This is a working draft of a Chapter of the Practical Manual on Transfer Pricing for Developing Countries and should not at this stage be regarded as necessarily reflecting

1. What is Transfer Pricing?

1.1 This introductory chapter intends to give a brief outline of the subject of transfer pricing and addresses the practical issues and concerns surrounding it, especially issues faced by, and approaches taken by, developing countries. Many of the issues discussed in the introduction are dealt with in greater detail in later chapters.

1.2 Rapid advances in technology, transportation and communication have given rise to a large number of multinational enterprises (MNEs) which have the flexibility to place their enterprises and activities anywhere in the world.

1.3 The fact is that a significant volume of global trade nowadays consists of international transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within a MNE group; such transfers are called “intra-group” transactions. There is evidence that intra-group trade is growing steadily and arguably accounts for more than 30 per cent of all international transactions.

1.4 Furthermore transactions involving intangibles and multi-tiered services constitute a rapidly growing proportion of an MNE’s commercial transactions and have greatly increased the complexities involved in analysing and understanding such transactions.

1.5 The structure of transactions within an MNE group (the component parts of which, such as companies, are also called “associated enterprises” in the language of transfer pricing) is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. Thus, a large and growing number of international transactions are no longer governed entirely by market forces, but by forces which are driven by the common interests of the entities of a group.

1.6 In such a situation, it becomes important to establish the right price, called the “transfer price”, for intra-group, cross-border

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1.8 The economic reason for associated entities charging transfer prices for intra-group trade is to be able to measure the performance of the individual entities in a multinational group. The individual entities within a multinational company group are separate profit centres and transfer prices are required to determine the profitability of the entities. Rationally, an entity having a view to its own interests as a distinct legal entity would only acquire products or services from an associated entity if the purchase price was eq

2.10 From the governments' perspective, the allocation of costs and income from the MNE resources needs to be addressed to calculate the tax. There sometimes tends to be a "tug-of-war" between countries in the allocation of costs and resources aimed towards maximising the tax base in their respective nation states.

2.11 From the MNE's perspective, any trade or taxation barriers in the countries in which it operates raise the MNE's transaction costs while distorting the allocation of resources. Furthermore, many of the common resources which are a source of competitive advantage for the MNEs cannot be disentangled from the global income of the MNEs for tax purposes – this is especially true in the case of intangibles and service-related intra-group transactions.

(iii) Valuation issues

2.12 Mere allocation of income and expenses to one or more members of the MNE group is not sufficient; the income and expenses must also be *valued*. This directly leads us to a key issue of transfer pricing, the valuation of intra-firm transfers.

2.13 With the MNE being an integrated entity with the ability to exploit international differentials and utilise economies of integration not available to domestic firms, transfer prices within the group are unlikely to be the same prices unrelated parties would negotiate.

2.14 More generally speaking there sometimes seems to be an underlying tension between the common goals of the MNEs and the overall economic and social goals of countries. This is because the perceived responsibility of business is often seen as using its resources to increase its profits as much as possible while staying within the rules. This seems to be in contrast with the social, economical and political consideration of countries, and it is probably true that MNEs least likely to engage in transfer pricing are those that see their role in a more nuanced way, as long term partners of countries and the people of those countries with whom they share some of these broader objectives. With so many complex forces at play, it is clear why international taxation is an open-ended problem with transfer pricing at its heart.

3. Evolution of Transfer Pricing

3.1 This section aims to trace the history a

Transfer Pricing Regulations also offer great detail while differing from the OECD Guidelines on important issues.[1]

3.4 Special attention must be focused on the meaning and scope of "associated enterprises", which is a topic of importance but one not defined or discussed adequately so far. This issue is discussed in more detail in subsequent sections of this chapter.

3.5 From a financial perspective, transfer pricing is probably the most important tax issue today globally. This is partly because the term "MNE" not only covers large corporate groups but also smaller companies with one or more subsidiaries or permanent establishments (PEs) in countries other than those where the parent company or head office is located.

3.6 Parent companies of large MNE groups usually have intermediary or sub-holdings in several countries around the world; research and development ("R&D") and services may be concentrated in centres operating for the whole group or specific parts of the group. Intangibles, developed by entities of the MNE group, may be concentrated around certain group members; finance and "captive insurance companies" (insurance companies within a group having the specific objective of insuring group risks) may operate as insurers or internal banks; production of the assembly of final products may take place in many countries around the world. From a management perspective, the decision-making in MNE groups may range from highly centralised structures to highly decentralised structures with profit responsibility allocated to individual group members.

3.7 There are many reasons why transfer pricing has become such a high profile issue over the last couple of decades:-

- the continuous, on-going relocation of the production of final products and components to particular countries. Infrastructure, presence of skilled labour, low production costs, a conducive economic climate in the form of tax incentives etc. all play a role;
- the varied concentration of R&D and service activities within MNEs as indicated above; and
- the round-the-clock trading in commodities and financial instruments, the rise of e-commerce and web-based business models, all of which are made possible by modern means of communication.

3.8 Other considerations have also had an impact on the current importance of transfer pricing. Some developed countries tightened their transfer pricing

4. Concepts in Transfer Pricing

4.1 The UN Model Convention Article 9(1) states the following

"Where

(a) an enterprise of a Contracting State participates directly or in-directly in the management, control or capital of an enterprise of the other Contracting State, or
(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of these conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly"

4.2 In other words, the transactions between two related parties must be based on the "arm's length principle" (ALP). The term "arm's length principle" itself is not a term specifically used in Article 9, but is well accepted by countries as encapsulating the approach taken in Article 9, with some differing interpretations as to what this means in practice. The principle laid out above in the UN Model has also been reiterated in the OECD Model Convention and the OECD's 1995 and now 2010 Transfer Pricing Guidelines.

4.3 Thus, the "arm's length principle" is currently the accepted guiding principle in choosing an acceptable "transfer price". Note that the arm's length principle by itself is not new – it has its origins in contract law to arrange an equitable agreement that will stand up to legal scrutiny, even though the parties involved may have shared interests.

4.4 Under the arm's length principle, intergroup transactions are compared to transactions between unrelated entities to determine acceptable transfer prices. Thus, the marketplace comprising of independent entities is the measure or benchmark for verifying the transfer prices for intra-entity or intra-group transactions and their acceptability for taxation purposes

4.5 The rationale for the arm's length principle itself is that because the market governs most of the transactions in an economy it is appropriate to treat intra-entity or intra-group transactions as equivalent to those between independent entities. Under the arm's length principle, the allocation of expenses and profits with respect to intra-group transactions is tested and adjusted, if the transfer prices are found to deviate from comparable arm's length transactions. The arm's length principle is argued to be acceptable to everyone concerned as it uses the marketplace as the norm

4.6 An argument in favour of using the arm's length principle is that it is geographically neutral, as it treats profits from investments in both source and residence jurisdictions in a similar manner. However this claim of neutrality is conditional on consistent rules and administration of

USA, cantons of Switzerland and provinces of Canada. As noted above, the EU is also considering a formulary approach, at the option of taxpayers, to harmonise its corporate taxes under the Common Consolidated Tax Base (CCTB) initiative.

(i) Applying the arm's length principle

4.14 The process to arrive at the appropriate arm's length price typically involves the following processes or steps:

(a) Comparability analysis

4.15 The concept of establishing comparability is central to the application of the arm's length principle. An analysis under the arm's length principle involves information on associated enterprises involved in the controlled transactions, the transactions at issue between the associated enterprises, the functions performed and the information derived from independent enterprises engaged in comparable transactions (i.e., uncontrolled transactions).

4.16 The objective of comparability analysis is always to seek the highest practicable degree of comparability, recognising that there will be unique transactions and cases where any applied method cannot be relied on. It is clear that the closest approximation of the arm's length price will be dependent on the availability and reliability of comparables.

4.17 There are many factors determining the comparability of transactions for transfer pricing analysis:

(1) Characteristics of the property or services

4.18 Property, tangible or intangible, as well as services, may have different characteristics which may lead to a difference in their values in the open market. Therefore, these differences must be accounted for and considered in any comparability analysis of controlled and uncontrolled transactions. Characteristics that may be important to consider are:

- In case of tangible property, the physical features, quality, reliability and availability of volume and supply;
- In the case of services, the nature and extent of such services; and
- In case of intangible property, the type and form of property, duration and degree of protection and anticipated benefits from use of property.

(2) Functional analysis (Functions, Assets and Risks)

4.19 In dealings between two independent enterprises, the compensation usually reflects the functions that each enterprise performs, taking into account assets used and risks assumed. Therefore, in determining whether controlled and uncontrolled transactions are comparable, a proper study of all specific characteristics of an international transaction or functional activity needs to be undertaken, including comparison of the functions performed, assets used and risks assumed by the parties. Such a comparison is based on a "functional analysis".

4.20 A functional analysis seeks to identify and compare the economically significant activities and responsibilities undertaken by the independent and associated enterprises. An

4.26 Consider an example where company S, situated in country A, is the wholly-owned subsidiary of company P, situated in country B but a foreign manufacturer. The subsidiary company S acts as the distributor of goods manufactured by the parent company P and both parties execute an agreement that any product liability costs will be borne by the parent company P. However, in practice when product liability claims are raised, subsidiary company S always pays the resulting damages. In such a case the tax authorities will generally disregard the contractual arrangement and treat the risk as having been in reality assumed by subsidiary company S.

(3) Contractual Terms

4.27 The conduct of the contracting parties is a result of the terms of the contract between them and the contractual relationship thus warrants careful analysis when arriving at the transfer price. Other than a written contract, the terms of the transactions may be figured out from correspondence and communication between the parties involved. In case the terms of the arrangement between the two parties are not explicitly defined, then the terms have to be deduced from their economic relationship and conduct.

4.28 One important point to note in this regard is that associated enterprises may not hold each other to the terms of the contract as they have common overarching interests, unlike independent enterprises, who are expected to hold each other to the terms of the contract. Thus, it is important to figure out whether the contractual terms between the associated enterprises are a "sham" (something that appears genuine, but when looked closer lacks reality, and is not valid under many legal systems) and/or have not been followed in reality.

4.29 Also, explicit contractual terms of a transaction involving members of a MNE may provide evidence as to the *form* in which the responsibilities, risks and benefits have been assigned among those members. For example, the contractual terms might include the form of consideration charged or paid, sales and purchase volumes, the warranties provided, the rights to revisions and modifications, delivery terms, credit and payment terms etc. This material may also indicate the *substance* of a transaction, but will usually not be determinative on that point.

4.30 It must be noted that contractual differences can influence *prices* as well as *margins* of transactions. The party concerned should document contractual differences and evaluate them in the context of the transfer pricing methods discussed in detail in a later chapter of this Manual, in order to judge whether comparability criteria are met and whether any adjustments need to be made to account for such differences.

4.31 An example of how contract terms affect transfer pricing is as follows: Consider company A in one country, an agricultural exporter, which regularly buys transportation services from company B (its foreign subsidiary) to ship its product, cocoa beans, from company A's country to overseas markets. Company B occasionally provides transportation services to company C, an unrelated domestic corporation in the same country as company B. However, provision of such services to company C accounts for only 10% of the gross revenues of company B and the remaining 90% of company B's revenues are attributable to its provision of transportation services for cocoa beans to company A. In determining the degree of comparability between company B's uncontrolled transaction with company C and its controlled transaction with company A, the difference in volumes involved in the two transactions and the

regularity with which these services are provided must be taken into account where such factors would have a material effect on the price charged.

(4) Market Conditions

4.32 Market prices for the transfer of the same or similar property may vary across different markets owing to cost differentials prevalent in the respective markets. Markets can be different for numerous reasons; it is not possible to itemise exhaustively all the market conditions which may influence transfer pricing analysis but some of the key market conditions which influence

4.37 **Government rules and regulations** – Generally, government interventions in the form of price controls, interest rate controls, exchange controls, subsidies for certain sectors, anti-dumping duties etc, should be treated as conditions of the market in the particular country and in the ordinary course they should be taken into account in arriving at

plausible or needs further investigation; an endless "market penetration strategy" that has yielded no profits in many years might under examination have no such real basis in practice.

(b) Transaction analysis

4.45 The arm's length price must be established with regard to transactions *actually undertaken*; the tax authorities should not substitute other transactions in the place of those that have actually happened and should not disregard those transactions actually undertaken unless there are special circumstances - such as that

on the conditions which determine comparability. Data from previous years can show whether an independent enterprise engaged in comparable transactions was affected by similar economic conditions so as to be used as a comparable or not.

(f) Losses

4.58 In an MNE group, one of the enterprises might be suffering a loss, even a recurring one, but the overall group may be extremely profitable. The fact that there is an enterprise making losses that is doing business with profitable members of its MNE group may warrant scrutiny by the tax authorities concerned. Such a situation perhaps indicates that the loss-making enterprise is not receiving adequate compensation from the MNE group of which it is a part in relation to the benefits derived from its activities. However the tax authorities should recognise the fact that these losses, if short-term, may be the result of a deliberate business strategy for market penetration, as noted above.

(g) Intentional set-offs

4.59 A deliberate or intentional set-off occurs when an associated enterprise has provided a benefit to another associated enterprise within the MNE group and is compensated in return by that other enterprise with some other benefits. These enterprises may claim that the benefit that each has received should be set-off against the benefit each provided and only the net gain or loss if any on the transactions needs to be considered for tax assessment.

4.60 Set-offs can be quite complex; they might involve a series of transactions and not just a simple "one transaction, two party" set-off. Ideally the parties disclose all set-offs accurately and have enough documentation to substantiate their set-off claims so that after taking account of set-offs, the conditions governing the transactions are consistent with the arm's length principle.

4.61 The tax authorities may evaluate the transactions separately to determine which of the transactions satisfy the arm's length principle. However, the tax authorities may also choose to evaluate the set-off transactions together, in which case comparables have to be carefully selected; set-offs in international transactions and in domestic transactions may not be easily comparable, such as due to the differences in the tax treatment of the set-offs under the taxation systems of different countries.

(h) Use of custom valuations

4.62 The General Agreement on Trades and Tariff (GATT, Article VII), now part of the World Trade Organization (WTO) set of agreements, has laid down the general principles for an international system of custom valuation. Customs valuation is the procedure applied to determine the customs value of imported goods. Member countries of WTO typically harmonise their internal legislation dealing with the customs valuation with the WTO Agreement on Customs Valuation.[3]

4.63 In appropriate circumstances, the documented custom valuation may be used for justifying the transfer prices of imported goods in international transactions between associated enterprises. The arm's length principle is applied by many customs administrations as a

[3] See http://www.wto.org/english/tratop_e/cusval_e/cusval_e.htm

principle of comparison between the value attributable to goods imported by associated enterprises and the value of similar goods imported by independent enterprises. However when there is no customs duty imposed and goods are valued only for statistical purposes, and for items which have no rate of duty, this approach would not be useful.

4.64 Even when utilising the custom valuation for imports in a transfer pricing context, certain additional upward or downward adjustments may be required to derive the arm's length price for the purpose of taxation.

4.65 Internationally, there is a great deal of focus on the interplay of transfer pricing methods on the one hand and custom valuation methods on the other hand. Debates have centred on the feasibility and desirability of the convergence of the systems surrounding the two sets of value determination. Those who favour the convergence, point to the lower compliance costs to business and lower enforcement costs to government arising out of two sets of rules existing in the same government. The opponents of this idea, point to the different principles underlying the determination of value, as between the levy of customs duty and the levy of tax on profits. The issue is considered in more detail in a later chapter.

(ii) Use of transfer pricing methods

4.66 The transfer pricing methods are set forth in more detail in the following section, and are dealt with more fully in a later chapter. It is, however, important to note at the outset that there is no one transfer pricing method which is generally applicable to every possible situation.

4.67 The bottom line is that comparables play a critical role in arriving at arm's length prices; it is also abundantly clear that computing an arm's length price using transfer pricing analysis is a complex task; it requires a lot of effort and good will from both the taxpayer and the tax authorities in terms of documentation, groundwork, analysis and research. This Manual seeks to assist developing countries in that task as much as is possible, but it has to be recognised that it will nevertheless hardly ever be a simple one.

5. Transfer Pricing Methods

5.1 The key question is how to apply the arm's length principle in practice to determine the arm's length price of a transaction? Several acceptable transfer pricing methods exist, providing a conceptual framework for the determination of the arm's length price. No single method is considered suitable in every situation and the taxpayer must select the method that provides the best estimate of an arm's length price for the transaction in question.

5.2 Most of the transfer pricing methods used

5.3 The five major transfer pricing methods (all discussed in more detail later in this Manual) are:

(i) Comparable Uncontrolled Price (CUP)

5.4 The CUP method compares the price charged for a property or service transferred in a controlled transaction to the price charged for a comparable property or service transferred in a comparable uncontrolled transaction in comparable circumstances. This method is reliable where an independent enterprise sells the same product as that sold between two associated enterprises. In other words, a high degree of comparability is necessary to apply this method. The CUP method is regarded as the best indicator of the arm's length price but in practice, it usually cannot be applied for want or proper comparables and therefore is not ultimately applied in the vast majority of cases. It is almost always the case that other methods have to be applied to find the arm's length price or range of prices. One of the purposes of this Manual will be to help developing countries to avoid wasting unnecessary time and resources on CUP analyses when it is apparent that only other methods can determine arm's length prices.

(ii) Resale Price Method (RPM)

5.5 The resale-price method is used to determine the price to be paid by a reseller for a product purchased from an associated enterprise and resold to an independent enterprise. The purchase price is set so that the margin earned by reseller is sufficient to allow it to cover its selling and operating expenses and make an appropriate profit. What is left after subtracting the gross margins can be regarded, after adjustments for other costs associated with the purchase of the product such as custom duties, as an arm's length price for the original transfer of property between the associated enterprises. This method is usually applied to marketing operations by distributors.

5.6 This method is appropriate when there are no direct comparables (so that "CUP" will not be helpful) and the reseller does not add significant value to the product itself. A good example where this method can be used is a distribution company. By contrast, in cases where the imported goods are significantly processed or modified, the resale price method would be difficult to use.

(iii) Cost Plus (C+, CP)

5.7 The cost-plus method is used to determine the appropriate price to be charged by a supplier of property or services to a related purchaser. The price is determined by adding to costs the supplier incurred an appropriate gross margin so that the supplier will make an appropriate profit in the light of market conditions and functions he or she performed. What is obtained after adding mark-up to costs may be regarded as the arm's length price of the original controlled transactions. When semi-finished goods are sold between related parties on the basis of joint agreements or where there is a provision of services in controlled transactions, this method is often used.

the members of the controlled group on a pro-rata basis according to their contributions. To determine their relative c

taxpayer should not be expected to provide more documentation than is objectively required for a reasonable determination by the tax authorities whether or not the tax payer has complied with the arm's length principle. To unnecessarily make demands in this area affects how a country is seen as an investment destination and may have particularly discouraging effects on small and medium enterprises, which are least able to absorb the often very high costs of transfer pricing documentation.

6.3 Broadly, the information or documents that the taxpayer needs to provide can be classified as

(i) *enterprise-related documents* (for example the ownership / shareholding pattern of the taxpayer, the business profile of the MNE, industry profile etc);

(ii) *transaction-specific* documents (for example the details of each international transaction, functional analysis of the taxpayer and associated enterprises, record of uncontrolled transactions for each international transactions etc), and

(iii) *computation-related* documents (for example the nature of each international transaction and the rationale for selecting the method for each international transaction, actual computation of the arm's length price, factors and assumptions influencing the determination of the arm's length price etc.)

6.4 Furthermore, the domestic legislation of some countries requires "contemporaneous documentation". The Oxford Dictionary defines the term "contemporaneous" as "*existing or occurring in the same period of time*", so that such documentation

(iii) Intra-group services

6.8 An intra-group service, as the name suggests, is a service provided by one enterprise to another in the same MNE group. For a service to be considered an intra-group service it must be similar to a service which an independent enterprise in comparable circumstances would be willing to pay for in-house or else perform by itself. If not, the activity should not be considered as an intra-group service under the arm's length principle. The rationale is that if specific group members do not need the activity and would not be willing to pay for it if they were independent, the activity cannot justify a payment. Furthermore, any incidental benefit solely by being the member of an MNE group, without any specific services provided or performed, should be ignored.

6.9 An arm's length price for intra-group services may be determined directly or indirectly – in the case of direct charge, the CUP method could be used if comparable services are provided in the open market. In the absence of CUP, the cost-plus method could be appropriate to apply in such cases.

6.10 If a direct charge method is difficult to apply, the MNE may apply the charge indirectly via cost sharing or incorporating a service charge or not charging at all. Such methods would usually be accepted by the tax authorities only if the charges are supported by foreseeable benefits and if the methods are based on sound accounting and commercial principles and are capable of producing charges or allocations that are commensurate with the reasonably expected benefits to the recipient. Indirect charge methods would be acceptable in cases where it would be too onerous administratively for the enterprise to provide separate recording and analysis of the relevant service activities for each beneficiary.

(iv) Cost-contribution agreements

6.11 Cost-contribution agreements (CCAs) may be formulated among group companies to jointly l(S com)8-1152 Tw{benefTw{llocat paD.005 0 TD.0004n80n.0006rrding a8rding 61t would(nce of CUo

information needs to be treated very carefully, especially as it may reveal sensitive business information about that taxpayer's profitability, business strategies and so forth.

6.15 A secret comparable generally means the use of information or data about a taxpayer by the tax authorities to form the basis of transfer pricing scrutiny of another taxpayer, who is often not given access to that information – it may reveal confidential information about a competitor's operations, for example.

6.16 The OECD Guidelines caution against the use of secret comparables unless the tax administration is able to (within limits of confidentiality) disclose the data to the taxpayer so as to defend against an adjustment. The reason for this caution is that taxpayers may contend that use of such secret information is against the basic principles of equity, as the taxpayer is required to benchmark his controlled transactions with comparables not available to him, without the opportunity to question comparability or argue that adjustments are needed. If adjustments are made on this basis, the taxpayer faces the consequences of additions to his income, typically coupled with interest, penalties etc.

7. Transfer Pricing in Treaties

(i) United Nations and OECD Model Conventions: An Overview

7.1 The OECD Model Convention was first published in 1963 and then later in 1977, following up some work done by the League of Nations, and then after World War II, by the United Nations. A read-only, but downloadable, version of the OECD Model is available at http://www.oecd.org/dataoecd/14/32/41147804.pdf. The United Nations produced a UN Model Convention for treaties between developed and developing nations in 1980, with a new version produced in 2001. It is currently being further revised. The UN Model is in many respects similar to the OECD Model but the differences (such as preserving greater taxation rights to countries hosting investments) are very significant, especially for developing countries. The UN Model is available at http://www.un.org/esa/ffd/tax/.

7.2 There has been a widespread view, historically, that the OECD Model was most appropriate for negotiations between developed countries and less suitable for capital importing or developing countries. In general, it can be said that the UN Model preserves more taxation rights to the source state (i.e. host State of investment) or capital-importing country than the OECD Model and the UN Model has been embraced by many developing states as the basis of their treaty policy. Some developed countries also adopt some UN Model provisions, and at times it has influenced changes to give aspects of the OECD Model a greater source country orientation.

7.8 Finally, there are a small number of bilate

the old OECD "hierarchy" rule would provide greater flexibility in choosing the specific methodology on the basis of business realities.

8. Transfer Pricing in Domestic Law

(i) Introduction

8.1 Article 9 of tax treaties typically only regulates the basic conditions for adjustment of transfer pricing and advises the application of arm's length principle, but does not go into the particulars of transfer pricing rules. It is generally understood that Article 9 is not "self-executing" as to domestic application – it does not create a transfer pricing regime in a country where such a regime does not already exist. In implementing transfer pricing rules, each country wishing to have a transfer pricing regime is required to formulate more detailed domestic legislation. Many countries have passed such domestic transfer pricing rules for international transactions, and they typically tend to limit their transfer pricing rules to cross-border related transactions only; however several of them include similar domestic transactions as well.

8.2 Long history with transfer pricing has proven that international consistency of rules is beneficial not only regarding the basic structure of taxable person and events but also in the manner of application of the arm's length principle. This consistency is an important goal to be aimed at in terms of encouraging investment in a country and international trade that assists a country's development, although it is ultimately for each country to adopt an approach that works in its domestic legal and administrative framework, and is consistent with its treaty obligations.

8.3 The threshold for whether a taxpayer is dealing with an associated entity varies, to some extent, amongst different countries. A majority of countries employ a hybrid qualification for such taxpayers, namely, a mixture of qualification by minimum shareholding (generally equal or more than 50%) and effective control by any other factors (dependency in financial, personnel and trading conditions). A *de minimis* criteria for the value of related party transactions may also exist In other words, some transactions may be considered small enough that the costs of compliance and collection do not justify applying the transfer pricing rules, but this should not allow for what are in reality larger transactions to be split into apparently smaller transactions to avoid the operation of the law. These differences in approach between countries are not considered to have caused significant risk of double taxation, so far.

(ii) Safe harbours

8.4 There are countries which have "safe harbour" rules providing that if a taxpayer meets certain criteria, it is exempt from the application of a particular rule, or at least from scrutiny as to whether the rule has been met. The intention is to increase taxpayer certainty and reduce taxpayer compliance costs, but also to reduce the administration's costs of collection, as well as allowing the administration to concentrate scarce audit and other resources on the cases where more is likely to be at stake in terms of non compliance and revenue. One example of a "safe harbour" is a rule that a taxpayer is deemed to have an appropriate transfer price when the average export sales price is at least 90% of the average domestic sales in the domestic market

followed unless a deviation can be clearly and openly justified because of local conditions which cannot be changed immediately (e.g. constitutional requirements or other overriding legal requirements). In other cases, there is great benefit for all in taking a widely accepted approach. The chapter on documentation in this Manual will seek to distil some of these widely accepted approaches.

(v) Advance Pricing Agreements

8.9 Recently, multi-national businesses have often depended on Advance Pricing Agreements (APAs) (or "Advance Pricing Arrangements", as some countries prefer) with authorities, especially with the Mutual Agreement Procedure agreement. These APAs are so named because pricing methodologies are agreed in advance in relation to certain types of transactions, often called the "covered transactions". They can be unilateral, between the taxpayer and one tax authority, bilateral (involving the taxpayer and two authorities, which is designed to prevent double taxation where one authority agrees to the APA but the other does not) or even multilateral, involving more than two countries.

8.10 APAs provide greater certainty for the taxpayer on the taxation of certain cross-border transactions and are considered by the taxpayers as the safest way to avoid double taxation, especially where bilateral or multilateral. Therefore, many countries have introduced APA procedures in their domestic laws. However, the APAs have different legal forms in different countries. In certain countries, it may be a legally binding engagement between taxpayers and tax authorities, and in other countries, it may be a one-way concessional document by tax authorities. The pros and cons of APAs for developing country administrations and taxpayers, and some implementation issues, are addressed in a later chapter.

(vi) Time limitations

8.11 Another important issue for transfer pricing domestic legislation is the "statute of limitation." issue – the time allowed in domestic law for the administration to do the transfer pricing audit and make necessary assessments or the like. Since a transfer pricing audit can place heavy burdens on both taxpayers and tax authorities, the normal "statute of limitation" for taking action is often extended to some extent compared with general domestic taxation cases. However, too long a period during which adjustment is possible leaves taxpayers in certain positions with possible large financial risks. Countries should keep this issue of balance between the interests of the revenue and of taxpayers in mind when setting an extended period during which adjustments can be made.

(vii) Are domestic transfer pricing rules necessary?

8.12 Developed and undeveloped countries have domestic transfer pricing rules to counter tax transfer pricing manipulation and the associated enterprises article of tax treaties (usually Article 9) deals with transfer pricing adjustments. One view is that the associated enterprises article of a tax treaty provides a separate and independent domestic basis for making transfer pricing adjustments. The contrary view, which as noted above is generally accepted, is that tax treaties do not increase a country's jurisdiction and consequently the associated enterprises article of a country's tax treaties cannot provide a separate source of tax jurisdiction. The detail

can only strictly be applicable in situations where direct comparable uncontrolled transactions exist.

10.2 Increasing globalisation, sophisticated communication systems and information technology allow an international enterprise to control the operations of its various subsidiaries from one or two locations worldwide. Trade between associated enterprises is often in intangible items, such as services and software. Developed countries have undergone structural changes and are witnessing tremendous growth in their service sectors while having a declining demand for products. The nature of the world on which international tax principles are based, has changed significantly. All these issues raise challenges in applying the arm's length concept to the globalised and integrated operations of international enterprises. Overall, it is clear that in the 21st century the arm's length principle presents real challenges in allocating the income of highly integrated international enterprises.

10.3 Furthermore, it is widely accepted that transfer pricing is not an exact science and that the application of transfer pricing methods requires the application of information, skill and judgment by both taxpayers and tax authorities. In view of the skill, information and resource “gaps” in many developing countries, this can be very difficult for developing countries, often requiring their best officers, who may, after skilling-up leave the organisation in view of their special skills. The intention of this Manual is to play one part in reducing those gaps.

(ii) Transfer pricing and developing countries

relied on in transfer pricing analysis tend to focus on developed country data that may not be relevant to developing country markets (at least without resource and information-intensive adjustments), and in any event, are usually very costly to access; and

(c) In many developing countries the economies of which have just opened up or are in the processing of opening up, there are many "first movers" who have come into existence in many of the sectors and areas hitherto unexploited or unexplored; in such cases there would be an inevitable lack of comparables.

10.7 Given these issues, critics of the current transfer pricing methods equate finding a satisfactory comparable to finding a needle in a haystack. Overall, it is quite clear that in developing countries finding appropriate comparables for analysis is quite possibly the biggest practical problem faced currently by enterprises and tax authorities alike, but the aim of this Manual is to assist that process in a practical way.

(b) Lack of knowledge and requisite skill-sets

10.8 Transfer pricing methods are complex and time-consuming, often requiring time and attention from some of the most skilled and valuable human resources in both MNEs and tax administrations. Transfer pricing reports often run into hundreds of pages with many legal and accounting experts employed to create them. This kind of complexity and knowledge-requirement puts tremendous strain on both the tax authorities and the taxpayers, especially in developing countries where resources tend to be scarce and the appropriate training in such a specialised area is not readily available.

(c) Complexity

10.9 Rules based on the arm's length principle are becoming increasingly difficult and complex to administer. Transfer pricing compliance today typically involves huge and expensive databases and high-level expertise to handle. Transfer pricing audits need to be performed on a case-by-case basis and are often complex and costly tasks for all parties concerned.

10.10 In developing countries, resources, monetary and otherwise, may be limited for the taxpayer (especially a SME) who has to prepare detailed and complex transfer pricing reports and comply with the transfer pricing regulations, and may have to be "bought-in". Similarly the tax authorities of many developing countries do not have sufficient resources to examine the facts and circumstances of each and every case so as to determine the acceptable transfer price, especially in cases where there is a lack of comparables. Furthermore, the transfer pricing audits tend to be long drawn, time consuming may be contentious and may ultimately result in "estimates" fraught with conflicting interpretations.

10.11 In case of disputes *between* the revenue authorities of two countries, the current available prescribed option is Mutual Agreement Procedure (MAP). This too can possibly lead to a protracted and involved dialogue, often between unequal economic powers, and may cause strain on the resources of the companies in questions and the revenue authorities of the developing countries.

11.3 For governments, transfer pricing administration is resource intensive and developing countries often do not have easy access to resources to effectively administer their transfer pricing regulations. Furthermore, from the government's perspective, transfer pricing manipulation reduces revenue available for country development, and with increasing globalisation, the potential loss of revenue may run into billions of dollars.

11.4 Overall, to simplify the international taxation system, especially transfer pricing, while keeping it equitable and judicious for all parties involved, is a difficult task. But a practical approach, such as proposed by this Manual, will help ensure the focus is on solutions to these problems and will help equip developing countries to address transfer pricing issues in a way that is robust and fair to all the stakeholders, while remaining internationally coherent and seeking to reduce compliance costs and the incidence of unrelieved double taxation.

11.5 This chapter served to introduce the fundamentals of the concepts involved in transfer pricing such as the arm's length principle and issues related to it. Subsequent chapters will deal with specific transfer pricing concepts in greater detail.