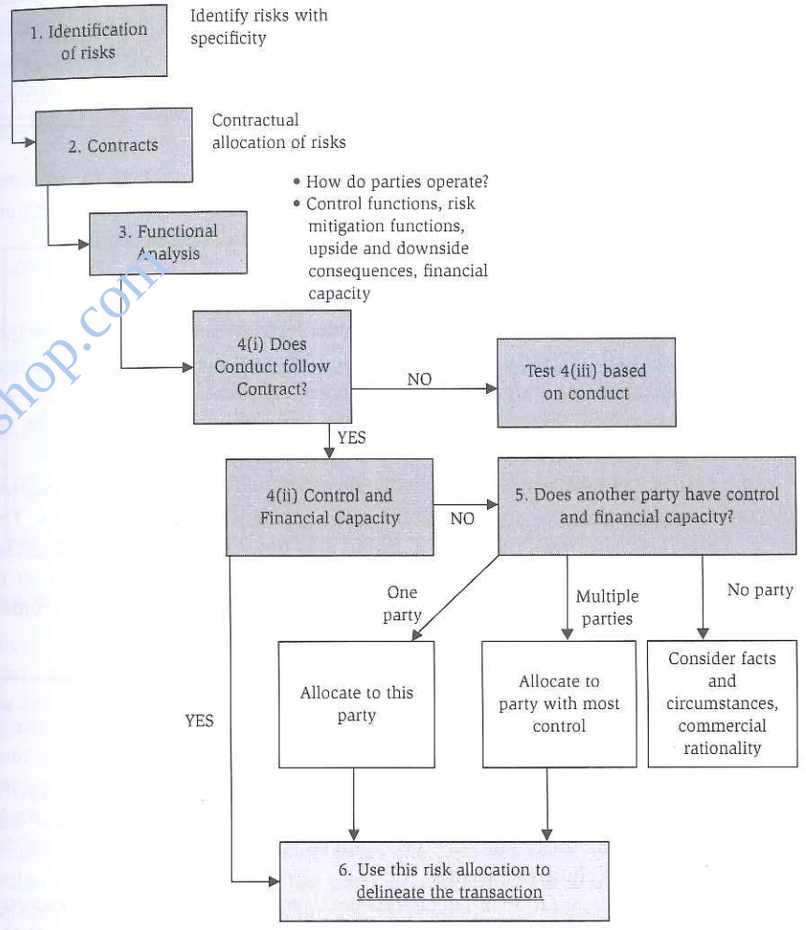
The functional analysis remains incomplete without a detailed analysis of material risks that are assumed by parties to the transaction(s) under review. For this purpose, the functional analysis of risk in the TPD 2017 is broken down to a six-step process:[45]

(1) *Step 1:* Identify economically significant risks with specificity
(2) *Step 2:* Contractual assumption of risk
(3) *Step 3:* Functional analysis in relation to risk
(4) *Step 4:* Interpreting steps 1–3
(5) *Step 5:* Allocation of risk
(6) *Step 6:* Pricing of the transaction, taking account of the consequences of risk allocation

41. *Ibid.*, para. 1.65.
42. *Ibid.*, para. 1.51.
43. *Ibid.*, para. 1.51.
44. *Ibid.*, para. 1.52.
45. *Ibid.*, paras 1.56–1.70.

While the process is prescribed consistently by the OECD and the UN, several individual tax jurisdictions have adopted a similar process for risk framework.[46] The steps are diagrammatically represented in Figure 2.2.

Figure 2.2 Risk Recognition Framework[47]



The process is described in detail below:

46. *See* Source: http://www.hmrc.gov.uk/gds/intm/attachments/flowchart-re-accurate-delineation.docx (last accessed 3 Mar. 2018).
47. *See* 2017 UN TPM, *supra*. p. 88.

person who made the request for arbitration.[163] Moreover, neither the OECD Commentaries nor the Sample Mutual Agreement specify rules on how to object to the appointment of the arbitrators.

The Sample Mutual Agreement provides that, for the purposes of the arbitration decision, information that was not available to both contracting states before the request for arbitration was received should not be taken into account unless otherwise agreed upon by the competent authorities.[164] According to the Sample Mutual Agreement, the arbitration decision must be communicated to the competent authorities and the person making the request for arbitration within six months from the date on which the Chair notifies the competent authorities and the person making the request for arbitration that the Chair has received all of the necessary information.[165]

3.3.2 *Procedural Aspects of Arbitration under Arbitration Convention and the Code of Conduct*

Practical aspects of the Arbitration Convention are clarified in the Code of Conduct for effective implementation of the Arbitration Convention (Code of Conduct). The Arbitration Convention does not provide a list of specific documentation to be submitted to the advisory commission. Instead, it enables taxpayers to submit any information, evidence, or document that is likely to be of use in the course of the arbitration process.[166] The Code of Conduct provides a detailed list of documentation and information that must be presented in order for the dispute to be considered submitted for the purposes of the commencement of the two-year period after which the case shall be transferred to arbitration. The list of required documents and information shall consist of:

- the identification information (such as name, address, tax identification number) of the enterprise of the Member State that presents its request and of the other parties to the relevant transactions;
- details of the relevant facts and circumstances of the case (including details of the relationships between the enterprise and the other parties to the relevant transactions);
- identification of the tax periods concerned;
- copies of the tax assessment notices, tax audit report, or equivalent leading to the alleged double taxation;
- details of any appeals and litigation procedures initiated by the enterprise or the other parties to the relevant transactions and any court decisions concerning the case;
- an explanation by the enterprise of why it considers that the principles established in Article 4 of the Arbitration Convention have not been observed;

163. *Ibid.*, p. 539, para. 5.
164. *Ibid.*, p. 540, para. 10.
165. *Ibid.*, 542, para. 16.
166. Article 10 of the EU Arbitration Convention.

- an undertaking that the enterprise shall respond as completely and quickly as possible to all reasonable and appropriate requests made by a Competent Authority and have documentation at the disposal of these authorities; and,
- any specific additional information requested by the Competent Authority within two months after the receipt of the taxpayer's request.[167]

As per the Arbitration Convention, the advisory commission comprises a chairperson, two representatives of each Competent Authority (this may be reduced to one), and an even number of independent persons of standing.[168] The independent persons must be nationals of a Member State of the European Union and resident within the territory to which the Arbitration Convention applies.[169] The advisory commission will normally consist of two independent persons of standing in addition to the chairperson and the representatives of the competent authorities.[170] The Code of Conduct sets out a procedure for identifying the candidates for the advisory commission:

- Member States commit themselves to provide the names of the five independent persons of standing who are eligible to become a member of the advisory commission to the Secretary-General of the Council without a delay;
- In addition to transferring the names of their independent persons of standing to the Secretary-General of the Council, Member States shall also deliver curriculum vitae of these persons which should, among other things, describe legal, tax, and especially transfer pricing experience of those persons;
- Member States may also indicate those independent persons of standing on their list who fulfil the requirements to be elected as Chairperson;
- Member States will have to confirm the names of their independent persons of standing or provide the names of their replacements to the Secretary-General of the Council in accordance with the yearly request presented by the latter;
- The aggregate list of all of the independent persons of standing will be published on the Council's website.[171]

The independent persons of standing should be appointed by mutual agreement from a list of individuals who are nominated by the contracting states.[172] The list of independent persons of standing shall consist of all of the independent persons who are nominated.[173] The contracting States have a right to nominate five individuals as persons of independent standing.[174] Independent persons are appointed by the drawing of lots by the competent authorities concerned where the mutual agreement is not reached.[175] The Chairperson is elected by the independent persons of standing from the

167. Article 5 of the EU Arbitration Convention.
168. Article 9(1) of the EU Arbitration Convention.
169. Article 7.1(f) of the EU Arbitration Convention.
170. Article 7.2(c) of the EU Arbitration Convention.
171. Articles 7.1 (a)–7.1(e) of the EU Arbitration Convention.
172. Article 9(1) of the EU Arbitration Convention.
173. Article 9(4) of the EU Arbitration Convention.
174. *Ibid.*
175. Article 9(1) of the EU Arbitration Convention.

list of the appointed independent persons of standing.[176] When the independent persons of standing are designated by drawing the lots, the EU Member States have the right to object to a selection provided that the circumstances mentioned in Article 9(3) of the Arbitration Convention are satisfied.[177] They can also oppose the selection of the Chairman of the advisory commission under the same conditions established in Article 9(3) of the Arbitration Convention.[178] The independent persons of standing are required to be the nationals of the contracting states of the Arbitration Convention and resident in the territory where the mentioned Convention applies. They shall meet the requirements of independence and competence.[179]

3.4 Issues and Possible Solutions

3.4.1 OECD and UN Model Convention

In some countries, court and/or administrative decisions are final, and the competent authorities might not be able to override them. Therefore, taxpayers may not always effectively benefit from the mentioned clause. As a result, the OECD Commentary on Article 25(5) provides that issues cannot be submitted to arbitration when a court or an administrative tribunal of any of the contracting states have delivered a decision on the case.[180] Moreover, the OECD recommends including the arbitration clause in a tax treaty when the contracting states consider that this provision will be effectively implemented in practice.[181] It also suggests that jurisdictions limit access to arbitration when a case has already been decided under the domestic litigation process of any of the contracting States (i.e., the decision must rendered by the court or an administrative tribunal of one the contracting States) in order to avoid the risk of conflicting decisions.[182]

The OECD Commentary on Article 25 states that some countries will allow access to the arbitration only when the legal remedies are no longer available.[183] In this respect, the proposed solution is to still allow access to arbitration when the taxpayer under consideration waives the right to pursue the case under the domestic legal remedies. In this aspect, the OECD even suggests terminology that can be adopted by the contracting States in the double tax treaties.[184] However, waiving the right to pursue the case under the domestic remedies might potentially subject the taxpayer to

176. Article 9(5) of the EU Arbitration Convention.
177. Article 9(3) of the EU Arbitration Convention.
178. Article 9(5) of the EU Arbitration Convention.
179. Article 9(4) of the EU Arbitration Convention.
180. OECD Model Convention, at Article 25(5).
181. OECD Model Convention, footnote to Article 25 (5).
182. OECD, *Commentaries on Model Tax Convention*, Article 25, at para. 76.
183. *Ibid.*, para. 80.
184. *Ibid.*

unresolved double taxation. Therefore, the OECD recommends modifying the paragraph in the bilateral tax treaty in order to ensure that the double taxation will, in fact, be relieved.[185]

3.4.2 Arbitration Convention and the Code of Conduct

As per the Arbitration Convention, a taxpayer cannot simultaneously pursue domestic dispute resolution techniques along with a MAP and arbitration. In this respect, the Arbitration Convention provides that, when the case has been submitted to the court or a tribunal of the Member State concerned, the two-year period shall be calculated from the date on which the judgment of the final Court of Appeal was delivered.[186] Therefore, a taxpayer can only initiate a MAP and a case may be subsequently transferred to the advisory commission only after the final decision has been achieved as per the domestic remedies. Thus, the resolution of double taxation in such cases will be time-consuming as the taxpayer is not allowed to pursue both the domestic and international dispute resolution mechanisms at the same time. Moreover, when the competent authorities cannot derogate from the decisions of their judicial bodies, paragraph 1 of Article 7 of the Arbitration Convention does not apply (i.e., the amount of time does not begin to apply for the purposes of submission of the case to the advisory commission) unless the amount of time for the appeal has expired or the appeal has been withdrawn before the decision is delivered.[187] Therefore, in such cases, the taxpayers must make a decision between the domestic and international remedies.

4 CONCLUSIONS

Following the introduction that contains the significance of dispute resolution mechanisms in the field of international tax and transfer pricing, in particular, this chapter provides a comprehensive overview and analysis of the administrative approaches to resolving transfer pricing disputes, including a MAP in section 2 and arbitration in section 3.

With respect to the MAP, this chapter first recognizes that, despite being a favourable dispute resolution tool, the MAP process contains certain flaws including: (1) the participation of taxpayers is limited in the MAP process; (2) the MAP procedure is time-consuming and lengthy; and (3) the MAP negotiation cannot ensure the elimination of the double taxation. Concerning the procedural aspect of a MAP, it identifies three key areas that impose difficulties in practice. These areas are: (1) the interaction between a MAP and domestic legislations; (2) the relationships between a MAP and domestic available remedies; and (3) the elimination of economic double taxation.

185. *Ibid.*
186. Article 7(1) of the EU Arbitration Convention.
187. Article 9(3) of the EU Arbitration Convention.

1 INTRODUCTION

Over the last twenty years, the documentation of transfer pricing arrangements accompanied by the standardization of Transfer Pricing Documentation (TPD) requirements have been given increased importance in many countries.[1] The proliferation of diverse local TPD rules has made it necessary to create a uniform international standard to reduce both the compliance costs for businesses and potential transfer pricing disputes arising from divergent documentation requirements and inconsistent documentation. However, previous initiatives to standardize the TPD have, for several reasons, not fully met the needs of either taxpayers or tax administrations. The most recent harmonization efforts have been focused on new standards for the TPD that enhance transparency for tax administrations while taking into consideration the compliance costs for MNEs.

Generally, the vast majority of MNEs can be said to have now accepted the imposition of statutory record-keeping obligations. However, criticism can still be levied at the multitude of terms in existence and the abundance of concepts requiring interpretation in which the application – as experience shows – frequently leads to disputes in tax audits. This is compounded by the international development and the incredibly explosive increase in documentation standards, especially in developing countries and emerging markets. This is leading almost instinctively to a more aggressive inspection of tax audits, particularly of arm's length documentation. To

1. OECD, *White Paper on Transfer Pricing Documentation*, Public Consultation, 30 Jul. 2013 (2013), p. 2.

date, MNEs have been precarious regarding compliance between jurisdictions with diverse levels of domestic legislation and documentation requirements that are not coordinated internationally and are hence exposed to the unilateral desire of tax authorities for a fair share of taxes.

This chapter first reviews the international development on TPD standards at the level of the OECD, the Pacific Association of Tax Administrators (PATA), and the EU in section 1.[2] Subsequently, it focuses on the three-tiered approaches on the TPD that are endorsed by OECD BEPS Action 13 with a detailed presentation of the master file in section 2, the local file in section 3, and the Country-by-Country Reporting (CbCR) in section 4. Before concluding this chapter, it also provides a critical review of the OECD's three-tiered approach in section 5.

1.1 International Developments Before BEPS Action 13

1.1.1 Chapter V of the OECD Guidelines

For quite some time now, efforts have been made to harmonize the TPD for MNEs in an attempt to avoid costly duplicative work derived from the multiplicity of documentation regulations.

In 1994, the United States became the first country to introduce documentation regulations for intra-group transfer pricing[3] and penalties in the event that the transfer pricing outcome was realised to be inadequate and that documentation requirements were not complied with. The introduction of penalties led to concerns in other countries that MNEs would henceforth disclose profits primarily in the United States in order to satisfy the IRS. In 1995, the OECD addressed these fears in its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995 OECD Guidelines) which urge all OECD Member States to observe the principle of proportionality that '[d]ocumentation requirements should not impose on taxpayers costs and burdens disproportionate to the circumstances'.[4]

The 2010, the OECD Guidelines address the TPD in a separate chapter, Chapter V.[5] However, the OECD countries declined to provide an exhaustive list of documents to be included in a TPD package. The 2010 OECD Guidelines merely outline the procedure for furnishing evidence and provide general indications about information and documentation that might be beneficial.

2. The UN Manual contains a good summary of the TPD development at various institutional and national levels and practical guiding principles. For more details, *see* Part C of the 2017 UN Manual.
3. *See* section 482 of the US Internal Revenue Code, 1994 Final Transfer Pricing Regulations of the United States; *see also* OECD, *White Paper on Transfer Pricing Documentation*, Public Consultation, 30 Jul. 2013 (2013), p. 7.
4. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*, Committee on Fiscal Affairs, OECD, Paris (1995), para. 309.
5. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Ch. V: Documentation, Publication Date: 18 Aug. 2010 (2010).

The 2010 OECD Guidelines represent a compromise of the OECD members.[6] Strictly speaking, the 2010 OECD Guidelines did not have any direct legal effect. Nonetheless, they did have significance for the national law of the OECD members even though, according to current knowledge, there are virtually no countries in which the OECD proposals for documentation were enshrined in law; rather, they were part of administrative instructions and pronouncements issued by the national competent authorities. A number of countries directly transposed the 2010 OECD Guidelines into national law through national regulations. For example, Ireland adopted the OECD Guidelines into its domestic legislation.[7] Others were unmistakably guided by the 2010 OECD Guidelines in their national transfer pricing rules, for example, the records required under German law (§ 90 (3) of the German Tax Code and related German Regulation) primarily corresponded to the proposals in Chapter V of the 2010 OECD Guidelines.[8]

Although the OECD Guidelines could generally be considered as a starting point for most national regulations, significant differences between the individual national requirements persisted in some cases. This situation is less than ideal for MNEs that are understandably keen to ensure that, as much as possible, documentation prepared for one country can also be used and accepted in another country. In this respect, it is desirable for MNEs that the broadest possible consensus is reached among the individual countries regarding documentation requirements. Similar approaches to standardization can be found not only in the OECD but also among the members of the Pacific Association of Tax Administrators (PATA)[9] – Australia, Canada, Japan, and the United States. The European Union (EU) also increased its efforts in this regard under the rubric of the EU Joint Transfer Pricing Forum (EU JTPF).[10]

1.1.2 *PATA Documentation Package*

On 12 March 2003, the PATA members attempted to synchronize national TPD regulations. However, the objective of the planned multilateral synchronization of the national TPD obligations was not actually to standardize these documentation requirements but to merely create uniform minimum documentation standards with the (sole) effect that an MNE that complies with these standards in all of the participating countries is no longer exposed to documentation-related penalties. Additionally,

6. *See* Abstract of OECD TPG: '*The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations Provide Guidance on the Application of the "Arm's Length Principle", Which Is the International Consensus on Transfer Pricing*' (accessed 15 Mar. 2016).
7. *See* section 835D of the Taxes Consolidation Act 1997 (as inserted by section 42 of the Finance Act 2010, available at: http://www.irishstatutebook.ie/eli/2010/act/5/enacted/en/html).
8. *See* section 90 para. 3 of the German Tax Code.
9. PATA, *Transfer Pricing Documentation Package*, http://www.drtp.ca/wp-content/uploads/2015/02/PATA_Transfer_Pricing_Documentation.pdf.
10. For more information to the EU Joint Transfer Pricing Forum *see* http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/forum/index_en.htm (accessed 15 Mar. 2016).

satisfaction of the principles of the PATA Documentation Package does not preclude PATA member tax administrations from making transfer pricing adjustments.[11]

The PATA Documentation Package prescribes covering forty-eight specific items from ten broad categories that should be included in a taxpayer's documentation.[12] The listed items are more specific than the regulations of any individual PATA member country and, therefore, represent documentary requirements that are more rigorous.[13] As a consequence, in order to produce TPD that complies with the PATA documentation package, MNEs must invest greater efforts than those needed to prepare documentation for any PATA member jurisdiction. Yet, the documentation regulations of the individual PATA members differ substantially in scope. This may lead to a taxpayer having to provide more or less information in one country than what is required in another in order to comply with the minimum standards.

1.1.3 *EU Code of Conduct on TPD*

On 10 November 2005, the European Commission adopted a proposal for a Code of Conduct on the TPD for associated enterprises in the European Union (EU TPD) that would standardize and partially centralize the TPD that MNEs must provide to tax authorities. This occurred as the regulations of the EU Member States varied considerably in some cases with regard to the content and structure of the TPD despite the OECD recommendations.

The EU TPD consists of two main elements. One comprises a set of documentation containing common standardized information (the 'master file') that is relevant for all EU group members of a multinational enterprise. The second component consists of several sets of standardized documentation each containing information of the specific country that is involved (the 'country-specific documentation') that businesses file with tax administrations in order to report on their pricing for cross-border intra-group activities.[14] The master file includes, for example, a general description of the business and business strategy, a general description of the transactions involving associated enterprises in the EU, and the enterprise's transfer pricing policy.[15] The country-specific documentation only contains information relevant to that country such as the amounts of transaction flows within that country, contractual terms, and the particular

11. PATA Documentation Package, at p. 1.
12. According to the PATA Documentation Package, the ten broad categories include detailed information on: (1) the organizational structure, (2) the nature of the business/industry and market conditions, (3) the controlled transactions, (4) the assumptions, strategies and policies, (5) the cost contribution arrangements, (6) the comparability, functional and risk analysis, (7) the selection of the transfer pricing method, (8) the application of the transfer pricing method, (9) the background documents and (10) the index to documents.
13. Philip Anderson, PATA Transfer Pricing Documentation Package, Asia-Pacific Tax Bulletin, at p. 199.
14. OECD, *White Paper on Transfer Pricing Documentation, Public Consultation*, 30 Jul. 2013 (2013), p. 8.
15. Resolution of the Council and of the representatives of the governments of the Member States, meeting within the Council, of 27 June 2006 on a code of conduct on transfer pricing documentation for associated enterprises in the European Union (EU TPD), (2006/C 176/01), para. 4 of the annex.

transfer pricing methods used.[16] Access to the common documentation and information contained in the master file is shared by all of the Member States that are involved; however, the country-specific documentation would generally be available only to the specific Member State concerned.[17]

The regulations are non-binding for the EU Member States;[18] however, each individual State must decide on the implementation or form of implementation of the EU TPD at the national level. In 2013, the European Commission conducted a survey with respect to the impact of the EU TPD on Member States' legislation and administrative practice of the TPD. The responses submitted by the twenty-six Member States revealed that all of the Member States consider their national practice to be in accordance with the EU TPD either by having their domestic rules explicitly aligned to the EU TPD or by accepting the TP documentation in the EU TPD format.[19] For a comparative perspective of various TPD requirements, *see* Annexes 1 and 2)

1.1.4 Evaluation of the Initiatives to Date

In 2013, the European Commission reviewed the acceptance of the proposed Code of Conduct, concluding that most non-governmental organizations had opted to use it informally and selectively.[20] In other words, similar to the PATA initiative, the EU TPD did not achieve the level of implementation and adherence initially hoped for in practice. There are a variety of reasons for this. First, there is a lack of acceptance outside the participating EU Member States or PATA countries. Additionally, complying with the recommendations does not effectively protect taxpayers from being penalized even though that was the intention.

Even though the OECD Guidelines are considered to be extremely important in international practice, the existing requirements of different countries reveal substantive and formal differences in the general conditions and transfer pricing regulations. Countries whose industry structure is fully developed (e.g., Germany) tend to have TPD requirements that are more in common than those in emerging economies (such as BRICS countries) due in part to the economic integration processes and individual interests of the States.

16. *Ibid.*, para. 5 of the annex.
17. *Ibid.*, paras 4.1 and 5.1 of the annex.
18. *Ibid.*, para. 10 of the annex.
19. *See* Summary of EU Member States' responses to the questionnaire on the implementation of the EU TPD (Summary MS responses), available at: https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/summary-ms.pdf.
20. For more information of the Summary of responses non-government stakeholders to the questionnaire on the implementation of the EU TPD (Summary NGS responses), please *see* JTPF/010/2014/EN: EU Joint Transfer Pricing Forum discussion paper on improving the functioning of the EU TPD.

1.1.5 Practical Experiences to Date

1.1.5.1 Relevance of the Documentation Requirements in Tax Audits

The continuing trend towards new, diversified national transfer pricing regulations and the heightened scrutiny of transfer pricing issues by national tax authorities have significantly increased audit intensity in relationship to the records prepared by enterprises. MNEs may encounter heterogeneous country-specific tax audit cultures in many jurisdictions around the world that range from commercial to economic to extremely formalistic approaches. Whereas it was sometimes sufficient in the early years of documentation requirements to simply submit documentation to tax auditors, the documentation is now inspected in detail, in particular the economic analysis supporting the arm's length nature of transfer pricing arrangements,.

To finding evidence that transfer pricing arrangements are at arm's length, tax audits focus on the comparability analysis. This analysis is essential for assessing the arm's length nature of the transaction in question, but is only briefly mentioned in the OECD Guidelines or individual countries' regulations. A lack of comparable transactions in the market often forces MNEs to refer back to database studies. In many cases, the credibility of these studies is questioned by tax administrations through the application of alternate database studies. It is, therefore, no surprise that especially the focus on 'profit margins' of associated enterprises has led to the greatest additional burdens for MNEs in recent years.

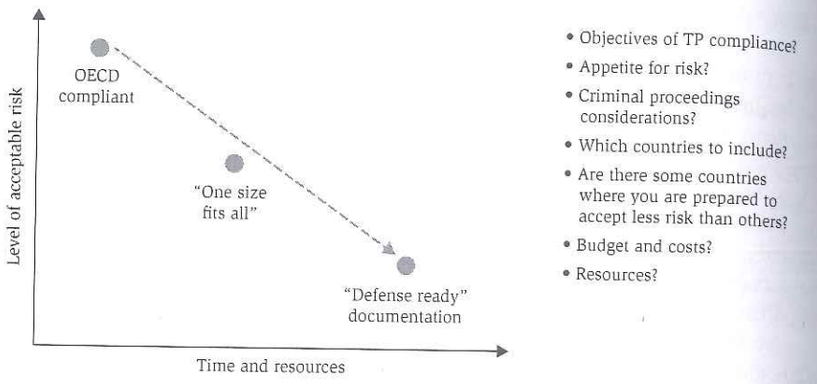
In terms of the content, a shift in focus can be observed. Whereas the primary focus in the past was on the sale of tangibles and the proof of the benefit test for intra-group services, it is now increasingly on documentation of the arm's length character of intra-group financial transactions as well as on the use and documentation of the CUP method for intangibles. Issues such as Location-Specific Advantages (LSAs) have also received considerable attention ever since India and China adopted a position on these in the UN Manual.[21]

1.1.5.2 Experience with Documentation Preparation Thus Far

Whether MNEs apply a centralized or decentralized documentation strategy or a combination of the two strategies and whether the introduction of internal worldwide documentation processes for standardization, simplification, and streamlining has resulted in simultaneous improvement of global consistency can be disregarded for the moment. MNEs still face manifold challenges of a practical nature in complying with local law requirements. To decide on the level of the TPD is an important risk management decision for each MNE (*see* Figure 7.1).

21. For the position of the China and India on LSAs, *see* D.2. and D.3. of the 2017 UN Manual respectively.

Figure 7.1 Finding the Appropriate Level of TP Compliance



Regarding the internationally accepted use of benchmark studies from databases of external providers, it can be repeatedly observed that many local tax authorities continue to request benchmark studies exclusively with local benchmark companies at the expense of functional comparability and automatically reject comparables found in pan-regional databases. A lack of publicly available data, however, makes adjustment calculations (e.g., capital adjustments) to improve the comparability of the benchmark companies used in the benchmark studies almost impossible. Some countries focus on divergent bandwidths that they do not provide for narrowing an interquartile range as is customary in the United States and Europe. Other topics to be addressed in connection with benchmark studies may include timing differences arising from these studies being prepared at different times in the context of the price-setting approach and for documentation purposes (outcome testing approach) as well as the question of the required frequency or amplitude of the benchmarks.

There is also the use of one-year or multi-year averages, local deviations in the selection of the profit level indicator (PLI) to be used, and the tax treatment of hybrid entities. Other challenges continuously facing MNEs are different submission deadlines, different fiscal years, the use of different accounting standards (e.g., local *GAAP v IFRSs*), submission or translation of the documents in(to) the national language, and varying practices in relationship to the admissibility of omnibus transactions or in the method to be used for the different forms of financing in the group (e.g., guarantees, loans, factoring, hedging). Individual local specifications still exist that, contrary to the OECD Guidelines, classify the local company as a tested entity without considering its functional and risk profile.[22]

22. *See* details in OECD, *Review of Comparability and of Profit Methods: Revision of Chapters I-III of the Transfer Pricing Guidelines* (2010), at section A3.3.

1.1.5.3 *Experience with Data Availability*

These substantive challenges notwithstanding, most MNEs are rarely able to supply all of the required data upon demand. IT systems are generally designed for performance controlling and/or reporting purposes. For transfer pricing purposes, however, information is generally required for each type of transaction. This means that data must be collected and prepared specifically for tax purposes. Although corporate tax departments have now taken steps to establish special reporting systems with operational transfer pricing management, data are often captured and monitored manually that is inefficient and prone to error. In addition, trade-offs between the transfer pricing methods used for taxes and for management accounting purposes as well as the related governance regularly occur. Management policy may also create practical difficulties for procuring information from other units in the group that makes systematic data collection and provision difficult. Setting up and managing an efficient transfer pricing documentation concept tailored to the MNE in question so that it is also compatible with the general recurring cost saving programmes is also a genuine challenge for most MNEs.

1.2 Development According to the BEPS Action 13

Recognizing that a common approach to documentation requirements would be an advantage for both businesses and tax administrations, the OECD established that new rules in BEPS Action 13 regarding the TPD would be developed to enhance transparency for tax administrations and take into consideration the burden of compliance costs for MNEs. On 16 September 2014, the OECD released its first set of deliverables on the fifteen actions of the BEPS Project including – in compliance with the task from Action 13 – documentation guidance.[23] On 5 October 2015, the OECD published the BEPS Action 13 Final Report.[24] This report recommends that countries implement a three-tiered standardized approach for the TPD and replace Chapter V of the 2010 OECD Guidelines.

The BEPS Action 13 Final Report and the new Chapter V of the OECD Guidelines describe a three-tiered standardized approach for the TPD. This standard consists of: (i) a master file containing standardized information that is relevant for all of the group members; (ii) local files referring specifically to transactions of the local taxpayer; and (iii) a CbCR that requires companies to produce global blueprints with jurisdiction-specific data on employee staffing, facilities, profit (loss) before income tax, and taxes paid.[25] The master file and local file approach, as well as the CbCR template, are to be

23. OECD (2014), *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. Available at: http://dx.doi.org/10.1787/9789264219236-en.
24. OECD (2015), Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report, OECD Publishing, Paris. Available at: http://dx.doi.org/10.1787/9789264241480-en.
25. BEPS Action 13 Final Report, para. 16.

re-examined from a practical viewpoint by 2020.[26] It is assumed that the new standards will be introduced in most countries with effect to financial years commencing after 1 January 2016 so that there is adequate practical experience for this re-examination.[27]

In principle, the practical challenges faced by MNEs in preparing international documentation remain the same irrespective of the new OECD approach. What is added to the existing challenges is a further increase in data gathering and an aggravated problem of data availability. Moreover, the interdependencies between the master file, local file, and CbCR will necessitate greater consistency in the transfer pricing practice. Besides providing an overview of an MNE's footprint using specific data, the CbCR should especially allow tax authorities to relatively quickly identify actual or purported inconsistencies between the more detailed documentation under the master file concept and the quantitative data provided as part of the CbCR.

2 MASTER FILE

2.1 Concepts

The master file concept requires MNEs to provide tax administrations around the globe with information regarding their global business operations, their overall transfer pricing policies, and their global allocation of economic activity.[28] The purpose of the master file, therefore, is to place the MNE group's transfer pricing practices into taxpayers' global economic, legal, financial, and tax context. It also provides all of the relevant tax administrations with the understanding of the MNE's global operations and policies that are necessary to evaluate the presence of significant transfer pricing risk for the local entities in their countries.[29]

The master file can be prepared either on a group basis or on a business unit basis.[30] However, even if a taxpayer creates a master file for each business unit, all of the master file documents must be submitted to all tax authorities even if the local subsidiary is not involved in the activities of this business unit. According to the OECD's recommendations, the master file document, despite being governed by domestic law, should be prepared in commonly used languages as the use of local languages may impose an extra burden on taxpayers.[31] At the latest, the master file should be completed on the date that the MNE group's ultimate parent entity (UPE) files its tax return.[32]

The list of information that must be included in the master file is provided in Annex I of the OECD Guidelines as amended by the BEPS Report.[33] The relevant required documents in the master file can be summarized into five categories: (a) the

26. *Ibid.*, para. 62.
27. *Ibid.*, para. 50.
28. *Ibid.*, para. 18.
29. *Ibid.*
30. *Ibid.*, para. 20.
31. *Ibid.*, para. 39.
32. *Ibid.*, para. 30.
33. *Ibid.*, pp. 25–26.

MNE group's organizational structure; (b) a description of the MNE's business or businesses; (c) the MNE's intangibles; (d) the MNE's intra-group financial activities; and (e) the MNE's financial and tax positions.[34] Under the five categories, important elements to be provided are:

- Important drivers of business profit;
- A list and brief description of the supply chain for the group's five largest products and/or service offerings by turnover plus any other products and/or services amounting to more than 5% of group turnover;
- A list and brief description of important service arrangements, other than R&D services, between members of the MNE group including a description of the capabilities of the principal locations providing important services and transfer pricing policies for allocating services costs and determining prices to be paid for intra-group services;
- A description of the primary geographic markets for the group's products and services;
- A brief written functional analysis describing the principal contributions to value creation by individual entities within the group, i.e., key functions performed, important risks assumed, and important assets used;
- A description of important business restructuring transactions, acquisitions, and divestitures occurring during the fiscal year;
- A general description of the MNE's overall strategy for the development, ownership, and exploitation of intangibles including the location of principal R&D facilities and location of R&D management;
- A list of intangibles or groups of intangibles of the MNE group that are important for transfer pricing purposes and which entities legally own them;
- A list of important agreements among identified associated enterprises related to intangibles including cost contribution arrangements, principal research service agreements, and license agreements;
- A general description of the group's transfer pricing policies related to R&D and intangibles;
- A general description of any important transfers of interests in intangibles among associated enterprises during the fiscal year concerned including the entities, countries, and compensation involved;
- A general description of how the group is financed including important financing arrangements with unrelated lenders;
- The identification of any members of the MNE group that provide a central financing function for the group;
- A general description of the MNE's general transfer pricing policies related to financing arrangements between associated enterprises.

34. *Ibid.*, para. 19.

These extensive information requirements must be interpreted in consideration of the general wording of the new Chapter V. From this terminology, it is evident that the role of the master file is to provide tax authorities with a comprehensive overview on the MNE group's value creation process and transfer pricing policies rather than providing exhaustive listings of minutiae.[35] Thus, taxpayers can limit the content of the master file to the generally relevant and important information for the entire group to the extent that the omission of certain information would not affect the reliability of the transfer pricing analysis. In order to determine the appropriate amount and scope of information to be provided, taxpayers need to use their prudent business judgment.[36]

It is not an obligation for all jurisdictions to implement the master file as it is only a recommendation of the OECD. Jurisdictions that are interested in the master file concept can implement it through local country legislation or administrative procedures.[37] The content of the master file is rather uniform jurisdiction-by-jurisdiction reporting according to the OECD standard that presents the 'blueprint' of the MNE group as a whole. Theoretically speaking, it means that one MNE group shares one master file. In practical terms, the master file would first be exchanged in the MNE group among entities in jurisdictions that require a master file by law and then those entities would file the master file directly with their local tax administrations.[38] Moreover, each country may define a threshold to relieve small- and medium-sized MNEs (SMEs) from the obligation to prepare a complete transfer pricing documentation in the style of a master file.[39] Nevertheless, SMEs should be obligated to provide information related to their material transactions at the request of tax administrations in the course of a tax audit.[40]

The concept of a master file is not such a new thing. As mentioned in section 1.1.3 of this chapter, in 2005, the European Commission adopted the EU TPD and was the first to introduce this concept. Different from the OECD master file, the EU master file would only apply to the MNEs' operations in the EU. The document typically includes an industry analysis, company background, functional analysis, selection of methods, and economic analyses which will enable local tax authorities to verify the arm's length nature of the intra-group transactions of the concerned MNE.[41] It is important to understand that the OECD master file together with other two components of the three-tiered approach are designed to be a transfer pricing risks assessment tool.

The master file under the new OECD standard, however, differs significantly from the OECD's previous documentation regulations and also those of many countries. First, the fact that there needs to be one uniform master file with a global scope that provides a mandatory set of information to all tax authorities that are involved goes beyond pre-BEPS regulations. Second, many countries have decided to require

35. *Ibid.*, para. 18.
36. *Ibid.*
37. *Ibid.*, para. 49.
38. *Ibid.*
39. *Ibid.*, para. 33.
40. *Ibid.*
41. Roderick Veldhuizen, Lazaros Teneketzis, *The OECD Master File: Past and Future*, International Transfer Pricing Journal (November/December 2016), at 447.

appendices to the master file, which means that MNEs need to prepare individualized information for each country in which they operate, for example, the Chinese tax authorities additionally require a supply chain analysis in the master file.[42] In essence, taxpayers are faced with a substantial extension of documentation requirements for group-wide information and information related to facts and circumstances outside the taxpayer's country.

2.2 Implementation

Realistically speaking, the goal of the OECD to create an internationally accepted standard for the TPD is rather ambitious. At the time of this writing, deviations from the OECD concept and variations across jurisdictions are anticipated and have already been observed.[43] The reasons are multifold. First, the OECD Guidelines are only soft law and do not impose binding legal force on individual countries. Furthermore, the master file endorsed by the OECD is not a minimum standard, and the BEPS participating countries only commit to the minimum standards. As a consequence, the participating countries have the discretion to decide the extent of implementation with respect to the master file.

For certain jurisdictions, it is an opportunity to bring their own perspective into the transfer pricing debate by making customized master file requirements notwithstanding the fact that it adds extra burden to taxpayers who would have to comply with all of these diversified requirements. Furthermore, the master file contains information such that tax administrations would gain an understanding of an MNE's overall transfer pricing philosophy and its sources of value creation. The motive of certain jurisdictions requiring additional elements in the master file might be to obtain a sense of the impact of intragroup transactions that do not directly involve specific local taxpayers versus the results of intragroup transactions that do involve such local group members.[44] From the perspective of MNEs, any variation of the standards at the actual implementation level makes their compliance with the new rules very challenging and burdensome and also requires additional efforts. For that reason, MNEs will need to be particularly aware of any such variations in local specific requirements and customize their documentation accordingly in each case, if required.

As an instance, the United States has indicated that they will not require a taxpayer to provide transfer pricing documentation based on the master file concept since they consider their currently existing TPD regulations to be at least equivalent and serving the same purposes as the OECD requirements. However, the IRS will likely request a taxpayers' master file in the event of audit. Other important counties, such as Brazil and Canada, have also currently expressed the intention not to implement the

42. Kevin A. Bell, *OECD Transfer Pricing 'Master File' Must Bow to Countries' Rules*, BNA Transfer Pricing Report 2017.
43. It is worth mentioning again that several countries, for example, Argentina, Brazil, China, Colombia, India, Mexico, South Africa, and Turkey, have already stated that they might request additional information in the Action 13 Final Report.
44. Kevin A. Bell, *OECD Transfer Pricing 'Master File' Must Bow to Countries' Rules*, BNA Transfer Pricing Report 2017.

master file concept.[45] In addition, some tax administrations of non-developing countries have recently become rather sceptical of the OECD documentation standards that are more stringent, since they find themselves faced with increased concerns that the enhanced transparency of MNE groups will particularly lead the BRICS countries to place pressure on MNEs to alter their profit allocation in favour of their market countries. The degree and uniformity of the implementation of the OECD master file approach around the globe, therefore, remains to be seen.

The proliferation of the TPD around the world enables tax authorities to gain an increased level of transparency; nevertheless, it also incites a worrisome concern of confidentiality. The confidentiality issue is particularly in regard to the master file. As mentioned previously, the exchange of the master file is realized through the share of information within the MNE group, and the master file information would eventually be channelled to the local tax administrations. In other words, the level of secrecy protection is entirely governed by domestic law. In contrast, the CbCR is exchanged through the applicable treaty, Tax Information Exchange Agreement (TIEA), or other bilateral agreements for the exchange of information in which provisions concerning confidentiality normally exist. The protection provided through government-to-government exchange schemes is certainly much stronger than that provided through a unilateral domestic regime. Even though the OECD urges tax authorities to take all reasonable steps to ensure no public discloser and no misuse of the commercially sensitive information contained in transfer pricing documents, there is no guarantee that all countries will actually do so. Furthermore, national laws on tax secrecy vary significantly around the world. In France, Finland, Norway, and Sweden, for example, tax information is publicly available. The variations will certainly exacerbate the situation.

2.3 Disclosure Challenges in Light of Practical Experience

Due to the nature of the information requested for the master file, most of the requirements for information were new to the majority of the previous transfer pricing legislations around the world. The new requirements established in the master file as well as the fact that most of the information requested is not directly related to the intra-group transactions of the group companies result in important challenges to MNEs.

2.3.1 Materiality

Several of the requirements request that an MNE provides information regarding the 'principal', 'material', or 'most important' parts of different issues. There is, however, no indication or methodology to guide a taxpayer in determining which factors should

45. *See* the transfer pricing country profile of Brazil, available at: https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-brazil.pdf, and that of Canada, available at: http://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-canada.pdf.

be taken into consideration to determine whether a particular fact, contract, asset, etc. should be considered as principal or important except for the definition of 'material products or services' in the second master file information item. This lack of a clear definition could create different interpretations of a taxpayer and a tax authority on whether the information provided is sufficient for complying with the requirements as defined by the OECD Guidelines and, therefore, whether or not penalties can be applied. Moreover, tax authorities might also have different interpretations on this point that would result in the master file of an MNE group being considered compliant with documentation requirements in some countries but not in others.

Furthermore, the level of information disclosure in the master file ([t]axpayers should present the information in the master file for the MNE as a whole)[46] means that every group company that is based in a country in which transfer pricing legislation exists as well as the tax authorities of the corresponding countries will have access to the information included in the group's master file. Since some of the information requirements defined by the OECD involve information only related to some group companies, this presents an MNE with the dilemma of deciding if the specific piece of information is relevant for the presentation of the group 'as a whole' and, therefore, should be disclosed to all group companies and their respective tax authorities or if the respective information is not relevant for the group 'as a whole' and, therefore, can be presented in the local files of only those entities that are directly involved. In this context, it must be noted that the expressions 'principal' and 'important' that are used to describe the information to be included in the master file are not meant to establish an objective standard. Instead the question of which information needs to be included in it depends on the facts of each specific case, especially the number of the items to list or transactions that have occurred within the MNE group and their effect on transfer pricing outcomes. The question to be asked when deciding about which information to include in the maser file, therefore, should always be: what information is necessary to provide a true and fair view of the facts and policies that define the overall transfer pricing concept of the MNE?

2.3.2 Intangibles

One of the primary focuses of the new documentation requirements is to provide tax authorities with more information on the creation of intangibles, the transfer of ownership, and the use of intangibles within an MNE group. Intangibles in many industries are the main value drivers of business and, therefore, additional information on the allocation of intangibles and the IP value chain of an MNE group are supposed to place all involved tax authorities in a better position to review intra-group arrangements and profit allocation.

The first of these new intangible-related information requirements is to provide '[a] general description of any important transfers of interests in intangibles among associated enterprises during the fiscal year concerned, including the entities,

46. BEPS Action 13 Final Report, para. 20.

the recipients are located. Otherwise, it would easily become a target of reassessment by the tax authorities. Equally important to bear in mind is that, in the event that a service package is provided, which is always the case, it is recommended to separately define the charging policy for each type of service activity. In comparison, to establish a charging method for a service package aggregately, a service charge in isolation is of easier convenience to defend the benefit test.

Table 9.2 Differences Between Classic Intra-group Service Arrangements and Service CCAs[67]

	Classic Intra-group Service Arrangements	*Service CCAs*
Definition	Intra-group services are limited to the provision and acquisition of specific services within an MNE group.	A CCA is an agreement to share costs, risks, and benefits when the participants contribute cash, property, or services.
Relation of Service provider and recipient	The associated enterprise providing the services may enter into a separate agreement with each associated enterprise. This may result in the service provider having numerous bilateral agreements for the provision of intra-group services.	The service providers and the recipients are all participants to the one CCA.
Consequence of change of service arrangement	If an associated enterprise decides to expand a service arrangement or to terminate the service arrangement, there is no effect on the other associated enterprises receiving the services.	If a participant joins or leaves a CCA, a corresponding adjustment may be required to be made on the contributions and the entitlements of each associated enterprise.
Contract management	Written contracts need to be prepared.	A detailed written agreement is usually required for tax compliance.
Remuneration	The service recipient will be charged a service fee that will include an arm's length profit margin for the service provider.	The contributions of the participants are measured on a contribution basis.
Allocation key	The allocation key is designed as a proxy measure of the expected benefits that the recipient associated enterprise will receive from the services.	The allocation of costs under the arm's length principle must be based on each participant's expected benefits under the CCA.

67. EU JTPF, Report on Cost Contribution Arrangements on Services not Creating Intangible Property, (2012) (JTPF/008/FINAL/2012/EN), para. 12.

2.2.2.1.1 Centralized Services in Classic Intra-group Arrangements

When addressing centralized services in a classic intra-group arrangement, the problem continually occurs of how to properly allocate costs for each recipient since a direct relationship of the services received by a service recipient *vis-à-vis* the service costs does not exist and can typically only be measured indirectly. In reality, the MNEs do not have a timesheet record on how much time the management team has spent on each production line or project, for instance. Therefore, it would be impossible to allocate the costs of the management team in a direct manner. In that situation, the MNEs would need to allocate the overall costs based on an allocation formula which, in principle, should reflect the benefits/expected benefits obtained by the recipient.

Example[68]

An MNE group operates an airline business in five countries (Countries A, B, C, D, and E) with the parent of the group being located in Country A. Customers of the airline in these countries are provided with the option of calling staff by telephone to book travel and receive advice when necessary. The MNE group decides to create a centralized call centre for the MNE group to exploit economies of scale. The low cost of telecommunications and the ability to share business information among group members allows the centralized call centre to be located in any country in which the MNE group operates. The call centre can operate on a twenty-four-hour basis to provide call services to all time zones in which the MNE group conducts business. The MNE group concludes that centralizing call centre functions in its subsidiary in Country E will allow the group to take advantage of both economies of scale and low costs. The call centre services provided by the subsidiary in Country E to the parent company and other group members satisfy the benefit test. Without the call centre, the group members would either have to establish their own call centres or engage an independent party to provide call centre services on their behalf.

2.2.2.1.2 Centralized Services in Service CCAs

In comparison to a classic intra-group service arrangement, a service CCA may offer additional benefits in administration. A CCA[69] can provide a mechanism for replacing a web of separate intra-group arm's length payments with streamlined net payments based on aggregated benefits and aggregated costs associated with the services.[70]

In regard to the service CCA, the key fact is that the participants agree to share the proportionate costs of the service provision and accordingly agree that they will have

68. This example extracted from the 2017 UN Manual, p. 235.
69. The OECD and the UN each provide a separate chapter discussing CCAs in their official guidance.
70. Paragraph B.6.1.3. of the 2017 UN Manual.

a corresponding proportionate interest in the services created under the CCA.[71] Otherwise stated, the participants have joint interests in the services, and their share of the benefits must be consistent with their contributions to the CCA.[72] Under the arm's length principle, the contribution of a participant to the CCA should be proportionate to its share of benefits or expected benefits under the CCA.[73]

A participant in a CCA must have an expected and identifiable benefit arising from its participation in the CCA.[74] That is exactly how independent enterprises would behave under comparable circumstances. The concerned entity will fail the participant test if it does not effectively assume specific risks of the service CCA including an inability to exercise control over the risk and a lack of the financial capacity to assume the risk.[75] The participant must have a specific interest in the services produced with the CCA and must be capable of using the services.[76] Therefore, a mere provision of funds to the service CCA may not meet the conditions whereby the funding supplier is a qualified CCA participant.

To determine if a CCA satisfies the arm's length principle, it is necessary to determine the value of each of the participant's contributions. For the service CCA, these primarily consist of, *inter alia*, the performance of the services. Irrespective of the type of CCA, the value at the time the contributions are made should be used to assess the contributions to a CCA in order to be consistent with the arm's length principle.[77] However, when the difference between the value and costs is relatively insignificant, the relative value of current contributions can be measured at cost for practical reasons.[78] This rule proves to be very beneficial in the case of service CCAs.[79] Yet, in some situations, for example, when the CCA involves a mixture of services, tangibles, and intangibles and uses costs to assess current contributions, it is unlikely to provide a reliable basis to evaluate the relative contributions and to reach an arm's length result.[80]

Another key factor influencing the arm's length nature of the CCA is the expected benefits one participant obtains from the CCA. The expected benefits broadly mean economic advantages, and they can be estimated based on the anticipated additional income that is generated, the costs that are saved, or other benefits obtained by each participant that have resulted from the CCA.[81] For service CCAs, an allocation key (or a set of allocation keys) is often applied to indirectly estimate the participants'

71. Paragraph B.6.2.1. of the 2017 UN Manual.
72. *Ibid.*
73. *Ibid.*
74. Paragraph 8.15 of the BEPS Actions 8–10 Final Reports; para. B.6.3.1. of the 2017 UN Manual.
75. Paragraph 8.15 of the BEPS Actions 8–10 Final Reports.
76. Paragraph B.6.3.1. of the 2017 UN Manual.
77. Paragraph 8.25 of the BEPS Actions 8–10 Final Reports; para. B.6.4.4. of the 2017 UN Manual.
78. Paragraph 8.28 of the BEPS Actions 8–10 Final Reports; para. B.6.4.6. of the 2017 UN Manual.
79. *Ibid.*
80. *Ibid.*
81. Paragraph 8.19 of the BEPS Actions 8–10 Final Reports; para. B. 6.5.1. of the 2017 UN Manual.

proportionate shares of expected benefits.[82] The allocation key is used to indicate the nexus between the contribution and the participant's entitlement in expected benefits.[83]

Example[84]

Company A and Company B are members of an MNE group and decide to enter into a CCA. Company A performs Service 1, and Company B performs Service 2. Company A and Company B each 'consume' both services (i.e., Company A receives a benefit from Service 2 performed by Company B, and Company B receives a benefit form Service 1 performed by Company A).
Assume that the costs and value of the services are as follows:

Costs of providing Service 1 (costs incurred by Company A)	100 per unit
Value of Service 1 (the arm's length price Company A would charge Company B for the provision of Service 1)	120 per unit
Costs of providing Service 2 (costs incurred by Company B)	100 per unit
Value of Service 2 (the arm's length price Company B would charge Company A for the provision of Service 2)	105 per unit

In Year 1 and in subsequent years, Company A provides 30 units of Service 1 to the group, and Company B provides 20 units of Service 2 to the group. Under the CCA, the calculation of costs and benefits are as follows:

Cost to Company A of providing Services (30 units * 100 per unit)	3,000	60% of total cost
Cost to Company B of providing Services (20 units * 100 per unit)	2,000	40% of total cost
Total cost to the group	5,000	
Value of contribution made by Company A (30 units * 120 per unit)	3,600	63% of total contributions

82. *Ibid.*
83. Paragraph B. 6.5.2. of the 2017 UN Manual.
84. This example extracted from the BEPS Actions 8–10 Final Reports, at pp. 177–178.

Value of contribution made by Company B (20 units * 105 per unit)	2,100	37% of total contributions
Total value of contributions made under the CCA	5,700	
Company A and Company B each consume 15 units of Service 1and 10 units of Service 2		
Benefit to Company A:		
Service 1: 15 units * 120 per unit	1,800	
Service 2: 10 units * 105 per unit	1,050	
Total	2,850	50% of total value (5,700)
Benefit to Company B:		
Service 1: 15 units * 120 per unit	1,800	
Service 2: 10 units * 105 per unit	1,050	
Total	2,850	50% of total value (5,700)

Under the CCA, the value of Company A and Company B's contributions should each correspond to their respective proportionate shares of expected benefits, i.e., 50%. Since the total value of contributions under the CCA is 5,700, this means each party must contribute 2,850. The value of Company A and Company B's in-kind contribution are 3,600 and 2,100, respectively. Accordingly, Company B should make a balancing payment[85] to Company A of 750. This has the effect of 'topping up' Company B's contribution to 2,850 and offsets Company A's contribution in the same amount.

If contributions were measured at cost instead of at value, since Company A and B each receive 50% of the total benefits, they would have been required to contribute 50% of the total costs, or 2,500 each, i.e., Company B would have been required to make a 500 (instead of 750) balancing payment to A.

In the absence of the CCA, Company A would purchase 10 units of Service 2 for the arm's length price of 1,050, and Company B would purchase 15 units of Service 1 for the arm's length price of 1,800. The net result would be a payment of 750 from Company B to Company A. As can be shown from the above, this arm's length result is only achieved in respect of the CCA when contributions are measured at value.

85. A balancing payment is an adjustment made to the contribution where the value of a participant's share of overall contributions under a CCA at the time the contributions are made is not consistent with that participant's share of expected benefits under the CCA. This leads to the contributions made by at least one of the participants being inadequate, and the contributions made by at least one of the participants will be excessive.

For compliance purposes, taxpayers should properly document service CCAs (as for all other service agreements). The BEPS Action 13 requires reporting important service arrangements, including CCAs, under the master file and the local file as well.[86] Furthermore, well-prepared documentation on the CCA should disclose, *inter alia*, the nature of the CCA, the terms, and the expected benefits and compliance with the arm's length principle.[87]

2.2.2.2 *On-Call Services*

In the business of an MNE, it makes economic sense to have on-call services such as legal, financial, IT, and tax advisory services. In the event that an emergency might occur at any time, it would be crucial to arrange standby services that ensure the immediate availability when a problem or even a crisis occurs. Though the services may not be fully (or not at all) utilized, the availability of qualified personnel and assets in a very short time creates a competitive strategic advantage for an MNE. Another advantage for the recipient company is obtaining certainties in the process of operations. In the context of independent enterprises, the purchase of on-call services is quite normal. One instance is that the independent enterprises pay an annual 'retainer' fee to a law firm or attorney in case of any litigation.[88] Hence, the chargeability of on-call services should be recognized.

However, on-call services are highly suspicious to tax authorities as they could easily be misused for base erosion and profits shifting. There are three situations expressly pointed out by the OECD under which it would be unlikely for the independent enterprise to engage an on-call service:[89]

86. Paragraph 8.51, the 2017 OECD Guidelines.
87. Paragraphs 8.50–8.53, the 2017 OECD Guidelines; paras B.6.8.3.–B.6.8.4., the 2017 UN Manual. Concerning the initial terms of CCA, the following information would be relevant and useful:

- the participants;
- any other associated enterprises who will be involved;
- any other associated enterprises that may be expected to benefit from the CCA;
- the activities of the CCA;
- the duration of the CCA;
- the measurement of the participants' share of expected benefits;
- the contributions of each participant;
- the consequences of a participant entering the CCA, leaving the CCA or termination of the CCA; and
- balancing payments and adjustments to the terms of the CCA to reflect changes in economic circumstances of the participants.

On the duration of the CCA term, the following information would be beneficial:

- changes to the arrangement;
- comparing projections on expected benefits and realized benefits; and
- the annual expenditure of the participants to the CCA, the form of cash contribution and the valuation methods used as well as the consistent application of accounting principles to the participants.

88. Paragraph 7.16, the 2017 OECD Guidelines.
89. Paragraph 7.17, the 2017 OECD Guidelines.

- The potential need for the service was remote;
- The advantage of having services on-call was negligible;
- The on-call services could be promptly and readily obtainable from other sources without the need for stand-by arrangements.

The economic benefits arising from the on-call services may not be readily visible at the time of review. This will consequently require an examination on a case-by-case basis to ensure that an associated enterprise is actually receiving a benefit from having a service stand by and that an independent enterprise under comparable situations would be willing to pay.[90] The opinion of the OECD elucidates how to identify the benefit conferred by the on-call arrangements, i.e., 'perhaps by looking at the extent to which the services have been used over a period of several years rather than solely for the year in which a charge is to be made before determining that an intra-group service is being provided'.[91]

Example[92]

A company that is a member of an MNE group provides an on-call service to its associated enterprises, and the service satisfies the economic benefit test. Once it has been established that an on-call service provides a benefit to group members, the next issue for consideration is the service fee that may be charged.
The fee for an on-call service may include part of the capital costs of providing the service such as business premises and equipment as well as a profit margin. If the premises and equipment were leased, the charge would be a proportion of the annual lease fees. If the premises and equipment were purchased, it would be appropriate to allocate depreciation expenses to the recipients. An independent enterprise providing such services would be expected to include these expenses in the prices it charges its customers.

Once it is established that an on-call service provides benefits to group members, the next relevant issue is to determine the service fee that may be charged. The difficulty arises from the nature of the on-call services whereby requiring the service never arises and actual services are never or are infrequently provided. The OECD suggests determining the charge on the usage basis by indicating that 'it may be necessary to examine the terms for the actual use of the services since these may include provisions that no charge is made for actual use until the level of usage exceeds a predetermined level'.[93] However, charging on an average usage is possible as well. However, the UN's perspective is that the charge for on-call services should be

90. Paragraph B.4.2.11. of the 2017 UN Manual.
91. Paragraph 7.17, the 2017 OECD Guidelines.
92. This example is extracted from the 2017 UN Manual, at pp. 254–255.
93. Paragraph 7.28, the 2017 OECD Guidelines.

determined on an ongoing basis. The fee for an on-call service may include part of the capital costs of providing the services such as business premises and equipment as well as a profit margin.[94]

2.3 The Selection and Application of the Most Appropriate Transfer Pricing Method

As previously mentioned, the third and fourth steps of the analysis would be the selection and application of the most appropriate transfer pricing method. The main compensations generated by intra-group services are the service fees. Therefore, the arm's length amount of such payments should be defined. This would typically imply considerations on the service fees that unrelated entities have agreed upon (or would agree upon) for similar transactions (i.e., the tested service) in similar circumstances. The two methods mentioned before that are most commonly used to determine the arm's length amount of the compensation for intra-group services are the CUP method and the cost plus method (cost plus method or cost-based TNMM in the case of service units).[95]

In principle, the CUP method is likely to be the most appropriate when comparable services rendered between independent parties can be observed in the market (i.e., an external CUP) and when the same group has also provided comparable services to independent parties (i.e., an internal CUP).[96] Regarding the CUP method, a high degree of comparability between the controlled and uncontrolled services is required. However, many types of intra-group services may not be observable from third parties. Hence, the application of the CUP method is often difficult in reality.

In the absence of CUPs, the cost plus method is a feasible alternative that is less reliant on the similarity of the services (though the services to be compared should still be similar and material differences, if they exist, should be properly adjusted).[97] The cost plus method uses the gross profit margin that the service provider was expected to earn from a certain service it provides as if it were an independent entity. The TNMM is different from the cost plus method in the sense that it uses the net profit margin of the service provider. In the event that a cost plus method cannot be applied in a reliable manner, for example, reliable information on the gross margin is absent or a cost base cannot be determined consistently due to the accounting inconsistencies across countries, a TNMM is applicable (for a service unit). However, it is still possible that, in certain situations, none of the aforementioned transfer pricing methods can generate a reliable result where, for example, both entities of the controlled transactions contribute significant intangibles.[98] In that situation, a transactional profit split method may be a beneficial tool.

94. Paragraph 7.16, the 2017 OECD Guidelines.
95. Paragraph 7.31, the 2017 OECD Guidelines.
96. *Ibid.*
97. *Ibid.*, para. B.4.4.5., the 2017 UN Manual.
98. Paragraph B.4.4.13., the 2017 UN Manual.

When applying the cost plus method or a cost-based TNMM, the following three steps must be performed:

(i) Assessment of the costs incurred in the provision of the intra-group service (excluding any costs for non-chargeable services).[99]
(ii) Selection of a proper charging mechanism to allocate those costs to the service recipient(s) (i.e., direct charging versus indirect charging)
(iii) Application of a profit margin (i.e., markup), if necessary.

From the perspective of the service providers, it is necessary to know their actual expenses for the provision of services before charging the recipient companies. As a rule, the computation of service costs follows general accounting standards and should include all of the costs incurred that are necessary for the purpose of supplying services, i.e., own direct costs and indirect costs as well as certain operating costs (e.g., supervisory). Of course, costs for non-chargeable services must be excluded. To some extent, the OECD does not provide any rigid or comprehensive guidance on the categories of costs to be summed in the computation. Yet, certain insights can be drawn from its guidance on the low value-adding services which states that 'the costs to be pooled are the direct and indirect costs of rendering the service as well as, where relevant, the appropriate part of operating expenses (e.g., supervisory, general, and administrative)'.[100] However, the UN adopts the 'total service costs' approach where total service costs are all of the costs in calculating the operating income (including direct and indirect costs).[101] However, it should always be noted that the cost base of the services so determined may vary depending on the profit indicator, i.e., whether it is gross margin or net profit margin that is used in the selected transfer pricing method. Most importantly, the cost base of services determined for the controlled and the uncontrolled transactions should be comparable.

The next step is to allocate the correct amount of service costs on the individual accounts of the various service recipients. Generally, there are two methods often used in practice for service charging purposes, i.e., the direct charging method and the indirect charging method. The direct charging method is straightforward. It is applicable when the beneficiary of the service is identifiable for a specific service, and the costs associated with the services are quantifiable.[102] It is ideal if the pair of services *vis-à-vis* the service recipient is of high visibility in the intra-group service arrangement so that the direct charging method applies with little difficulty. The direct charging method is usually appropriate when the group engages in substantial numbers of the same or similar services provided to associated enterprises as well as to those that are independent.[103] However, the application of the direct charging method may create disproportionate administrative burdens for the group if the group keeps separate recordings for each service broken down by service recipient especially when the

99. *See* section 2.1.1.
100. Paragraph 7.56, the 2017 OECD Guidelines.
101. Paragraph B.4.4.9., the 2017 UN Manual.
102. Paragraph 7.21, the 2017 OECD Guidelines; para. B.4.3.9., the 2017 UN Manual.
103. Paragraph 7.22, the 2017 OECD Guidelines.

service itself adds little value. However, in situations where the direct charging method is not actually applicable, the indirect charging method proves to be useful. The principle objective of the indirect charging method is to indirectly allocate costs proportionately to the benefit of the associated recipients who anticipate benefitting from the concerned service.[104] The costs can be assigned in an arm's length way by utilizing adequate allocation keys such as turnover, number of staff, number of orders processed, etc.[105] The selection of allocation keys should allow for the commercial nature of the service, i.e., providing a good proxy of the reasonably foreseeable benefits and safeguarding against manipulation (i.e., being objective, measurable, and consistently determined and well documented within the group).[106]

Example[107]

Company P operates a centralized data processing facility that performs automated invoice processing and order generation for all of its subsidiaries, Companies X, Y and Z pursuant to a centralized services arrangement.
In evaluating the shares of reasonable benefits from the centralized data processing services, the total value of the merchandise on the invoices and orders may not provide the most reliable measure of reasonably anticipated benefit shares because the value of the merchandise sold does not bear a relationship to the anticipated benefits from the underlying covered services.
The total volume of order and invoices that are processed may provide a more reliable basis for evaluating the shares of reasonably anticipated benefits from the data processing services. Alternatively, depending on the facts and circumstances, the total central processing unit time that is attributable to the transactions of each subsidiary may provide a more reliable basis on which to evaluate the shares of reasonably anticipated benefits.

Example[108]

Service Provider Co in Country A is a member of an MNE group, and it provides centralized marketing services for the group. Service Provider Co is requested by a group company Seller Co in Country B to design a marketing program for a new product. Following research, Service Provider Co has concluded that the CUP Method and the cost-plus method is not applicable. In applying the TNMM (net cost plus method at the budgetary level) to the Service Provider Co, the costs of providing services and operating expenses are calculated. The unknown variable is the arm's length charge for the intra-group service. A comparability analysis is

104. Paragraph 7.23, the 2017 OECD Guidelines; para. B.4.3.7., the 2017 UN Manual.
105. In the 2017 UN Manual, it provides some useful examples with practical insights under paras B.4.4.15.–B.4.4.21.
106. Paragraph 7.23, the 2017 OECD Guidelines; paras B.4.3.7. and B.4.4.15, the 2017 UN Manual.
107. For example 16, US: Treas. Reg. s. 1.482-9(b)(8).
108. This example is extracted from the 2017 UN Manual, at pp. 255–256.

then performed to determine the appropriate arm's length net profit margin for Service Provider Co (net cost plus). It is decided that this should be 5%.
Ex ante:

- If we assume that the cost of providing the service is USD 80,000 and the operating expenses are USD 20,000, the total direct and indirect costs of providing the services are USD 100,000. The total charge would then be USD 105,000.

Ex post testing:

- A search of comparable independent marketing enterprises has revealed that they are making a net profit to costs (TNMM) of providing services of 3–8%.
- Country A accepts the range of indicative comparables, therefore, the cost plus a 5% charge is arm's length.

Example 1

A Incorporated is engaged in providing internet and related services to the group's customers worldwide. The services offered by A Incorporated include internet direct connections, installations, configuration of routers, and fully managed support solutions developed around the network services with the aim that each member of the MNE can provide seamless network connectivity to customers between various locations and countries. The total circuit connectivity is also provided by the local licensed services provider. The MNE group operates in a number of countries and territories by successfully integrating several different networks into one and consolidating its entities such that A Incorporated conducts business in most countries as a single multifunctional entity that provides a full range of solution services. In such a situation, the profit split method can commonly be used as the most appropriate method for determining the arm's length price of the international transactions that are based on a residual profit analysis.

The profit element charged in the price for services is usually a key element as the provider will need to be remunerated.[109] The next sections focus the discussion on the profit element of the intra-group services to the extent of their chargeability.

2.3.1 Services Chargeable with No Markup

Pursuant to an economic assumption that enterprises are profit-driven, it is expected that enterprises engaging in services provision earn a return that is more than cost

109. Paragraph 7.35, the 2017 OECD Guidelines.

recovery. That reflects the arm's length result that the associated enterprises under comparable situations should follow. Despite that common understanding, an associated enterprise in an arm's length situation may not be able to charge a margin on the costs incurred for services provided.

One possibility is the pass through costs. They particularly refer to the situation that an associated enterprise acts as an agent/intermediary on behalf of the group to arrange the group outsourcing activities. In the process of fulfilling its responsibility, the agent may need to purchase services/goods from third parties and immediately remit payment. Afterwards, the agent allocates the costs to the group members for payment to the agent. In that case, the costs of the outsourcing activities passing through the agent entity are charged to the account of beneficiary entities in the group with no added markup.[110] Strictly speaking, pass through costs just constitute one part of the costs relevant to the agent service performed by the associate enterprise. For the costs incurred solely attributable to the agent function other than the payment for the outsourcing activities, a compensation with a proper margin (i.e., at arm's length) is typical.

Example[111]

An MNE group has a parent company, Controller Company, in Country A and has an associated enterprise, Subsidiary Company in Country B. Controller Co has ten subsidiaries in total around the world. The MNE group has reviewed its operations and has decided to keep in-house the activities in which it has a comparative advantage and to outsource activities that independent enterprises can provide at a lower cost. The MNE group has decided to outsource its human resources activities to an independent enterprise, Independent Company, in Country B for the entire group. It has decided to outsource the work through Subsidiary Company since it is located in the same jurisdiction as Independent Company. The role of Subsidiary Company is to pay Independent Company and to recharge the costs it incurs in doing so to group members. In this situation, Subsidiary Company is operating as an agent. Subsidiary Company passes on the service costs charged by Independent Company to group members on the basis of full time employee equivalents in the group. The charge is on a pass through basis as Subsidiary Company is not adding value and is merely used for convenience to distribute the human resource costs of outsourcing to Independent Company without a profit markup. In addition, Subsidiary Company may provide a service in paying Independent Company and allocating the cost to group members. The costs incurred as such shall be remunerated with a proper margin.

110. Paragraph 7.34, the 2017 OECD Guidelines; para. B.4.4.14., the 2017 UN Manual.
111. This example is extracted from the 2017 UN Manual, at pp. 258–259.