CHAPTER 6
Transfer Pricing

6.1 INTRODUCTION

A transfer price is the price established in a transaction between related persons. For example, if ACo manufactures goods in Country A and sells them to its foreign affiliate, BCo, resident in Country B, the price at which that sale takes place is called a transfer price. A transfer price may be different from the market price, which is the price set in the marketplace for transfers of goods and services between unrelated persons. In a sale of goods or services between unrelated parties, the conflicting interests of the parties usually ensure that the price charged for the goods or services is neither artificially high nor low. However, related parties do not have conflicting interests, and therefore the prices charged in transactions between related parties may be significantly different from market prices.

Multinational companies use transfer prices for sales and other transfers of goods and services within their corporate group. These intercompany prices are the most important category of transfer prices. Transfer prices may also used by individuals dealing with corporations or other entities under their control and by individuals dealing with close family members.

Unless prevented from doing so, related persons engaged in cross-border transactions can avoid tax through their manipulation of transfer prices. For example, in the example above, ACo might avoid paying income taxes in Country A by setting a price on the sale of its manufactured goods to BCo that results in its earning little or no profit. If the effective tax rate in Country B is lower than the effective tax rate in Country A, then the total tax burden on ACo and BCo would be reduced through the use of inappropriate transfer prices. If Country B is a low-tax country, then ACo and BCo would pay little or no tax on their combined profits.

In a well-designed income tax system, the tax authorities should have the power to adjust the transfer prices set by related persons if those prices differ from the market prices. This authority should include the power to allocate revenue, deductions,

credits, and other allowances among related persons so that the country is able to prevent the erosion of its domestic tax base and collect its fair share of tax revenue.

In general, related persons include persons that are owned or controlled, directly or indirectly, by the same interests. A good indicator of such a relationship is the ability to set transfer prices that differ from market prices.

As suggested above, the tax authorities should be given the power to adjust transfer prices to prevent taxpayers from shifting income to related persons resident in tax havens or in countries where they enjoy some preferential tax treatment. Examples of preferential tax treatment include a relatively low tax rate, a tax holiday or other tax incentive, and a tax-deductible loss. Although taxpayers generally do not seek to deflect income to a country that has high statutory tax rates, they may do so when a member of their affiliated group has losses in that country or if they are able to exploit some loophole or preferential tax regime in the high-tax country's tax system.

The tax authorities of a country also need the power to adjust transfer prices in order to prevent other countries from obtaining an unfair share of the tax revenue on income derived from cross-border transactions through overly aggressive enforcement of their transfer pricing rules. When one country is aggressive in making transfer price adjustments and another country is not, taxpayers engaged in transactions in both countries may divert income to the aggressive country in order to mitigate their risks of double taxation.

Double taxation is a serious possibility when multiple countries apply their transfer pricing rules. For example, assume that ACo manufactures goods in Country A at a cost of 60 and sells them to a related company, BCo, that is resident in Country B. BCo then sells the goods to retail customers in Country B for 150. ACo is taxable in Country A on its manufacturing profits and BCo is taxable in Country B on its sales profits. The corporate group (consisting of ACo and BCo) has a net profit of 90 (150 - 60). Assume that Country A concludes that the proper transfer price on the sales from ACo to BCo is 90, whereas Country B takes the position that the proper price for the sales is 50. In that event, double taxation will result because the combined group will have income of 90 but will be taxable on income of 130, as follows:

Income of ACo taxable in Country A:	
Sales	90
Cost of goods	60
Income	30
Income of BCo taxable in Country B:	
Sales	150
Cost of goods	50
Income	100
Total income of ACo and BCo	130

The double taxation illustrated in the above example would be eliminated if both countries had uniform rules for adjusting inappropriate transfer prices and applied

those rules in the same way in all cases. Thus, on the facts of the example, double taxation would be eliminated either if Country B accepted Country A's transfer price of 90 (because Country B would then tax BCo on income of only 60) or if Country A accepted Country B's transfer price of 50 (because then Country A would treat ACo as having a loss of 10).

In an attempt to achieve some degree of uniformity, Article 9 of both the OECD and UN Model Treaties provides that transfer prices should be adjusted to reflect the prices that would have been used in the same transaction between unrelated enterprises acting independently. This so-called "**arm's-length method (standard, principle, or approach)**" has been adopted by most countries of the world. The wide acceptance of the arm's-length method, however, masks substantial disagreements over the way the method is applied in practice. The main transfer pricing methods employed for implementing the arm's-length standard are described in section 6.4 below.

Some countries try to reach agreement with taxpayers on the methodologies to be used by them in setting their transfer prices before a transfer pricing dispute actually arises. A major objective of this type of approach is to reduce the high costs that taxpayers and the tax authorities typically incur in litigating disputes over transfer prices. A taxpayer that wants advance approval of its pricing methodology with respect to one or more transactions typically submits a request to the tax authorities for what is generally known as an "**advance pricing agreement**" or APA. The taxpayer must give details about the transfer pricing methodology that it intends to apply to the transactions covered by the APA and must explain why that methodology would produce an appropriate result. In some instances, two or more governments may use the dispute-resolution mechanism in their tax treaties to agree jointly on the pricing methodology to be used by a taxpayer. The OECD has issued guidelines for countries in developing joint APAs.

6.2 THE OECD TRANSFER PRICING GUIDELINES

Beginning in the 1960s, the United States (US) took the lead in developing techniques for limiting transfer pricing abuses. The definition of the arm's-length standard under section 482 of the US Internal Revenue Code was initially controversial, but is now widely accepted. The regulations under section 482 promoted three methods for determining the arm's-length price: the comparative uncontrolled price (CUP) method, the resale price method, and the cost plus method. In 1995, the US adopted new transfer pricing regulations that endorsed some additional methods, to be applied primarily when products embodying intangible property are sold or licensed. Although initially quite controversial, those methods have now been accepted by many other governments and, with some qualifications, have been endorsed by the OECD.

The OECD has been working steadily for many years to achieve an international consensus on transfer pricing rules. In 1979, the OECD published a report, *Transfer Pricing and Multinational Enterprises*, which advocated the adoption of the arm's-length standard to determine the prices of transactions between associated enterprises.

The 1979 report was supplemented by a 1984 report, *Transfer Pricing and Multinational Enterprises: Three Taxation Issues*, which dealt with the mutual agreement procedure, banking, and the allocation of central management and service costs. In 1992, the OECD established a task force to review transfer pricing developments in the US; another task force was established in 1993 to revise the 1979 and 1984 reports on transfer pricing. These efforts culminated in a comprehensive and fundamental review of transfer pricing issues and the publication, in 1995, of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines).

The OECD Guidelines were published in loose-leaf format to accommodate subsequent revisions. Revisions to the Guidelines have been made on several occasions since 1995 (most recently in 2010), and more revisions are proposed as part of the OECD's BEPS project. For example, the chapters dealing with intangibles, **cost-contribution arrangements**, and documentation requirements are likely to be revised.

6.3 UNITED NATIONS, *PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES*

In 2013, the United Nations Committee of Experts published a *Practical Manual on Transfer Pricing for Developing Countries* (New York: United Nations, 2013). This Manual is intended to provide practical assistance to the tax authorities of developing countries in applying the arm's-length standard while recognizing the particular needs and administrative capacities of those countries. It is generally consistent with the OECD Transfer Pricing Guidelines. In addition to material on transfer pricing methods, documentation requirements, comparability analysis, and similar material that is also dealt with in the OECD Transfer Pricing Guidelines, the Manual deals with building capacity to handle transfer pricing issues in developing countries, audits and risk assessment techniques, and dispute resolution procedures, as well as a description of transfer pricing practices in Brazil, China, India, and South Africa.

6.4 THE ARM'S-LENGTH STANDARD

6.4.1 Introduction

According to international custom, an appropriate transfer price is one that meets the so-called arm's-length standard. This standard is met if a taxpayer sets its transfer prices in its dealings with related persons so that those prices are the same as the prices used in comparable dealings with unrelated persons.

The above definition of the arm's-length standard provides little guidance as to how transfer prices should be established in concrete situations. Some of the basic rules that countries have adopted to give content to the arm's-length standard are summarized below. Section 6.4.2 describes the identification of comparable arm's-length transactions or enterprises that are used to determine the appropriate arm's-length price for transactions between associated enterprises. Section 6.5 describes rules applicable to setting transfer prices when a group of related corporations shares

common resources. Section 6.6 describes the rules that apply to cost-contribution arrangements, under which related persons share the profits from the exploitation of intangible property that they have developed jointly.

The OECD Guidelines on transfer pricing strongly endorse the arm's-length standard. At the same time, they acknowledge frankly that the application of that standard sometimes presents serious difficulties for taxpayers and tax administrations. The Guidelines provide a valuable discussion of the factors to be considered in determining whether transactions between unrelated persons are comparable to the transactions actually entered into by members of a corporate group. Like most of the literature on the arm's-length approach, however, the OECD Guidelines are better at highlighting the problems of establishing the comparability of controlled and uncontrolled transactions than they are at giving practical advice to tax administrators on how to cope with these problems.

Many methods are used throughout the tax world for determining the arm's-length price for sales of tangible personal property. Five methods are discussed below. The first three methods - the comparable uncontrolled price (CUP) method, the resale price method, and the cost plus method - are sometimes referred to as the traditional methods and are widely accepted by the international tax community. Unfortunately, these methods are extremely difficult, if not impossible, to apply in many important cases, especially cases in which the products being sold incorporate valuable intangible property. The traditional methods are described in section 6.4.3 through 6.4.5 and compared in section 6.4.6.

The two other arm's-length methods can be applied in more situations. The **profit-split method** is frequently used on an informal basis by tax authorities in settling disputes with taxpayers through internal appeal procedures. The **transactional net margin method** (TNMM), also known as the **comparable profit method** (CPM), was formally approved by the US in revisions to the section 482 regulations, finalized in 1994. The OECD, in its 1995 Report on transfer pricing, suggests that the profit-split and TTNM methods should be used only as a last resort. They methods are described in sections 6.4.7 and 6.4.8.

6.4.2 Comparability Analysis

The essence of transfer pricing is determining the appropriate price for a non-arm's-length transaction based on a comparable arm's-length transaction. The arm's-length transaction used for comparison may be a transaction between the taxpayer (the person whose non-arm's-length transaction is being priced) and an arm's-length person (internal comparable) or between unrelated arm's-length persons (external comparables). For example, an enterprise may sell the same goods to both related and unrelated persons; therefore, the prices charged for the sales to unrelated persons may provide good comparables for determining the arm's-length price for the related-party sales. However, if the enterprise does not sell the same goods to unrelated parties, it would be necessary to search for an independent enterprise operating in the same market or industry that sells the same goods to arm's-length parties.

In most cases, it is impossible to find perfect comparables because arm's-length prices reflect many considerations (e.g., the quantity sold, the quality of the goods, terms of sale, the conditions of the market, the location of the market, etc). However, it is not necessary to identify precise comparables as long as it is possible to make adjustments to a transaction so that, with the adjustments, it becomes comparable.

All the transfer pricing methods discussed below require some type of comparability analysis. In the case of the traditional methods - CUP method, resale price method, and cost plus method - the key is to find a comparable transaction between arm's-length parties; however, in the case of a profit split or TNMM, the search is for a comparable independent enterprise rather than a comparable transaction. In both cases, comparability analysis is used to select the most appropriate transfer pricing method and apply that method to determine the arm's-length price.

The comparability of a related-party or controlled transaction and an arm's-length or uncontrolled transaction is usually based on five factors:

(1) the characteristics of the transferred property or services;
(2) a functional analysis of the parties to the transaction;
(3) the terms of the contract;
(4) the economic circumstances; and
(5) the business strategies pursued by the parties.

It is apparent from these factors that comparability analysis requires good information about the taxpayer and its business as well as the transactions involved.

Functional analysis is a key element in identifying useful comparable transactions. (It is also a key element in the attribution of profits to PEs under new Article 7 of the OECD Model Treaty (see Chapter 8, section 8.8.5)). Functional analysis involves an examination of the functions performed, assets used, and risks assumed by the parties to the relevant transaction, since these factors should determine the returns that the parties should expect from the transaction. Functions include research and development, manufacturing, purchasing, transportation, storage, marketing, and management services; assets include both tangible and intangible assets; risks include financial, product, collection, market, country/locational, and general business risks.

In many situations, reliable comparable transactions or enterprises may not be available for one reason or another, such as a lack of information or transactions involving new technology, for which there are no comparables.

6.4.3 Comparable Uncontrolled Price Method

The CUP method establishes an arm's-length price by reference to sales of similar products made between unrelated persons in similar circumstances. The CUP method is the preferred method if comparable sales exist. It is widely used for pricing oil, iron ore, wheat, and other goods sold on public commodity markets. It is also useful for pricing manufactured goods that do not depend substantially for their value on special know-how or brand names. However, it is not suitable for pricing many intermediate

goods, such as custom-made automobile parts, that are not generally sold to unrelated parties. Nor is it suitable for setting the price on sales of goods that are highly dependent for their value on the trade name of the producer. The operation of the CUP method is illustrated by the following example.

Assume that XCo is a corporation organized and resident in Country X. It manufactures wooden chairs in Country X at a cost of 40 and sells them to unrelated foreign distributors for 47 each. It also sells nearly identical chairs to YCo, a wholly owned foreign subsidiary resident in Country Y. YCo resells the chairs purchased from XCo to unrelated consumers at 70. If the conditions of the sales to YCo and the unrelated distributors are essentially equivalent, the arm's-length price for the sale of the chairs to YCo is 47. Thus, XCo would have a profit of 7 (47 - 40) from the intercompany sales, and YCo would have a profit of 23 (70 - 47).

The CUP method may be used even if the terms and conditions of the related-party sales are not identical to the sales to unrelated parties, as long as adjustments can be made to account for those differences. For example, if in the previous example the sales by XCo to unrelated distributors do not include delivery costs, whereas the sales to YCo do include delivery costs, the sales may still be considered to be comparable, although some adjustment must be made for freight and handling costs.

6.4.4 Resale-Price Method

The resale-price method sets the arm's-length price for the sale of goods between related parties by subtracting an appropriate markup from the price at which the goods are ultimately sold to unrelated parties. The paradigm case for its application is the sale by a taxpayer of its manufactured goods to a related party acting as a distributor, followed by a resale to unrelated customers without any further processing of the goods. The appropriate markup is the gross profit, expressed as a percentage of the resale price that distributors would typically earn from similar transactions with unrelated parties.

Assume that in the previous example XCo does not make any sales of furniture to unrelated parties and that no CUP is available. Assume also that the only activity performed by YCo is to resell the chairs in foreign markets. Under these assumptions, the resale price method might be appropriate for determining an arm's-length price for the chairs. Under the resale-price method, the first step is to determine the normal markup for a distributor engaging in activities similar to those performed by YCo. If independent foreign distributors earn commissions of 20 percent on the purchase and sale of products comparable to the wooden chairs, a 20 percent markup might be used to determine the arm's-length price on sales of chairs by XCo to YCo. Thus, if YCo sells the chairs to customers for 70 (the resale price), then the arm's-length price of the controlled sale between XCo and YCo under the resale-price method would be 56 (70 - 14 (20 percent of 70)). Thus, under the resale-price method, XCo would have an arm's-length profit of 16 (56 - 40) and YCo would have a profit of 14 (70 - 56).

6.4.5 Cost Plus Method

The cost plus method uses the manufacturing and other costs of the related seller as the starting point in establishing the arm's-length price. The seller's costs are then multiplied by an appropriate profit percentage and the result is added to the seller's costs to determine the arm's-length price. The profit percentage is determined by reference to the gross profit percentage earned by the seller in transactions with unrelated parties, or by comparable unrelated parties in similar transactions with unrelated parties. A paradigm case for the application of the cost plus method is a sale by a manufacturer of goods to a related party, with the related party affixing its brand name to the goods and reselling them to unrelated customers.

Assume that in the previous example XCo sells furniture to YCo without any brand name affixed to the furniture. YCo affixes its valuable brand name to the furniture and resells it to customers in foreign markets. In such circumstances, the cost plus method may provide the appropriate arm's-length price. Assume, for example, that the standard gross profit margin practice in the furniture manufacturing industry is 25 percent of the costs of production. XCo's average cost of producing furniture, determined under generally accepted accounting principles (GAAP), is 40. Under these assumptions, the arm's-length price under the cost plus method on sales of furniture by XCo to YCo is 50 (125 percent of 40).

It is not necessary for the gross profit margin to be based on the gross profit margins of other taxpayers engaged in the same activities, as long as adjustments are made to take account of the differences.

6.4.6 Comparison of Traditional Methods

In the examples above, XCo and YCo were engaged in entrepreneurial activities that could result in an overall gain or an overall loss. Under the CUP method, the entrepreneurial gain or loss is allocated between XCo and YCo by reference to comparable transactions between arm's-length parties. Under the resale-price method, the distributor, YCo, is guaranteed a profit and all the entrepreneurial gain or loss is allocated to XCo, the manufacturer. In the cost plus method, XCo is guaranteed a profit and the entrepreneurial gain or loss is allocated to YCo. Table 6.1 summarizes the income attributable to PCo and SCo under the three traditional methods.

Table 6.1 Income Attributable to PCo and SCo under the Three Traditional Methods

	CUP Method	*Resale Price Method*	*Cost Plus Method*
(1) XCo's cost of goods sold	40	40	40
(2) YCo's sales price to related customers	70	70	70
(3) Arm's-length transfer price	47	56	50

	CUP Method	*Resale Price Method*	*Cost Plus Method*
(4) Profit for XCo (Line (3) - Line (1))	7	16	10
(5) Profit for YCo (Line (2) - Line (3)	23	14	20
(6) Total profits to PCo and SCo	30	30	30
(7) Recipient of entrepreneurial profit	shared	PCo	SCo

When a multinational group of corporations is engaged in the manufacture and sale of products that embody valuable intangible property, it usually earns substantial entrepreneurial profits. The CUP method generally cannot be applied when the goods sold embody valuable intangible property because the goods sold are usually unique - there are no comparable transactions. In some cases, however, the conditions required for applying the resale-price method or the cost plus method may be met. If the manufacturer (XCo in the above example) is producing the goods in a low-tax country and the distributor (YCo in the above example) is selling those goods in a high-tax country, the corporate group is likely to favor the application of the resale-price method because that method allocates the entrepreneurial profits to the manufacturer in the low-tax country. In contrast, if the country of production is a high-tax country and the country of sale is a low-tax country, the corporate group would prefer to use the cost plus method, which allocates the entrepreneurial profit to the country of sale.

6.4.7 Profit-Split Method

Under the profit-split method, the worldwide taxable income of related parties engaging in a common line of business is allocated among the related parties in proportion to their contributions to earning the income. This method typically is employed when none of the three traditional methods can be applied. If a group of affiliated companies has more than one product line, the profit-split method might be applied separately to each product line. Indeed, there is a wide variety of ways that a profit-split method might be applied. A distinctive feature of the method is that it applies to aggregate profits from a group of transactions and not to individual transactions. The traditional methods, in contrast, are all based on individual transactions. The following example illustrates the application of a profit-split method.

XCo and YCo are related companies engaged in the production and sale of pharmaceuticals. XCo engages in extensive research activities and uses patented processes to manufacture the pharmaceutical products, which it sells to YCo. YCo repackages the products for retail sale, attaches its valuable trade name, and resells them through an extensive marketing operation. XCo does not make any sales to unrelated parties, and there are no comparable sales of equivalent products by other pharmaceutical companies.

Under these conditions, some countries might use a profit-split method to establish an appropriate transfer price for the pharmaceuticals. Assume that XCo incurs costs of 300 in manufacturing the drugs and YCo incurs costs of 100 in packaging, marketing and selling them. Assume also that the sales proceeds from aggregate sales by YCo to unrelated customers is 600. On these facts, the corporate group has net profits of 200 (600 - (300 + 100)). If XCo's contribution to the enterprise accounts for approximately 75 percent of the total net profits, then a 75/25 split of the profits might be appropriate. Thus, XCo would have profits of 150 and YCo would have profits of 50.

There are many possible variations of the profit-split method, including combining it with one or more of the traditional methods. For example, traditional methods might be used to allocate average profits from routine activities, and the profit-split method might be reserved for dividing entrepreneurial profits from the exploitation of valuable intangible property.

Assume in the example above that XCo engages in routine production activities and YCo engages in routine sales activities. XCo has gross costs of production of 300. Unrelated companies engaged in comparable manufacturing activities earn gross profit margins of 20 percent of costs. On these facts, XCo would have profits of 60 (20 percent of 300) allocated to it under the cost plus method. YCo has gross sales revenue of 600. Unrelated companies engaged in similar activities earn gross profit margins of 10 percent. Under the resale price method, therefore, YCo would have profits allocated to it of 60 (10 percent of 600). The remaining profits of 80 (200 - (60 + 60)) would be allocated under the profit-split method. Assuming that a 75/25 split is applied, then XCo would be considered to have profits of 60 (75 percent of 80) under the profit-split method, and total profits of 120 (60 + 60). YCo would be considered to have profits of 20 (25 percent of 80) under the profit-split method, and total profits of 80 (20 + 60).

For the profit-split method to operate fairly and effectively, some fair and effective method must be applied to determine the appropriate profit split. One approach used by the OECD is to examine profit splits between uncontrolled persons that are engaged in comparable activities. Unfortunately, such information is typically not available. Because the profit-split method is most likely to be applied when valuable intangible property is involved, a profit split based on the relative contributions of the related parties to the development of that intangible property might be appropriate.

6.4.8 Transactional Net Margin Method

Under the TNMM, (which can be viewed as the OECD equivalent of the US (CPM), the taxpayer must establish, either for itself or a related party (the tested party), an arm's-length range of profits for a set of transactions. If the tested party's reported profits from those transactions fall within that range, its transfer prices will be accepted by the tax authorities. If its profits fall outside that range, the tax authorities may adjust transfer prices so that the profits fall within the range, typically at the midpoint. Despite

the use of the term "transactional" in the name TNMM, TNMM is not a transaction method for determining arm's-length transfer prices. Instead, TNMM is based on an entity's profits from a group of transactions and not on the prices for particular transactions, which is the focus of the traditional transfer pricing methods.

In general terms, the profits of a tested party are determined by determining the ratio of profits to some economic indicator for an unrelated person and then applying that ratio to calculate the profits of the tested party. Assume, for example, that an unrelated person has taxable income of 80 and invested capital of 800, and that invested capital is the economic indicator used in applying TNMM. The ratio of taxable income to invested capital for the unrelated person is 80:800, or 10 percent. If the tested party has invested capital of 500, then under a simplified version of TNMM, its arm's-length profits will be 50 (500 × 80/800).

To refine the application of TNMM, the taxpayer or the government might make TNMM calculations for more than one unrelated person. The more such calculations are made, the more reliable the results are likely to be. The arm's-length profits of the tested party are an amount falling within the range of profits determined under the several calculations. Statistical techniques might be applied to select the point within that range that would be deemed to be the tested party's arm's-length profits. If the tested party is a related corporation rather than the taxpayer, then the profits of the taxpayer are determined by subtracting the profits of the tested person, as determined under TNMM, from the combined profits of the two corporations.

Whether the taxpayer or a related person is used as the tested party depends on the facts and circumstances of each particular case. The objective is to have, as the tested party, the related corporation that is most similar with respect to its business functions to the unrelated corporations that are used as comparables. For example, assume that ACo manufactures goods in Country A, sells the goods to BCo, its wholly owned subsidiary, and BCo sells the goods in Country B after affixing its valuable trade name to those goods. If information necessary for applying the traditional pricing methods or for applying TNMM to ACo is not available, such information for applying TNMM to BCo might be available. If so, BCo would be the tested party, whether or not it is the taxpayer.

To apply TNMM, a taxpayer must determine a range of profits that unrelated persons would be expected to earn from engaging in comparable transactions. The taxpayer can establish this range in a variety of ways. One way, illustrated above, is to determine the rate of return on capital employed by two or more unrelated parties engaging in activities that are broadly similar to the activities of the taxpayer. This rate of return on capital for each unrelated person is then multiplied by the amount of capital of the taxpayer (or tested party, as the case may be). An alternative approach is for the taxpayer to determine the ratio of operating profits to gross sales receipts for two or more comparable related persons and then apply these ratios to its own (or the tested party's) sales. A third way is to determine the ratio of gross profit to operating expenses for two or more related persons and apply these ratios to the taxpayer's or the tested party's operating expenses. Other economic indicators might also be used.

Assume, for example, that ACo, the tested party, is engaged in business activities similar in complexity and character to the activities of XCo and YCo, corporations

unrelated to ACo and to one another. XCo and YCo have ratios of operating profits to gross receipts of 0.2 and 0.3, respectively. ACo has gross receipts of 200,000. Under TNMM, ACo's arm's-length range of profits would be from 40,000 (200,000 × 0.2) to 60,000 (200,000 × 0.3). Assuming that the various conditions for application of TNMM are met, ACo's arm's-length profits would be considered to be in the range of 40,000 to 60,000.

Once the TNMM range has been established, it is necessary to select some amount within that range as the arm's-length profits of the tested party. In general, the tax authorities would probably accept the transfer prices shown in the taxpayer's books and records if the profits determined by using those prices fall within the TNMM range. If the taxpayer's reported profits fall outside the range, the tax authorities are likely to treat the midpoint of the range as the arm's-length profits. If data for more than two unrelated persons is used to establish the TNMM range, then a weighted average of the resulting profit numbers would be used to establish the midpoint of the range.

TNMM can be manipulated, by the taxpayer or the tax authorities, through the choice of comparable companies. To prevent systemic biases in favor of either the taxpayer or the tax authorities, criteria need to be developed for selecting appropriate comparable companies. In addition, neutral rules should be applied to eliminate comparable companies that yield unreasonable results and to select the arm's-length profits from within the TNMM range.

6.5 SHARING OF CORPORATE RESOURCES

6.5.1 Introduction

Related corporations frequently share funds, credit lines, corporate headquarters, know-how, trade names, employees, and other corporate resources. The arm's-length standard requires that the owner of the shared resources charge related parties an arm's-length fee for their use. In theory, the fee should equal the amount that the owner of an equivalent resource would charge an unrelated party for its use. In practice, the appropriate arm's-length price is difficult to determine, in part because unrelated corporations do not often share comparable resources.

6.5.2 Loans or Advances

A group company engaged in the business of making commercial loans should be required to use a rate of interest for loans or advances to related parties that reflects the current cost of borrowing. For a group company that is not in the business of making loans, some countries provide a safe-harbor interest rate so that the interest rate charged on the loan will not be adjusted if it is within the safe harbor. For example, a country may allow taxpayers to use an interest rate pegged to the average cost of government borrowing.

6.5.3 Performance of Services

If marketing, managerial, administrative, technical, or other services are performed by one person for the benefit of a related person, the person providing the services should charge an amount that an independent service provider would charge for the same services. If no comparable arm's-length services are available, the arm's-length fee might be based on the cost of providing the services plus an appropriate profit. However, the problem of setting an appropriate arm's-length price in these circumstances is formidable.

6.5.4 Use of Tangible Property

If tangible property, such as an office or equipment, is made available by a person to a related person, the owner of the property should charge the user an arm's-length rental fee. The same rule should apply to subleases of tangible property.

6.5.5 Use or Transfer of Intangible Property

If intangible property, such as a patent or trademark, is made available to a related party, the owner of the property should charge whatever amounts would be charged to an unrelated person for the use of the property in similar circumstances. This charge might be set by reference to royalty rates charged by the owner on the same or similar property made available to unrelated parties. However, obtaining the data necessary to determine the proper arm's-length royalty is often difficult, both for the tax authorities and the taxpayer, and multinational companies are commonly accused of avoiding tax through the use of inappropriate royalty rates.

If intangible property is sold to a related person, the arm's-length sales price can be established by reference to the discounted value of the arm's-length royalties anticipated over the life of the property.

In 1986, the US adopted legislation requiring that royalty rates charged between related parties be commensurate with the income from the intangible property. Under the arm's-length standard, royalty rates generally are based on facts known or knowable at the time the license for the use of the property is concluded. The commensurate-with-income standard requires periodic adjustments in royalty rates to reflect the actual experience of the parties in utilizing the intangible property. For example, if XCo, a US corporation, transfers patents and know-how to its Irish subsidiary that allows it to manufacture plastic contact lenses, under the commensurate-with-income standard, the parties may be required to make periodic adjustments in the royalty charged for use of that property to reflect the level of profits earned by the Irish subsidiary from the manufacture and sale of the contact lenses.

Despite their potential, the US commensurate-with-income rules have not been effective in curbing transfer pricing abuses. The OECD has endorsed the limited application of a commensurate-with-income standard where unrelated persons operating at arm's length would not have made an outright sale or long-term license of

intangible property. For example, a multinational enterprise with unique and valuable intangible property would never sell or lease that property to an unrelated party. In these circumstances, it is more appropriate to ignore the related-party sale or license and substitute a different arrangement, under which the transferor is entitled to a substantial share of the actual profits earned through use of the transferred intangible property. See section 6.7 below, describing the circumstances in which the tax authorities are permitted to recharacterize the actual transactions entered into by associated enterprises.

The OECD's BEPS Action 8: *Guidance on Transfer Pricing Aspects of Intangibles* proposes extensive revisions to the OECD Transfer Pricing Guidelines, especially Chapter 6 dealing with the basic treatment of intangibles for transfer pricing purposes. These revisions clarify the definition of intangibles and provide guidance for identifying transactions involving intangibles and determining the arm's-length conditions for cases involving intangibles. The revisions also include several examples that illustrate the application of the guidelines to intangibles. This work will not be finalized until the related BEPS work on intangibles is completed.

6.6 COST-CONTRIBUTION ARRANGEMENTS

If a group of corporations intends to develop valuable intangible property and share the benefits among two or more of its members, it can avoid transfer pricing issues by having all the prospective users of the intangible property jointly develop that property through a **cost-contribution** or **sharing arrangement**. In that situation, all the contributors to the development of the property have rights to the profits generated by the property in proportion to their contributions, and no transfer of the property or rights to the use of the property between members of the corporate group is required. Cost-contribution arrangements are dealt with in Chapter 8 of the OECD Transfer Pricing Guidelines. In general, the OECD rules are designed to recognize bona fide cost-contribution arrangements, but limit their use for tax avoidance purposes.

For a cost-contribution arrangement to be consistent with the arm's-length standard, it should have the following characteristics:

- The arrangement should be embodied in a legally enforceable written contract entered into when the arrangement was initially established that clearly establishes the nature of the arrangement, its duration, and the terms for its enforcement and amendment.
- Only persons with a legitimate expectation of benefiting under the arrangement should be permitted to be participants.
- The contract should require the participants to the arrangement to contribute to the costs of development of the intangible property in proportion to the benefits that they might reasonably be anticipated to derive from the use of that property.

- The participants to the arrangement should be required to keep adequate records documenting their costs and explaining how their anticipated benefits were calculated.

Assume, for example, that ACo and BCo are related corporations engaged in manufacturing small electrical appliances. ACo is engaged in business in Country A and BCo is engaged in business in Country B. ACo and BCo intend to develop new technology that would allow them to manufacture their appliances at a lower cost. They enter into a written contract that assigns to ACo the rights to exploit any intangible property developed under the agreement in Country A. BCo receives similar rights with respect to Country B. ACo has current sales of appliances in Country A of 400, and BCo has sales in Country B of 600; that general pattern is expected to continue in the future. Under the cost-contribution arrangement, ACo agrees to pay 40 percent of the costs and BCo agrees to pay the remaining 60 percent. They both agree to keep detailed accounting records with respect to their costs and their sales.

Assuming that County A has adopted rules for cost-contribution arrangements similar to those in the OECD Guidelines, the arrangement between ACo and BCo would qualify as a bona fide cost-contribution arrangement. Country A should permit ACo to take a deduction for payments made under that arrangement under the rules generally applicable to amounts paid to develop intangible property. In addition, ACo should be treated as a coowner of the resulting intangible property; therefore, ACo should not be treated as paying a deemed royalty to BCo under the transfer pricing rules of Country A. If ACo makes an actual royalty payment to BCo, that payment should not be deductible.

As part of BEPS Action 8 dealing with transfer pricing, the OECD has proposed revisions to Chapter 8 of the Transfer Pricing Guidelines dealing with cost-contribution arrangements. In general terms, the arm's-length standard requires each participant's contribution to a cost-contribution arrangement to be consistent with its share of the expected benefits from the arrangement. For this purpose, the revised Guidelines will require each participant's contribution to be based on its value rather than on its cost unless, in certain limited circumstances, cost is a reliable indicator of the value of contributions.

The rules governing cost-contribution arrangements among related persons should permit the participants to modify an arrangement to reflect changed economic circumstances. To conform to the arm's-length standard, however, those rules should require that the participants receive a payment equal to the fair market value of any rights that they may have relinquished and that they pay a fair market fee for any new rights obtained. If a new participant is brought into a cost-contribution arrangement, that participant should be required to compensate the other participants for the fair market value of the dilution of their interests in the arrangement. Any revision of a qualifying cost-contribution arrangement should be in writing and otherwise conform to the requirements for a new cost-contribution arrangement.

To prevent tax avoidance, governments should have the authority to treat related persons as if they had entered into a cost-contribution arrangement when their economic behavior is consistent with such an arrangement. Assume, for example, that

ACo and BCo are related persons and have jointly developed some intangible property. However, they have not entered into a cost-contribution arrangement. ACo makes use of the intangible property in its business in Country A and pays a royalty for that use to BCo, a resident of Country B. Under the tax treaty between Country A and Country B, the royalty is not subject to withholding tax by Country A because the treaty contains an article similar to Article 12 of the OECD Model Treaty, giving the exclusive right to tax royalties to the residence country. ACo claims a deduction for the royalty payment in computing its income taxable in Country A. Country A should have the authority to treat ACo and BCo as having entered into a constructive cost-contribution arrangement, with the result that ACo would not be permitted to take a deduction for the royalty payment to BCo.

Cost-contribution arrangements have been widely used to shift profits to low-tax countries. This result is possible largely because multinational enterprises have access to information about their intellectual property and research and development activities that is not available to the tax authorities. Therefore, for example, a group company in a low-tax country might enter into a cost-contribution arrangement with another group company in a high-tax country; the high-tax country would allow the first company to acquire rights to research that is disproportionately profitable compared to all the research and development activities of the group.

6.7 DISREGARDED TRANSACTIONS

The OECD Transfer Pricing Guidelines emphasize that the tax authorities must accept the actual transactions entered into by associated enterprises and apply the transfer pricing rules to those transactions. However, in two narrow circumstances, the OECD Guidelines permit the tax authorities to ignore the legal transactions entered into by related enterprises and allocate the profits between the enterprises on a different basis. First, if the economic substance of the actual transaction differs from the legal form of the transaction, the transaction may be recharacterized by the tax authorities in accordance with its substance and taxed on that basis. For example, depending on the circumstances, including its terms, a loan to an associated enterprise might be recharacterized as equity. Second, if the arrangements entered into by the associated enterprises would not have been entered into by arm's-length parties, the tax authorities may recharacterize the arrangements in accordance with what arm's-length parties would have done. For example, a multinational enterprise with valuable intangible property would not sell or lease that property on a long-term basis to an unrelated enterprise without some price-adjustment mechanism allowing the transferor to share in future profits.

These exceptional circumstances, in which the tax authorities can disregard actual transactions, are strikingly similar to anti-avoidance rules. It is questionable whether the tax authorities have the power to recharacterize transactions, as provided in the OECD Guidelines, without explicit statutory authority in domestic law. Part of the OECD's BEPS Action 10 involves clarifying the circumstances in which transactions between associated enterprises can be recharacterized in order to prevent base erosion.

6.8 TRANSFER PRICING DOCUMENTATION REQUIREMENTS

Many countries have attempted to deal with perceived transfer pricing abuses by requiring multinational companies to provide the tax authorities with extensive, contemporaneous documentation to support the methods used to establish their transfer prices. The idea is that by forcing multinational companies to establish their transfer prices in advance, a country can prevent after-the-fact shifting of income for tax avoidance purposes. Taxpayers failing to provide the requisite documentation may be subject to substantial penalties.

For example, assume that ACo, operating in Country A, is selling goods to BCo, a related corporation operating in Country B. The corporate tax rate is 40 percent in Country A and 20 percent in Country B. ACo and BCo set the transfer prices for their intercompany sales so that there is a small profit in Country A and a large profit in Country B. After setting those prices and providing the documentation to Country A, ACo discovers that it will suffer a large tax loss in Country A from some unrelated operations. If its pricing methodology had not been fixed, ACo might have been strongly tempted to revise the methodology to deflect some income from Country B to Country A so that it could fully utilize the Country A loss. The contemporaneous documentation rules, however, may prevent such a revision.

The OECD Guidelines support the dual strategy of requiring contemporaneous documentation and penalizing taxpayers for failure to comply with the documentation requirements. However, tax administrators are advised to pursue that strategy with extreme caution so as to avoid imposing unfair or excessively burdensome obligations on taxpayers acting in good faith.

Action 13 of the OECD's BEPS project proposes important enhancements to the existing transfer pricing documentation requirements. Multinational enterprises will be expected to provide the tax authorities of all countries in which they do business with a master file containing general information about their business operations and their transfer pricing practices and policies. In addition, each country must be provided with a local file containing information with respect to any related-party transactions occurring in the country. Most important, multinationals will be required to provide an annual report to each country in which they operate setting out the amount of revenue, profit, and taxes accrued and paid with respect to that country. Although these country-by-country reports will not require information to be provided on an entity-by-entity basis, they should nevertheless provide the tax authorities with an important tool with which to apply their transfer pricing rules more effectively.

Countries can limit the most egregious forms of transfer pricing abuses by giving appropriate discretion and resources to their tax departments and by imposing stiff penalties on taxpayers that have not set their transfer prices in good faith. They can take away some of the incentive for transfer pricing abuses by setting their marginal tax rates at levels that are moderate by international standards. Adoption of specific legislation targeted at tax havens can also take away some of the incentive for transfer pricing abuses because taxpayers commonly set improper transfer prices in order to deflect their income to affiliated entities in tax havens. Chapter 7 describes such anti-avoidance provisions. Countries can also obtain help in controlling transfer pricing

abuses through cooperation with their tax treaty partners, particularly their close neighbors. However, despite determined efforts by national tax authorities and increased cooperation with their trading partners, transfer pricing continues to be a serious ongoing problem.

6.9 TREATY ASPECTS OF TRANSFER PRICING

The provisions of the OECD and UN Model Treaties do not deal with the problem of transfer pricing in any detailed way. Article 9(1) of both Model Treaties authorizes an adjustment to the profits of an enterprise that is associated with another enterprise if "conditions are made or imposed between the two enterprises which differ from those which would be made between independent enterprises." Literally, therefore, Article 9(1) focuses on the terms and conditions of related-party transactions, rather than just on the prices charged in specific transactions.

Article 9 is entitled "Associated Enterprises." It applies if an enterprise of one contracting state participates directly or indirectly in the management, control, or capital of another enterprise in the other contracting state or if the same persons participate directly or indirectly in the management, control, or capital of two or more enterprises in the contracting states. Beyond this wording, Article 9 does not define "associated enterprises"; as a result, whether enterprises are associated must be determined in accordance with domestic law. Most countries apply their transfer pricing rules to transactions between enterprises where one enterprise controls the other, or where they are both controlled by another person and control is considered to be the ownership of more than 50 percent of the shares or interests in an entity.

Article 9(1) of both the OECD and UN Model Treaties provides that the profits that would have accrued to an enterprise, but did not because of non-arm's-length transactions with associated enterprises, "may be included" in the profits of the enterprise. Thus, read literally (and unlike other treaty provisions), Article 9(1) is not worded as a mandatory provision ("shall be included") that the contracting states must apply. Some commentators argue that, as a result of the permissive wording of Article 9(1), contracting states are entitled to tax resident enterprises on profits that are more or less than their profits in accordance with the arm's-length standard. For example, if ACo, a resident of Country A, charges its subsidiary, BCo, resident in Country B, 100 for goods or services that have an arm's-length price of only 75, Country A is not required by Article 9(1) to unilaterally reduce the price to 75. Conversely, if the arm's-length price of the goods or services is 125, Country A is not required by Article 9(1) to increase the price to 125, although in most circumstances it will want to do so.

On this view, Article 9(1) is merely a statement of principle about the determination of the profits of associated enterprises in accordance with the arm's-length standard. However, Article 9(2) of both the OECD and UN Model Treaties requires a country to make adjustments to the transfer prices used to compute taxable income of their taxpayers if those prices have been adjusted by the other contracting state in accordance with the arm's-length standard.

Assume, on the facts of the previous example, that Country A adjusts the price at which ACo sells its manufactured goods to its foreign affiliate, BCo, from 60 (the actual sales price) to 90 (the price that Country A considers that arm's-length parties would have charged). Therefore, Country A will increase ACo's taxable income by 30. If Country B concurs with Country A's determination of the proper transfer price, it should allow BCo to increase its actual cost of acquiring the goods by 30 (60 + 30 = 90) and reduce its taxable income accordingly, to 60. An adjustment of a transfer price used by one taxpayer to take into account an adjustment made by another country to the transfer price used by an affiliated taxpayer is referred to as a "**corresponding adjustment**".

It is arguable whether profit-based transfer pricing methods, such as the profit-split method and TNMM, are consistent with the language of Article 9(1). The reference to profits in Article 9(1) could be a reference to all profits, or just the profits from particular transactions or types of business. In any event, by endorsing the profit-based methods, the OECD Transfer Pricing Guidelines clarify that those methods are acceptable in certain circumstances under Article 9.

Conflicts between countries over transfer prices are commonplace, despite the fact that all countries have agreed in their bilateral tax treaties to adhere to the arm's-length standard. Most tax treaties provide that an enterprise that is subject to double taxation because of inconsistent transfer prices may seek redress through the mutual agreement procedure. Under that procedure, the competent authorities are required to try and deal with the taxpayer's complaint, but they are not generally obligated to resolve it. A few newer treaties include a procedure for binding arbitration. For a discussion of the mutual agreement procedure for resolving treaty disputes and arbitration, see Chapter 8, sections 8.8.3 and 9.5, respectively.

6.10 TAX POLICY CONSIDERATIONS: FORMULARY APPORTIONMENT AND THE FUTURE OF THE ARM'S-LENGTH METHOD

To be blunt, the current transfer pricing rules based on the arm's-length standard do not work effectively, despite decades of practical experience and refinement. Although there are many reasons for the failure of arm's-length transfer pricing rules, the most fundamental reason is that the underlying assumption – that the separate parts of a multinational enterprise can be considered to behave as if they were independent – is patently false. Multinational enterprises exist because there are economic and financial advantages to the economic integration of their activities. However, transfer pricing in accordance with the arm's-length standard ignores the economic integration of a multinational enterprise's activities, but respects its legal structure and the legal form of its intercorporate transactions.

The arm's-length standard has received considerable criticism from academic commentators, from taxpayers directly affected by the standard, and from tax administrators. Taxpayers complain that it often imposes unreasonable burdens of proof on them, that it presents them with problems of double taxation not resolved by the competent authority mechanism of tax treaties, and that frequently it is not followed by

the tax authorities during audits. The tax authorities complain that the arm's-length standard allows considerable undertaxation of taxpayers engaged in cross-border transactions, that it encourages taxpayers to take aggressive positions on their tax returns in the hope of avoiding detection or of striking a favorable bargain on audit, and that it is extremely time-consuming and expensive to enforce. Some academics contend that, in some cases, the arm's-length method necessarily produces improper results because it cannot account for the profits that related corporations typically enjoy from conducting an integrated business. All of these criticisms are valid.

Although arm's-length transfer pricing is generally acknowledged to be seriously and irreparably flawed, it has one very important advantage - namely, that it is widely accepted. The transitional costs in moving to a different, even if better, system would likely be enormous. Moreover, it is not clear that there is a better system. Some commentators argue that the profits of multinational groups should be allocated among the members of the group based on profit-split methods. In fact, as noted above, the OECD Transfer Pricing Guidelines currently recognize the use of profit splits in certain circumstances and, in practice, it would appear that they are used increasingly to resolve transfer pricing disputes. The difficulty with profit-split methods is that it is unclear on what basis the profits of a multinational enterprise should be allocated to the countries in which it does business.

The alternative to the arm's-length approach that is most frequently advanced is a global **formulary apportionment system**. In a formulary apportionment system, affiliated entities engaged in a common enterprise are taxed as if they were a single entity. The worldwide income of the enterprise is attributed by a predetermined formula among all the countries where the enterprise engages in meaningful economic activity. Assuming that all countries could agree on the use of this system and could also agree on a reasonably uniform definition of taxable income, multinational corporations would be taxable once, and only once, on their worldwide income.

For example, in the case of a multinational enterprise engaged in the manufacture and sale of goods, an apportionment formula might allocate some fraction - perhaps one-half - of the income of the enterprise among the countries in accordance with the sales in those countries. The remaining part of the income would be apportioned among the countries where the manufacturing is conducted, with the allocation based on the total manufacturing assets or the payroll of the enterprise, or some combination of these two factors. Little or no income would be apportioned to any group entity in a tax haven unless sales or manufacturing activities take place in that country.

There are obviously many problems with the use of formulary apportionment as a means of allocating profits among related corporations. The arbitrariness of predetermined formulas makes it difficult to take into account the particular circumstances of each multinational enterprise. It relies heavily on access to foreign-based information. It almost guarantees that the amount of profits attributed to each member of a multinational group will differ, sometimes markedly, from the income shown on its books of account, even if those books are kept in good faith and in accordance with approved accounting methods. Substantial cooperation among governments is necessary to solve these problems, and it is unlikely that countries would be able to agree on a common apportionment formula.

Nevertheless, formulary apportionment has some attractive features. A well-designed system can eliminate the tax advantages of low-tax countries without the need for complex, difficult-to-administer controlled foreign corporation (CFC) rules. Formulary apportionment also avoids some of the difficult audit problems that frequently arise under the arm's-length approach. Unlike the arm's-length approach, it does not require separate agreement on the source of gross income and deductions in order to avoid double taxation because source rules are implicitly incorporated into the apportionment formulas. Although it is sometimes argued that formulary apportionment would be better for developing countries than arm's-length transfer pricing, this claim is questionable. The use of factors such as sales, property, and employees or payroll in the formula are unlikely to result in the allocation of substantial income to developing countries.

In comparing the formulary apportionment method to the arm's-length method, it is useful to contrast the treatment of income from intangible property under the two approaches. Under formulary apportionment, all income, including income derived from intangibles, would be apportioned to the countries in which goods are produced and sold. In contrast, under the arm's-length method, such income is allocated to the entity owning the intangible property. Ownership rights within a corporate group, however, have little economic significance. As a result, under the arm's-length method, it is frequently possible for a multinational enterprise to avoid tax on income from intangibles by shifting ownership of the intangibles to an affiliated corporation in a low-tax country.

Formulary apportionment has an undeservedly bad reputation, largely for political reasons. A sensible discussion of that method and the alternatives to it must go beyond labels and preconceived ideas. Moreover, the arm's-length standard and formulary apportionment should not be seen as polar extremes - instead, they should be viewed as part of a continuum of methods ranging from CUPs to predetermined formulas.

A formulary apportionment system uses an arm's-length approach in some circumstances, and the arm's-length approach sometimes uses formulas (profit splits). Recent refinements in the arm's-length approach rely increasingly on formulas, and that trend seems to be gaining international acceptance. Consequently, it is sometimes unclear where the arm's-length principle ceases and formulary apportionment begins. Applying pejorative and misleading labels to either approach is counterproductive.

Despite its deficiencies, the arm's-length standard is likely to continue to be the internationally accepted approach for resolving transfer pricing issues, except in special circumstances. As the earlier discussion of pricing methodologies indicates, however, the arm's-length standard is vague and has been interpreted to accommodate pricing methodologies, such as the profit-split method and TNMM, that seem closer to formulary apportionment than to an arm's-length approach.

Formulary apportionment is used in some federal countries (e.g., Canada and the US) to allocate the income of an entity among the subnational governments. It has been proposed for internal use within the North America Free Trade Agreement and the European Union. For several years, the European Union has been exploring the possibility of adopting some type of formulary apportionment to deal with the complex

problems that Member States encounter in determining the amount of income derived by corporations from activities occurring within their borders. However, agreement on a common consolidated tax base has been elusive.

The OECD has approved the use of formulas for apportioning the income of corporate groups engaged in global trading, banking, and insurance. Therefore, current transfer pricing rules are a mix of arm's-length methods and formulary apportionment methods. Given the deficiencies of both the arm's-length method and formulary apportionment, as well as the difficulty of changing the existing system, it seems likely that transfer pricing will continue to be a complex mixture of rules that, despite continuous refinement, will never deal with the underlying problem in a satisfactory manner.