

# Guide to International Transfer Pricing

Law, Tax Planning  
and Compliance Strategies

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EIGHTH EDITION

DUFF & PHELPS



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Law, Tax Planning and Compliance Strategies

Duff & Phelps



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Mike Heimert is a managing director and global leader of the Transfer Pricing Services practice for Duff & Phelps, which is one of the largest independent transfer pricing practices in the world. Mike has significant experience providing transfer pricing and valuation services for multinational companies across a wide range of industries – including consumer packaged goods, automotive, oil and gas, mining, high tech, heavy manufacturing and retail. Mike has been retained as an expert witness on various transfer pricing matters, including the largest US Transfer Pricing case on record. He also provides litigation support to attorneys and their clients in diverse matters involving tax issues.

Mike was formerly the CEO and founder of Ceteris, a multi-country firm specializing in transfer pricing and tax valuation matters that was acquired by Duff & Phelps. Before that, Mike was a partner and the National Director of Transfer Pricing and Economics for Ernst & Young, LLP. He holds a PhD and MA in Economics from the University of Wisconsin-Milwaukee, and a BS in Business Economics from Marquette University.

### ***T.J. Michaelson***

T.J. Michaelson is a Vice President of transfer pricing at Duff & Phelps with experience in advising clients on a variety of transfer pricing and valuation matters including assisting multinational companies with the design, implementation, documentation and defense of their global transfer pricing strategies. Specifically, T.J. has consulted in areas including global policy planning and implementation, preparation of US, OECD and local country transfer pricing documentation for tangible, intangible and service transactions, intellectual property planning and valuation, corporate services, litigation/expert witness support projects, and ASC 740 risk measurements. T.J. has worked with clients in a wide variety of industries including consumer products, diamonds, food and beverage, healthcare, industrial products, medical devices, mining, non-for-profit, power management, retail, semiconductors, specialty chemicals, technology, and telecommunications.

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Prior to joining Duff & Phelps, T.J was a transfer pricing consultant at Ceteris and obtained his Bachelors degree in Economics and Finance from Marquette University. He also studied in Strasbourg, France at the University of Strasbourg.

### ***Duff & Phelps***

The Duff & Phelps transfer pricing practice provides an independent and uncompromised perspective on all aspects of transfer pricing, including compliance, planning, controversy and implementation. Our internationally-recognized transfer pricing advisors provide clients with deep technical expertise coupled with industry-specific experience. Our transfer pricing advisors are able to seamlessly collaborate with accounting, tax, legal and finance groups while providing objective viewpoints that are unequivocally free from regulatory conflict and independence concerns set forth by various governing bodies.

Duff & Phelps is the global advisor that protects, restores and maximizes value for clients in the areas of valuation, corporate finance, investigations, disputes, cybersecurity, compliance and regulatory matters, and other governance-related issues. We work with clients across diverse sectors, mitigating risk to assets, operations and people. With Kroll, a division of Duff & Phelps since 2018, our firm has nearly 3,500 professionals in twenty-eight countries around the world. For more information, visit [www.duffandphelps.com](http://www.duffandphelps.com).

The editors would like to thank Annie Lu of Duff & Phelps for her valuable contributions in preparing the current edition of this publication.

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Andrew Cousins is a Director in the London TP practice of Duff & Phelps. An international tax practitioner for more than twenty years, his cross-border experience spans private practice, industry and government. Eight of those years were spent as global head of TP in two FTSE 100 multinationals, first Gallaher plc, then Cadbury plc, where he led the TP team handling development of TP policy, business restructuring, negotiation of APAs and ATCA, TP documentation, management of audits and resolution of controversy, focusing on practical solutions aligned with the business. As an industry observer, he submitted papers in response to the OECD's Working Party No. 6 business restructuring and intangibles discussion drafts and contributed to the debate at the associated public consultations. He has continued to participate in the OECD's public consultations in relation to the BEPS Project.

Immediately prior to joining Duff & Phelps, Andrew served as Deputy Comptroller of Taxes in the Jersey tax authority, responsible for implementing and interpreting all Jersey's international tax agreements, including DTAs, TIEAs and the Multilateral Convention. As competent authority, he managed the Mutual Agreement Procedure (MAP) process and exchange of information (EOI) with other tax authorities around the world, including automatic EOI under the EU Savings Directive and FATCA. He created the EOI Unit within the Taxes Office to handle the increasing demands of inter-governmental information flow and was heavily involved in the nascent field of litigation associated with this area. A regular participant at the OECD, Andrew acted as Jersey's representative at the OECD's Global Forum for Transfer Pricing and Global Forum for Tax Treaties. As Jersey delegate and expert assessor for the Global Forum on Transparency and EOI for Tax Purposes, Andrew co-authored three OECD publications: the peer review reports on the Bahamas (2013), Portugal (2015) and Lithuania (2015).

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Andrew is a Fellow of the Institute of Chartered Accountants in England and Wales, having originally qualified at Deloitte & Touche before focusing on TP at Ernst & Young, where he was a member of the Tax Effective Supply Chain Management (TESCM) team. Andrew is a graduate of Oxford University.

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He holds a German undergraduate degree in Tax Law and Accounting as well as an MSc in Quantitative Finance from the University of Strathclyde in Glasgow and passed the German Certified Tax Advisor qualification exam. Previously Daniel worked for EY in Munich as a Transfer Pricing Economist and Manager.

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Ted began his transfer pricing career with KPMG in Los Angeles. After three years there, he moved to KPMG's London office and became partner two years later. In 2005 he joined the Ballentine Barbera group to lead their European Transfer Pricing practice, a position he continued to hold after their acquisition by Charles River Associates International. In 2009 Ted joined Ernst & Young, where as a partner he was on the global leadership team for transfer pricing in the life sciences, mining and minerals and agribusiness sectors. Prior to joining Duff & Phelps, Ted retired from EY to establish his own transfer pricing consultancy business.

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Matt's experience includes a wide variety transfer pricing planning, dispute resolution and compliance projects, including with respect to intellectual property and financial transactions. He has helped clients develop post-acquisition planning to meet both their tax and business objectives; establish frameworks for entering new foreign markets; obtain tax certainty through Bilateral and Unilateral Advance Pricing Arrangements; and negotiate favourable conclusions to tax audits.

Prior to joining Duff and Phelps, Matt served as a transfer pricing partner at PwC.

Matt speaks regularly at seminars, on such topics as *BEPS and Intangibles*, *Pricing Guarantee Fees*, *Intellectual Property Migration*, *Transfer Pricing and Thin Capitalisation*, and *Implementing and Monitoring Transfer Pricing*. He has published articles through the Canadian Tax Foundation, International Transfer Pricing Journal, and BNA Tax Management Transfer Pricing Report.

Born in Fredericton, New Brunswick, Matt earned a master's degree in economics from Queen's University, with dual concentrations in international economics and financial economics. He also has a Bachelor of Business Administration degree from the University of New Brunswick, with a major in economics and a concentration in international business.

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Michelle is an award-winning speaker and has presented at numerous conferences and seminars regarding transfer pricing issues. In addition to this volume, her publications include several books on transfer pricing, including BNA's Tax Management Portfolio on ASC 740-10 (FIN 48), Lexis-Nexis's Practical Guide to U.S. Documentation, and Wiley's Cost of Capital (Transfer Pricing Chapter). In a previous role she was responsible for her firm's US operations, focusing on the areas of quality and training. Michelle obtained her Masters degree in Economics from New York University and a BS in Economics and French, with a minor in Mathematics, from the University of Illinois (magna cum laude).

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Rod obtained a BS in Finance from Georgetown University and an MA in International Affairs also from Georgetown University.

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Stefanie is also a thought leader on Duff & Phelps' Financial Services Transfer Pricing team, spending a significant amount of time focused on transfer pricing strategy for financial services clients as well as establishing best practices for assessing intercompany debt and other intercompany financing arrangements for clients across a wide spectrum of industries. Stefanie also has significant experience providing transfer pricing valuation services associated with cost sharing arrangements and intangible transfers to clients primarily in the pharmaceutical and medical device space. Stefanie has co-authored a number of articles for publications, such as Bloomberg BNAI and Thomson Reuters's Practical International Tax Strategies, and is an award-winning speaker that has also presented on transfer pricing topics at international conferences.

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Justin's clients include Fortune 100 and Fortune 500 companies across a broad range of industries – including e-commerce, automotive, chemicals, consumer goods, pharmaceutical, telecommunications, software and software development, retail and industrial goods. He has published several articles about TP, including an in-depth look at the US Services Regulations. Previously, Justin joined Ceteris after acquiring a BA in Psychology from DePaul University.

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Cristian is pleased to serve you as a point of contact as to Argentine TP regulations and any questions regarding the Quick Reference Table.

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Previously, Stean was a Partner at Quanterra Global, the Asian transfer pricing leader for Crowe Horwath International, and worked as a senior transfer pricing specialist for Big 4 firms in New Zealand, Canada and Australia. He started his career with the Inland Revenue Department in New Zealand.

Stean is the author of a number of transfer pricing articles and a regular speaker on transfer pricing matters at seminars in Australasia, South-East Asia, North America and Europe.

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# Summary of Contents

Editors	v
Contributors	vii
List of Abbreviations	lxxi
Preface	lxxix
CHAPTER 1	
Overview/Best Practices	
<i>Michelle Johnson, Justin Radziewicz &amp; Jay Hudson</i>	1
CHAPTER 2	
OECD Transfer Pricing Guidelines	
<i>Andrew Cousins</i>	65
CHAPTER 3	
Argentina	
<i>Matías Federico Lozano &amp; Cristian E. Rosso Alba</i>	103
CHAPTER 4	
Australia	
<i>Stean Hainsworth</i>	139
CHAPTER 5	
Belgium	
<i>Natalie Reypens</i>	225

## Summary of Contents

---

CHAPTER 6 Brazil <i>Luís Rogério Farinelli, Cristiane M.S. Magalhães, Stephanie Makin &amp; Nathália Fraga</i>	281
CHAPTER 7 Canada <i>Matt Billings</i>	335
CHAPTER 8 China <i>Glenn DeSouza</i>	397
CHAPTER 9 France <i>Serge Lambert &amp; Arnaud Le Boulanger</i>	437
CHAPTER 10 Germany <i>Angelika Thies</i>	501
CHAPTER 11 Hong Kong <i>Steven Carey &amp; Douglas Fone</i>	551
CHAPTER 12 Indonesia <i>Douglas Fone &amp; Steven Carey</i>	581
CHAPTER 13 Ireland <i>Joe Duffy &amp; Barry McGettrick</i>	615
CHAPTER 14 Israel <i>Jonathan Lubick</i>	649
CHAPTER 15 Italy <i>Marco Valdonio, Aurelio Massimiano &amp; Mirko Severi</i>	667

## Summary of Contents

---

CHAPTER 16 Malaysia <i>Douglas Fone &amp; Steven Carey</i>	731
CHAPTER 17 Mexico <i>Yoshio Uehara</i>	769
CHAPTER 18 The Netherlands <i>Rogier Sterk &amp; Robert Jan van Lie Peters</i>	789
CHAPTER 19 Singapore <i>Douglas Fone &amp; Steven Carey</i>	857
CHAPTER 20 South Korea <i>Tae Yeon (TY) Nam, Jae Suk (JS) Park &amp; Christopher Sung</i>	891
CHAPTER 21 Spain <i>Pilar Barriguete</i>	925
CHAPTER 22 United Kingdom <i>Andrew Cousins, Daniel Othmann &amp; Ted Keen</i>	961
CHAPTER 23 United States <i>Jill Weise, Stefanie Perrella, Rod Koborsi &amp; Jay Hudson</i>	1009
CHAPTER 24 Vietnam <i>Steven Carey, Tu Ha Anh &amp; Douglas John Fone</i>	1113

## Summary of Contents

---

Annexes	1151
ANNEX I	
Transfer Pricing Rules Summary	1153
ANNEX II	
Transfer Pricing Implementation Checklist	1165
Table of Cases	1169
Index	1177

# Table of Contents

Editors	v
Contributors	vii
List of Abbreviations	lxxi
Preface	lxxix
CHAPTER 1	
Overview/Best Practices	
<i>Michelle Johnson, Justin Radziewicz &amp; Jay Hudson</i>	1
§1.01 What Is Transfer Pricing and Why Does It Exist?	3
[A] Transfer Pricing Example	4
[B] Arm's-Length Standard	6
[1] Arm's-Length Standard as Defined in the US	
Transfer Pricing Regulations	7
[2] Arm's-Length Standard Defined in the OECD Guidelines	7
[3] Exceptions to the Arm's-Length Standard	8
[C] Importance of Transfer Pricing to Today's Multinational	
Companies	8
[1] High -Profile Litigation Cases	8
[2] OECD Guidelines – BEPS Action Items	9
[3] Significant Tax Reform in the United States	9
[D] European Union Enforcement of CbC Reporting and	
Other Transfer Pricing Measures	10
[1] Who Cares About Transfer Pricing?	11
[a] Tax Departments	11
[b] Chief Financial Officers	12
[c] Operations	13
[d] Accounting Departments	13
[e] Legal Counsel	14

## Table of Contents

---

	[f] Government Authorities	14
	[g] Board of Directors	14
	[h] Independent Auditors	15
	[i] Tax Planning and Compliance Advisors	15
§1.02	Transfer Pricing Lifecycle	15
	[A] Phase 1: Planning	16
	[1] Identifying Intercompany Transactions for Analysis	18
	[2] Types of Intercompany Transactions	18
	[a] Tangible Property Transactions	18
	[b] Intangible Transactions	18
	[c] Services Transactions	20
	[d] Financing and Insurance Transactions	21
	[e] Cost Contribution Arrangements	22
	[3] How to Prioritize Risk Areas	23
	[4] How to Conduct Functional Analysis Interviews	24
	[5] Determining How to Price Intercompany Transactions	26
	[6] Selecting Transfer Pricing Methods	26
	[a] Prioritization of Methods of Analysis	27
	[7] Identifying Comparable Companies	29
	[a] Comparability Considerations	30
	[b] Geographic Differences	31
	[8] Arm's-Length Range	32
	[9] <i>Single-Year Versus Multiple-Year Data</i>	34
	[10] Specific Transactional Considerations	35
	[a] Loans and Loan Guarantees	36
	[b] Stock Option Expense	37
	[B] Phase 2: Implementation	37
	[1] Key Implementation Steps and Timeline	38
	[a] Step 1: Communicating Transfer Pricing Policies to Key Stakeholders	38
	[i] Local Country Tax Personnel	38
	[ii] Senior Management	39
	[iii] Operations Personnel	39
	[iv] IT and Accounting Departments	39
	[v] Legal Department	40
	[vi] Tax Planning and Compliance Advisors	40
	[b] Step 2: Drafting and Executing Intercompany Agreements	41
	[c] Step 3: Determining Internal Pricing Mechanism	42
	[d] Step 4: Monitoring	44
	[e] Step 5: Developing Transfer Pricing Policy and Procedure Manuals	45
	[i] Accounting and Systems Manuals	45
	[ii] Headquarter Service Allocation Manuals	45
	[iii] Tax Department Policy and Procedures Manuals	46

Table of Contents

[C]	Phase 3: Compliance and Documentation	46
[1]	Documentation Strategies and Considerations	46
[a]	Performing a Risk Assessment to Optimize Documentation Strategy	48
[i]	What Protection Do Transfer Pricing Documentation Reports Provide?	48
[ii]	Evaluating the Cost/Benefit of Documentation	49
[b]	Decisions Concerning Local Country Documentation	50
[i]	Direct Local Country Documentation	50
[ii]	CbC Documentation	51
[c]	Planning Reports	52
[d]	Limited Study	52
[2]	Documentation Review and Updates	53
[D]	Phase 4: Audit and Controversy	54
[1]	Best Practices for Transfer Pricing Audits	54
[a]	Understand Your Risk	55
[b]	Centralize Efforts and Develop a Clear Chain of Command	55
[c]	Control Information Flow	56
[d]	Do Not Panic	57
[2]	Addressing Transfer Pricing Disputes Between Countries	57
[a]	Nature of Conflicts	58
[b]	Mutual Agreement Procedures	59
[c]	Advanced Pricing Agreements	61
§1.03	Resources for Basic Information on Transfer Pricing Rules and Regulations, Documentation Requirements and Penalties	62
§1.04	Conclusion	64
CHAPTER 2		
OECD Transfer Pricing Guidelines		
	<i>Andrew Cousins</i>	65
§2.01	The OECD Transfer Pricing Guidelines	67
[A]	Purpose of the OECD Transfer Pricing Guidelines	67
[B]	Contents of the OECD Transfer Pricing Guidelines	70
[1]	The Arm's Length Principle	71
[a]	Statement of the Arm's Length Principle	71
[b]	A Non-Arm's-Length Approach: Global Formulary Apportionment	72
[c]	Guidance for Applying the Arm's Length Principle	73
[2]	Transfer Pricing Methods	75
[a]	Traditional Transaction Methods	76
[i]	Comparable Uncontrolled Price Method	76
[ii]	Resale Price Method	77
[iii]	Cost Plus Method	78

## Table of Contents

---

	[b] Transactional Profit Methods	79
	[i] Transactional Net Margin Method	79
	[ii] Transactional Profit Split Method	79
	[3] Comparability Analysis	81
	[4] Administrative Approaches to Avoiding and Resolving Transfer Pricing Disputes	82
	[5] Documentation	84
	[a] Master file	84
	[b] Local file	85
	[c] CbC Report	85
	[6] Special Considerations for Intangible Property	86
	[7] Special Considerations for Intra-Group Services	88
	[8] Cost Contribution Arrangements	90
	[9] Transfer Pricing Aspects of Business Restructurings	92
§2.02	Additional Guidance and Projects of the OECD Relating to Transfer Pricing Matters	93
	[A] Attribution of Profits to Permanent Establishments	93
	[B] Toolkits for Developing Nations	95
	[C] Dispute Resolution	95
§2.03	Transfer Pricing Guidance of Other International Bodies	96
	[A] The EU Joint Transfer Pricing Forum	96
	[1] Code of Conduct for the Effective Implementation of the Arbitration Convention (2004)	97
	[2] Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in the EU (2005)	97
	[3] Guidelines for Advance Pricing Agreements ('APAs') in the EU (2007)	98
	[4] Guidelines on Low-Value-Adding Intra-Group Services (2011)	98
	[5] Potential Approaches to Non-EU Triangular Cases (2011)	98
	[6] Report on Small and Medium Enterprises ('SMEs') and Transfer Pricing (2012)	98
	[7] Report on Cost Contribution Arrangements on Services Not Creating Intangible Property ('IP') (2012)	98
	[8] Report on Secondary Adjustments (2014)	99
	[9] Report on Transfer Pricing Risk Management (2014)	99
	[10] Report on Compensating Adjustments (2014)	99
	[11] Report on Improving the Functioning of the Arbitration Convention Including a Revised Code of Conduct for the Effective Implementation of the Arbitration Convention	99
	[12] Work Programme	100
	[B] The UN Practical Transfer Pricing Manual for Developing Countries	101
	[C] Transfer Pricing and Developing Economies: A Handbook for Policy Makers and Practitioners	102

CHAPTER 3		
Argentina		
	<i>Matías Federico Lozano &amp; Cristian E. Rosso Alba</i>	103
§3.01	Importance of Transfer Pricing for Multinational Enterprises Operating in Argentina	105
§3.02	Regulatory Framework	107
	[A] Legal Authority	107
	[B] Transfer Pricing Penalty Framework	109
	[1] Failure to Comply with Formal Obligations of International Operations Returns	109
	[2] Failure to Retain Documentation	110
	[3] Failure to Comply with Income Tax Payment Obligations	110
	[4] Relationship between Fulfilling Documentation Requirements and Protection from Adjustments	111
	[C] Arm's-Length Standard	111
§3.03	Determining the Appropriate Intercompany Price	112
	[A] Method Selection	112
	[B] Comparables Selection	113
	[1] Range of Comparables	113
	[2] Comparables	114
	[a] Tested Party Rules	114
	[b] Methods	115
	[i] Comparable Uncontrolled Price Method ( <i>Precio Comparable entre Partes Independientes</i> )	115
	[ii] Resale Price Method ( <i>Precio de Reventa entre Partes Independientes</i> )	117
	[iii] Cost Plus Method ( <i>Costo más Beneficios</i> )	119
	[iv] Profit Split Method ( <i>División de Ganancias</i> )	120
	[v] Transactional Net Margin Method ( <i>Margen Neto de la Transacción</i> )	121
	[vi] Quotation Price at the Shipment Date Method (If Higher Than the Contractual Price) or Sixth Method ( <i>Precio de Cotización a la Fecha de Embarque</i> )	122
	[C] Transfer Pricing Adjustments	123
§3.04	Developing Support for Actual Pricing	123
	[A] Transfer Pricing Documentation Requirements	123
	[1] Documentation Requested in Operations with Unrelated Parties	123
	[a] Semestral Return with Unrelated Parties (F-741)	123
	[b] Annual Return with Unrelated Parties (F-867)	123
	[2] Documentation Requested in Operations with Related Parties	124

## Table of Contents

---

	[3] Transfer Pricing Report	126
	[4] Document Retention Requirements	126
	[5] Example of Requested Documentation	126
	[6] Conservation of Documents	127
	[B] Relationship between Fulfilling Documentation Requirements and Protection from Adjustments	128
	[C] Sufficiency of Compliance Reports for Purposes of Applying Penalties	128
§3.05	Hot Topics/Special Considerations In Local Country Transfer Pricing	128
§3.06	Local Country Administrative Practices	129
	[A] Availability of Advanced Pricing Agreements	130
	[B] Access to Competent Authority	130
	[C] Other Items	131
§3.07	Significant Transfer Pricing Litigation	131
	[A] Industrial Manufacturing Sector	132
	[B] Pharmaceutical Industry	134
	[C] Commodity Export Sector	136
CHAPTER 4		
Australia		
	<i>Stean Hainsworth</i>	139
§4.01	The Importance of Transfer Pricing for Multinational Companies Operating Within Australia	141
§4.02	Regulatory Framework	145
	[A] Legal Authority	145
	[1] Subdivision 815-A of the ITAA 1997 (repealed)	146
	[2] Subdivisions 815-b, 815-C and 815-D of the ITAA 1997	146
	[a] Arm's-Length Conditions	147
	[b] Transfer Pricing Benefit	148
	[c] OECD Guidance	148
	[d] Economic Substance Requirement	148
	[e] Reconstruction Powers	148
	[f] Interaction Between Transfer Pricing and Thin Capitalization	149
	[g] Subdivision 815-C: Arm's-Length Principle for Permanent Establishments	149
	[h] Subdivision 284-E: Special Rules About Unarguable Positions for Cross-Border Transfer Pricing	149
	[i] Subdivision 815-D: Special Rules for Trusts and Partnerships	150
	[j] Subdivision 815-E: CbC Reporting	150
	[k] Penalties	150
[3]	Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015	150

Table of Contents

	[4] Other Sections of the Income Tax Legislation	153
	[5] Double Tax Agreements (DTAs)	153
	[a] DTA Article 5: PE	154
	[b] DTA Article 7: Business Profits	155
	[c] DTA Article 9: Associated Enterprises	155
	[d] OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS	156
	[6] Transfer Pricing Rulings and Publications	157
	[B] Relationship with OECD Guidelines	160
	[C] Transfer Pricing Penalty Framework	161
§4.03	Determining the Appropriate Intercompany Price	163
	[A] Method Selection	163
	[1] Selection of the Most Appropriate Method	163
	[2] <i>Internal Pricing Mechanism Versus Independent Testing         of Transfer Prices</i>	163
	[3] Discussion of the Methods	163
	[4] Types of Dealings TPMs Typically Applied to	165
	[B] Comparability	166
	[1] Functional Analysis	168
	[2] Practical Issues Associated with Identifying Comparable Companies in Australia	170
	[3] Use of Foreign Comparables in Australia	171
	[4] Use of Databases in Australia	171
§4.04	Developing Support for Actual Pricing	172
	[A] Transfer Pricing Documentation Requirements	172
	[1] Statutory Requirements	172
	[2] Simplified Transfer Pricing Record Keeping	172
	[3] Tax Return Disclosures	179
	[4] The ATO's Five Key Questions Approach	179
	[5] Deadline to Prepare Documentation	181
	[B] Relationship Between Fulfilling Documentation Requirements and Protection from Adjustments	183
	[C] Sufficiency of Compliance Reports for Purposes of Applying Penalties	183
§4.05	OECD Action 13 of the BEPS Initiative: CbC Reporting	184
§4.06	Hot Topics/Special Considerations in Local Country Transfer Pricing	191
	[A] Intra-Group Finance Guarantees and Loans	191
	[B] Business Restructuring	198
	[C] Offshore Hubs	199
§4.06	Local Country Administrative Practices	205
	[A] Advanced Pricing Agreements	205
	[1] APA Process	206
	[2] Annual Compliance Reports and Compensating Adjustments	212

## Table of Contents

---

	[B] Access to Competent Authority	213
	[1] The MAP Process	214
	[C] The ATO Risk Review and Risk Assessment Process	215
	[2] ATO Transfer Pricing Risk Review Process	215
§4.07	Significant Transfer Pricing Litigation	216
	[A] <i>Chevron Australia Holdings Pty Ltd v. FCT</i>	216
	[B] <i>SNF (Australia) Pty Ltd v. FCT [2010] FCA 635</i>	219
	[C] <i>Roche Pty Ltd v. FCT 2008 ATC 10-036</i>	220
§4.08	Country-Specific Planning Opportunities	221
§4.09	List of Abbreviations	222
CHAPTER 5		
Belgium		
	<i>Natalie Reypens</i>	225
§5.01	Importance of Transfer Pricing for Multinational Companies Operating Within Belgium	227
§5.02	Regulatory Framework	228
	[A] Legal Authority	228
	[1] Article 185 Section 2 ITC	229
	[a] Scope of Application	229
	[b] Adjustments	230
	[2] Abnormal or Benevolent Advantage Granted:	
	Article 26 ITC	231
	[a] Escape Clause	233
	[b] Exceptions to the Escape Clause	234
	[3] Abnormal or Benevolent Advantage Received:	
	Articles 79 and 207 ITC	235
	[4] Interconnection Between Article 185 §2 ITC and Articles 26, 79 and 207 ITC	238
	[5] Other Provisions	239
	[B] Relationship to OECD Guidelines	240
	[C] TP Penalty Framework	241
	[D] Arm's-Length Standard	241
§5.03	Determining the Appropriate Intercompany Price	243
	[A] Method Selection	243
	[1] Traditional Transaction Methods	243
	[a] Comparable Uncontrolled Price Method	243
	[b] Resale Price Method	244
	[c] Cost Plus Method	244
	[2] Transactional Profit Methods	245
	[a] Profit Split Method	245
	[b] Transactional Net Margin Method	246
	[3] Transaction Analysis	247

Table of Contents

	[4]	Method Selection by Transaction Type	248
	[a]	Service Activities	248
	[b]	Finance Activities	249
	[c]	Distribution Activities	250
	[d]	Manufacturing Activities	251
	[e]	Intangibles	251
	[B]	Comparables Selection	251
§5.04		Developing Support for Actual Pricing	252
	[A]	TP Documentation Requirements	252
	[B]	Relationship Between Fulfilling Documentation Requirements and Protection from Adjustments	254
	[C]	Sufficiency of Compliance Reports for Purposes of Applying Penalties	254
§5.05		Hot Topics/Special Considerations in Local Country TP	254
§5.06		Local Country Administrative Practices	255
	[A]	Availability of Advanced Pricing Agreements	255
	[1]	The Ruling Commission	255
	[a]	Ruling Procedure	255
	[b]	TP Rulings	257
	[B]	Access to Competent Authority	258
	[C]	Other Items	260
	[1]	TP Audits	260
§5.07		Significant TP Litigation	261
	[A]	TP Methodology	261
	[B]	Empirical, Pragmatic and Subjective Approaches to the Arm's-Length Standard	261
	[C]	Profit Shifting to Loss-Making Entities	263
	[D]	The Arm's-Length Price of Shares	264
§5.08		Country-Specific Planning Opportunities	265
	[A]	'Excess Profit' Rulings	265
	[B]	Notional Interest Deduction	268
	[C]	Patent Income Deduction	269
§5.09		Appendices	271
§5.10		List of Abbreviations	280
CHAPTER 6			
Brazil			
		<i>Luís Rogério Farinelli, Cristiane M.S. Magalhães, Stephanie Makin &amp; Nathália Fraga</i>	281
§6.01		Introduction	283
§6.02		Importance of TP for Multinational Companies Operating Within Brazil	283
§6.03		Regulatory Framework	287
	[A]	Legal Authority	287
	[B]	Relationship to OECD Guidelines	288

## Table of Contents

---

	[C] TP Penalty Framework	289
	[D] Arm's-Length Standard (or Alternative Standard)	290
§6.04	Determining the Appropriate Intercompany Price	291
	[A] Method Selection	291
	[1] Summary under Local Country Rules	291
	[a] Transactions Subject to TP	291
	[b] TP Methods for Acquisitions and Imports	294
	[c] TP Methods for Exports	299
	[d] Common Rules on Imports and Exports	302
	[e] TP Rules on Interest	302
	[f] Practical Cases	303
	[g] Differences in Method Selection Criteria by Transaction Type	303
	[B] Comparables Selection	304
§6.05	Developing Support for Actual Pricing	305
	[A] TP Documentation Requirements	305
	[B] Relationship between Fulfilling Documentation Requirements and Protection from Adjustments	308
	[C] Sufficiency of Compliance Reports for Purposes of Applying Penalties	309
§6.06	Hot Topics/Special Considerations in Local Country TP	309
	[A] Specificities of National Tax Law	309
	[B] Scrutiny of Transactions Involving Intangibles	309
	[C] Interposed Persons	309
	[D] Sales of Equity Stakes	311
	[E] Basket Approach	313
	[F] Prevalence of Tax Treaties over Domestic Legislation	314
§6.07	National Administrative Practices	317
	[A] Availability of Advanced Pricing Agreements	317
	[B] Access to Competent Authority	317
§6.08	Significant TP Litigation	319
§6.09	Local Country Planning Opportunities	321
	[A] Safe Harbours	321
	[B] Worksheets	322
	[C] Intercompany Transaction Prioritization Matrix	326
	[D] Implementation Checklist	326
	[E] Information Exchange	327
	[F] Case Study 1: Selecting An Appropriate Method	330
	[G] Case Study 2: Prioritizing TP Documentation Initiatives	331
§6.10	List of Abbreviations	332

CHAPTER 7		
Canada		
<i>Matt Billings</i>		335
§7.01	Importance of Transfer Pricing for Multinational Companies Operating Within Canada	337
§7.02	Regulatory Framework	338
	[A] Legal Authority	338
	[1] Penalties Relating to Intercompany Debt	341
	[2] Section 15(2): Shareholder Debt	342
	[3] Section 17: Amount Owing by Non-resident	342
	[4] Section 80.4 Loans	342
	[5] Section 78(1): Unpaid Amounts	343
	[6] Consequences for Failure to Provide Documentation: Section 231.6: Foreign-Based Information or Documentation	343
	[B] Relationship to OECD Guidelines	343
	[1] OECD BEPS Project	344
	[C] Transfer Pricing Penalty Framework	344
	[1] Transfer Pricing Adjustment Penalties	344
	[D] Arm's-Length Principle	346
§7.03	Determining the Appropriate Intercompany Price	347
	[A] Method Selection	347
	[1] Summary of Applicable Methods	348
	[2] CUP Method	348
	[a] CUP: Application	349
	[3] Cost Plus Method	349
	[a] CPLM: Application	350
	[4] Resale Price Method	351
	[a] RPM: Application	352
	[b] Profit Split Method	353
	[i] PSM: Application	353
	[5] Transactional Net Margin Method	354
	[a] TNMM: Application	355
	[6] Application of Transfer Pricing Methods	356
	[a] Method Selection for Intra-Group Services	356
	[b] Method Selection for Transfers of Intangible Property	357
	[c] Methods to Price QCCAs	358
	[d] Methods to Price Intercompany Loans	360
	[B] Comparables Selection	361
§7.04	Developing Support for Actual Pricing	362
	[A] Transfer Pricing Documentation Requirements	362
	[B] Relationship between Fulfilling Documentation Requirements and Protection from Penalties	363

## Table of Contents

---

	[C] Sufficiency of Compliance Reports for Purposes of Applying Penalties	364
	[1] <i>Compliance versus Accuracy</i>	365
	[2] Demonstrated Efforts	365
	[3] Administrative Burden	366
§7.05	Hot Topics/Special Considerations in Canada Concerning Transfer Pricing	366
	[A] Range and Multiple Year Data Issues	366
	[B] Business Restructuring	368
	[C] Customs	368
	[D] Bundled Transactions	369
§7.06	National Administrative Practices	370
	[A] Availability of Advance Pricing Agreements	370
	[1] Advance Pricing Arrangements	370
	[2] When Should a Taxpayer Consider an APA?	374
	[3] Annual Report	375
	[B] Access to Competent Authority	377
	[1] Accelerated Competent Authority Procedure	379
	[2] Binding Arbitration	380
	[3] Annual Report	381
	[C] Other Items	382
	[1] Transfer Pricing Audit	382
	[2] Advance Income Tax Rulings and Technical Interpretations	385
§7.07	Significant Transfer Pricing Legal Cases	386
	[A] Tax Haven Cases	386
	[1] Spur Oil	386
	[2] Irving Oil	386
	[3] Indalex	387
	[B] Targeted Industries	387
	[1] The Pulp and Paper Industry	387
	[a] Crestbrook	387
	[2] Pharmaceutical Industry	388
	[a] Wyeth	388
	[b] GlaxoSmithKline	388
	[3] Technology Industry	390
	[a] Alberta Printed Circuits	390
	[C] Guarantee Fee	390
	[1] General Electric Capital Canada Inc.	390
	[D] Other Cases	391
	[1] Teletech	391
	[2] McKesson	392
	[3] Soft-Moc Inc.	393

Table of Contents

	[4] Marzen Artistic Aluminum Ltd.	393
	[5] Cameco Corp.	394
	[6] Sifto	394
§7.08	National Planning Opportunities	395
§7.09	List of Abbreviations	395
CHAPTER 8		
China		
	<i>Glenn DeSouza</i>	397
§8.01	Introduction	399
	[A] New Developments	399
	[B] 2018 Targets	400
	[C] Rethinking How to Handle Audits	401
	[D] Planning Ahead	401
§8.02	Chinas Position As World Economic Leader	402
§8.03	Importance of TP for Multinationals in China	403
§8.04	Bulletin 42	404
§8.05	Bulletin 6	405
	[A] The New China Platform	405
	[B] Two Steps Forward and One Step Back	406
	[C] Key Directions	407
	[D] The Index to Bulletin 6	407
	[E] Profit Monitoring System: Widening the Voluntary Net	409
	[F] The Audit Regime	410
	[G] Intangibles: Recognizing the China Contribution	410
	[H] Time-Adjusted Royalties	411
	[I] Service Fees: Some Good News	411
	[J] How China Differs from OECD	412
	[K] Special Issues Facing Us Companies	414
§8.06	Sat View: Why China Deserves More Profit	415
§8.07	Regulatory Framework	416
	[A] Political and Tax Structure	416
	[B] Types of Taxes in China	417
§8.08	Developing Support for Actual Pricing	418
	[A] The Documentation Requirements	418
	[B] Deadline for Preparation	418
	[C] Exemptions from Documentation	418
	[D] Penalties for Failure to Document	419
	[E] Definition of Related Party	419
	[F] Transactions Covered by Bulletin 42	420
	[G] TP Disclosure Forms	420
	[H] Country-by-Country Reporting	421

## Table of Contents

---

	[I] Master File	422
	[J] Local File	422
	[K] Collecting and Grading Documentation	423
§8.09	Determining the Appropriate Intercompany Price	424
	[A] Available Methods	424
	[B] Comparable Uncontrolled Price Method	424
	[C] Resale Price Method	425
	[D] Cost Plus Method	425
	[E] TNMM	425
	[F] Profit Split Method	426
	[G] Methods in Practice Versus Documentation	426
	[H] Illustration of Method Selection	426
§8.10	Local Administrative Practices	427
	[A] Who Conducts the Audit	427
	[B] Information Requested	428
	[C] Who Gets Audited	428
	[D] Special Audit Situations	428
	[E] Closing an Audit	428
	[F] Advanced Pricing Agreement and Competent Authority	429
	[1] Evolution and Statistics	429
	[2] APA Regulations	430
	[3] Should You Get an APA?	432
	[4] Competent Authority	432
§8.11	Significant TP Litigation	433
	[A] Why Tax Litigation Is Rare	433
	[B] The Process	434
§8.12	List of Abbreviations	435
CHAPTER 9		
France		
	<i>Serge Lambert &amp; Arnaud Le Boulanger</i>	437
§9.01	Importance of Transfer Pricing for Multinational Companies Operating Within France	439
§9.02	Regulatory Framework	440
	[A] Legal Authority	440
	[1] Fundamental Rules for Transfer Pricing Adjustments in France	442
	[a] Transactions with Related Companies	442
	[b] Transactions with Companies in Preferred Tax Regimes	443
	[c] Failure to Provide Information	443
	[2] Statute of Limitation under French Corporate Tax Law as Applicable to Transfer Pricing Matters	444
	[B] Relationship to OECD Guidelines	444

Table of Contents

	[C] Transfer Pricing Penalty Framework	444
	[1] Penalty for Missing or Incomplete TPD	445
	[a] Penalty Provided in the Framework of the Formal Documentation Requirement (Articles L 13 AA and L 13 AB of the FTPC and Article 1735 ter of the FTC)	445
	[b] Penalty for the Failure to Provide Annually the FTA with Simplified TPD	445
	[c] Penalty for the Failure to Provide Annually the FTA with CbCR	446
	[d] Penalty for the Failure to Answer to an FTA Request Based on Article L 13 B of the FTPC	446
	[2] Interest for Late Payment	446
	[3] Deliberate Breach and Fraud Penalties	447
	[D] Arm's-Length Standard	447
§9.03	Determining the Appropriate Intercompany Price	448
	[A] Method Selection	448
	[1] Statutory Rules	448
	[2] Administrative Guidelines	448
	[a] How Transactions Should Be Analyzed	448
	[b] Transfer Pricing Methods	449
	[i] Comparable Uncontrolled Price Method	449
	[ii] Resale Price Method	450
	[iii] Cost-Plus Method	451
	[iv] Profit Split Method	452
	[v] Transactional Net Margin Method	453
	[vi] Other Specifications Regarding Transfer Prices Setting	454
	[3] Case Law	455
	[4] The FTA's TP Guide	456
	[B] Comparables Selection	456
	[1] Internal Comparables	456
	[2] External Comparables	456
	[a] Databases Used	456
	[b] Practical Conduct of a Benchmark Study	457
	[c] Outcome of the Search	457
§9.04	Developing Support for Actual Pricing	458
	[A] Transfer Pricing Documentation Requirement	458
	[1] Code of Conduct on TPD for Associated Enterprises in the European Union	458
	[2] TPD Requirements in France: Articles L 13 AA, L 13 AB and L 13 B of the FTPC and Articles 223 Quinquies B and 223 Quinquies C of the FTC	460
	[a] Formal TPD Requirements (Articles L 13 AA and L 13 AB of the FTPC)	460
	[i] Scope of the TPD	460

## Table of Contents

---

	[ii]	Content of the TPD Required under French Law for Tax Years Beginning Before January 1, 2018	461
	[iii]	Content of the TPD Required under French Law for Tax Years Beginning on or after January 1, 2018	463
	[iv]	Timing of the Documentation Requirement	465
	[b]	Transfer Pricing Requirements under Article 223 Quinquies B of the FTC	466
	[c]	Transfer Pricing Requirements under Article 223 Quinquies C of the FTC	467
	[d]	Transfer Pricing Requirements under Article L 13 B of the FTPC	469
	[i]	Circumstances under Which Information May Be Required	469
	[ii]	Information that May Be Required	469
	[iii]	Timing of the Documentation Requirement	471
	[B]	Relationship Between Fulfilling Documentation Requirements and Protection from Adjustments	471
	[C]	Sufficiency of Compliance Reports for Purposes of Applying Penalties	472
§9.05		Hot Topics/Special Considerations in France Concerning Transfer Pricing	472
	[A]	Specificities of French Tax Audits: Audit of Electronic Accounting Records and Remote Tax Audits	472
	[1]	Audit of Electronic Accounting Records	472
	[2]	Remote Tax Audits	474
	[B]	Consolidated and Analytical Accounting Disclosure	474
	[C]	Scrutiny of Transactions Involving Intangibles	475
§9.06		France Administrative Practices	475
	[A]	Availability of Advanced Pricing Agreements	475
	[1]	Historical Evolution of APA Procedures	475
	[a]	1999: First Step: Bilateral and Multilateral Agreements	476
	[b]	2004: Second Step: Unilateral Agreements	476
	[c]	2006: Third Step: Simplified Procedure for SMEs	477
	[d]	International Outlook	478
	[e]	Assessment of the Implementation of APA Procedure	478
	[2]	The APA Procedure	479
	[a]	Step 1: Pre-filing Stage	479
	[b]	Step 2: The Official Submission to “MEJEI”	480
	[i]	Official Submission of the Request	480
	[ii]	Required Documentation	480

Table of Contents

		[c] Step 3: Evaluation and Negotiation of the APA	483
		[i] Evaluation of the APA	484
		[ii] Negotiation of the APA	484
		[d] Step 4: The Conclusion of the Agreement	485
	[3]	APAs and Tax Audits	486
	[4]	Monitoring the Implementation of the APA	486
	[5]	The Renewal of the Agreement	487
	[B]	Access to Competent Authority	487
	[1]	The Mutual Agreement Procedure	488
	[2]	The Arbitration Procedure	490
		[a] Arbitration Procedure Opened on the Basis of the European Arbitration Convention	490
		[b] Arbitration Procedure in Other Treaties	494
	[3]	Other Items	494
		[a] The Practical Conduct of a TP Tax Audit in France	494
		[b] Consequences of a TP Adjustment	495
		[i] Withholding Tax	495
		[ii] Business Tax	495
		[iii] Profit-Sharing Schemes	496
		[c] Resolving Controversy at the National Level	496
§9.07		Significant Transfer Pricing Litigation	497
	[A]	Transfer Pricing Methods	497
	[B]	Market and Competitive Conditions to be taken into Account	497
	[C]	Compensation of Several Transactions	497
	[D]	Burden of Proof and Comparability	498
	[E]	Median and Interquartile Range	499
§9.08		National Planning Opportunities	499
§9.09		List of Abbreviations	500
CHAPTER 10			
Germany			
		<i>Angelika Thies</i>	501
§10.01		Importance of Transfer Pricing for Multinational Companies Operating Within Germany	503
§10.02		Regulatory Framework	504
	[A]	Legal Authority	504
		[1] Statutory Rules	504
		[2] Administrative Decrees	509
		[3] Statutory Period of Limitation	511
	[B]	Relationship to OECD Guidelines	511

## Table of Contents

---

	[C] Transfer Pricing Penalty Framework	512
	[D] Arm's-Length Standard	513
§10.03	Determining the Appropriate Intercompany Price	514
	[A] Method Selection	514
	[1] Product and Service Transactions	516
	[2] Interest on Loans	517
	[3] Use of Patents, Know-How and Other Intangible Assets	519
	[4] Contract Research and Development	519
	[5] Administrative Services	520
	[6] Cost-Sharing Agreements	520
	[B] Comparables Selection	522
§10.04	Developing Support for Actual Pricing	524
	[A] Transfer Pricing Documentation Requirements	524
	[1] General Requirements for Cross-Border Transactions	524
	[2] Specific Documentation Requirements for Cost-Sharing Agreements	528
	[B] Relationship Between Fulfilling Documentation Requirements and Protection from Adjustments	529
	[C] Sufficiency of Compliance Reports for Purposes of Applying Penalties	529
§10.05	Hot Topics/Special Considerations in Local Country Transfer Pricing	530
	[A] Change of Business Concepts	530
	[B] Transfer of Business Functions	533
	[C] Income Determination of a Permanent Establishment	536
	[D] Implementation of BEPS Action Plan Concerning Transfer Pricing in Germany	537
	[1] Support of BEPS Action Plan	537
	[2] Actions 8-10 on Aligning Transfer Pricing Outcomes with Value Creation	538
	[3] Action 13 on Transfer Pricing Documentation and Country-by-Country Reporting	539
§10.06	Local Country Administrative Practices	540
	[A] Availability of Advanced Pricing Agreements	540
	[B] Access to Competent Authority	542
	[1] Tax Ruling	543
	[2] Mutual Agreement Procedure and EU Arbitration Convention	543
	[C] Other Items	544
	[1] Tax Assessment	544
	[2] Tax Audit	544
	[3] Legal Procedures	545
§10.07	Significant Transfer Pricing Litigation	545
	[A] Documentation Requirements: Decision of the Federal Tax Court (BFH) of 17 October 2001	546
	[B] Marketing Costs: Decision of the Federal Tax Court (BFH) of 17 February 1993	546

	[C] Interest-Free Loan: Decisions of the Federal Tax Court (BFH) of 30 May 1990 and 25 June 2014	547
§10.08	Country-Specific Planning Opportunities	548
§10.09	List of Abbreviations	549
CHAPTER 11		
Hong Kong		
	<i>Steven Carey &amp; Douglas Fone</i>	551
§11.01	The Importance of Transfer Pricing for Multinational Companies Operating Within Hong Kong	553
§11.02	Regulatory Framework	554
	[A] Legal Authority	554
	[1] Statutory Laws	554
	[2] Other Guidelines and Regulations Issued	555
	[a] Departmental Interpretation and Practice Note 45	555
	[b] DIPN 46	555
	[c] DIPN 48	555
	[B] Relationship with OECD Guidelines	556
	[C] Transfer Pricing Risks	556
	[1] Investment Management Industry	556
	[2] Service Fees	556
	[3] Interaction of Transfer Pricing and Source Rules	557
	[4] Hong Kong Procurement Entities	557
	[D] Transfer Pricing Documentation	557
	[E] Recent Developments	558
	[1] BEPS Consultation Paper and Draft Bill	558
	[2] Master and Local Files	560
	[3] Country-by-Country Reporting	561
§11.03	Local Country Administrative Practices	562
	[A] Advanced Pricing Arrangements	562
	[1] Types of APAs	562
	[2] APA Application Process	563
	[a] Pre-filing	563
	[b] Formal Application	564
	[c] Analysis and Evaluation	564
	[d] Negotiation and Agreement	564
	[e] Drafting, Execution and Monitoring	564
	[3] Other Significant Provisions in DIPN 48	564
	[4] Other Significant Provisions in the Bill (No. 6/2017)	565
	[B] Mutual Agreement Procedures	565
	[1] MAP Application Process (Two Stages to MAP)	565
	[a] Presentation of Case	565
	[b] Joint Resolution	566
	[2] Other Significant Provisions in the MAP Guidelines	566

## Table of Contents

---

§11.04	Other Transfer Pricing issues	566
	[A] Corporate Treasury Centres	566
§11.05	Determining the Appropriate Intercompany Price	568
	[A] Method Selection	568
	[1] Comparable Uncontrolled Price	568
	[2] Cost Plus Method	570
	[3] Resale Price Method	570
	[4] Profit Split Method	572
	[a] Projected Profits or Actual Profits	573
	[b] Splitting using a Contribution Analysis	573
	[c] Splitting using a Residual Analysis	573
	[d] Other Approaches to Splitting Profits	574
	[5] Transactional Net Margin Method	574
	[B] Comparability Factors	575
	[1] Characteristics of Property or Services	575
	[2] Functions, Assets and Risks	575
	[3] Contractual Terms	576
	[4] Economic and Marketing Circumstances	576
	[5] Business Strategies	576
	[C] Comparables Selection	577
	[1] Internal Comparables	577
	[2] External Comparables	577
	[3] Foreign Comparables	577
	[4] Secret Comparables	577
	[5] Database	577
	[6] Timing in Carrying Out the Comparability Analysis	578
§11.06	Significant Transfer Pricing Litigation	578
	[A] <i>Ngai Lik Electronics Company Limited v. CIR</i>	578
	[B] <i>CIR v. Li &amp; Fung (Trading) Limited</i>	579
§11.07	List of Abbreviations	580
CHAPTER 12		
Indonesia		
	<i>Douglas Fone &amp; Steven Carey</i>	581
§12.01	The Importance of Transfer Pricing for Multinational Companies Operating Within Indonesia	583
§12.02	Regulatory Framework	584
	[A] Legal Authority	584
	[1] Statutory Laws	584
	[a] Article 18 of the 1983 Income Tax Law, as revised by the 1991, 1994 and 2000 Income Tax Laws and further by Income Tax Law No. 36/2008	584

Table of Contents

	[2]	Other Guidelines and Regulations Issued	585
	[a]	DGT Circular Letter SE-04/PJ/1993 (guidelines for handling transfer pricing cases), which has been replaced by the DGT Circular Letter SE-50/PJ/2013 (technical guidelines on transfer pricing audits)	585
	[b]	Government Regulation No. 80/2007 regarding the Implementation Procedures on Taxation Rights and Obligations based on General Tax Provisions and Procedures Law as amended by Government Regulation 74 of 2011	585
	[c]	DGT Regulation PER-39/PJ/2009 (PER-39) as amended by DGT Regulation PER-26/PJ/2013 (PER-26).	585
	[d]	DGT Regulation PER-61/PJ/2009 (PER-61) as amended by DGT Regulation PER-24/PJ/2010 (PER-24)	585
	[e]	DGT Regulation PER-62/PJ/2009 (PER-62) as amended by DGT Regulation PER-25/PJ/2010 (PER-25)	585
	[f]	DGT Regulation PER-43/PJ/2010 (PER-43) as amended by DGT Regulation PER-32/PJ/2011 (PER-32)	586
	[g]	DGT Regulation PER-48/PJ/2010 (PER-48)	586
	[h]	DGT Regulation PER-69/PJ/2010 (PER-69)	586
	[i]	DGT Regulation PER-22/PJ/2013 (PER-22)	586
	[j]	MoF Regulation 240/PMK.03/2014 regarding the implementation of Mutual Agreement Procedure (PMK-240).	587
	[k]	MoF Regulation 7/PMK.03/2015 regarding the procedures and implementation of APA (PMK-7)	587
	[l]	MoF Regulation 213/PMK.03/2016 (PMK-213)	587
	[m]	DGT Regulation PER-29/PJ/2017 (PER-29)	591
	[B]	Relationship with OECD Guidelines	593
	[C]	Transfer Pricing Risks	593
	[D]	Transfer Pricing Penalty Framework	594
	[E]	Arm's-Length Standard	595
	[1]	The Arm's-Length Principle	595
	[2]	Arm's-Length Range	595
§12.03	Local	Country Administrative Practices	596
	[A]	Advanced Pricing Agreements	596
	[1]	APA Application Process	596
	[2]	Other Significant Provisions in the APA guidelines	596
	[3]	Types of APAs	597
	[4]	Advantage and Disadvantages of APAs	599

## Table of Contents

---

	[a]	Based on the OECD, the advantages of an APA include, among others:	599
	[b]	Based on the OECD Guidelines, the disadvantages of an APA include, among others:	599
	[B]	Mutual Agreement Procedures	600
		[1] MAP Application Process	600
		[2] Competent Authority	601
		[3] Other Significant Provisions in the MAP guidelines	601
		[4] Expectation from a successful MAP application	601
		[5] Disadvantage of MAP	602
§12.04		Other Transfer Pricing issues	602
§12.05		Determining the Appropriate Intercompany Price	602
	[A]	Method Selection	602
		[1] Comparable Uncontrolled Price	603
		[2] RP Method	604
		[3] CP Method	605
		[4] Transactional PS Method	605
		[5] Transactional Net Margin Method	606
	[B]	Comparability Factors	607
		[1] Characteristics of Property or Services	607
		<b>[2] Functional Analysis</b>	607
		[3] Contractual Terms	607
		[4] Economic Circumstances	608
		[5] Business Strategies	608
	[C]	Comparables Selection	609
		[1] Internal Comparables	609
		[2] External Comparables	609
		[3] Foreign Comparables	609
		[4] Secret Comparables	609
		[5] Database	610
		[6] Timing in Carrying Out the Comparability Analysis	610
§12.06		Significant Transfer Pricing Litigation	611
		[1] Transfer Pricing Audit—The DGT	611
		[2] Tax Court	611
		[3] Supreme Court	612
		[4] Litigation Cases	612
	[A]	Putusan Pengadilan Pajak Nomor: Put-46787/PP/M.IV/15/2013	612
	[B]	Putusan Pengadilan Pajak Nomor: Put-65598/PP/M.IIIB/15/2015	612
	[C]	Putusan Pengadilan Pajak Nomor: Put-63637/PP/M.XIA/15/2015	613
§12.07		List of Abbreviations	613

CHAPTER 13		
Ireland		
<i>Joe Duffy &amp; Barry McGettrick</i>		615
§13.01	Importance of Transfer Pricing for Multinational Companies Operating Within the Country	617
§13.02	Regulatory Framework	618
	[A] Legal Authority	618
	[1] Legislation	618
	[a] Circumstances in Which the Transfer Pricing Rules Apply	618
	[b] Consequences of the Application of the Transfer Pricing Rules	618
	[c] Interpretation of the Irish Transfer Pricing Rules	619
	[d] Important Concepts	619
	[i] Arrangement	619
	[ii] Association	619
	[iii] Control	620
	(a) Company	620
	(b) Partnership	620
	[iv] Trading	620
	[v] Domestic Transactions	621
	[vi] Exemptions from the Transfer Pricing Rules	622
	(a) Small- or Medium-Sized Enterprises Exemption	622
	(b) Grandfathered Transactions	622
	(c) Irish Securitization Companies	622
	[2] Non-statutory Guidance/Reference/Authority	624
	[a] The Revenue Commissioners' Tax and Duty Manuals	624
	[b] The Revenue Commissioners' Notes for Guidance on Legislation	624
	[c] The Revenue Commissioners' Tax Briefings	624
	[d] The Revenue Commissioners' Guidance on APAs	625
	[B] Relationship to OECD Guidelines	625
	[C] Transfer Pricing Penalty Framework	626
	[1] Tax-Geared Penalties	626
	[2] Penalty for Lack of Proper Records	628
§13.03	Determining the Appropriate Intercompany Price	628
	[A] Method Selection	628
	[1] Particular Views of the Irish Tax Authorities on the OECD Methods	628
	[B] Comparables Selection	628
	[C] Interquartile Range	629

## Table of Contents

---

§13.04	Developing Support for Actual Pricing	630
	[A] Transfer Pricing Documentation Requirements	630
	[1] Time at Which Documentation Should Exist	631
	[2] Country-by-Country Reporting	631
	[B] Relationship between Fulfilling Documentation Requirements and Protection from Adjustments	633
	[C] Sufficiency of Compliance Reports for Purposes of Applying Penalties	633
§ 13.05	Hot Topics/Special Considerations in Irish Transfer Pricing	633
	[A] Hot Topics	633
	[1] Increased Audits	633
	[2] Modernization of the Transfer Pricing Regime	634
	[B] Thin Capitalization/Lending/Guarantees/Leasing	634
	[1] Thin Capitalization	634
	[2] Lending	635
	[a] Interest	635
	[b] Cash Pooling	636
	[3] Guarantees	637
	[4] Leasing	638
	[C] Interest-Free Loans	639
	[D] Management Services	640
	[E] Low-Value Intragroup Services	640
§ 13.06	Local Country Administrative Practices	641
	[A] Availability of Advance Pricing Agreements	641
	[B] Access to Competent Authority	642
	[C] Other Items	643
	[1] Transfer Pricing Enquiries	643
	[2] Risk Assessment	644
§ 13.07	Significant Transfer Pricing Litigation	645
	[A] Current Cases	645
	[B] Historical Cases of Note	645
§ 13.08	Country-Specific Planning Opportunities	646
§ 13.09	List of Abbreviations	646
CHAPTER 14		
Israel		
	<i>Jonathan Lubick</i>	649
§14.01	Importance of Transfer Pricing for Multinational Companies Operating Within the Country	651
§14.02	Regulatory Framework	653
	[A] Legal Authority	653
	[B] Relationship to the OECD Guidelines	655
	[C] Transfer Pricing Penalty Framework	656
	[D] Arm's-Length Standard	656

Table of Contents

§14.03	Determining the Appropriate Intercompany Price	656
	[A] Method Selection	657
	[1] Methods under Israel Transfer Pricing Rules	657
	[B] Comparables Selection	660
§14.04	Developing Actual Support for Transfer Pricing	662
	[A] Transfer Pricing Documentation Requirements	662
	[B] Relationship Between Fulfilling Documentation Requirements and Protection from Adjustments	663
	[C] Sufficiency of Compliance Reports for Purposes of Applying Penalties	663
§14.05	Hot Topics/Special Considerations in Israeli Transfer Pricing	663
§14.06	Local Country Administrative Practices	665
	[A] Availability of Advanced Pricing Agreements	665
	[B] Access to Competent Authority	666
	[C] Other Items	666
§14.07	Significant Transfer Pricing Litigation	666
§14.08	Country-Specific Planning Opportunities	666
§14.09	List of Abbreviations	666
CHAPTER 13		
Italy		
	<i>Marco Valdonio, Aurelio Massimiano &amp; Mirko Severi</i>	667
§15.01	Regulatory Framework	669
	[A] Legal Authority	669
	[1] Legislative Framework	669
	[a] History	669
	[2] Control	671
	[3] Burden of Proof	672
	[4] ITA/ITA Transactions	673
	[B] Relationship to OECD Guidelines	674
	[C] Transfer Pricing Penalty Framework	675
	[1] Administrative Penalties	675
	[2] Criminal Penalties	676
	[D] Arm's-Length Standard	676
§15.02	Determining the Appropriate Transfer Prices	677
	[A] Method Selection	677
	[1] General Framework	677
	[2] Traditional Transaction Methods	678
	[a] Comparable Uncontrolled Price ('CUP Method')	678
	[b] Resale Price Method	678
	[c] Cost Plus Method	679
	[3] Transactional Profit Methods	680
	[a] Profit Split Method ('PSM')	680
	[b] Transactional Net Margin Method ('TNMM')	680

## Table of Contents

---

	[B] Comparable Selection	681
	[1] Use of Foreign Comparables	681
	[2] Use of Databases	681
§15.03	Developing Support for Actual Pricing	682
	[A] Transfer Pricing Documentation	682
	[1] General Framework	682
	[2] The Master File	683
	[3] The Country File	684
	[B] Relationship Between Fulfilling Documentation Requirements and Penalty Protection from Adjustments	685
	[C] Country-by-Country Reporting	686
	[1] Entities Obligated to File the CbCR	687
	[2] Communication Duties and Penalties	688
	[3] Contents of the CbCR	689
	[4] Use of Information by the ITA	689
§15.04	Hot Topics/Special Considerations in Italy Concerning Transfer Pricing	689
	[A] Service Agreements	689
	[B] IPs	691
	[C] Leveraged-Buy-Out	691
	[D] Business Restructuring	692
	[E] Allocation of Income to Permanent Establishments	692
§15.05	Italian Administrative Practices	694
	[A] Availability of Advanced Pricing Agreements	694
	[B] Access to Competent Authority	697
	[1] Double Taxation	697
	[2] The Competent Authorities	698
	[3] Submission Terms	698
	[4] Relationship with Internal Dispute	699
	[5] Relation with Internal Settlement Procedures	700
	[6] Collection of Taxes	701
	[7] The Role of the Taxpayer	701
	[8] The Arbitration Clauses under Double Tax Treaties	702
	[9] The ‘Serious Penalty’ Concept under the EU Arbitration Convention	702
	[10] Corresponding Adjustments	702
	[C] Other Items	704
§15.06	Significant Transfer Pricing Litigation	704
	[A] List of Significant Court Decisions	704
	[B] Notes on Main Rulings	711
§15.07	National Planning Opportunities	720
§15.08	List of Abbreviations	720
Annex:	Non-Official Translation of the Italian TPDG Made by the Italian Revenue Agency	721
	The Commissioner of Agenzia Delle Entrate	721

CHAPTER 16		
Malaysia		
<i>Douglas Fone &amp; Steven Carey</i>		731
§16.01	The Importance of Transfer Pricing For Multinational Companies Operating Within Malaysia	733
§16.02	Regulatory Framework	734
[A]	Legal Authority	734
[1]	Statutory Laws	734
[a]	Income Tax Act 1967	734
[2]	Other Guidelines and Regulations Issued	735
[a]	Income Tax (TP) Rules 2012	735
[b]	Malaysia Advance Pricing Arrangement Guidelines 2012 (amended in 2017)	735
[c]	Mutual Agreement Procedure (MAP) Guidelines (revised in 2017)	736
[d]	Malaysian TP Audit Framework 2013 (amended on February 1, 2015 and May 1, 2017)	736
[e]	MTPG 2012 (updated on July 15, 2017)	737
[f]	Income Tax (Country-by-Country Reporting) Rules 2016 (amended on December 27, 2017)	740
[g]	Labuan Business Activity Tax (Country-by-Country Reporting) Regulations 2017	742
[h]	Malaysia Public Rulings	743
[B]	Relationship with OECD Guidelines	743
[C]	TP Risks	743
[D]	TP Penalty Framework	745
[E]	Arm's-length Standard	745
[1]	The Arm's-Length Principle	745
[2]	Arm's-Length Range	746
§16.03	Local Country Administrative Practices	746
[A]	Advanced Pricing Agreements	746
[1]	APA Application Process	746
[2]	Other Significant Provisions in the APA Guidelines	747
[3]	Types of APAs	747
[4]	Advantage and Disadvantages of APAs	749
[a]	Based on the OECD, the advantages of an APA include, among others:	749
[b]	Based on the OECD Guidelines, the disadvantages of an APA include, among others:	750
[B]	Mutual Agreement Procedures	750
[1]	MAP Application Process	751
[2]	Competent Authority	751
[3]	Other Significant Provisions in the MAP guidelines	752
[4]	Limitation on Access to MAP	752

## Table of Contents

---

§16.04	Other TP issues	752
	[A] Loss Making	752
	[B] Arm's-Length Price-Setting Versus Price-Checking Approach	753
§16.05	Determining The Appropriate Intercompany Price	753
	[A] Method Selection	753
	[1] Comparable Uncontrolled Price	755
	[2] RP Method	756
	[3] CP Method	758
	[4] Transactional PS Method	759
	[5] Transactional Net Margin Method	761
	[B] Comparability Factors	762
	[1] Contractual Terms	762
	[2] Functional Analysis of Functions Performed, Risks Assumed and Assets Employed	762
	[3] Characteristics of Property or Services	763
	[4] Economic Circumstances	763
	[5] Business Strategies	763
	[C] Comparables Selection	764
	[1] Internal Comparables	764
	[2] External Comparables	764
	[3] Foreign Comparables	764
	[4] Secret Comparables	765
	[5] Database	765
	[6] Timing in Carrying Out the Comparability Analysis	765
§16.06	Significant TP Litigation	766
	[A] MM Sendirian Berhad v. Ketua Pengarah Hasil Dalam Negeri	766
§16.07	List of Abbreviations	767
CHAPTER 17		
Mexico		
	<i>Yoshio Uehara</i>	769
§17.01	Transfer Pricing in Mexico	771
§17.02	Base Erosion Profits Shifting	772
§17.03	Mexican Transfer Pricing Legislation	772
	[A] Legislation Framework	772
	[B] Contemporaneous Transfer Pricing Documentation	779
	[C] Advance Pricing Agreements	779
	[D] Financial Information	780
	[E] Selection of Comparables	780
	[F] Transfer Pricing Adjustments	781
	[G] Pro rata Expenses	783
	[H] Maquila Company	783
	[I] Audit Trends	785
	[J] Additional Reporting and Compliance	786
	[K] Conclusions	787

CHAPTER 18		
The Netherlands		
<i>Rogier Sterk &amp; Robert Jan van Lie Peters</i>		789
§18.01	Importance of Transfer Pricing for Multinational Companies Operating Within the Netherlands	791
§18.02	Regulatory Framework	792
	[A] Legal Authority	792
	[B] Article 8b CITA	792
	[1] Related Entities	793
	[2] Adjustments	794
	[3] CbC Reporting and Transfer Pricing Documentation	794
	[C] Decrees of the State Secretary with Regard to the Dutch APA/ATR Practice	800
	[1] 2018 Transfer Pricing Decree	800
	[2] Advance Pricing Agreement (APA) Decree	816
	[3] Decrees on Financial Intermediary Entities	818
	[4] Question and Answer Decree	819
	[a] Equity Risk Remuneration (ERR)	819
	[b] Financial Remuneration (FR)	820
	[c] Interest on Inter Company Loan	820
	[5] Decree on Mutual Agreement Procedures and EU Arbitration Convention	820
	[6] Decree on Allocation of Profits to Permanent Establishments	821
	[7] Other Transfer Pricing-related Decrees	822
	[D] Letter from the State Secretary of Finance	823
	[E] Relationship to OECD Guidelines	824
	[F] Transfer Pricing Penalty Framework	824
§18.03	Determining the Appropriate Intercompany Price	825
	[A] Method Selection	825
	[1] Service Activities	825
	[a] Group Service Activities	825
	[b] Head Office Services	825
	[2] Finance Activities	826
	[a] Write-Off on a Loan provided to an Affiliated Party	826
	[b] Establishing an Arm's-Length Interest Rate	826
	[c] Conclusion	827
	[d] Guarantees	827
	[3] Distribution Activities	828
	[4] Manufacturing Activities	828
	[5] Procurement Activities	828
	[6] Intangibles	829
	[a] Participation in CCA	829
	[b] Transfer of Intangibles	829
	[B] Comparable Selection	829

## Table of Contents

---

§18.04	Developing Support For Actual Pricing	830
	[A] Transfer Pricing Documentation Requirements	830
	[1] Burden of Proof	831
	[2] No Safe Harbour Rules	831
	[3] Timing of the Documentation	831
§18.05	Hot Topics Special Considerations	832
	[A] EC Action Plan for Fair and Efficient Corporate Taxation in the EU/Link with Transfer Pricing	832
	[B] State Aid Investigations	832
	[C] Final Decision Starbucks	834
	[D] Investigation opened into IKEA's tax treatment	835
§18.06	Dutch Administrative Practices	836
	[A] APA/ATR Procedure	836
	[B] Customs Value and Transfer Pricing in the Netherlands	836
	[1] The New Union Customs Code	838
	[2] Advance Pricing Agreements	839
§18.07	Significant Transfer Pricing Litigation	839
	[A] Transfer Pricing Methodology	839
	[1] HR 28 JUNI 2002, No. 36 446, VN 2002/ 34.9 (Car Importer)	839
	[B] Tangible Property Transactions	840
	[1] Supreme Court, 1 July 1969, BNB 1969/217	840
	[2] Supreme Court, 11 October 2000, BNB 2001/142 (Tangible Property Transactions)	840
	[3] Court of Appeal, The Hague, 22 January 1982, BNB 1983/109 (Tangible Property Transactions)	841
	[4] Court of Appeal, Amsterdam, 11 February 2009, No. 04/04338 (Sale and Leaseback, Goodwill Realization)	841
	[5] Supreme Court, 4 January 2013, No. 11/00762 (Swiss Paper Trader)	842
	[6] Lower Court of Zeeland/West-Brabant, 19 September 2017, ECLI: NL: RBZWB:2017:5965 (Zinc Case)	842
	[C] Intangible Property Transactions	844
	[1] Supreme Court, 25 June 1969, BNB 2010/93 (Transfer of Intellectual Property Rights)	844
	[2] Supreme Court, 17 August 1998, BNB 1998/385 (Intangible Property Transactions)	844
	[3] Court of Appeal, The Hague, 10 May 1984, BNB 1986/8 (CUP)	845
	[D] Services	845
	[1] Court of Appeal, Amsterdam, 15 June 1978, BNB 1979/188 (Services)	845
	[2] Supreme Court, 28 November 1984, BNB 1989/114 (Services/'Bankgirocentrale')	845

Table of Contents

	[E] Financial Transactions	846
	[1] Court of Appeal, Leeuwarden, 19 September 1997, VN/1998/30.17 (Interest on Loans)	846
	[2] Court of Appeal, The Hague, 16 January 2001, VN 2001/37.15 (Guarantee)	846
	[3] BNB 1998/3 (Supreme Court, 29 August 1997), BNB 2004/265 (Supreme Court, 12 December 2003) VN 2005/2.15 (Supreme Court, 17 December 2004) (Guarantee)	846
	[4] Supreme Court, 1 March 2013, No. 11/01985 (Umbrella Guarantee)	847
	[5] Supreme Court, 8 November 1995, BNB 1996/64 (Currency Exchange Results)	847
	[6] Supreme Court, 28 February 2001, BNB 2001/199 (Currency Exchange Results)	848
	[7] Lower Court of The Hague, 11 July 2011, No. AWB08/9105 (captive)	848
	[8] Lower Court of Zeeland/West-Brabant, 17 January 2014, No. AWB11/3717	848
	[F] Customs valuation and transfer pricing	849
	[1] Court of Justice European Union, 20 December 2017, No. C-529/16	849
§18.08	Country-Specific Planning Opportunities	849
	[A] Innovation Box	849
	[1] Qualifying Business Assets	850
	(a) Specific Qualification Rules for SMEs	850
	(b) Additional Qualification Rules for Taxpayers that exceed the SME size	851
	[2] Qualifying Income	851
	[3] Self-Created	852
	[4] For Which a Patent or S&O Certificate Has Been Obtained	852
	[5] Effective Tax Rate of 7%	852
	[6] Practical Aspects of the Application of the Innovation Box	852
	[a] Not Applicable to Intangibles That Existed before 1 January 2007	852
	[b] Election	852
	[c] Profit Allocation	852
	[d] Modified Nexus Approach and Grandfathering Rules	853
§18.09	List of Abbreviations	853

## Table of Contents

---

CHAPTER 19		
Singapore		
Douglas Fone & Steven Carey		857
§19.01	The Importance of Transfer Pricing for Multinational Companies Operating Within Singapore	859
§19.02	Regulatory Framework	860
[A]	Legal Authority	860
[1]	Statutory Laws	861
[a]	Singapore Income Tax Act	861
[2]	Other Guidelines and Regulations Issued	863
[a]	IRAS e-Tax Guide TP Guidelines (Fifth Edition)	863
[b]	IRAS e-Tax Guide Country-by-Country Reporting (Second Edition)	863
[B]	Relationship with OECD Guidelines	864
[C]	TP Risks	865
[D]	TP Penalty Framework	866
[E]	Arm's-Length Standard	866
[1]	The Arm's-Length Principle and Application	866
[2]	Conduct Comparability Analysis	867
[a]	Comparability Factors	867
[i]	Contractual Terms	867
[ii]	Characteristics of Property or Services	868
[iii]	Functional Analysis of Functions Performed, Risks Assumed and Assets Employed	868
[iv]	Economic Circumstances	869
[b]	Other Relevant Aspects of a Comparability Analysis:	870
[i]	Use of Multiple-Year Data	870
[3]	Identify the Most Appropriate TP Method and Tested Party	870
[4]	Arm's-Length Range	870
[F]	TP Documentation Requirements	871
[1]	TP Documentation Requirements under Section 34F of SITA	871
[a]	Information Required in TP Documentation	871
[2]	Exemptions from TP Documentation for Specific Transactions	872
§19.03	Local Country Administrative Practices	873
[A]	Reporting of Related Party Transactions	873
[B]	TP Consultation	874
[C]	Advanced Pricing Agreements	875
[1]	Types of APAs	875
[2]	APA Application Process	877
[D]	Mutual Agreement Procedures	878
[1]	MAP Application Process	878

Table of Contents

§19.04	Other TP issues	878
	[A] Arm's-Length Adjustments by the IRAS	878
	[1] Types of Adjustments	879
	[B] Qualifying Past TP Documentation	879
	[C] Related Party Services	879
	[1] Strict-Pass Through Costs	880
	[2] Routine Support Services	880
	[3] Cost-Pooling Arrangements	880
	[D] Related Party Loans	881
	[1] Indicative Margins on Related Party Loans	881
	[2] Refinancing Transactions	881
	[E] Arm's-Length Price-Setting Versus Price-Checking Approach	882
§19.05	Determining the Appropriate Intercompany Price	882
	[A] Method Selection	882
	[1] Comparable Uncontrolled Price	882
	[2] Resale Price Method	883
	[3] CP Method	884
	[4] Transactional Profit Split Method	885
	[5] Transactional Net Margin Method	887
	[B] Comparables Selection	888
	[1] Internal Comparables	888
	[2] External Comparables	888
	[3] Commercial Databases	888
	[4] Comparables with Publicly Available Information	889
	[5] Foreign Comparables	889
	[6] Secret Comparables	889
	[7] Loss-Generating Comparables	889
§19.06	Significant TP Litigation	889
§19.07	List of Abbreviations	890
CHAPTER 20		
South Korea		
	<i>Tae Yeon (TY) Nam, Jae Suk (JS) Park &amp; Christopher Sung</i>	891
§20.01	Importance of Transfer Pricing for Multinational Companies	
	Operating Within Korea	893
§20.02	Regulatory Framework	894
	[A] Legal Authority	894
	[1] Legislation	894
	[a] Tax Law and Regulations	894
	[b] Other Government Regulations	894
	[2] Tax Administrations	895
	[a] Ministry of Strategy and Finance	895
	[b] National Tax Service	895
	[B] Relationship to OECD Guidelines	896

## Table of Contents

---

	[C] Transfer Pricing Penalty Framework	896
	[1] Underreporting Penalty	896
	[2] Underpayment Penalty	896
	[3] Penalty for Failure to Submit Documentation	897
	[D] Arm's-Length Standard	897
	[1] Historical Development of Arm's-Length Principle	897
	[2] Concepts of 'Associated Enterprises' and 'Control'	897
	[a] Equity Ownership Test	897
	[b] Substantial Control Test	898
	[E] Substance-Over-Form Principle	899
	[1] Set-Offs	900
§20.03	Determining the Appropriate Intercompany Price	900
	[A] Method Selection	900
	[1] 'Most Reasonable Method' Rule	900
	[2] Description of Methods Available	900
	[a] CUP Method	900
	[b] RPM	900
	[c] CPM	901
	[d] PSM	901
	[e] TNMM	902
	[f] Other Reasonable Methods	902
	[3] Criteria for Method Selection	902
	[4] Considerations by Transaction Type	903
	[a] Intercompany Services	903
	[b] Intercompany Loans	904
	[c] Cost Sharing Arrangement	904
	[d] Transfer and Use of Intangible Property	905
	[e] Business Restructuring and Supply Chain Management	905
	[B] Comparables Selection	905
	[1] Comparability Factors	905
	[2] Use of Domestic Transaction as Comparable	906
	[3] Calculation of Arm's-Length Range	906
	[4] Use of Database	906
§20.04	Developing Support for Actual Pricing	906
	[A] Transfer Pricing Documentation Requirements	906
	[1] Annual Documentation	907
	[2] Upon Request Documentation	908
	[3] Contemporaneous Documentation	908
	[a] Overview	908
	[b] Documents Required	909
	[c] Timing of Documentation	909
	[d] Determination of 'Reasonableness'	910
	[4] Comprehensive Report on International Transactions	910
	[a] Background	910

Table of Contents

	[b]	Overview of Comprehensive Report	910
	[c]	Procedures and Administration	911
	[B]	Relationship between Fulfilling Documentation Requirements and Protection from Adjustments	911
	[C]	Sufficiency of Compliance Reports for Purposes of Applying Penalties	912
§20.05		Hot Topics/Special Considerations in Korean Transfer Pricing	912
	[A]	Management Service Fee	912
	[B]	Substance-Over-Form Rule	913
	[C]	Aggregation of Transactions	913
	[D]	Use of Multi-Year Data and Downward Income Adjustment	913
	[E]	Coordination of Transfer Pricing and Customs Valuation	914
	[F]	New TP Documentation Rules for BEPS Compliance	915
§20.06		Local Country Administrative Practices	915
	[A]	Availability of Advanced Pricing Agreements	915
	[1]	Overview	915
	[2]	Application	916
	[3]	Coverage	917
	[4]	Processing Time	917
	[5]	Annual Report	917
	[6]	APA Statistics	918
	[B]	Access to Competent Authority	918
	[1]	Overview	918
	[2]	Requirements to Request Competent Authority Resolution	918
	[3]	Other Considerations	918
	[a]	Coincidence with Domestic Litigation	918
	[b]	Time Limits	918
	[c]	Interest on Unpaid Taxes	919
	[C]	Other Items	919
	[1]	Consequences of Transfer Pricing Adjustment	919
	[a]	Primary Adjustment	919
	[b]	Secondary Adjustment	919
	[c]	Corresponding Adjustment	919
	[d]	Return of Additional Income	919
	[2]	Tax Audit	920
	[3]	Appeal Procedures	920
§20.07		Significant Transfer Pricing Litigation	920
	[A]	Application of Cup Method to Pharmaceutical Products	921
	[B]	Transfer Pricing of Indent Transactions	921
§20.08		Country-Specific Planning Opportunities	922
	[A]	Expanded Application of Map Result	922
	[B]	Proactive Dispute Resolution by a Combined Filing of APA and ACVA	923
	[C]	Regulatory Change in the MIRPs and Strategic Adjustments	923
§20.09		List of Abbreviations	923

## Table of Contents

---

### CHAPTER 21

#### Spain

*Pilar Barriguete*

925

§21.01	Importance of TP	927
[A]	Background	927
[1]	Main Developments for TP Law and Practice in Spain	928
[B]	Regulatory Framework	928
[1]	TP Legislation in Spain	928
[2]	Local Legislation	928
[3]	International TP Treaties and Agreements	929
[C]	Relationship to OECD Guidelines	929
[D]	Arm's-Length Standard	929
[1]	Definition Related Entity	930
[E]	TP related Transactions: Categories of Inter-company Transfer	930
[F]	TP Penalty Framework	931
[1]	Adjustments and Penalties	931
§21.02	Intercompany Price	933
[A]	Method Selection	933
[B]	Methods: Description and Application Example	933
[1]	Traditional Transaction Methods	933
[a]	CUP (Comparable Uncontrolled Price)	933
[i]	Description	933
[ii]	CUP: Use in Practice	934
[b]	Cost Plus	935
[i]	Description	935
[ii]	Cost Plus: Use in Practice	935
[iii]	Application Example	935
[c]	Resale Price	935
[i]	Description	935
[ii]	Resale Price: Use in Practice	937
[iii]	Application Example	937
[2]	Transactional Profit Methods	937
[a]	TNMM (Transactional Net Margin Method)	937
[i]	Description	937
[ii]	TNMM: Use in Practice	939
[iii]	Application Example	939
[b]	Profit Split	939
[i]	Description	939
[ii]	Profit Split: Use in Practice	942
[iii]	Application Example	942
[iv]	Comparables Selection	942
[v]	Availability of Benchmarking/Comparative Data	943

Table of Contents

	[C] IQR	944
	[1] Determining the Arm's-Length Range	944
	[2] Selecting the Most Appropriate Point in the Range	945
	[3] Extreme Results: Comparability Conditions	946
§21.03	Support for Actual Pricing	947
	[A] TP Doc Requirements	947
	[B] Article 14 of Decree No. 634/2015: CbCR (Form 231)	948
	[C] Article 15 of Decree No. 634/2015: Master File	949
	[D] Article 16 of Decree No. 634/2015: Local File	951
	[1] Determination of the Market Value of Related Operations: Comparability Analysis:	952
	[1] Exemptions	953
	[2] Time at Which Documentation Should Exist	954
	[3] Acceptable Languages for Documentation	954
	[E] Form 232. The New Filing Requirements	955
	[F] Exceptions	957
§21.04	Local Practice	957
	[A] APA	957
	Bibliography	959
CHAPTER 22		
United Kingdom		
	<i>Andrew Cousins, Daniel Othmann &amp; Ted Keen</i>	961
§22.01	Importance of Transfer Pricing for Multinational Companies Operating Within the United Kingdom	965
§22.02	Regulatory Framework	966
	[A] Legal Authority	966
	[1] Legislation	966
	[a] Statutory Rules	966
	[b] Adjustment Mechanism	967
	[2] Participation/Association	968
	[a] Persons to Whom the Association Test Applies	968
	[3] Control	969
	[a] Joint Ventures	970
	[b] Acting Together	970
	[4] Indirect Control	970
	[5] UK/UK Transactions	971
	[a] Compensating Adjustments	971
	[b] Balancing Payments	972
	[6] Exemptions from the Transfer Pricing Rules	972
	[a] Small Enterprise Exemption	973
	[b] Medium-Sized Enterprise Exemption	973
	[c] Dormant Company Exemption	974
	[7] Documentation	974

## Table of Contents

---

	[8] Diverted Profits Tax	975
	[9] Non-statutory Guidance/Reference/Authority	975
	[B] Relationship to OECD Guidelines	976
	[C] Transfer Pricing Penalty Framework	976
	[1] Tax-Geared Penalties	976
	[2] Penalty for Lack of Proper Records	977
	[3] Penalties on Company Officers	977
	[D] Arm's-Length Standard	978
§22.03	Determining The Appropriate Intercompany Price	978
	[A] Method Selection	978
	[1] Particular Views of UK Tax Authorities on the OECD Methods	978
	[a] Comparable Uncontrolled Price Method	978
	[b] Transactional Net Margin Method	979
	[c] Cost Plus Method	980
	[d] Resale Price Method	982
	[e] Profit Split Method	982
	[B] Comparables Selection	982
	[C] Interquartile Range	982
§22.04	Developing Support for Actual Pricing	982
	[A] Transfer Pricing Documentation Requirements	982
	[1] Time at Which Documentation Should Exist	985
	[B] Relationship between Fulfilling Documentation Requirements and Protection from Adjustments	986
	[C] Sufficiency of Compliance Reports for Purposes of Applying Penalties	986
§22.05	Hot Topics/Special Considerations in UK Transfer Pricing	986
	[A] Thin Capitalization/Interest/Guarantees	986
	[1] Clearances	988
	[2] Specific UK Legislation	988
	[3] Guarantees and Guarantee Fees	989
	[B] Interest-Free Loans	990
	[C] Management Services	990
	[1] Allocation Keys	991
	[2] Need for Markup	991
	[3] Share Options	991
	[D] Public Country-by-Country Reporting	992
	[E] Corporate Tax and the Digital Economy	992
§22.06	Local Country Administrative Practices	993
	[A] Availability of Advance Pricing Agreements	993
	[B] Access to Competent Authority	996
	[C] Other Items	998
	[1] Transfer Pricing Enquiries	998
	[2] Risk Assessment	999
	[3] Real-Time Working	1000
	[4] Transfer Pricing and Discovery Assessments	1001

Table of Contents

§22.07	Significant Transfer Pricing Litigation	1002
	[A] DSG Retail Ltd & Others versus HMRC	1002
	[B] Employee Share Options: Waterloo	1005
§22.08	Country-Specific Planning Opportunities	1006
§22.09	List of Abbreviations	1006
CHAPTER 23		
United States		
	<i>Jill Weise, Stefanie Perrella, Rod Koborsi &amp; Jay Hudson</i>	1009
§23.01	Regulatory Framework	1013
	[A] Overview and Legal Authority of Sections 482 and 6662	1013
	[B] Relationship between Section 482 and the OECD Guidelines	1014
	[1] Choice of Method	1015
	[2] The Use of Safe Harbours	1016
	[3] Profit-Based Methods: CPM versus TNMM	1018
	[4] Cost Sharing Agreements/Cost Contribution Agreements	1018
	[C] Summary of Transfer Pricing Regulatory Framework	1019
	[1] Intercompany Transactions: Identification and Characterization	1019
	[2] Functional Analysis	1020
	[D] Arm's-Length Standard	1021
	[1] Available Methods and the Best-Method Rule	1022
	[2] Arm's-Length Range	1025
§23.02	Determining The Arm's-Length Pricing From A US Perspective	1025
	[A] Tangible Property Transactions	1026
	[1] CUP Method	1026
	[a] Description	1026
	[b] Application Example	1026
	[2] Resale Price Method	1027
	[a] Description	1027
	[b] Application Example	1027
	[3] Cost Plus Method	1028
	[a] Description	1028
	[b] Application Example	1029
	[B] Intangible Property Transactions	1029
	[1] CUT Method	1030
	[a] Description	1030
	[b] Application Example	1030
	[2] Comparable Profits Method	1031
	[a] Description	1031
	[b] Application Example	1032
	[3] Profit Split Method	1032
	[a] Description	1032
	[b] Application Example	1033

## Table of Contents

---

	[4] Unspecified Method	1034
[C]	Service Transactions	1034
	[1] Services Cost Method	1036
	[a] Description	1036
	[b] Application Example	1036
	[2] CUSP Method	1037
	[a] Description	1037
	[b] Application Example	1037
	[3] Gross Services Margin Method	1038
	[a] Description	1038
	[b] Application Example	1038
	[4] Cost of Services Plus Method	1038
	[a] Description	1038
	[b] Application Example	1038
	[5] Comparable Profits Method	1039
	[a] Description	1039
	[b] Application Example	1039
	[6] Profit Split Method	1040
	[a] Description	1040
	[b] Application Example	1040
[D]	Loans	1041
	[1] Arm's-Length Interest Rate	1041
	[2] Characterization of Intercompany Debt	1043
[E]	Cost Sharing	1044
	[1] Evolution of the Regulations	1045
	[2] Pre-January 4, 2009 Regulations	1046
	[a] Buy-In Payments for Pre-existing IP	1046
	[b] Determination and Allocation of Cost Pools	1046
	[c] Documentation and Administrative Requirements	1047
	[3] 2008 Temporary Regulations	1047
	[a] Payments Made for Pre-existing IP	1047
	[b] Determination and Allocation of Cost Pools	1049
	[c] Periodic Adjustments	1050
	[d] Documentation and Administrative Requirements	1051
	[4] 2011 Final Regulations	1051
	[a] Payments Made for Pre-existing IP	1051
	[b] Determination and Allocation of Cost Pools	1053
	[c] Periodic Adjustments	1053
	[d] Documentation and Administrative Requirements	1053
	[e] Other Updates to the 2008 Temporary Regulations	1053
	[5] Coordination within IRS Code Section 367 and Section 482	1054
§23.03	Penalties for Non-Compliance	1055
	[A] US Transfer Pricing Documentation Requirements	1055

Table of Contents

[B]	US Transfer Pricing Penalty Framework	1056
[1]	Reported Results	1056
[2]	The Transactional Penalty	1057
[a]	Substantial Valuation Misstatement	1057
[b]	Gross Valuation Misstatement	1057
[3]	The Net Adjustment Penalty	1058
[a]	Substantial Valuation Misstatement	1059
[b]	Gross Valuation Misstatement	1059
[4]	Coordination of Penalties	1060
[a]	Coordination of a Net section 482 Adjustment Subject to the Net Adjustment Penalty and a Gross Valuation Misstatement Subject to the Transactional Penalty	1060
[b]	Coordination of a Net section 482 Adjustment Subject to the Net Adjustment Penalty and Substantial Valuation Misstatement Subject to the Transactional Penalty	1061
[5]	Reasonable Cause and Good Faith	1061
[6]	Specified and Unspecified Method Requirements	1061
[7]	Carrybacks and Carryovers	1062
[C]	Sufficiency of Documentation Reports for Purposes of Avoiding Penalties	1063
§23.04	Special Considerations in US Transfer Pricing	1063
[A]	US Tax Cuts and Jobs Act Impacts and Considerations	1063
[1]	US Corporate Income Tax Rate Reduction	1063
[2]	Global Intangible Low-Tax Income	1063
[3]	Foreign Derived Intangible Income	1064
[4]	Base Erosion and Anti-Abuse Tax	1065
[5]	Interest Rate Deduction Limitations	1065
[B]	ASC 740 Consideration	1066
[1]	Justification for Issuing ASC 740	1066
[2]	ASC 740 Scope	1067
[3]	ASC 740 Implementation Guidelines	1068
[4]	ASC 740 Disclosures	1070
[5]	ASC 740 and Transfer Pricing	1070
[6]	Implementing ASC 740 for Transfer Pricing	1071
[a]	Step 1: Identify Unit of Accounts	1071
[b]	Step 2: Preliminary Analysis	1072
[c]	Step 3: Detailed Review	1072
[d]	Step 4: Implementation	1073
[7]	Schedule and Instructions for UTPs	1074
[8]	Impact of H.R. 1 Tax Reform	1075

## Table of Contents

---

[C]	Global Dealing	1075
[1]	Introduction	1075
[2]	Permanent Establishment	1076
[3]	The Role of Capital	1077
[4]	Guarantees	1078
[D]	Advance Pricing Agreements	1079
[1]	APA Program Background	1079
[2]	Revised Procedures for APAs	1081
[3]	APA Process	1082
[a]	Step 1: APA Application	1082
[b]	Step 2: Due Diligence	1085
[c]	Step 3: Analysis	1086
[d]	Step 4: Discussion and Agreement	1086
[e]	Step 5: Drafting, Reviewing, and Executing the Agreement	1087
[4]	Other Considerations	1087
[5]	Administering and Renewing the APA	1088
[6]	Conclusion	1088
[E]	State and Local Tax Considerations	1089
[1]	State Adoption of Treasury Regulations Section 1.482 Principles	1090
[2]	Other State Mechanisms	1092
[F]	Tax Audits and Related Controversy Procedures	1093
[1]	Transfer Pricing Audit Roadmap	1093
[2]	Request for Documentation	1094
[3]	Notice of Proposed Adjustment	1095
[4]	Appeals and Alternative Dispute Resolution	1095
[a]	Appeals Fast Track Settlement Procedure	1095
[b]	Early Referral to Appeals	1096
[c]	Delegation Orders	1096
[d]	Appeals Mitigation and Arbitration	1096
[e]	APMA Program	1097
§23.05	Significant US Transfer Pricing Litigation	1097
[A]	Asiatic Petroleum co. v. Commissioner (1936)	1097
[1]	Case Summary	1097
[2]	Commentary	1097
[B]	PPG Industries, Inc. v. Commissioner (1970)	1098
[1]	Case Summary	1098
[2]	Commentary	1098
[C]	EI Dupont DE Nemours & Co. v. United States (1979)	1098
[1]	Case Summary	1098
[2]	Commentary	1099

Table of Contents

---

[D]	Hospital Corporation of America v. Commissioner (1980)	1099
	[1] Case Summary	1099
	[2] Commentary	1099
[E]	ELI Lilly & Co. v. Commissioner and G.D. Searle & Co. v. Commissioner (1987)	1100
	[1] Case Summary	1100
	[2] Commentary	1100
[F]	Bausch & Lomb, Inc. v. Commissioner (1989)	1100
	[1] Case Summary	1100
	[2] Commentary	1101
[G]	Westreco, Inc. v. Commissioner (1992)	1101
	[1] Case Summary	1101
	[2] Commentary	1102
[H]	Compaq Computer Corporation and Subsidiaries v. Commissioner (1999)	1102
	[1] Case Summary	1102
	[2] Commentary	1103
[I]	DHL Incorporated and Subsidiaries v. Commissioner (2002)	1103
	[1] Case Summary	1103
	[2] Commentary	1104
[J]	Xilinx, Inc. v. Commissioner (2009)	1104
	[1] Case Summary	1104
	[2] Commentary	1105
[K]	Veritas Software Corporation v. Commissioner (2009)	1105
	[1] Case Summary	1105
	[2] Commentary	1106
[L]	Altera Corporation v. Commissioner (2015)	1106
	[1] Case Summary	1106
	[2] Commentary	1107
[M]	Tyco Corporation v. Commissioner (2015)	1107
	[1] Case Summary	1107
	[2] Commentary	1107
[N]	Guidant LLC v. Commissioner (2016)	1108
	[1] Case Summary	1108
	[2] Commentary	1108
[O]	Amazon.com Inc. v. Commissioner (2017)	1108
	[1] Case Summary	1108
	[2] Commentary	1109
[P]	The Coca-Cola Company & Subsidiaries v. Commissioner (2017)	1110
	[1] Case Summary,	1110
	[2] Commentary	1111
§23.06	List of Abbreviations	1111

## Table of Contents

---

### CHAPTER 24

#### Vietnam

*Steven Carey, Tu Ha Anh & Douglas John Fone*

1113

§24.01	The Importance of Transfer Pricing for Multinational Companies Operating Within Vietnam	1115
§24.02	Regulatory Framework	1116
[A]	Legal Authority	1116
[1]	Regulatory Frameworks	1116
[a]	Law on Tax Administration 2006	1116
[b]	Revised Law on Tax Administration 2012 and Decree 83/2013/NĐ-CP	1117
[c]	Circular 201/2013/TT-BTC (Circular 201)	1117
[d]	Circular 66/2010/TT/BTC (Circular 66)	1117
[e]	Circular 156/2013/TT-BTC (Circular 156)	1118
[f]	Decree No. 20/2017/NĐ-CP (Decree 20)	1119
[g]	Circular 41/2017/TT-BTC (Circular 41)	1122
[B]	Relationship with the OECD Guidelines	1126
[1]	Choice of Method	1127
[2]	Profit-Based Method: CPM Versus TNMM	1127
[C]	Arm's-Length Standard	1127
[1]	Arm's-Length Principle	1127
[2]	Arm's-Length Range	1128
[D]	Transfer Pricing Risks	1129
[E]	Transfer Pricing Penalty Framework	1130
§24.03	Local Country Administrative Practices	1130
[A]	Disclosure Form Requirements	1130
[B]	Transfer Pricing Documentation Requirements	1132
[C]	Advanced Pricing Arrangements (APA)	1133
[1]	APA Application Process	1133
[a]	Formal Application	1133
[b]	Evaluation	1134
[c]	Negotiation	1135
[d]	Conclusion	1135
§24.04	Special Considerations in Vietnam Country Transfer Pricing	1135
[A]	Interest Expenses Cap	1135
[B]	Safe-Harbor Rule Implementation	1135
[C]	Restriction on Management Fees and Royalties	1136
[D]	Administrative Filing Requirements	1137
[E]	Applicable Period of the New Regulations	1137
[F]	TP Compliance and Audits	1137
§24.05	Determining the Appropriate Intercompany Price	1138
[A]	Method Selection	1138
[1]	CUP Method	1138
[2]	RPM	1139

## Table of Contents

	[3] CPLM	1140
	[4] PSM	1141
	[5] CPM	1143
[B]	Profit Level Indicator (PLI)	1144
[C]	Comparability Factors	1144
	[1] Characteristics of Assets, Goods and Services	1145
	[2] Functional Analysis	1145
	[3] Contractual Terms	1146
	[4] Economic Circumstances	1146
	[5] Quantitative and Qualitative Analyses	1147
[D]	Comparables Selection	1147
	[1] Internal Comparables	1147
	[2] External Comparables	1147
	[3] Foreign Comparables	1148
	[4] Secret Comparables	1148
	[5] Multiple-Year Data	1149
§24.06	Significant Transfer Pricing Litigation	1149
§24.07	List of Abbreviations	1149
Annexes		1151
ANNEX I		
	Transfer Pricing Rules Summary	1153
ANNEX II		
	Transfer Pricing Implementation Checklist	1165
	Table of Cases	1169
	Index	1177



## List of Abbreviations

ACAP	Accelerated Competent Authority Procedure
ACCI	Associate Chief Counsel International
ADIRF(s)	Federal Revenue Service Tax/Customs Auditors Overseas
AERR	Actually Experienced Return Ratios
AFIP	Administración Federal de Ingresos Públicos
AFR	Applicable Federal Rate
APA	Advance Pricing Agreement
APMA	Advance Pricing and Mutual Agreement
ARS	Argentine Revenue Service
ASC 740	Accounting Standards Codification
ASIC	Australian Securities and Investment Commission
ATCA	Advance Thin Capitalisation Agreement
ATO	Australian Taxation Office
AUDIN	International Auditing System
BACEN	Central Bank of Brazil
BAPA	Bilateral Advance Price Agreement
BEPS	Base Erosion and Profit Shifting
BFH	Bundesfinanzhof (German Federal Tax Court)
BGBI	Bundesgesetzblatt
BMF	Bundesministerium der Finanzen (German Federal Ministry of Finance)
BsGaV	Regulation regarding the application of the arm's length principle to permanent establishments pursuant to section 1 paragraph 5 German Foreign Tax Act (Außensteuergesetz)

## List of Abbreviations

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BStBl	Bundessteuerblatt
BVCI	Brigades de Vérification des Comptabilités Informatisées
CAD	Canadian Dollar
CAP	Purchasing or Production Cost Plus Taxes and Profit Method
CAPM	Capital Asset Pricing Model
CARF	Administrative Council of Tax Appeals <sup>lxiii</sup>
CbCR	Country-by-Country Report
CASD	Competent Authority Services Division
CBSA	Canada Border Services Agency
CCA	Cost Contribution Arrangements
CFC Rules	Rules governing the taxation in Brazil of profits of foreign controlled or affiliated legal entities
CFOs	Chief Financial Officer
CIP	Coordinated Issue Paper
COFINS	Contribution for the Social Security Funding
COGS	Cost of Goods Sold
COSIT	General Tax Coordination
CP	Cost Plus
CPL	Production Cost Plus Profit Method
CPM	Comparable Profits Method
CRA	Canada Revenue Agency
CSA	Cost Sharing Arrangement
CSLL	Social Contribution on Net Profits
CSRF	Superior Council of Tax Appeals (replaced by CARF)
CTD	Consolidated Tax Decree or Article 110(7) Presidential Decree 22 December 1986, No. 917
CTN	Law 5172/66 or National Tax Code
CUP	Comparable Uncontrolled Price
CUSP	Comparable Uncontrolled Services Price
CUT	Comparable Uncontrolled Transaction
DBA	Abkommen zur Vermeidung der Doppelbesteuerung
DEAIN	Brazilian Federal Revenue Service International Affairs Department

## List of Abbreviations

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DEMAC	Federal Revenue Service Largest Taxpayers' Office
DIPJ	Brazilian Legal Entities Annual Income Tax Return
DIRCOFI	Directions Interrégionales de Contrôle Fiscal
DTA	Double Tax Agreements
DVNI	Direction des Vérifications Nationales et Internationales
EBIT	Earnings before Interest and Taxes
EBITDA	Earnings before Interest, Taxes, Depreciation and Amortization
ECJ	European Court of Justice
ECR	European Court Report
EEC	European Economic Community
EFG	Entscheidungen der Finanzgerichte
ESAF	Brazilian School of Tax Administration (Escola de Administração Fazendária)
EU JTPF	European Union Joint Transfer Pricing Forum
EU	European Union
EUR	Euro
EUTPD	Transfer Pricing Documentation for associated enterprises in the European Union
F-741	Semestral Tax Return Form Number 741
F-742	Six month Tax Return Form Number 742
F-743	Annual Tax Return Form Number 743
F-867	Annual Tax Return Form Number 867
FAS	Financial Accounting Standards
FASB	Financial Accounting Standards Board
FCA	Federal Court of Appeals
FCAPA	Federal Contentious Administrative Procedures Act
FFC	Federal Fiscal Code
FIFO	First In First Out
FIN 48	FASB Interpretation Number 48
FLC	French Labour Code (Code du Travail)
FRBT Law	Flat-Rate Business Tax Law
FRBT	Flat-Rate Business Tax

## List of Abbreviations

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FTA	French Tax Administration
FTA's TP Guide	Transfer Pricing Guide published by the French Tax Administration
FTC	French General Tax Code
FTPC	French Tax Procedure Code
FVerlV	Funktionsverlagerungsverordnung
GAAP	Generally Accepted Accounting Principles
GAAR	General Anti-Avoidance Rules
GAufzV	Gewinnabgrenzungsaufzeichnungsverordnung (Regulation regarding transfer pricing documentation)
GBP	Pound Sterling
GmbH	Gesellschaft mit beschränkter Haftung (limited liability company)
GR 1122/01	General Resolution number 1122 of year 2001
GSM	Gross Services Margin Method
HCA	Hospital Corporation of America
HMRC	Her Majesty's Revenue and Customs
IC	Information Circular
ICMS	State Tax on Circulation of Goods and Services
ICTA88	Income and Corporation Tax Act 1988lxv
IDA	Intangible Development Activities
IDC	Intangible Development Costs
IDS	International Dealings Schedule
IFRS	International Financial Reporting Standards
ILBD	International and Large Business Directorate
IN SRF 32	Federal Revenue Service Normative Instruction 32/01
IN SRF 243	Federal Revenue Service Normative Instruction 243/02
IN SRF 740	Federal Revenue Service Normative Instruction 740/07
INTM	International Manual
IP	Intellectual Property
IPR	Intellectual Property Right
IRC	Internal Revenue Code
IRPJ	Corporate Income Tax

## List of Abbreviations

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IRS	Internal Revenue Service
ISS	Municipal Service Tax
IT	Income Tax
ITA	Income Tax Act
ITAA	Income Tax Assessment Act
ITC	Income Tax Code
ITL	Argentine Income Tax Law
ITO	Income Tax Ordinance
LAW 9430	Law 9430/96
LB&I	Large Business & International
LIFO	Last-In-First-Out
LMSB	Large and Mid-Size Business
LSA	Law 6404/76 or Brazilian Corporation Law
MAP	Mutual Agreement Procedure
MAPA	Multilateral Advance Price Agreement
MCAA	Multilateral Competent Authority Agreement
MFPC	Ministry of Finance and Public Credit
MITL	Mexican Income Tax Law
MLTN	More Likely Than Not
MNE	Multinational Enterprise
MP 472	Executive Measure 472/09
MP 476	Executive Measure 476/09
MP 478	Executive Measure 478/09
MTR	Mexican Tax Regime (Chapter Mexico)
MTR	Miscellaneous Tax Resolution
NACE	Nomenclature d'Activités de la Communauté Européenne
NAF	Nomenclature d'Activités Françaises <sup>xvi</sup>
NAFTA	North American Free Trade Agreement
NAICS	North American Industrial Classification System
NCM	Mercosur Common Nomenclature
NCPM	Net Cost Plus Margin
NID	Notional Interest Deduction

## List of Abbreviations

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OECD	Organisation for Economic Co-operation and Development
OECD Guidelines	Transfer Pricing Guidelines for Multinational Companies and Tax Administrations
OEM	Original Equipment Manufacturer
OG	Official Gazette
OM	Operating Margin
PATA	Pacific Association of Tax Administrators
PCG	Practical Compliance Guideline
PCTs	Platform Contribution Transactions
PE	Permanent Establishment
PFC	Pre-Filing Conference
PIC	Comparable Independent Prices Method
PIS	Contribution for the Social Integration Program
PLI	Profit Level Indicator
PP&E	Property, Plant & Equipment
PRL	Resale Price Less Profit
PRL 20	Resale Price Less 20 Percent Profit Method
PRL 60	Resale Price Less 60 Percent Profit Method
PRRR	Periodic Return Ratio Range
PS	Profit Split
PSM	Profit Split Method
PVA	Wholesale Price in Country of Destination Less Profit Method
PVEX	Export Sales Price Method
PVL	Sales Price Less Profit Method
PVV	Retail Price in Country of Destination Less Profit Method
QCCA	Qualifying Cost-Contribution Arrangement
R&D	Research and Development
RAB	Reasonably Anticipated Benefits
RD	Regulatory Decree
RFB	Federal Revenue Service (formerly SRF)
RIR99	Decree 3000/99 or Income Tax Code
RMCCI	Consolidation of Brazilian Exchange Control Rules

## List of Abbreviations

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ROA	Return on Assets
RP	Resale Price
RPM	Resale Price Method
RPSM	Residual Profit Split Method
RTA	Real-Time Audit
SAT	Tax Administration Service
SCM	Services Cost Method
SEC	Securities and Exchange Commission
SELIC	Special Liquidation and Custody Interest Rates
SEStEG	Gesetz über steuerliche Begleitmaßnahmen zur Einführung der Europäischen Gesellschaft und zur Änderung weiterer steuerrechtlicher Vorschriften
SFAS 109	Statement of Financial Accounting Standards No. 109
SIC	Standard Industrial Classification
SISCOMEX	International Trade Integrated System
SISCOSERV	Service and Trade Integrated System
SME	Small and Medium Enterprises
SP	Statement of Practice
SPED	Public System of Digital Accounting
SR&ED	Scientific Research and Experimental Development
SRF	Federal Revenue Service (nowadays RFB)
STF	Supreme Court (Supremo Tribunal Federal)
STJ	Superior Court of Justice (Superior Tribunal de Justiça)
TAS	Tax Administration Service
TCC	Tax Court of Canada
TIN	Tax Identification Number
TIOPA 2010	Taxation (International and Other Provisions) Act 2010
TNM	Transactional Net Margin
TNMM	Transactional Net Margin Method
TP	Transfer Pricing
TPD	Transfer Pricing Documentation
TPM	Transfer Pricing Methodology

## List of Abbreviations

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TPRC	Transfer Pricing Review Committee
TPRR	Transfer Pricing Risk Review
TRFs	Federal Justice Regional Courts (Tribunais Regionais Federals)
TSO	Tax Service Offices
USD	United States Dollar
VAT	Value Added Tax (Umsatzsteuer)
VWG BsGa Decree	Administrative decree on the application of the arm's length principle to permanent establishments pursuant to section 1 paragraph 5 German Foreign Tax Act ( <i>Außensteuergesetz</i> )
WIR	UNCTAD's World Investment Report

## Preface

This book addresses both the general issues that surround transfer pricing and the specific rules and issues that any company must concern itself with in various jurisdictions around the world. As practitioners in the field, we hear time and again that transfer pricing is the most important international tax issue facing multinational enterprises. Moreover, allegations of improper transfer pricing conduct and abusive tax structures have been raised against multinationals in very public forums across many nations, leading to concerns at the highest levels of government that the international tax system required an overhaul. Driven by these concerns, the Organisation for Economic Co-operation of Development (OECD) issued a 15-point Action Plan to address base erosion and profit shifting (BEPS) in September 2013.<sup>1</sup> The BEPS project, as it came to be known, included the participation of the OECD and G20 countries and contributions from developing countries, regional tax organizations and international organizations, including the United Nations, World Bank and International Monetary Fund. The 15-point Action Plan is substantially completed, and the ‘BEPS package of measures represents the first substantial renovation of the international tax rules in almost a century’.<sup>2</sup>

A significant portion of the BEPS project was focused on transfer pricing matters, including the OECD’s guidance addressing Actions 8-10, ‘Aligning Transfer Pricing Outcomes with Value Creation’. Many tax authorities around the world are adopting all or part of the BEPS guidance such as Action Item 13, which includes a three-tiered standardization of transfer pricing documentation, including: (1) a master file; (2) local file; and (3) country-by-country reporting (CbC Reporting). The adoption of such documentation requirements has added additional layers of complexity to the burden of compliance for multinational enterprises and will likely result in increased information sharing among global tax authorities.

Not only must a multinational understand different nuances in transfer pricing laws and a tax authority’s practical interpretation of those laws in each local country

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1. OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, <http://dx.doi.org/10.1787/9789264202719-en>
  2. OECD (2015), Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241244-en>

in which it has a presence, but also it must appreciate that operating in jurisdictions with varying tax rates, transactional structures or intercompany pricing policies can impact the multinational's global effective tax rate. It is this same labyrinth of differing local country laws and tax rates, however, that also increases the potential for double taxation. Maintaining legal compliance with local country tax laws while reducing tax burdens via effective transfer pricing structures is an on-going challenge facing today's multinational enterprises.

Tax authorities around the globe are increasingly scrutinizing multinationals' transfer pricing practices to ensure an appropriate allocation of income among the various tax jurisdictions in which a multinational operates under the arm's length standard. However, an 'appropriate' allocation of income is not a bright-line test and may lead to increased controversy if tax authorities seek to claim that their tax jurisdiction deserves a greater allocation of income than either the company or other tax jurisdictions feel is warranted.

In writing this book, our primary objective was to create a comprehensive guide that would arm the various constituents impacted by transfer pricing – including tax directors, legal counsel, accounting and operations personnel, CFOs and outside advisors – with the knowledge base and resources needed for effective transfer pricing decision-making. *Guide to International Transfer Pricing* presents an overview of the fundamental concepts applied in transfer pricing. Country-specific profiles follow so that readers can compare and contrast rules and real-world applications over multiple jurisdictions. A particular focus is on practical guidance and implementation, enabling the reader to execute a coordinated and informed approach to global policies and documentation needs.

This guide represents a collaboration of many leading transfer pricing experts from around the world. Their experience gained from assisting multinationals in implementing planning and compliance strategies, and their insights into dealing with local tax authorities, is evident throughout these pages. Our hope is that through sharing their knowledge, we shed light on how some of the complexities raised by transfer pricing – from planning to compliance to controversy – can be effectively managed.

The content of this guide has been updated till June 2018.

*Michael Heimert, PhD (ed.)*

&

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## CHAPTER 1

# Overview/Best Practices

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Michelle Johnson has been practising transfer pricing for over seventeen years. A managing director, Michelle has significant experience advising clients on global transfer pricing documentation preparation, transfer pricing audits and controversy matters, BEPS compliance and global transfer pricing policy development. Michelle is a member of Duff & Phelps's financial services team and has significant experience assisting companies with pricing matters involving asset management, insurance, banking and global dealing transactions. Michelle is also a frequent speaker on intercompany services transactions and has performed dozens of analyses in this area. Her clients range from start-ups to Fortune 100 firms.

Michelle is an award-winning speaker and has presented at numerous conferences and seminars regarding transfer pricing issues. In addition to this volume, her publications include several books on transfer pricing, including BNA's Tax Management Portfolio on ASC 740-10 (FIN 48), Lexis-Nexis's Practical Guide to U.S. Documentation, and Wiley's Cost of Capital (Transfer Pricing Chapter). In a previous role she was responsible for her firm's US operations, focusing on the areas of quality and training. Michelle obtained her Master's in Economics from New York University and a BS in Economics and French, with a minor in Mathematics, from the University of Illinois (magna cum laude).

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Justin Radzewicz joined Duff & Phelps as a director with significant experience advising clients' senior management teams on a variety of transfer pricing and valuation matters. Justin has supported and managed large litigation support projects, prepared US, OECD and local country transfer pricing documentation for tangible, intangible and service transactions, assisted in the design and preparation of economic planning and global transfer pricing policy projects, performed cost-sharing analyses, ASC 740 (formerly

FIN 48) recognition, and analysed complex transfer pricing issues in compliance and controversy contexts. Justin has considerable experience with the design, implementation and maintenance of large and complex intercompany services analyses for Fortune 100 companies, providing a seamless integration between service provider and his client's internal team. Justin also has considerable experience related to intangible property licensing transactions, royalty rates and agreements.

Justin's clients include Fortune 100 and Fortune 500 companies across a broad range of industries – including e-commerce, automotive, chemicals, consumer goods, pharmaceutical, telecommunications, software and software development, retail and industrial goods. He has published several articles about transfer pricing, including an in-depth look at the US Services Regulations. Previously, Justin joined Ceteris after acquiring a BA in Psychology from DePaul University.

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## CHAPTER 1

# Overview/Best Practices

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### §1.01 WHAT IS TRANSFER PRICING AND WHY DOES IT EXIST?

In a rapidly globalizing economy, multinational enterprises (MNEs) are expanding their operations into an increasing number of countries around the world. This expansion has resulted in a growing number of intercompany transfers of tangible goods, intangible property, services and financial instruments across international borders. The price at which these transfers occur has an effect on the taxable income reported by the legal entities involved in the transaction and the overall effective tax rate of the consolidated organization. These internal prices are called ‘transfer prices’.

Transfer pricing regimes (e.g., the arm’s-length standard discussed later in this chapter) provide the conceptual framework for pricing intercompany transactions and ensuring an appropriate allocation of income between the various tax jurisdictions in which a multinational company operates. Transfer pricing for tax purposes is governed by local country tax authorities, many of which have issued formal rules regulating transfer pricing practices. In most instances, the regulations are accompanied by documentation requirements and penalty provisions for non-compliance.

In recent years, MNEs have seen an increased focus from governments and their tax administrations on transfer pricing. This was due, in large part, to the Organisation for Economic Co-operation and Development (OECD)<sup>1</sup> and Group of Twenty (G20)<sup>2</sup> Base Erosion and Profit Shifting (BEPS) project, introduced in 2013 and incorporated

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1. The OECD is comprised of thirty-five member countries that work together, in part, to coordinate domestic and international policies. The OECD has issued specific guidelines on transfer pricing, which are discussed in detail in Ch. 2.
  2. G20 is an international forum for the governments and central bank governors from twenty major economies. Members include Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States and the European Union.

into the 2017 version of the OECD Guidelines. The goal of this initiative was to address tax planning strategies that exploit gaps and mismatches in tax rules in order to shift profits. In response, many local tax authorities have implemented measures to reflect this guidance, which has resulted in a highly complex transfer pricing compliance environment for MNEs.

#### [A] Transfer Pricing Example

The impact of transfer pricing on taxable income can be seen in the following examples. Consider the case of a manufacturer that sells all of its products to a related party distributor located in another tax jurisdiction. Assume that the distributor does not sell any third party manufactured products, and that it sells everything it buys from the manufacturer instantly, so that its cost of goods sold (COGS) entirely consists of the purchases from its related party manufacturer during the relevant period. See Figure 1.1 (the related party transactions in the following are shown with arrows and, for purposes of this example, all figures are in US dollars).

Figure 1.1 Scenario 1: Tangible Transaction

	Manufacturer	Distributor	Consolidated
Revenues	\$100	\$120	\$120
COGS	75	100	75
Operating Expenses	10	5	15
<b>Taxable Income</b>	<b>\$15</b>	<b>\$15</b>	<b>\$30</b>
Tax rate	10%	40%	
<b>Taxes Paid</b>	<b>\$1.5</b>	<b>\$6</b>	<b>\$7.5 (25% ETR)</b>

In Scenario 1, the manufacturer charges the distributor USD 100 for the goods. If the manufacturer has total costs of USD 85 (COGS of USD 75 and operating expenses of USD 10), it will have USD 15 of taxable income. The tax rate in the country in which the manufacturer is incorporated is 10%, resulting in USD 1.5 in taxes paid.

The distributor's profit and loss statement is made up of USD 120 in third-party revenue, USD 100 in related party COGS, and an additional USD 5 in operating expenses. In total, the distributor earns USD 15 of profit. After applying the 40% tax rate, the

distributor pays USD 6 in taxes. In Scenario 1, the consolidated group pays a total of USD 7.5 in taxes. Since the total taxable income of the group is USD 30, this represents an effective tax rate of 25%. Now consider Scenario 2, shown in Figure 1.2.

Figure 1.2 Scenario 2 – Tangible Transaction

	Manufacturer	Distributor	Consolidated
Revenues	\$110	\$120	\$120
COGS	75	110	75
Operating Expenses	10	5	15
<b>Taxable Income</b>	<b>\$25</b>	<b>\$5</b>	<b>\$30</b>
Tax rate	10%	40%	
<b>Taxes Paid</b>	<b>\$2.5</b>	<b>\$2</b>	<b>\$4.5 (15% ETR)</b>

In Scenario 2, the manufacturer charges the distributor USD 110 for the goods rather than the USD 100 charged in Scenario 1. The change in price has a significant impact on total taxes paid because of the varying tax rates in the two jurisdictions. Specifically, because the manufacturer now receives USD 110 in revenue rather than the USD 100 it earned in Scenario 1, its taxable income increases by USD 10—USD 25. Applying the 10% tax rate results in USD 2.5 in taxes paid. On the other side of the transaction, the distributor's taxable income has decreased by USD 10 as a result of the increase in its COGS. This results in taxable income of USD 5, which, after applying the 40% tax rate, results in USD 2 in taxes paid by the distributor.

On a consolidated basis, the company's revenues, COGS, operating expenses and taxable income remain identical to the corresponding amounts in Scenario 1. However, because profit has been shifted from the higher tax jurisdiction into the lower tax jurisdiction, the company has saved USD 3 in taxes (USD 7.5 less USD 4.5), and the company's overall effective tax rate has been reduced from 25% to 15%.

This simple example illustrates how taxpayers with material intercompany transactions can manipulate their financial results to reduce their overall effective tax rates. It also shows how the amounts collected by individual tax authorities are affected by transfer pricing practices. Not surprisingly, tax authorities around the world have adopted formal rules and regulations that limit taxpayers' ability to either understate or overstate their transfer prices, and the rules grant the tax authority the right to adjust the taxable income of a taxpayer that is not in compliance with the country's transfer pricing laws.

**[B] Arm's-Length Standard**

The fundamental concept behind pricing intercompany transactions is the arm's-length standard. The arm's-length standard has become the basis for evaluating transactions between members of a controlled group in virtually all tax jurisdictions. The concept was first introduced in the United States, was subsequently adopted by the OECD, and has since been adopted by virtually all tax authorities in major market countries. To understand its status as the global standard for transfer pricing matters, it is helpful to examine its origins in the United States.

The first regulatory initiative addressing transfer pricing in the world was implemented in the United Kingdom as part of the Finance (No. 2) Act of 1915,<sup>3</sup> which stipulated that if business between connected British resident and non-resident firms is conducted so that it ' . . . produces to the resident either no profits or less than the ordinary profits which might be expected to arise from that business, the non-resident person shall be chargeable to income tax in the name of the resident as if the resident person were an agent of the non-resident person.' This was followed by the United States War Revenue Act of 1917, which required corporations to file consolidated returns where necessary to 'equitably determine the invested capital or taxable income'.<sup>4</sup> This brief mention of transfer pricing was expanded in the Revenue Act of 1921, in which Congress declared:

In any case of two or more related trades or businesses. . . owned or controlled directly or indirectly by the same interests, the commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses.<sup>5</sup>

Subsequent to the Revenue Act of 1921, numerous laws were passed which expanded the ability of the Commissioner to reallocate gross income or deductions in order to 'clearly reflect the income' or prevent the 'milking' of profits of US-based entities. However, the definition of the proper or 'accurate' allocation of income remained quite vague until the promulgation of the Revenue Act of 1934. In section 45 of the Revenue Act of 1934, the arm's-length standard as it is known today became explicit:

The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. . .

The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's-length with another uncontrolled taxpayer.<sup>6</sup>

Since the passage of the Revenue Act of 1934, subsequent legislation has adhered to and advanced the arm's-length principle, solidifying it as the basis for testing intercompany transactions in the United States. Although the arm's-length principle first emerged as

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3. Finance (2) Act 1915, s. 31.3.

4. War Revenue Act of 1917, s. 1331(a).

5. Revenue Act of 1921, s. 240(d).

6. Revenue Act of 1934, s. 45.

a formal concept in the United States, it has since spread to countries throughout the world. The principle was first included in the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) in 1979. As a result, OECD member countries and countries outside the organization have largely built their transfer pricing regulations around the arm's-length principle, making it the key global transfer pricing standard.

**[1] *Arm's-Length Standard as Defined in the US Transfer Pricing Regulations***

The United States has adopted the arm's-length principle as the general standard behind the laws and regulations that govern intercompany pricing for multinational companies. The current definition of the arm's-length standard is contained in section 1.482-1(b)(1) of the treasury regulations that were finalized in 1996 and last revised in 2015, as follows:

In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's-length with an uncontrolled taxpayer. A controlled transaction meets the arm's-length standard if the results of the transaction are consistent with the results that would have been realised if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's-length result).

**[2] *Arm's-Length Standard Defined in the OECD Guidelines***<sup>7</sup>

The OECD Guidelines provide an international standard for companies located in both member countries and non-member countries to price their intercompany transactions. Within the current OECD Guidelines, approved by the OECD Council in 1995 and last revised in 2017, the arm's-length standard is described as follows:

[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.<sup>8</sup>

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7. The OECD Guidelines for MNEs and Tax Administrations were originally approved by the OECD Council in 1995. They were completed with additional guidance on cross-border services, intangibles, costs contribution arrangements and advance pricing arrangements in 1996–1999. In the 2009 edition, some amendments were made to Ch. IV, primarily to reflect the latest developments on dispute resolution. In 2010, Chapters I–III were substantially revised with the addition of new guidance on the selection of the most appropriate transfer pricing method to the circumstances of the case, on how to apply transactional profit methods and on how to perform a comparability analysis. Furthermore, a new Ch. IX was added, dealing with the transfer pricing aspects of business restructurings. In October 2015, the OECD issued the final BEPS reports. The 2017 OECD Guidelines represent the most recent version, incorporating BEPS and other revisions since 2010.

8. OECD Guidelines, para. 1.6.

**[3] Exceptions to the Arm's-Length Standard**

There are jurisdictions that do not follow the arm's-length standard. Brazil is the most notable example. Brazil's transfer pricing regulations deviate significantly from the OECD Guidelines when transactional methods are not applied in that, in the absence of such methods, they employ fixed-margin methods that have no direct link to observed arm's-length results. Under Brazil's regulations, intercompany transactions must be documented under the transactional methods or by applying fixed statutory profit margins (which are generally not consistent with the arm's-length principle). In addition, the regulations do not require the functional or industry analyses that are generally incorporated into transfer pricing studies for other countries, but they do require that each Brazilian entity document tangible and intangible intercompany transactions to ensure that they comply with at least of one of Brazil's statutory transactional methodologies (i.e., Comparable Uncontrolled Price (CUP), Resale Price, or Cost Plus).<sup>9</sup>

**[C] Importance of Transfer Pricing to Today's Multinational Companies****[1] High -Profile Litigation Cases**

For many years, transfer pricing has been cited as the most important international tax issue (and often, more broadly, as the most important tax issue) facing MNEs.<sup>10</sup> If an MNE operates in jurisdictions with widely varying tax rates, different transactional structures and intercompany pricing policies can have major implications on its global tax burden. Even in the absence of tax-rate variation, the potential for double taxation could have a material adverse impact on the financial well-being of a multinational corporation. Two well-known transfer pricing cases help illustrate the potential impact that transfer pricing can have on reported profits (along with cash flows, stock prices, and other important variables): (1) the settled Glaxo Smith Kline case which resulted in a USD 3.4 billion payment to the Internal Revenue Service (IRS) in 2006;<sup>11</sup> and (2) the 2018 trial of *Coca-Cola v. Commissioner* where the soft drink maker is battling proposed adjustments exceeding USD 9.4 billion related to the licensing of intangibles to related parties in Europe, South America, and Africa.<sup>12</sup>

With such a large magnitude of dollars potentially at risk, it is not surprising that transfer pricing is a key concern for many corporate tax departments and other stakeholders. Transfer pricing also straddles being governed by the court of law and the court of public opinion. The transfer pricing litigation battles involving well-known

9. See the Brazil chapter for a more detailed discussion of Brazil's regulations.

10. See, Ernst & Young's 2016 Global Transfer Pricing Survey available at <http://www.ey.com/gl/en/services/tax/ey-2016-transfer-pricing-survey-series>, accessed 7 Apr. 2017.

11. The IRS and Glaxo Smith Kline (GSK) were engaged in a dispute over intercompany transactions associated with certain 'heritage' products. The dispute was, at its core, a disagreement over the value of marketing contributions made by the US GSK group vis-à-vis the value of product intangibles and trademarks owned by its UK parent. This settlement was made to settle transfer pricing disputes with the IRS for years 1989 to 2005, and it generated the largest single payment made to the IRS to settle a tax dispute. For further detail, see IR-2006-142 available at [www.irs.gov/uac/IRS-Accepts-Settlement-Offer-in-Largest-Transfer-Pricing-Dispute](http://www.irs.gov/uac/IRS-Accepts-Settlement-Offer-in-Largest-Transfer-Pricing-Dispute), accessed 9 Jul. 2015.

12. For further background on the Coca-Cola case, please refer to s. 18.05 [P] of this guide.

brands such as Amazon, Coca-Cola, Facebook and Google have been widely publicized in recent years. In 2012, in response to public protest regarding alleged tax avoidance and to garner goodwill with the public and tax authorities, Starbucks pledged a voluntary corporate tax payment of GBP 20 million for 2013 and 2014 regardless of its profitability.<sup>13</sup> In 2016, HM Revenue & Customs significantly increased the number of its investigations into multinationals' intercompany transactions, partially as a result of the public backlash against perceived corporate tax avoidance.<sup>14</sup>

### **[2] OECD Guidelines – BEPS Action Items**

Included in the 2017 OECD Guidelines are the fifteen BEPS Action Items, introduced in 2013, that sought to address many of the concerns surrounding the use of tax planning strategies that exploit gaps and mismatches in tax rules to shift profits to tax jurisdictions where little or no economic support for such profit exists. Each of the fifteen Action Items issued by the OECD addressed a specific aspect of what the OECD viewed as the issues underlying BEPS behaviour and recommended changes to make BEPS more difficult. Incorporated into the revised OECD Guidelines was the three-tiered approach to transfer pricing documentation, proposed under BEPS Action Item 13, which includes the master file, local file and Country-by-Country report. MNEs were expected to adhere to the guidance and reporting requirements as early as 1 January 2016, with the IRS and Treasury Department releasing final Country-by-Country reporting regulations modelled on the OECD recommendations, effective for reporting periods that begin on or after 30 June 2016.<sup>15</sup>

### **[3] Significant Tax Reform in the United States**

The US introduced significant tax reform in 2017 that will impact transfer pricing for both MNEs and tax authorities globally. H.R. 1, previously referred to as the Tax Cuts and Jobs Act, was approved by the US Congress on 22 December 2017. The following list outlines certain provisions from the legislation that will have an impact on global transfer pricing:<sup>16</sup>

- (1) Reduction of the United States corporate income tax rate from 35% to 21%.
- (2) Tax on global intangible low-taxed income (GILTI): This provision applies additional U.S. corporate income tax on earnings above a specified routine return for subsidiaries of an MNE headquartered in the US. The introduction of the GILTI tax will have an impact on the way MNE's establish transfer prices to minimize the amount of additional tax related to GILTI.

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13. Goodall, Andrew. 'Starbucks pledges voluntary tax payments', *Tax Journal*, 6 December 2012; <https://www.taxjournal.com/articles/starbucks-pledges-voluntary-tax-payment-06122012>, accessed 22 May 2018.

14. Houlder, Vanessa. 'HMRC steps us inquiries into cross-border deals by big business', *Financial Times*, 27 November 2016, <https://www.ft.com/content/60590986-b334-11e6-9c37-5787335499a0>, accessed 15 May 2018.

15. For companies filing on December 31, regulations apply to fiscal years on or after 1 Jan. 2017.

16. Heimert, Mike, and Jill Weise, Douglas Fone, and Shiv Mahalingham; 'Transfer Pricing Times: IRS Issues New LB&I Directives'; Duff & Phelps, LLC; 6 February 2018.

- (3) Deduction for foreign-derived intangible income (FDII): At a high level, the FDII rules aim to encourage exports of products and services by domestic corporations where embedded IP may be generating a higher level of profits than the ‘routine’ return on fixed assets. It accomplishes this by allowing taxpayers to deduct various tax credits attributable to revenues earned from foreign customers.
- (4) Base Erosion and Anti-Abuse Tax (BEAT): The BEAT is a threshold test that seeks to penalize companies that benefit from high levels of potentially ‘base eroding’ payments to offshore related parties, including royalties, service payments, and certain reinsurance deductions. The BEAT generally applies to taxpayers with USD 500 million in average annual gross receipts for the three-year period ending with the preceding taxable year and a base erosion percentage of 3% or higher for the taxable year.<sup>17</sup>
- (5) Limitation on the deduction of net business interest expense; The interest deduction rules under Code section 163(j) were amended to limit the deduction for business interest expense for most large companies. This change, which is similar to thin capitalization rules adopted in other countries, effectively places a cap on the optimal amount of debt in a capital structure of a US corporate group, or allocated to US members of a multinational group.<sup>18</sup>

For further background on the provisions of H.R. 1, please refer to Chapter 18 of this guide. The US is certainly not the only country experiencing changes in its regulatory environment. Many non-US tax authorities have submitted tax proposals aimed at addressing concerns targeted by the BEPS project, such as planning involving hybrid entities and arrangements, avoidance of tax on digital goods and services, and excessive interest expense.<sup>19</sup>

#### **[D] European Union Enforcement of CbC Reporting and Other Transfer Pricing Measures**

On 28 January 2016, the European Union (‘EU’) released an anti-tax avoidance package that includes a proposed EU Anti-Tax Avoidance Directive (‘ATA Directive’) with an eye towards future implementation by EU Member States. The BEPS project made it clear that captive companies are widely regarded as potential sources of profit shifting and the ATA Directive takes aim at these companies. The Council adopted the directive on 12 July 2016 and its amendment introducing rules to address hybrid mismatches on 29 May 2017. The Member States will have until 31 December 2018 to transpose it into their national laws and regulations, with a few exceptions.<sup>20</sup>

17. For banks and securities dealers, the threshold is reduced from 3% to 2%.

18. ‘New Tax Law (H.R. 1): Key Highlights Related to Interest Bearing Debt; Proskauer, 12 January 2018; <https://www.proskauer.com/blog/new-tax-law-hr-1-key-highlights-related-to-interest-bearing-debt>, accessed 22 May 2018.

19. See RSM’s Insight Article dated 14 Mar. 2016 on ‘The current BEPS landscape: What to do now’ available at <http://rsmus.com/what-we-do/services/tax/international-tax-planning/the-current-beps-landscape--what-to-do-now.html>, accessed 04 May 2016.

20. European Council: Anti-tax avoidance package; <http://www.consilium.europa.eu/en/policies/anti-tax-avoidance-package/>, accessed on 16 May 2018.

In May of 2016, as part of EU Directive 2016/881/EU, the European Parliament voted to approve CbC reporting in line with the OECD BEPS Action 13 guidance.<sup>21</sup> Further, in July of 2017, the European Parliament voted to approve an amended 2016 proposal requiring companies, with consolidated worldwide turnover of greater than EUR 750 million, to publicly disclose certain tax information for each tax jurisdiction in which they operate.<sup>22</sup> The directive is currently undergoing interinstitutional negotiations among the EU Member States and has already received opposition.

A series of papers recently released by the UK Treasury, the OECD and the European Commission have focused attention on the challenges of taxing the digital economy and the potential reforms that may lay ahead. On 13 March 2018, the UK Treasury issued an updated position paper on corporate tax and the digital economy, in which it set out its belief that there is a misalignment between where digital businesses are taxed and where they create value. It presents its view that the participation and engagement of users is an important aspect of value creation for certain digital business models and that the international corporate tax framework should reflect the value of user participation. The UK Treasury has also expressed concern that in the absence of tax reform that addresses the specific issues raised by the digital economy, there is a need to consider interim measures, such as revenue-based taxes.<sup>23</sup>

### **[1] Who Cares About Transfer Pricing?**

Transfer pricing policies permeate many facets of an MNE's business. A number of key internal and external stakeholders have a vested interest in the development, implementation, and defence of an MNE's transfer pricing policies. Key internal stakeholders include tax departments, Chief Financial Officers (CFOs), operations personnel, accounting departments, and legal counsel.<sup>24</sup> Key external stakeholders include government authorities, independent auditors, and tax planning and compliance advisors.

The interests of each of these stakeholders are described in detail in the following sections.

#### **[a] Tax Departments**

The tax department's objectives are most directly affected by transfer pricing. Meeting tax compliance objectives requires that the tax department:

- understand the transfer pricing regulations in the jurisdictions in which the company operates;

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21. Council Directive 2016/882/EU; [https://ec.europa.eu/taxation\\_customs/business/tax-cooperation-control/administrative-cooperation/enhanced-administrative-cooperation-field-direct-taxation/country-country-reporting\\_en](https://ec.europa.eu/taxation_customs/business/tax-cooperation-control/administrative-cooperation/enhanced-administrative-cooperation-field-direct-taxation/country-country-reporting_en), accessed 25 May 2018.

22. See Ernst & Young's Global Tax Alert available at <http://www.ey.com/gl/en/services/tax/international-tax/alert--european-parliament-votes-in-favor-of-public-country-by-country-reporting-in-first-reading>, accessed 16 May 2018.

23. Heimert, Mike, and Jill Weise, Douglas Fone, and Shiv Mahalingham; 'Transfer Pricing Times: Taxation of the Digital Economy'; Duff & Phelps, LLC; 2 April 2018.

24. Legal counsel may be internal or external.

- set transfer pricing policies that it can demonstrate are in compliance with those regulations;
- for some countries, compile documentation reports demonstrating that compliance; and
- in some cases, file additional disclosures or statements with tax authorities associated with intercompany transactions.<sup>25</sup>

Poor execution at the compliance level increases the likelihood of adjustments and/or substantial tax penalties.

In the tax department of MNEs, transfer pricing plays a central role in tax planning. Companies undergoing tax and business restructurings can maximize tax efficiency (and therefore returns on reorganization efforts) by optimizing intercompany transactional flows and pricing to reduce global tax burden. Centralizing ownership and management of intangible property in lower tax jurisdictions, for instance, is one tool that MNEs frequently use to help minimize their global tax burden.

In addition to compliance and planning efforts, tax departments may find themselves devoting substantial internal and external resources to resolving transfer pricing controversies with tax authorities.

*[b] Chief Financial Officers*

In addition to the obvious concern transfer pricing creates for CFOs, given that they typically oversee the tax responsibilities within companies, transfer pricing also affects CFO's financial reporting and cash-management responsibilities and objectives. Regardless of the tax system relevant to the jurisdiction in which an MNE is headquartered, transfer pricing can have a material impact on its overall taxes paid (and therefore its available cash) in any given period.

Transfer pricing can also have an important impact on reported earnings due to its impact on income tax expense recognized for financial reporting purposes. Under US generally accepted accounting principles (GAAP) (specifically, APB 23), companies are permitted to exclude deferred US taxes on the earnings of their foreign subsidiaries as long as those earnings are expected to be permanently reinvested outside the United States (rather than being repatriated back as dividends). Therefore, for MNEs in this situation, the effect of transfer pricing on the global cash tax burden may carry through to reported tax expense for financial reporting purposes. The question of whether an MNE may recognize tax benefits associated with profits earned in lower tax countries can be incredibly complex, and could require a thorough evaluation of the merits of all of its transfer pricing positions (such as would be required under US GAAP by Accounting Standards Codification 740 (ASC 740)).<sup>26</sup>

For MNE's headquartered in a country with a tax-credit system, transfer pricing policies will have potentially important cash-management implications on an

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25. One example of this would be the cost sharing statement that is required under US Treas. Regs. 1.482-7(k)(4).

26. Formerly known as Financial Accounting Standards Board Interpretation No. 48 or 'FIN 48'.

entity-by-entity basis since movement of cash across entities in the form of dividends may trigger undesirable tax and financial reporting consequences.

*[c] Operations*

Transfer prices must meet the tax regulatory requirements (in most cases, some version of the arm's-length standard). The tax department's objectives (insofar as they relate to setting transfer prices) are to select the transfer prices that are defensible under these requirements, while at the same time yielding the lowest overall tax burden (obviously optimizing the trade-offs between these two sometimes contrary objectives).

However, transfer prices within firms also serve purposes beyond the tax compliance and planning objectives discussed thus far. Since transfer prices also determine the level of profits recognized by each subsidiary (and each division within each subsidiary), transfer pricing can play a critical role in many managerial objectives.

These objectives may not be met if companies use the same transfer pricing system for 'managerial' purposes as for tax purposes. Many MNEs impose such a constraint because it simplifies their accounting processes (i.e., there is no need to keep separate books using two different transfer pricing systems) and because the presence of multiple transfer pricing systems could potentially weaken the company's defence of its tax transfer prices should those prices become the subject of litigation. In many instances, the transfer pricing system that maximizes overall post-tax profit (including managerial effects) is not going to be the same, in isolation, as the transfer pricing regime that would minimize taxes and optimize managerial performance.<sup>27</sup>

*[d] Accounting Departments*

Accounting departments' concerns also intersect in multiple ways with transfer pricing concerns. In addition to the financial reporting issues discussed above, accounting departments are vital players in ensuring that the intended transfer pricing policies are correctly implemented (and that reporting systems are set up to capture the necessary information in the required format). Companies that do not carefully monitor the implementation of their policies (and the results derived from that implementation) run the risk of needing to make substantial transfer pricing adjustments at year end (or worse, finding themselves in situations where adjustments cannot be made to bring actual results in line with the intended policy).

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27. See Reichelstein, Stefan, Tim Baldenius & Nehun Melumad. 'Integrating Managerial and Tax Objectives in Transfer Pricing', *The Accounting Review* 79 (July 2004): 591–616. This tension derives from the fact that in the absence of taxes, the optimal transfer price would be set equal to the marginal cost of production of the supplying division. To the extent that tax objectives would seek to charge a price in excess of that marginal cost, tax and managerial objectives will necessarily be at odds.

*[e] Legal Counsel*

Transfer pricing concerns an MNE's internal and external legal counsel for several reasons. In many cases, intercompany transactions are conducted in accordance with intercompany agreements. An MNE's legal counsel plays a critical role in ensuring that these agreements are constructed appropriately. This is particularly important for intercompany transfers of intellectual property, where poorly drafted agreements might weaken a company's ability to protect its intellectual property against threats from outside of the enterprise. Legal counsel will likely also become involved in any transfer pricing disputes that arise, because such disputes could eventually develop into litigation.

*[f] Government Authorities*

Given the direct and obvious impact that transfer pricing has on their revenue base, governments are increasingly focused on the transfer pricing practices of taxpayers with operations within their borders. In the mid-1990s, countries with documentation requirements could be counted on a single hand. That number has grown rapidly over the years. As of 15 August 2016, approximately 118 jurisdictions had rules, regulations or summary level guidance related to transfer pricing.<sup>28</sup>

*[g] Board of Directors*

Controversy surrounding MNEs' tax planning has recently made headlines in countries around the world. These media reports on corporate tax planning have been politicized, and have negatively influenced public perception of international tax planning strategies involving transfer pricing. Specifically, transfer pricing has been criticized as a way for MNEs to avoid taxation. As a result, transfer pricing practices, compliance, and overall risk mitigation have become an important consideration for the company's public image. Boards of Directors that are concerned with avoiding negative press related to their company's tax practices want to understand the potential risks inherent in their international tax and transfer pricing structures, and generally there is a trend to avoiding tax structures that would now be viewed as problematic from a 'good corporate citizen' standpoint, even if such structures may be perfectly legal today. Boardrooms need to start assessing their respective companies' financing, operations, and legal structures from a post-BEPS perspective. BEPS will now have to be considered for any current transactions – whether it be an M&A deal, an infrastructure investment, or an operational restructuring project. The progression towards a more transparent corporate environment can potentially result in more commercially sensitive material becoming readily available and boardrooms need to mitigate this risk proactively.<sup>29</sup>

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28. At <http://www.ey.com/GL/en/Services/Tax/International-Tax/Transfer-Pricing-and-Tax-Effective-Supply-Chain-Management/Worldwide-Transfer-Pricing-Reference-Guide---Country-list>, accessed 3 May 2016.

29. Walduck, Robin. 'BEPS in the Boardroom'. *KPMG Insights*. 11 Apr. 2016.

*[h] Independent Auditors*

In performing their duties, an MNE's auditors need to evaluate whether or not their client's provision for income taxes is appropriate. This requires a thorough evaluation of all of their client's material intercompany transactions and associated transfer pricing practices. Auditors also need to evaluate whether or not their client's internal controls are sufficient to mitigate the risk of a material misstatement in its financial statements. Intercompany transaction processes and their associated transfer pricing policies (and support) should be evaluated by the auditors. Suppose, for example, that the internal controls around intercompany transactions are weak in that there is no process in place to ensure that all material intercompany transactions are identified and, when necessary, documented. Such a weakness could yield an unacceptable level of risk of material misstatement with respect to the tax-expense provision.

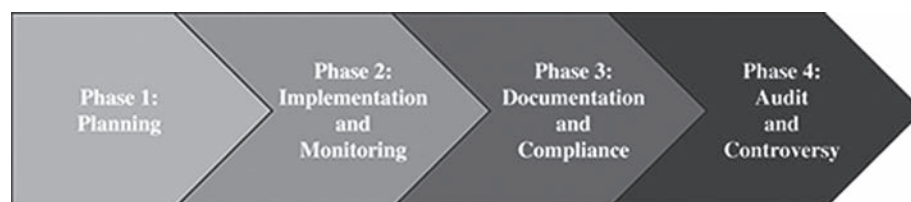
*[i] Tax Planning and Compliance Advisors*

As previously noted, transfer pricing is a major determinant of an MNE's overall cash tax burden and the tax expense it reports for financial reporting purposes. Further, tax authorities are increasingly focused on auditing taxpayers' transfer pricing as an important source of additional revenue. Given the complexity of transfer pricing regulations and, in some cases, the transfer pricing analysis that is necessary to develop and support appropriate transfer pricing policies, it is difficult for most companies to manage all of their transfer pricing needs internally. Transfer pricing has therefore become a major practice area in many law firms, accounting firms, and economic consulting firms.

**§1.02 TRANSFER PRICING LIFECYCLE**

As described in §1.01[D][1], transfer pricing is a dynamic and multifaceted field that involves a number of key stakeholders. Each of these stakeholders plays an important role in the different phases of the 'transfer pricing lifecycle'. Broadly speaking, the transfer pricing lifecycle consists of four stages: (1) planning, (2) implementation and monitoring, (3) documentation/compliance, and (4) audit and controversy (see Figure 1.3).

*Figure 1.3 The Transfer Pricing Lifecycle*



Transfer pricing policies evolve through each of these stages, i.e., that is, they are developed during the planning phase, implemented within the organization, documented for compliance with local country tax laws, and then defended in the event of audit. The remainder of this chapter explains each of the four phases within the transfer pricing lifecycle in detail and provides practical considerations for taxpayers when navigating through each of the stages.

### **[A] Phase 1: Planning**

The term ‘planning’ is generally used in a transfer pricing context to denote the process by which a company designs intercompany pricing frameworks and prioritizes its transfer pricing initiatives for a given time period. Before a company sets, implements, or documents its intercompany prices, it must have a plan for doing so. A strategic mind set is imperative in the planning phase, as the quality of the decisions made in this phase will determine whether a company’s time and resources will be wasted or put to good use and whether the most important exposures will be neutralized, or the greatest opportunities realized.

With the rapid proliferation of new transfer pricing regulations and documentation requirements around the world, multinational companies are finding it increasingly difficult to manage their transfer pricing responsibilities. For larger companies that have material operations in dozens of countries, it is often too costly to produce comprehensive documentation and ensure worldwide compliance every year. However, as tax authorities become more sophisticated and financial reporting concerns such as ASC 740 heighten the scrutiny of companies’ transfer pricing policies, the risks of non-compliance have become more substantial. For these reasons, it is more important than ever for companies to implement an effective planning process.

A clear articulation of a company’s goals is imperative to the planning process. When contemplating its transfer pricing goals and objectives, a company will want to consider the following:

- (1) **Penalty avoidance.** Many countries have implemented penalty provisions that apply to companies that are found upon audit to have transfer prices that require adjustment. Penalties can range from nominal fines to percentages of underpayment of tax, and even to percentages of the actual revenue or expense adjustment. A sample of penalty frameworks for major countries can be found in the Transfer Pricing Rules Summary included as Annex I. Given that such penalties directly impact companies’ bottom lines and can often be avoided if certain measures are taken, companies often view penalty avoidance as a high priority in their overall transfer pricing planning objectives.
- (2) **Audit simplification.** Explaining transfer pricing outcomes during a standard tax audit can consume valuable time and resources within a company’s tax team. This can be exacerbated in situations in which tax authorities are known to be aggressive on transfer pricing matters, the individual tax

agents are auditing a company for the first time, or past problems attract extra scrutiny to this area. In many situations, actions such as developing transfer pricing documentation, centralizing information about transfer pricing policies, and communicating results in an easy-to-understand manner can simplify the audit dialogue and potentially reduce time and resources spent in this process.

- (3) Tax efficiency. By effectively managing the pricing of intercompany transactions between legal entities that are subject to different tax rates, a company can reduce its effective tax rate, and ensure that they do not pay 'too much' tax on a consolidated basis. For this reason, managing tax efficiency is often a primary goal of transfer pricing planning.
- (4) Financial risk. ASC 740 under US GAAP and IAS 37 under International Accounting Standards have placed increased emphasis on tax uncertainties. Transfer pricing can be quite subjective and uncertainties in this area can lead companies to book substantial reserves related to transfer pricing issues. Reducing these reserves is a common goal of transfer pricing planning.
- (5) CbC reporting compliance. BEPS Action Item 13 contained certain filing requirements for CbC reporting which have been widely adopted by the G20. CbC reporting requires MNEs to submit a form detailing information about each of their subsidiaries, where they have business operations, and material intercompany transactions with Constituent Entities in MNE Groups with consolidated annual revenues over EUR 750 million.<sup>30</sup> This information can be used by tax administrations to assess transfer pricing risks and allocate audit resources. Streamlining planning and compliance with knowledge of these requirements can allow MNEs to better anticipate potential controversies and reduce risk associated with intercompany transactions.
- (6) Cash management. One of the most tax efficient ways to move cash between legal entities is to have those entities enter into transactions with one another.<sup>31</sup> Such intercompany transactions can be priced in different manners to optimize cash management, which may translate into an important goal of the transfer pricing planning process. For example, structuring a transaction with a significant up-front payment can establish a cash transfer that is much quicker than a series of recurring payments. Transactions such as intangible property transfers, retainers for the provision of services, intercompany loans, or those established subsequent to an overall supply chain restructuring can facilitate the movement of large sums of cash. They may also have significant long-term effects on the operations and risk allocations within a business that must be carefully considered.

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30. OECD Guidelines, para. 5.52.

31. Hart, Robin & Marcela Lopez. 'Cash Emergency: The Transfer Pricing Toolkit'. BNA Tax Management Transfer Pricing Report. 17 Transfer Pricing Report 541. 6 Nov. 2008.

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

**[1] Identifying Intercompany Transactions for Analysis**

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

**[2] Types of Intercompany Transactions**

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

**[a] Tangible Property Transactions**

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

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

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

**[b] Intangible Transactions**

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

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

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

As defined under the US transfer pricing rules under section 482-4, an intangible includes any asset that comprises any of the following items and has substantial value independent of the services of any individual.<sup>34</sup>

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

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

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

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33. OECD Guidelines, para. 6.6.

34. Treas. Reg. 1.482-4(b).

35. Heimert, Mike, and Jill Weise, Douglas Fone, and Shiv Mahalingham; ‘Transfer Pricing Times: IRS Issues New LB&I Directives’; Duff & Phelps, LLC; 6 February 2018.

*Table 1.1 Sources of Information Available to Identify Intangible Property Transfers*

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

*[c] Services Transactions*

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

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

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

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

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

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

[d] *Financing and Insurance Transactions*

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

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

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37. OECD Guidelines, para. 7.2.

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

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

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

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

*[e] Cost Contribution Arrangements*

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

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39. Van der Breggen, et al. 'Does Debt Matter? The Transfer Pricing Perspective', *BNA Tax Management Transfer Pricing Report*. 16 Transfer Pricing Report 200. 11 Jul. 2007.

40. Also referred to as Platform Contribution Transactions (PCT) under the final cost sharing regulations issued by US Treasury on 16 Dec. 2011 (s. 1.482-7(a)(2)).

41. Note that specific guidance about what constitutes a CSA, CCA or buy-in/PCT payment is provided in the US regulations and the OECD guidelines.

**[3] How to Prioritize Risk Areas**

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

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

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

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

*Table 1.2 Sample Transaction Inventory Matrix*

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

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

**[4]      *How to Conduct Functional Analysis Interviews***

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

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

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

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

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

*Table 1.3 Characterizing Manufacturing Entities<sup>42</sup>*

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

*Table 1.4 Characterizing Distribution and Selling Entities<sup>43</sup>*

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

42. *Ibid.*

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

**[5] Determining How to Price Intercompany Transactions**

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

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

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

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

**[6] Selecting Transfer Pricing Methods**

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

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

The transactional profit methods include the:

- (1) Transactional Net Margin Method (TNMM).<sup>45</sup>

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44. See Section 1.8 for more detail on alternative dispute resolution mechanisms.

45. The TNMM is similar to the Comparable Profits Method (CPM) under the US regulations.

(2) Profit Split Method.<sup>46</sup>

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

*[a] Prioritization of Methods of Analysis*

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

The US regulations state that:

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

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

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

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

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46. Each of these methods is described in detail in Ch. 2.

47. OECD Guidelines, para. 2.3.

48. OECD Guidelines, para. 2.15.

49. Section 1.482-3(b)(2)(ii)(A).

50. The Resale Price method evaluates whether the amount charged in a controlled transaction is at arm’s-length by reference to the gross margin realized in comparable uncontrolled transactions. The Resale Price method is most often used for distributors that resell products without physically altering them or adding substantial value to them.

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

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

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

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

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

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

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

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

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

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

### **[7] Identifying Comparable Companies**

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

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

52. At <https://www.pwc.com/gx/en/tax/newsletters/pricing-knowledge-network/assets/pwc-TP-China-SAT-issues-TP-compliance-requirements.pdf>, accessed 7 Apr. 2017.

53. See s. 1.482-1(c)(2)(iii) of the US regulations and para. 2.12 of the OECD Guidelines.

54. LB&I-04-0118-005: Memorandum for Large Business and International Division Employees (12 Jan. 2018).

55. Heimert, Mike, and Jill Weise, Douglas Fone, and Shiv Mahalingham; 'Transfer Pricing Times: IRS Issues New LB&I Directives'; Duff & Phelps, LLC; 6 February 2018.

*[a] Comparability Considerations*

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

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

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

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56. OECD Guidelines, para. 2.13.

57. OECD Guidelines, paras 2.21 and 2.39.

58. OECD Guidelines, para. 2.58.

59. See the local country reports in Part IV of this book for a more detailed description of the comparability requirements of each of the methods.

60. ‘Tested party’ is a US term, however, the concept of a tested party is applied globally. Under profits-based methods (i.e., the CPM and TNMM), the tested party is ‘. . . the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments . . .’ (s. 1.482-5(b)(2)(i)).

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

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

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

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

*[b] Geographic Differences*

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

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

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

not available.<sup>62</sup> Second, less populous jurisdictions simply do not have the volume of companies required to allow for the identification of robust sets of comparables performing specialized functions in specialized industries.

Given these data limitations, many countries allow the use of comparable companies that operate in other countries with similar economic characteristics when sufficient local country data are not available. For example, the US regulations state:

Uncontrolled comparables ordinarily should be derived from the geographic market in which the controlled taxpayer operates, because there may be significant differences in economic conditions in different markets. If information from the same market is not available, an uncontrolled comparable derived from a different geographic market may be considered if adjustments are made to account for differences between the two markets. If information permitting adjustments for such differences is not available, then information derived from uncontrolled comparables in the most similar market for which reliable data is available may be used.<sup>63</sup>

One of the most common applications of this concept is the use of ‘pan-European’ or ‘pan-Asian’ sets of comparable companies to benchmark entities operating in a particular European or Asian country, respectively. For instance, a transfer pricing practitioner that is performing a benchmark analysis of an Italian distributor of farm equipment would likely have difficulty identifying a set of comparable companies comprised entirely of Italian distributors of farm or other heavy equipment. As such, the practitioner would be likely to expand the search to include companies operating in other European countries with similar economic and market characteristics. Similarly, practitioners often use pan-Asian sets of comparables when they cannot identify a sufficiently robust set of comparable companies in a particular Asian country.

In certain instances, tax authorities explicitly reject the use of foreign comparables when benchmarking companies located in their jurisdiction. For instance, Japan will not allow the use of comparable companies from other countries to benchmark the activities of a Japanese firm.<sup>64</sup>

Given the unique requirements of various tax jurisdictions, it may be prudent in certain circumstances for a taxpayer to work in conjunction with local country tax practitioners in foreign jurisdictions to ensure that any comparable company benchmarks identified will satisfy the local country tax authorities.

### **[8] Arm’s-Length Range**

Once a taxpayer or practitioner has identified a set of comparable companies and performed its transfer pricing planning analysis, the taxpayer needs to think strategically about what point within the arm’s-length range of results the company should target. In the US,

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62. There are a number of countries in which comparable company data are not widely available including, but not limited to: Austria, Brazil, Chile, Ecuador, Indonesia, Ireland, Israel, Italy, Kenya, Mexico, New Zealand, Peru, the Philippines, Poland, Portugal, Russia, South Africa, Switzerland, Turkey, and Vietnam. <http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-transfer-pricing-country-guide-2015.pdf>, accessed 3 May 2016.

63. Section 1.482-1(d)(4)(ii)(A).

64. At <https://www2.deloitte.com/us/en/pages/tax/articles/global-transfer-pricing-country-guide.html>, accessed 7 Apr. 2017.

section 1.482 acknowledges that the ‘application of a method may produce a number of results from which a range of reliable results may be derived. A taxpayer will not be subject to adjustment if its results fall within such a range (arm’s-length range).’<sup>65</sup> However, if all material differences between the comparable companies cannot be adjusted for, the taxpayer must increase the reliability of the results by using the interquartile range. The interquartile range is ‘the range from the 25th to the 75th percentile of the results derived from the uncontrolled comparables.’<sup>66</sup> The use of the interquartile range of results is meant to exclude potential outliers and, consequently, increase the reliability of the comparison of results. Under US law, a taxpayer’s results must generally fall within the interquartile range of results if it is to be considered operating at arm’s length. Similarly, Mexico and Germany have adopted the concept of the interquartile range.<sup>67</sup>

Certain local country rules and regulations do not contain a concept that is equivalent to the interquartile range.<sup>68,69</sup> Rather, a company’s results are considered to be arm’s length if they fall within the full range of results realized by the comparable companies (or the comparable transactions). As such, a non-US taxpayer that engages in intercompany transactions with a related party in the United States will need to ensure that the results of the party being benchmarked not only fall within the full range of results earned by the comparable companies, but also within the interquartile range of results. See Table 1.5 for an example.

*Table 1.5 Arm’s-Length Range Example*

<i>2014–2016 Weighted Average Operating Margin Results (%)</i>	
Observation 1	12.5
Observation 2	3.5
Observation 3	7.4
Observation 4	8.1
Observation 5	6.2
<b>Maximum</b>	<b>12.5</b>
<b>Upper quartile</b>	<b>8.1</b>
<b>Median</b>	<b>7.4</b>
<b>Lower quartile</b>	<b>6.2</b>
<b>Minimum</b>	<b>3.5</b>
<b>US related party</b>	<b>4.0</b>

65. Section 1.482-1(e)(1).

66. Section 1.482-1(e)(2)(iii)(C).

67. Note that the formula for computing the interquartile range differs between jurisdictions in certain instances.

68. For instance, Canadian law (CRA 87-2R p. 4) does not support the use of the interquartile range but also does not disapprove of the use of the interquartile range when presenting results in transfer pricing documentation (CRA TPM-16, 13 Feb. 2015).

69. However, para. 3.57 of OECD Guidelines now recognizes the concept of the interquartile range and its potential validity in certain circumstances.

In the example presented in Table 1.5, the US related party to the transaction earned an operating margin of 4.0% for its activities over the period 2014–2016. This result falls within the full range of results of the comparable companies over the same period (i.e., 3.5%–12.5%), but below the interquartile range of results (i.e., 6.2%–8.1%). Although the non-US tax authority would view this as an arm’s-length result, the IRS would require an adjustment (assuming that the taxpayer’s multi-year average result also fell outside of a multi-year average range). In this instance, the IRS would adjust the taxpayer’s single-year result (i.e., 2016) so that the taxpayer earned a margin equal to the median of the range of results (i.e., 7.4%) for the comparable companies in that year.<sup>70</sup>

To avoid such scenarios, taxpayers should generally set their transfer pricing policies to target a return that is comfortably within the interquartile range of results. In practice, taxpayers often target the median of the range. This has a number of potential benefits. First, since transfer prices are often set at the beginning of the year based on budget numbers, companies often miss their targeted result because of differences between their budgeted and actual financials. By targeting a point that is comfortably within the range, a company provides itself with a certain amount of leeway to miss its target and still fall within an acceptable range of results. Second, since comparable company results are likely to vary from year-to-year, a transfer pricing policy that targets a midpoint in the range will be more likely to fall within the range year-after-year as the comparable company data is updated for documentation purposes. Furthermore, tax authorities might view targeting the median of the range as a conservative tax strategy.

#### [9] *Single-Year Versus Multiple-Year Data*

In the above example, three-year average results for the tested party are compared to the three-year average results of the comparable companies. In practice, virtually all US and non-US transfer pricing practitioners rely on multiple year data when performing profits-based analyses (e.g., CPM or TNMM analyses). The US regulations state:

Data from multiple years may be considered to determine whether the same economic conditions that caused the controlled taxpayer’s results had a comparable effect over a comparable period of time on the uncontrolled comparables that establish the arm’s-length range.<sup>71</sup>

Similarly, the OECD Guidelines state:

Multiple year data should be considered in the transactional net margin method for both the enterprise under examination and independent enterprises to the extent their net margins are being compared, to take into account the effects on profits of product life cycles and short term economic conditions.<sup>72</sup>

In general, the use of multiple-year data is considered to be appropriate when there are variations in the year-to-year performance of the tested party and the comparable companies that are due to factors other than transfer pricing. Such variations are most

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70. Section 1.482-1(f)(2)(iii)(D[0]).

71. Section 1.482-1(f)(2)(iii)(C).

72. OECD Guidelines, para. 3.75.

commonly attributable to short-term changes in market conditions. For example, an economic downturn in a particular industry may not affect the performance of all of the companies in that industry at the same time. Rather, certain companies may be able to withstand the effects of a downturn in the industry longer than others. This type of timing difference can create inconsistencies in short-term results of companies within the same industry and can therefore make a single-year data comparison between the tested party and the comparable companies unreliable. To smooth out fluctuations in short-term results, most tax jurisdictions will allow taxpayers to take multiple years of data into consideration.

One notable exception, however, is Canada. Since the issuance of a 2002 article by Ronald Simkover, a CRA economist,<sup>73</sup> the CRA has often looked to single-year comparisons between tested party and comparable company data when determining whether an adjustment is warranted.

As such, any taxpayer that has transfer pricing issues in Canada must be especially vigilant about ensuring that its single-year results are consistent with the results of the comparable companies in that year. In addition, a company with Canadian transactions must be sure to document the single and multiple-year results of the analysis. When the results of the multiple-year comparison diverge from the single-year results, the taxpayer must be able to explain why the divergence exists and why one result may be more reliable than the other. Being aware of this issue at the outset of a project allows a company to set its transfer pricing policies in a way that will increase the likelihood that the company will be able to meet the varying requirements of the jurisdictions in which it operates. For instance, a company with an intercompany transaction between its US parent and Canadian subsidiary may want to target a more conservative point in its range of results to increase the probability that, at year end, its results will fall within both the three-year and single-year average ranges of results.

#### **[10] Specific Transactional Considerations**

Approaches to transfer pricing are continually evolving. As multinational entities become more complex and sophisticated, and as new ways of doing business emerge, intercompany transactions also become more complex and sophisticated. As such, tax authorities are faced with the task of analysing increasingly complex transactions without the benefit of explicit regulatory guidance on ways to price certain types of transactions. For example, few tax authorities have issued any significant guidance on analysing intercompany loan guarantees. Similarly, only a few jurisdictions have expressed a clear opinion on the treatment of stock option expenses related to service transactions and CSAs. The lack of regulatory guidance on such issues creates even more uncertainty than usual about the treatment of such transactions by various tax authorities and can make it very difficult for a company to price these types of transactions during the transfer pricing planning phase. When there is limited regulatory guidance on a particular issue, taxpayers should seek a local country practitioner's advice to

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73. Ronald I. Simkover, 'Transfer Pricing: Acceptable Arm's-length Prices Within the Range', Canadian Tax Foundation, 2002 Conference Report, 17:1-17:12.

determine how the tax authority in that jurisdiction is dealing with these issues in practice. If there is a significant divergence between the rules in various jurisdictions, the taxpayer should explore different strategies for addressing the issue and take the position that provides the right risk/reward profile for the company. Loan guarantees and stock option expense transactions are explicitly addressed in the following subsections.

[a] *Loans and Loan Guarantees*

Regulatory frameworks that apply to the pricing and deductibility of interest expense are numerous and diverse. For example, many countries have ‘thin cap’ regimes, whereby a specific limit is placed on the amount of interest expense that can be deducted for tax purposes. Limits are usually expressed as a ratio of debt to equity or a ratio of interest expense to a profit-based variable such as EBIT or EBITDA. The OECD’s Action 4 guidance suggests a fixed ratio rule that limits interest expenses deductions to a fixed ratio between 10% and 30% of EBITDA. This rule can be supplemented with a group ratio rule, which would tie an entity’s limits on interest expense deductions to the group’s total net third party interest expense, or targeted rules to address specific risks. The arm’s length standard may still apply when pricing interest rates if thresholds for deductibility under a thin cap regime or an Action 4 rule are not met. Finally, countries may have unique rules or legal precedents that govern whether a transaction can be characterized as debt in the first place, and whether any interest expense can be deducted at all.

In the United States, the IRS issued final section 385 regulations on 13 October 2016 that were designed to address earnings stripping associated with corporate tax inversions. These regulations focus specifically on intercompany debt issued by US companies and contain expanded loan documentation requirements<sup>74</sup> as well as modified rules related to the characterization of debt instruments.<sup>75</sup> While the formal documentation requirements under section 385 will only apply to relevant debt instruments that will be issued on or after 1 January 2019, the issuance of these regulations serves as a signal of increased IRS scrutiny related to intercompany financing transactions.<sup>76</sup> On 21 April 2017, as part of Executive Order 13789, the US Treasury was charged with identifying and providing recommendations for regulations that impose an undue burden on US taxpayers, add undue complexity to the U.S. federal tax laws, and/or exceed the statutory authority of the IRS. On 16 October 2017, Treasury determined that certain aspects of the section 385 Regulations could potentially impose an undue burden on taxpayers. This was despite the fact that, in Notice 2017-36, the Treasury and IRS announced that application of the section 385 documentation regulations would be delayed until 2019. The Tax Reform and Jobs Act implemented new, stricter interest expense deduction limitations, which may help to alleviate certain problems that the 385 documentation regulations were attempting to solve. However, as of the writing of this chapter, no

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74. Treasury Regs. s. 1.385-2.

75. Treasury Regs. s. 1.385-3.

76. Johnson, Michelle, ‘385 Documentation – Three Actions to Take Now’, Duff & Phelps, 22 Feb. 2017, p. 14.

further legislative action has been taken with the regulations and they still remain in effect starting January 2019.<sup>77</sup>

The result is a complex, overlapping set of standards governing financing transactions. Companies with a pattern of frequent intercompany financing transactions or high-volume transactions should ensure they have a robust inventory of their annual transactions and can sufficiently monitor how those transactions might be impacted by the various rules or restrictions in relevant countries. In addition, tax departments should work closely with treasury departments to ensure that interest pricing policies are informed by tax rules.

The lack of regulatory guidance related to guarantee fees has led to uncertainty about the treatment of such fees in various jurisdictions. Evidence suggests that the IRS believes that the guarantor should be compensated through a guarantee fee for providing financial backing to its subsidiary.

In contrast, the CRA has disallowed deductions for guarantee fees paid by Canadian subsidiaries to non-Canadian parents (*see* General Electric Capital Canada Inc., T.C. of Canada, No. 2006-1385(IT)G and 2006-1386(IT)G).

*[b] Stock Option Expense*

Similarly, the US services and cost sharing regulations explicitly require the inclusion of stock option expenses in the calculated cost of services (§1.4829(j)) and in the calculation of intangible development costs within CSAs (§1.482-7(d)(3)). Treatment of these expenses varies between jurisdictions. For instance, Peru, the Philippines, Singapore, South Africa, Taiwan and the United States all allow for the inclusion of stock option expenses in the cost base for intercompany service charges and CSAs. However, Canada and Denmark generally disallow deductions related to stock option expenses.<sup>78</sup> While the IRS position on inclusion of these SBC is explicitly outlined in regulatory guidance, the IRS issued a directive on 12 January 2018, providing instructions to its LB&I examiners to suspend any examinations, related to the addition of stock-based compensation ('SBC') to intangible development costs within cost sharing arrangements, until the Ninth Circuit issues an opinion in the *Altera* case<sup>79</sup> currently under appeal.<sup>80</sup>

**[B] Phase 2: Implementation**

The planning, analysis and documentation phases of transfer pricing are guided heavily by economic and financial theory. In contrast, the implementation phase of any transfer pricing project involves practical considerations that are unique to the internal political

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77. Executive Order 13789-Second Report to the President on Identifying and Reducing Tax Regulatory Burdens: A Proposed Rule by the Treasury Department on 10/16/2017; <https://www.federalregister.gov/documents/2017/10/16/2017-22205/executive-order-13789-second-report-to-the-president-on-identifying-and-reducing-tax-regulatory>, accessed on 16 May 2018.

78. At <https://www2.deloitte.com/us/en/pages/tax/articles/global-transfer-pricing-country-guide.html>, accessed 8 May 2018.

79. For more background on the *Altera* case, please refer to §18.05[L] of this guide.

80. LB&I-04-0118-005: Memorandum for Large Business and International Division Employees (12 Jan. 2018).

structure of the taxpayer, its day-to-day operations, and its internal accounting and financial management systems. In addition, although transfer pricing practitioners are often hired to assist a company with developing transfer pricing policies, a taxpayer is often left to its own devices to implement that policy. The implementation process can be complex and arduous, so it is important for a company to have well thought out procedures in place for implementing new transfer pricing policies.

This section describes key implementation steps, provides guidance on some of the most common implementation issues and discusses best practices for taxpayers when navigating through the implementation process.

**[1] Key Implementation Steps and Timeline**

Once a company has established its transfer pricing policies, the company enters the implementation phase. The implementation phase typically consists of the following five broad steps:

- Step 1: Communicating transfer pricing policies to key stakeholders
- Step 2: Drafting and executing intercompany agreements
- Step 3: Determining internal pricing mechanisms
- Step 4: Monitoring results
- Step 5: Developing transfer pricing policy manuals or guides.

Each of these steps is described in detail below.

**[a] Step 1: Communicating Transfer Pricing Policies to Key Stakeholders**

Generally, the tax department is responsible for transfer pricing compliance, identifying transfer pricing planning exposures/opportunities and amending existing transfer pricing policies as needed as the taxpayer's business evolves. Therefore, the tax team bears the responsibility of communicating its objectives to the key internal stakeholders. This is to ensure that the tax objectives are well aligned with the company's broader corporate and operational objectives. The key stakeholders include: (1) local country tax personnel; (2) senior management (such as the CFO); (3) relevant operations personnel; (4) the IT, accounting, and finance department personnel who will be responsible for the back office support related to the implementation effort; (5) the legal department; and (6) the company's tax planning and compliance advisors.

**[i] Local Country Tax Personnel**

Transfer pricing policies are often implemented on a global level, and changes to transfer pricing policies are commonly initiated by headquarters. For the headquarters of any company, this means that it must clearly communicate its objectives to the local country tax personnel to ensure that the company's global tax objectives do not conflict with its local country tax objectives. In addition, headquarters personnel may rely on the local country tax personnel to communicate a change in policy to key local country operations personnel.

[ii] Senior Management

When implementing changes, the tax department will usually need buy-in from senior management. This likely includes the CFO and Controller, but may also include other executives such as the chief executive officer (CEO) and chief operations officer (COO), depending on the size of the organization and the materiality of the transfer pricing issue.

Generally, buy-in from senior management is critical for several reasons. First, it is important to ensure that the objectives of the tax department are well aligned with the company's overall corporate strategy. Second, there are times when changes in transfer pricing policies can have unintended effects that require attention from senior personnel.<sup>81</sup> It is therefore critical that senior management is well informed of any material changes in pricing policies so they are not caught off guard if issues arise. When approaching the CFO, Controller, or other senior management about a change in transfer pricing policy, it is important to be able to clearly communicate: (1) the reasons for the change; (2) the expected tax implications of the change (transfer pricing and other); (3) any identified risks; and (4) the anticipated tax and financial statement impact, as applicable.

[iii] Operations Personnel

From an operations perspective, the most common issue that arises during the implementation phase is related to employee incentive structures. In many instances, employee incentive structures are tied to the performance of business units – either through some measure of revenue generation, cost savings, or profitability, among others. Since a change in transfer pricing will affect the performance of a business as reported on its legal entity financial statements, a company that does not keep separate management financials (or whose managerial books are tied to the legal entity financials) may unintentionally alter its employee incentive structure.

Taxpayers must ensure that changes in the company's transfer pricing policies do not cause unintended changes in employee incentive structures or other operational metrics used for managing the business, and the tax department must make a concerted effort to address these issues with operations personnel when changes are made. Having an open line of communication between the tax and operations personnel is critical to avoiding any such mishaps.

[iv] IT and Accounting Departments

In addition to communicating changes in transfer pricing policies to management and operations personnel, it is equally important to clearly communicate the changes to the company's IT and accounting departments.

IT Department

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81. For instance, a change in a transfer pricing policy could have the unintended effect of altering the incentive/compensation structure of an employee or a group of employees. See s. 1.6.1.1.3 for a detailed example.

A company's IT systems play a key role in the transfer pricing implementation process. Specifically, the systems must be capable of supporting the implementation of the policy and monitoring the results of the relevant businesses once the policy has been put into place. More specifically, the systems must be capable of tracking segmented legal entity financial data, intercompany payments between legal entities, individual employee time spent adjusting payments and terms, and, ideally, flagging any potential issues, such as an underpayment or overpayment between two entities.

Given the importance of IT systems to the implementation process, the tax department will need to clearly communicate its objectives to the IT department when implementing its transfer pricing policies. Tax personnel should work with IT personnel to determine the most effective way to implement the policies given any constraints posed by the company's internal IT systems.

#### Accounting Department

The accounting department will be responsible for ensuring that the transfer pricing policies flow through the financial statements of the relevant legal entities. As such, any intercompany invoices that are issued must reflect the appropriate pricing. In addition, it may be strategically important to ensure that third-party invoices are issued from a particular entity, given the function and risk profile of that entity for transfer pricing purposes.

As with the IT department, it will be important for tax personnel to clearly communicate any changes in policy to the accounting department to ensure that all of these factors are taken into consideration, and that the policies can be easily monitored.

#### [v] Legal Department

An important step in the implementation process is the drafting and execution of intercompany agreements. A company's legal department generally plays an important role in this process. The legal department should, therefore, be informed any time a new transfer pricing policy is put in place or an existing policy is changed to ensure that these changes are incorporated in the company's agreements.<sup>82</sup>

#### [vi] Tax Planning and Compliance Advisors

Ideally, the company's tax advisors will be consulted during the planning phase to ensure that the policies are consistent with local country rules and regulations and the company's overall tax objectives. Changes in transfer pricing policies should be vetted with the company's tax planning and compliance advisors for several reasons.

First, a company's tax advisors can inform the taxpayer of any potential risks associated with the change. Second, they are likely to have helpful insight into implementation issues through their experiences with other taxpayers. Third, any changes in the company's transfer pricing policies will need to be incorporated into year-end documentation.

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82. This is discussed in more detail in s. 1.6.1.2.

*[b] Step 2: Drafting and Executing Intercompany Agreements*

Once a transfer pricing policy has been set and the key stakeholders informed, a taxpayer will want to memorialize that policy in an intercompany agreement. Intercompany agreements provide a forum for the taxpayer to, at the outset of an arrangement, describe the functions and risks of the parties to the transaction, their rights and obligations under the contract, and the corresponding pricing policy or policies.

A well-constructed agreement should provide the right balance between formalizing the policy and maintaining the flexibility to change that policy.

Listed below are a few best practices related to drafting intercompany agreements:

- (1) The agreement should be drafted and executed at the time the policy is put into place.
- (2) It should reflect the functions and risks actually being undertaken by the parties to the transaction (i.e., the form should match the economic substance of the transaction).
- (3) The agreement should be flexible. For instance, parties should not enter into agreements for unduly long periods of time.
- (4) The terms of the arrangement should allow the taxpayers to make periodic adjustments to the transfer price throughout the year to align actual results with forecasts. It may also be desirable to allow the pricing terms of the agreement to change (upon mutual agreement of the parties) to reflect changes in market conditions. It is important to note if such pricing changes need to be made, they should not be made in a way that fundamentally changes the allocation of risk under the agreement.
- (5) All intercompany agreements should be reviewed by tax personnel and legal counsel prior to execution.

Tax authorities typically request any such relevant intercompany agreements during an audit. Intercompany agreements, in conjunction with contemporaneous documentation, can be a key element in defending a company's pricing policies and its tax return position; however, companies should be wary of instances in which the terms of the intercompany agreements may not match the economic substance of the transaction (i.e., the relevant parties engage in functions or bear risks that do not match the terms set forth in the agreement).

If a disparity exists between the form and substance of a transaction, the tax authority, if allowed under the rules of the relevant country, must determine whether to respect the terms of the contract or impute pricing terms that are consistent with the actual behaviour of the parties to the transaction. Tax jurisdictions have differing opinions on – and approaches to – this issue. For instance, the US regulations state:

If the contractual terms [of an agreement] are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.<sup>83</sup>

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83. Section 1.482-1(d)(3)(ii)(B)(1).

Based on this guidance, the IRS will typically follow the economic substance of the intercompany transaction when evaluating the pricing terms regardless of whether or not there is an intercompany agreement in place. In contrast, certain countries (e.g., Germany), tend to place far more emphasis on the existence of and language in the intercompany agreement itself. In certain scenarios, these conflicting perspectives lead to significantly different results and potential adjustments.

To avoid potential issues, companies should ensure that the terms of the arrangement are consistent with the true economic substance of the transaction. In addition, companies should keep their intercompany agreements up-to-date by reflecting any changes in the functions and risks being performed by the parties to the transaction in the agreement in a timely manner. In addition, any changes in pricing terms should be immediately reflected in the intercompany agreement.

*[c] Step 3: Determining Internal Pricing Mechanism*

In many instances, the results of a transfer pricing analysis (as well as the pricing terms outlined in the intercompany arrangement) are expressed in terms of an arm's-length range of results (e.g., the manufacturing segment should earn an operating margin<sup>84</sup> of between 3% and 6%). The taxpayer can pick any point within that range including the lower or upper bound. When implementing its transfer pricing policy, the taxpayer will want to think strategically about its objectives to determine what point it wants to target within the range. For a company that is interested in minimizing the taxable income in a particular jurisdiction, it may make sense to target a point close to the bottom of the range. Conversely, a company that wants to take advantage a favourable tax rate in a particular jurisdiction may want to target a point close to the top of the range. However, as discussed in §1.02[A][8], companies often target the median, or midpoint, of the range of results to be conservative.

Once a taxpayer has determined its target point within the range, it must go about determining how to actually achieve that result. It can be particularly challenging for companies to implement transfer pricing policies based on profitability ratios that rely on operating income (e.g., operating margin, return on total operating costs, return on operating assets, return on invested capital) since it is often very difficult to track and allocate general, administrative, and overhead expenses to specific products or business segments.

As such, companies typically need to perform some analysis at the beginning of the year, using budget numbers, to determine an appropriate mechanism for pricing its transactions (*see* Table 1.6).

In the example shown in Table 1.6, the manufacturing segment of LabCo has budgeted operating costs of USD 95.0 million (USD 65.5 million + USD 25.5 million + USD 4.0 million). In order to target a 5% operating margin, the company would need to charge its related-party entity USD 100 million, or a markup on its total operating

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84. Operating margin is equal to operating profit (or earnings before interest and tax, 'EBIT') divided by net sales.

Table 1.6 Hypothetical Example of an Internal Pricing Mechanism

<i>LabCo – Manufacturing Segment</i>	
	<i>Annual Budget (in USD '000s)</i>
Intercompany Revenue Target	USD 100,000
Third party COGS	USD 65,500
Gross profit	USD 34,500
Gross margin	34.5%
Operating expenses	USD 25,500
Depreciation and amortization	USD 4,000
Operating profit	USD 5,000
Target operating margin	5%
Arm's-length range	3%–6%

costs<sup>85</sup> of approximately 5.3% (USD 5 million/USD 95 million). In practice, however, LabCo does not track operating expenses or depreciation and amortization separately for its related-party manufacturing segment. Rather, these expenses are solely tracked for the legal entity as a whole (including its other business lines). Estimated allocations are made only at the beginning of the year, when budget financials are prepared and transfer pricing policies are set, with true-ups at the end of the year, when the company's transfer pricing documentation report is compiled.

Because of this, LabCo needs to develop an alternative mechanism for implementing its transfer pricing policy. In this instance, the most straightforward approach would be to target a markup on the segment's manufacturing COGS. Although LabCo does not separately track expenses that fall below the gross profit line, it does know exactly what direct manufacturing costs (i.e., COGS) are attributable to the product line it sells to its related party. Using budget numbers, LabCo can estimate the markup on its COGS that would be required to cover the total estimated operating expenses of its manufacturing segment. In the above example, LabCo estimates its third-party COGS will be USD 65.5 million. If the company wants to target USD 100 million in revenue, it must charge its related party its manufacturing costs (i.e., COGS) plus a markup of 52.7%  $[(\text{USD } 100 \text{ million} / \text{USD } 65.5 \text{ million}) - 1]$ .<sup>86</sup> Based on this information and the desire for a simplified policy, Labco determines that it will charge its related party its manufacturing costs plus 50%.

This type of strategy (i.e., applying a standard markup) is particularly appealing to a company that sells a variety of product lines because it can apply a single markup across all products. However, there may be reasons that a company wants its business segment to charge different markups on different product lines (e.g., issues with customs). In the United States, companies have the flexibility to implement policies

85. Section 1.482-1(f)(2)(v)(A).

86. Section 1.482-1(f)(2)(v)(A).

in any way they choose, as long as the overall result is consistent with arm's-length pricing.<sup>87</sup> The US regulations state:

In evaluating whether the result of a controlled transaction is arm's-length, it is not necessary for the district director to determine whether the method or procedure that a controlled taxpayer employs to set the terms for its controlled transactions corresponds to the method or procedure that might have been used by a taxpayer dealing at arm's-length with an uncontrolled taxpayer. Rather, the district director will evaluate the result achieved rather than the method the taxpayer used to determine its prices.<sup>88</sup>

However, there are tax authorities that place greater emphasis on the need for pricing policies to be memorialized in intercompany agreements prior to the beginning of the tax year (e.g., HMRC and the German Ministry of Finance), and therefore do not allow the same level of flexibility. In addition, certain tax authorities may, in fact, want to see product-by-product markups. For these reasons, it is critical for companies to understand the unique requirements of the jurisdictions in which they are operating.

*[d] Step 4: Monitoring*

Once a transfer pricing policy is set, it becomes the job of the tax department to monitor the financial results of the relevant business segments to ensure the transfer pricing policies are creating the intended results. Many large multinationals have established Transfer Pricing Committees, which are internal groups of individuals who are responsible for reviewing a company's transfer pricing initiatives, priorities and results every quarter to address any problems as they arise. In smaller companies, it may be sufficient to have one-or-two individuals monitor transfer pricing results periodically to ensure that the company's objectives are achieved.

Unless a company is able to predict its revenue and/or cost structure with a high degree of accuracy from year to year, it is often extremely difficult for it to implement pricing policies that will achieve a particular result without performing periodic adjustments.

Consequently, it is prudent for companies to monitor their results on a periodic basis (typically monthly or quarterly) and perform adjustments as needed. This type of adjustment mechanism is particularly important for companies operating in jurisdictions in which taxpayer-initiated adjustments are not permitted after the financial books are closed (e.g., Australia, China, Czech Republic, Spain, and the United Kingdom).<sup>89</sup> Taxpayers that engage in intercompany transactions involving entities in these jurisdictions must be particularly vigilant about ensuring any pricing adjustments flow through the financial statements prior to year-end. If they fail to do so, they are at risk of double-taxation.

Because so many jurisdictions restrict taxpayers' ability to make self-initiated adjustments following year end, it is always preferable for a company to have systems

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87. Section 1.482-1(f)(2)(v)(A).

88. Section 1.482-1(f)(2)(v)(A).

89. Deloitte 2016 Global Transfer Pricing Country Guide; <https://www2.deloitte.com/ru/en/pages/tax/articles/2016/global-transfer-pricing-guide.html>, accessed 7 May 2018.

in place that allow it to monitor and adjust its transfer pricing policies periodically throughout the fiscal year. It is generally advisable to review transfer pricing results on a quarterly basis to make sure that proper pricing is being achieved. Although there are mechanisms by which a taxpayer may be able to avoid double taxation (e.g., Appeals and/or Competent Authority),<sup>90</sup> the processes are long and arduous and can be cost prohibitive.

*[e] Step 5: Developing Transfer Pricing Policy and Procedure Manuals*

In particularly complex situations, it may be prudent for a taxpayer to develop an internal guide for its employees to help them navigate through the implementation process. This type of guide can take a number of forms and it can be developed for a number of different audiences. The following common examples will be described in more detail below:

- accounting and systems manuals;
- headquarter service allocation manuals; and
- tax department policy and procedures manuals.

*[i] Accounting and Systems Manuals*

Accounting and systems manuals are developed for the finance, accounting, and IT personnel who are responsible for the day-to-day implementation of the transfer pricing policies. The accounting manual typically includes instructions regarding intercompany invoicing and collections activities, while the systems manual includes details on the requirements of the time tracking systems and the systems used to monitor the transfer pricing policies.

*[ii] Headquarter Service Allocation Manuals*

Many companies have management fee structures that require a detailed headquarter services analysis. Headquarter service allocation models require individuals to track time spent on different types of activities. For instance, individuals will need to separately track time spent on activities performed for the benefit of the group as a whole, specific foreign affiliates, or the parent (i.e., stewardship). As such, it can be extremely helpful for a company to develop a time reporting manual that provides guidance to headquarters personnel regarding time classification. A well-developed time reporting system and manual can dramatically reduce the work required at year end to support the company's management fee charges. In addition, it allows for simplified monitoring throughout the year.

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90. See s. 1.8.2.2 for a discussion of Mutual Agreement Procedures (MAPs) (such as competent authority assistance).

[iii] Tax Department Policy and Procedures Manuals

The tax department has overall responsibility for developing and monitoring the company's transfer pricing policies. As such, it may be helpful to develop a manual for tax personnel that details reporting, monitoring, and communications procedures. Ideally, this manual will be developed for the global tax team so the company can ensure consistency in the group's transfer pricing policies and procedures.

**[C] Phase 3: Compliance and Documentation**

Once a company's transfer pricing policies have been developed and implemented, the company enters the compliance phase of the transfer pricing lifecycle. The compliance phase includes documenting the arm's-length nature of the company's intercompany pricing policies.

**[1] Documentation Strategies and Considerations**

The phrase 'transfer pricing documentation' generally refers to a study or report that justifies the manner in which a company prices its intercompany transactions for a particular fiscal year. In most cases companies prepare such reports for the primary purpose of avoiding the assessment of penalties by the authorities due to 'misstatements' in its intercompany pricing. Such reports are usually backward looking, in that they are written after the fiscal year end to justify pricing results for the period corresponding to the filing of a tax return. A second, and closely related purpose is to avoid unfavourable transfer pricing adjustments by demonstrating that the company's transfer pricing satisfies the requirements and expectations of the tax authorities (so that no adjustment is necessary).

Transfer pricing documentation requirements have proliferated considerably in recent years. As recently as the 1990s, only five jurisdictions had effective documentation requirements, whereas by 2016 the number approached sixty-nine.<sup>91</sup>

Documentation requirements vary by jurisdiction. The following categories of information are usually always required:

- summary of the company's business;
- overview of the intercompany transactions; - detailed description of the functions and risks of the legal entities involved in the transactions;
- explanation of the transfer pricing method selected to price the transactions; and
- economic analysis demonstrating the application of such method.<sup>92</sup>

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91. Deloitte 2016 Global Transfer Pricing Country Guide; <https://www2.deloitte.com/ru/en/pages/tax/articles/2016/global-transfer-pricing-guide.html>, accessed 7 May 2018.

92. Note that many countries have checklists of what must be included in transfer pricing documentation reports in order to qualify for penalty protection. In the United States, for example, Treasury Regs. s. 1.6662-6 provides for 'ten principal documents'. See the US chapter of this work for a description of such documents.

When companies once needed to produce such reports for the one or two countries in which they had operations and for which documentation requirements existed, this tended to be a tedious, but somewhat tolerable process. Now that more and more countries require such effort, multinational companies face an enormous burden. When CbC reporting requirements contained in BEPS Action Item 13 were officially enacted, it further increased the compliance burden of MNEs.

In addition to the increasing number of countries requiring documentation, the trend in the global compliance environment is towards heightened scrutiny by tax authorities. Requests for documentation are becoming mandatory on tax examiners' checklists, and in practice, the threshold for sufficient documentation is climbing higher. Many European countries have established dedicated transfer pricing audit enforcement teams.<sup>93</sup> In the United States, the IRS issued a directive in 2003 requiring examiners to request transfer pricing documentation in large and medium-sized business audits.<sup>94</sup> Further, on 17 September 2015, the IRS announced a significant reorganization of its Large Business & International ('LB&I') division, which it hopes will allow it to apply a more issue-based approach to identifying and addressing compliance risks.

In addition to increased scrutiny from tax examiners, increased requirements for disclosure of uncertain tax positions for purposes of financial reporting have attracted greater attention to transfer pricing from audit committees, financial statement auditors, and CFOs.

The most important driver of this change in the United States is the issuance of ASC 740, an accounting standard with which all companies that issue US GAAP financial statements must comply. Financial statement auditors require significant supporting documentation to approve ASC 740 reserves that are affected by transfer pricing.

These trends have placed a significantly increased burden on companies with finite resources and budgets, and staff that are continuously being stretched thin. Tax departments can no longer address all issues, despite the best intentions of the parties involved. In the meantime, the factors that contribute to tightened budgets and resource strain (e.g., slowing economy and decreasing revenues) are those that will cause governments to become even more aggressive in their pursuit of transfer pricing adjustments in the years to come. This suggests that if a company does not devote enough resources to establishing appropriate transfer pricing policies and preparing sufficient transfer pricing documentation in current years, it could result in serious issues and significant costs in future years.

As the global regulatory environment grows increasingly more complex, some multinational companies have looked to technology solutions to mitigate the increased compliance burden and risks. It is no longer enough for companies to just satisfy documentation requirements. They may also be required to prove documented policies

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93. Ernst & Young LLP. *Global Transfer Pricing Survey 2014* [www.ey.com/Publication/vwLUAssets/EY-global-transfer-pricing-tax-authority-survey/\\$FILE/ey-2014-global-transfer-pricing-tax-authority-survey.pdf](http://www.ey.com/Publication/vwLUAssets/EY-global-transfer-pricing-tax-authority-survey/$FILE/ey-2014-global-transfer-pricing-tax-authority-survey.pdf), accessed 15 Jul. 2015.

94. Internal Revenue Service. 'LMSB Commissioner Directive: Transfer Pricing Compliance Process' 22 Jan. 2003. <http://www.irs.gov/Businesses/International-Businesses/Transfer-Pricing-Compliance-Directive>, accessed 15 Jul. 2015.

to tax authorities and technology can assist with that process.<sup>95</sup> Companies offer scalable software solutions addressing a range of transfer pricing compliance functions, including data and process as well as economic analysis.<sup>96</sup>

To create an appropriate balance, tax departments of multinational companies need to be thoughtful when deciding how to prepare their documentation, and what level of documentation they need. Before embarking on a documentation project, tax directors must maintain a strategic mindset and ask important questions, such as:

- What countries should be covered?
- Which transactions are most important?
- In what format should the documentation be produced?
- When should outside experts be employed to prepare the documentation instead of using internal resources?

Approaching transfer pricing issues with these questions in mind can help focus the decision-making process related to documentation. The answers will be different for every firm, but §1.02[C][1][a] provides a tool that companies can use to develop their documentation strategy.

*[a] Performing a Risk Assessment to Optimize Documentation Strategy*

A transfer pricing risk assessment can help a company make decisions regarding prioritizing transfer pricing documentation needs. To properly perform such an assessment, companies must understand the risks associated with not preparing documentation, as well as the various options for creating documentation. Each of these concepts is discussed further below.

*[i] What Protection Do Transfer Pricing Documentation Reports Provide?*

Incomplete or inadequate transfer pricing documentation can have a measurable impact on a company. Exposure may be related to a company's intercompany transactions, its overall tax position, and its audit history. Specifically, non-compliance can result in:

- *Penalties.* Transfer pricing adjustments are subject to penalties in many jurisdictions, and proper documentation is the only mechanism available to mitigate this exposure.
- *Adjustments.* In cases where companies cannot pursue relief from double taxation through Competent Authority or other mechanisms, or where an adjustment leads to a net increase in taxable income in a higher tax jurisdiction, the lack of transfer pricing documentation can increase the likelihood of adjustments, and could lead to a higher overall effective tax rate or double taxation.
- *Financial reporting concerns.* Due to ASC 740 and other measures that have heightened scrutiny of tax positions for financial reporting purposes, the lack of

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95. At <https://tax.thomsonreuters.com/wp-content/pdf/onesource/transfer-pricing/leveraging-technology.pdf> , accessed 15 May 2018.

96. At <https://www.worldfinance.com/wealth-management/the-challenge-of-transfer-pricing-can-be-solved-with-key-technology>, accessed 15 May 2018.