Chapter I

The arm's length principle

A. Introduction

1.1. This Chapter provides a background discussion of the arm's length principle, which is the international transfer pricing standard that OECD member countries have agreed should be used for tax purposes by MNE groups and tax administrations. The Chapter discusses the arm's length principle, reaffirms its status as the international standard, and sets forth guidelines for its application.

1.2. When independent enterprises transact with each other, the conditions of their commercial and financial relations (e.g. the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces. When associated enterprises transact with each other, their commercial and financial relations may not be directly affected by external market forces in the same way, although associated enterprises often seek to replicate the dynamics of market forces in their transactions with each other, as discussed in paragraph 1.5 below. Tax administrations should not automatically assume that associated enterprises have sought to manipulate their profits. There may be a genuine difficulty in accurately determining a market price in the absence of market forces or when adopting a particular commercial strategy. It is important to bear in mind that the need to make adjustments to approximate arm's length conditions arises irrespective of any contractual obligation undertaken by the parties to pay a particular price or of any intention of the parties to minimise tax. Thus, a tax adjustment under the arm's length principle would not affect the underlying contractual obligations for non-tax purposes between the associated enterprises, and may be appropriate even where there is no intent to minimise or avoid tax. The consideration of transfer pricing should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes.

1.3. When transfer pricing does not reflect market forces and the arm's length principle, the tax liabilities of the associated enterprises and the tax revenues of the host jurisdictions could be distorted. Therefore, OECD member countries have agreed that for tax purposes the profits of associated enterprises may be adjusted as necessary to correct any such distortions and thereby ensure that the arm's length principle is satisfied. OECD member countries consider that an appropriate adjustment is achieved by establishing the conditions of the commercial and financial relations that they would expect to find between independent enterprises in comparable transactions under comparable circumstances.

1.4. Factors other than tax considerations may distort the conditions of commercial and financial relations established between associated enterprises. For example, such enterprises may be subject to conflicting governmental pressures (in the domestic as well as foreign country) relating to customs valuations, anti-dumping duties, and exchange or price controls. In addition, transfer price distortions may be caused by the cash flow requirements of enterprises within an MNE group. An MNE group that is publicly held may feel pressure from shareholders to show high profitability at the parent company level, particularly if shareholder reporting is not undertaken on a consolidated basis. All of these factors may affect transfer prices and the amount of profits accruing to associated enterprises within an MNE group.

1.5. It should not be assumed that the conditions established in the commercial and financial relations between associated enterprises will invariably deviate from what the open market would demand. Associated enterprises in MNEs sometimes have a considerable amount of autonomy and can often bargain with each other as though they were independent enterprises. Enterprises respond to economic situations arising from market conditions, in their relations with both third parties and associated enterprises. For example, local managers may be interested in establishing good profit records and therefore would not want to establish prices that would reduce the profits of their own companies. Tax administrations should keep these considerations in mind to facilitate efficient allocation of their resources in selecting and conducting transfer pricing examinations. Sometimes, it may occur that the relationship between the associated enterprises may influence the outcome of the bargaining. Therefore, evidence of hard bargaining alone is not sufficient to establish that the transactions are at arm's length.

B. Statement of the arm's length principle

B.1. Article 9 of the OECD Model Tax Convention

1.6. The authoritative statement of the arm's length principle is found in paragraph 1 of Article 9 of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties involving OECD member countries and an increasing number of non-member countries. Article 9 provides:

> [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.

By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances (i.e. in "comparable uncontrolled transactions"), the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the transactions between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions. Such an analysis of the controlled and uncontrolled transactions, which is referred to as a "comparability analysis", is at the heart of the application of the arm's length principle. Guidance on the comparability analysis is found in Section D below and in Chapter III.

1.7. It is important to put the issue of comparability into perspective in order to emphasise the need for an approach that is balanced in terms of, on the one hand, its reliability and, on the other, the burden it creates for taxpayers and tax administrations. Paragraph 1 of Article 9 of the OECD Model Tax Convention is the foundation for comparability analyses because it introduces the need for:

- A comparison between conditions (including prices, but not only prices) made or imposed between associated enterprises and those which would be made between independent enterprises, in order to determine whether a re-writing of the accounts for the purposes of calculating tax liabilities of associated enterprises is authorised under Article 9 of the OECD Model Tax Convention (see paragraph 2 of the Commentary on Article 9); and

- A determination of the profits which would have accrued at arm's length, in order to determine the quantum of any re-writing of accounts.

1.8. There are several reasons why OECD member countries and other jurisdictions have adopted the arm's length principle. A major reason is that the arm's length principle provides broad parity of tax treatment for members of MNE groups and independent enterprises. Because the arm's length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment.

1.9. The arm's length principle has also been found to work effectively in the vast majority of cases. For example, there are many cases involving the purchase and sale of commodities and the lending of money where an arm's length price may readily be found in a comparable transaction undertaken by comparable independent enterprises under comparable circumstances. There are also many cases where a relevant comparison of transactions can be made at the level of financial indicators such as mark-up on costs, gross margin, or net profit indicators. Nevertheless, there are some significant cases in which the arm's length principle is difficult and complicated to apply, for example, in MNE groups dealing in the integrated production of highly specialised goods, in unique intangibles, and/or in the provision of specialised services. Solutions exist to deal with such difficult cases, including the use of the transactional profit split method described in Chapter II, Part III of these Guidelines in those situations where it is the most appropriate method in the circumstances of the case.

1.10. The arm's length principle is viewed by some as inherently flawed because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses. There are, however, no widely accepted objective criteria for allocating between associated enterprises the economies of scale or benefits of integration resulting from group membership. The issue of possible alternatives to the arm's length principle is discussed in Section C below.

1.11. A practical difficulty in applying the arm's length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Such transactions may not necessarily be motivated by tax avoidance but may occur because in transacting business with each other, members of an MNE group face different commercial circumstances than would independent enterprises. Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises. The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length.

1.12. In certain cases, the arm's length principle may result in an administrative burden for both the taxpayer and the tax administrations of evaluating significant numbers and types of cross-border transactions. Although associated enterprises normally establish the conditions for a transaction at the time it is undertaken, at some point the enterprises may be required to demonstrate that these are consistent with the arm's length principle. (See discussion of timing and compliance issues in Sections B and C of Chapter III and at Chapter V on Documentation). The tax administration may also have to engage in this verification process perhaps some years after the transactions have taken place. The tax administration would review any supporting documentation prepared by the taxpayer to show that its transactions are consistent with the arm's length principle, and may also need to gather information about comparable uncontrolled transactions, the market conditions at the time the transactions took place, etc., for numerous and varied transactions. Such an undertaking usually becomes more difficult with the passage of time.

1.13. Both tax administrations and taxpayers often have difficulty in obtaining adequate information to apply the arm's length principle. Because the arm's length principle usually requires taxpayers and tax administrations to evaluate uncontrolled transactions and the business activities of independent enterprises, and to compare these with the transactions and activities of associated enterprises, it can demand a substantial amount of data. The information that is accessible may be incomplete and difficult to interpret; other information, if it exists, may be difficult to obtain for reasons of its geographical location or that of the parties from whom it may have to be acquired. In addition, it may not be possible to obtain information from independent enterprises because of confidentiality concerns. In other cases information about an independent enterprise which could be relevant may simply not exist, or there may be no comparable independent enterprises, e.g. if that industry has reached a high level of vertical integration. It is important not to lose sight of the objective to find a reasonable estimate of an arm's length outcome based on reliable information. It should also be recalled at this point that transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer.

B.2. Maintaining the arm's length principle as the international consensus

1.14. While recognising the foregoing considerations, the view of OECD member countries continues to be that the arm's length principle should govern the evaluation of transfer prices among associated enterprises.

The arm's length principle is sound in theory since it provides the closest approximation of the workings of the open market in cases where property (such as goods, other types of tangible assets, or intangible assets) is transferred or services are rendered between associated enterprises. While it may not always be straightforward to apply in practice, it does generally produce appropriate levels of income between members of MNE groups, acceptable to tax administrations. This reflects the economic realities of the controlled taxpayer's particular facts and circumstances and adopts as a benchmark the normal operation of the market.

1.15. A move away from the arm's length principle would abandon the sound theoretical basis described above and threaten the international consensus, thereby substantially increasing the risk of double taxation. Experience under the arm's length principle has become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administrations. This shared understanding is of great practical value in achieving the objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation. This experience should be drawn on to elaborate the arm's length principle further, to refine its operation, and to improve its administration by providing clearer guidance to taxpayers and more timely examinations. In sum, OECD member countries continue to support strongly the arm's length principle. In fact, no legitimate or realistic alternative to the arm's length principle has emerged. Global formulary apportionment, sometimes mentioned as a possible alternative, would not be acceptable in theory, implementation, or practice. (See Section C, immediately below, for a discussion of global formulary apportionment.)

C. A non-arm's-length approach: global formulary apportionment

C.1. Background and description of approach

1.16. Global formulary apportionment has sometimes been suggested as an alternative to the arm's length principle as a means of determining the proper level of profits across national taxing jurisdictions. The approach has not been applied as between jurisdictions although it has been attempted by some local taxing jurisdictions.

1.17. Global formulary apportionment would allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different jurisdictions on the basis of a predetermined and mechanistic formula. There would be three essential components to applying global formulary apportionment: determining the unit to be taxed, i.e. which of the subsidiaries and branches of an MNE group should comprise the global taxable entity; accurately determining the global profits; and establishing the formula to be used to allocate the global profits of the unit. The formula would most likely be based on some combination of costs, assets, payroll, and sales.

1.18. Global formulary apportionment should not be confused with the transactional profit methods discussed in Part III of Chapter II. Global formulary apportionment would use a formula that is predetermined for all taxpayers to allocate profits whereas transactional profit methods compare, on a case-by-case basis, the profits of one or more associated enterprises with the profit experience that comparable independent enterprises would have sought to achieve in comparable circumstances. Global formulary apportionment also should not be confused with the selected application of a formula developed by both tax administrations in co-operation with a specific taxpayer or MNE group after careful analysis of the particular facts and circumstances, such as might be used in a mutual agreement procedure, advance pricing agreement, or other bilateral or multilateral determination. Such a formula is derived from the particular facts and circumstances of the taxpayer and thus avoids the globally pre-determined and mechanistic nature of global formulary apportionment.

C.2. Comparison with the arm's length principle

1.19. Global formulary apportionment has been promoted as an alternative to the arm's length principle by advocates who claim that it would provide greater administrative convenience and certainty for taxpayers. These advocates also take the position that global formulary apportionment is more in keeping with economic reality. They argue that an MNE group must be considered on a group-wide or consolidated basis to reflect the business realities of the relationships among the associated enterprises in the group. They assert that the separate accounting method is inappropriate for highly integrated groups because it is difficult to determine what contribution each associated enterprise makes to the overall profit of the MNE group.

1.20. Apart from these arguments, advocates contend that global formulary apportionment reduces compliance costs for taxpayers since in principle only one set of accounts would be prepared for the group for domestic tax purposes.

1.21. OECD member countries do not accept these propositions and do not consider global formulary apportionment a realistic alternative to the arm's length principle, for the reasons discussed below.

1.22. The most significant concern with global formulary apportionment is the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation. To achieve this would require substantial international co-ordination and consensus on the predetermined formulae to be used and on the composition of the group in question. For example, to avoid double taxation there would have to be common agreement to adopt the approach in the first instance, followed by agreement on the measurement of the global tax base of an MNE group, on the use of a common accounting system, on the factors that should be used to apportion the tax base among different jurisdictions (including non-member countries), and on how to measure and weight those factors. Reaching such agreement would be time-consuming and extremely difficult. It is far from clear that jurisdictions would be willing to agree to a universal formula.

1.23. Even if some jurisdictions were willing to accept global formulary apportionment, there would be disagreements because each jurisdiction may want to emphasise or include different factors in the formula based on the activities or factors that predominate in its jurisdiction. Each jurisdiction would have a strong incentive to devise formulae or formula weights that would maximise that jurisdiction's own revenue. In addition, tax administrations would have to consider jointly how to address the potential for artificially shifting the production factors used in the formula (e.g. sales, capital) to low tax jurisdiction. There could be tax avoidance to the extent that the components of the relevant formula can be manipulated, e.g. by entering into unnecessary financial transactions, by the deliberate location of mobile assets, by requiring that particular companies within an MNE group maintain inventory levels in excess of what normally would be encountered in an uncontrolled company of that type, and so on.

1.24. The transition to a global formulary apportionment system therefore would present enormous political and administrative complexity and require a level of international co-operation that is unrealistic to expect in the field of international taxation. Such multilateral co-ordination would require the inclusion of all major jurisdictions where MNEs operate. If all the major jurisdictions failed to agree to move to global formulary apportionment, MNEs would be faced with the burden of complying with two totally different systems. In other words, for the same set of transactions they would be forced to calculate the profits accruing to their members under two completely different standards. Such a result would create the potential for double taxation (or under-taxation) in every case.

1.25. There are other significant concerns in addition to the double taxation issues discussed above. One such concern is that predetermined formulae are arbitrary and disregard market conditions, the particular circumstances of the individual enterprises, and management's own allocation of resources, thus producing an allocation of profits that may bear no sound relationship to the specific facts surrounding the transaction. More specifically, a formula based on a combination of cost, assets, payroll, and sales implicitly imputes a fixed rate of profit per currency unit (e.g. dollar, euro, yen) of each component to every member of the group and in every tax jurisdiction, regardless of differences in functions, assets, risks, and efficiencies and among members of the MNE group. Such an approach could potentially assign profits to an entity that would incur losses if it were an independent enterprise.

1.26. Another issue for global formulary apportionment is dealing with exchange rate movements. Although exchange rate movements can complicate application of the arm's length principle they do not have the same impact as for global formulary apportionment; the arm's length principle is better equipped to deal with the economic consequences of exchange rate movements because it requires the analysis of the specific facts and circumstances of the taxpayer. If the formula relies on costs, the result of applying a global formulary apportionment would be that as a particular currency strengthens in one jurisdiction consistently against another currency in which an associated enterprise keeps its accounts, a greater share of the profit would be attributed to the enterprise in the first jurisdiction to reflect the costs of its payroll nominally increased by the currency fluctuation. Thus, under a global formulary apportionment, the exchange rate movement in this example would lead to increasing the profits of the associated enterprise operating with the stronger currency whereas in the long run a strengthening currency makes exports less competitive and leads to a downward pressure on profits.

1.27. Contrary to the assertions of its advocates, global formulary apportionment may in fact present intolerable compliance costs and data requirements because information would have to be gathered about the entire MNE group and presented in each jurisdiction on the basis of the currency and the book and tax accounting rules of that particular jurisdiction. Thus, the documentation and compliance requirements for an application of global formulary apportionment would generally be more burdensome than under the separate entity approach of the arm's length principle. The costs of a global formulary apportionment would be further magnified if not all jurisdictions could agree on the components of the formula or on the way the components are measured.

1.28. Difficulties also would arise in determining the sales of each member and in the valuation of assets (e.g. historic cost versus market value), especially in the valuation of intangibles. These difficulties would be compounded by the existence across taxing jurisdictions of different accounting standards and of multiple currencies. Accounting standards among all jurisdictions would have to be conformed in order to arrive at a meaningful measure of profit for the entire MNE group. Of course, some of these difficulties, for example the valuation of assets and intangibles, also exist under the arm's length principle, although significant progress in respect of the latter has been made, whereas no credible solutions have been put forward under global formulary apportionment.

1.29. Global formulary apportionment would have the effect of taxing an MNE group on a consolidated basis and therefore abandons the separate entity approach. As a consequence, global formulary apportionment cannot, as a practical matter, recognise important geographical differences, separate company efficiencies, and other factors specific to one company or sub-grouping within the MNE group that may legitimately play a role in determining the division of profits between enterprises in different tax jurisdictions. The arm’s length principle, in contrast, recognises that an associated enterprise may be a separate profit or loss centre with individual characteristics and economically may be earning a profit even when the rest of the MNE group is incurring a loss. Global formulary apportionment does not have the flexibility to account properly for this possibility.

1.30. By disregarding intra-group transactions for the purpose of computing consolidated profits, global formulary apportionment would raise questions about the relevance of imposing withholding taxes on cross-border payments between group members and would involve a rejection of a number of rules incorporated in bilateral tax treaties.

1.31. Unless global formulary apportionment includes every member of an MNE group, it must retain a separate entity rule for the interface between that part of the group subject to global formulary apportionment and the rest of the MNE group. Global formulary apportionment could not be used to value the transactions between the global formulary apportionment group and the rest of the MNE group. Thus, a clear disadvantage with global formulary apportionment is that it does not provide a complete solution to the allocation of profits of an MNE group unless global formulary apportionment is applied on the basis of the whole MNE group. This exercise would be a serious undertaking for a single tax administration given the size and scale of operations of major MNE groups and the information that would be required. The MNE group would also be required, in any event, to maintain separate accounting for corporations that are not members of the MNE group for global formulary apportionment tax purposes but that are still associated enterprises of one or more members of the MNE group. In fact, many domestic commercial and accountancy rules would still require the use of arm’s length prices (e.g. customs rules), so that irrespective of the tax provisions a taxpayer would have to book properly every transaction at arm’s length prices.

C.3. Rejection of non-arm’s-length methods

1.32. For the foregoing reasons, OECD member countries reiterate their support for the consensus on the use of the arm’s length principle that has emerged over the years among member and non-member countries and agree that the theoretical alternative to the arm’s length principle represented by global formulary apportionment should be rejected.

D. Guidance for applying the arm's length principle

D.1. Identifying the commercial or financial relations

1.33. As stated in paragraph 1.6 a "comparability analysis" is at the heart of the application of the arm's length principle. Application of the arm's length principle is based on a comparison of the conditions in a controlled transaction with the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances. There are two key aspects in such an analysis: the first aspect is to identify the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated; the second aspect is to compare the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and the economically relevant circumstances of comparable transactions between independent enterprises. This section of Chapter I provides guidance on identifying the commercial or financial relations between the associated enterprises and on accurately delineating the controlled transaction. This first aspect of the analysis is distinct from the second aspect of considering the pricing of that controlled transaction under the arm's length principle. Chapters II and III provide guidance on the second aspect of the analysis. The information about the controlled transaction determined under the guidance in this section is especially relevant for steps 2 and 3 of the typical process of a comparability analysis set out in paragraph 3.4.

1.34. The typical process of identifying the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations requires a broad-based understanding of the industry sector in which the MNE group operates (e.g. mining, pharmaceutical, luxury goods) and of the factors affecting the performance of any business operating in that sector. The understanding is derived from an overview of the particular MNE group which outlines how the MNE group responds to the factors affecting performance in the sector, including its business strategies, markets, products, its supply chain, and the key functions performed, material assets used, and important risks assumed. This information is likely to be included as part of the master file as described in Chapter V in support of a taxpayer's analysis of its transfer pricing, and provides useful context in which the commercial or financial relations between members of the MNE group can be considered.

1.35. The process then narrows to identify how each MNE within that MNE group operates, and provides an analysis of what each MNE does (e.g. a production company, a sales company) and identifies its commercial or financial relations with associated enterprises as expressed in transactions between them. The accurate delineation of the actual transaction or transactions between the associated enterprises requires analysis of the economically relevant characteristics of the transaction. These economically relevant characteristics consist of the conditions of the transaction and the economically relevant circumstances in which the transaction takes place. The application of the arm's length principle depends on determining the conditions that independent parties would have agreed in comparable transactions in comparable circumstances. Before making comparisons with uncontrolled transactions, it is therefore vital to identify the economically relevant characteristics of the commercial or financial relations as expressed in the controlled transaction.

1.36. The economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations between the associated enterprises in order to accurately delineate the actual transaction can be broadly categorised as follows:

- The contractual terms of the transaction (D.1.1).
- The functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices (D.1.2).
- The characteristics of property transferred or services provided (D.1.3).
- The economic circumstances of the parties and of the market in which the parties operate (D.1.4).
- The business strategies pursued by the parties (D.1.5).

This information about the economically relevant characteristics of the actual transaction should be included as part of the local file as described in Chapter V in support of a taxpayer's analysis of its transfer pricing.

1.37. Economically relevant characteristics or comparability factors are used in two separate but related phases in a transfer pricing analysis. The first phase relates to the process of accurately delineating the controlled transaction for the purposes of this chapter, and involves establishing the characteristics of the transaction, including its terms, the functions performed, assets used, and risks assumed by the associated enterprises, the nature of the products transferred or services provided, and the circumstances of the associated enterprises, in accordance with the categories set out in the previous paragraph. The extent to which any one of the characteristics categorised above is economically relevant in a particular transaction depends on the extent to which it would be taken into account by independent enterprises when evaluating the terms of the same transaction were it to occur between them.

1.38. Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that offers a clearly more attractive opportunity to meet their commercial objectives. In other words, independent enterprises would only enter into a transaction if it is not expected to make them worse off than their next best option. For example, one enterprise is unlikely to accept a price offered for its product by an independent commercial enterprise if it knows that other potential customers are willing to pay more under similar conditions, or are willing to pay the same under more beneficial conditions. Independent enterprises will generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk) when valuing those options. Therefore, identifying the economically relevant characteristics of the transaction is essential in accurately delineating the controlled transaction and in revealing the range of characteristics taken into account by the parties to the transaction in reaching the conclusion that there is no clearly more attractive opportunity realistically available to meet their commercial objectives than the transaction adopted. In making such an assessment, it may be necessary or useful to assess the transaction in the context of a broader arrangement of transactions, since assessment of the options realistically available to third parties is not necessarily limited to the single transaction, but may take into account a broader arrangement of economically related transactions.

1.39. The second phase in which economically relevant characteristics or comparability factors are used in a transfer pricing analysis relates to the process set out in Chapter III of making comparisons between the controlled transactions and uncontrolled transactions in order to determine an arm's length price for the controlled transaction. To make such comparisons, taxpayers and tax administrations need first to have identified the economically relevant characteristics of the controlled transaction. As set out in Chapter III, differences in economically relevant characteristics between the controlled and uncontrolled arrangements need to be taken into account when establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability.

1.40. All methods that apply the arm's length principle can be tied to the concept that independent enterprises consider the options realistically available to them and in comparing one option to another they consider any differences between the options that would significantly affect their value. For instance, before purchasing a product at a given price, independent enterprises normally would be expected to consider whether they could buy an equivalent product on otherwise comparable terms and conditions but at a lower price from another party. Therefore, as discussed in Chapter II, Part II, the comparable uncontrolled price method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative to the controlled transaction. However, the method becomes a less reliable substitute for arm's length transactions if not all the characteristics of these uncontrolled transactions that significantly affect the price charged between independent enterprises are comparable. Similarly, the resale price and cost plus methods compare the gross profit margin earned in the controlled transaction to gross profit margins earned in similar uncontrolled transactions. The comparison provides an estimate of the gross profit margin one of the parties could have earned had it performed the same functions for independent enterprises and therefore provides an estimate of the payment that party would have demanded, and the other party would have been willing to pay, at arm's length for performing those functions. Other methods, as discussed in Chapter II, Part III, are based on comparisons of net profit indicators (such as profit margins) between independent and associated enterprises as a means to estimate the profits that one or each of the associated enterprises could have earned had they dealt solely with independent enterprises, and therefore the payment those enterprises would have demanded at arm's length to compensate them for using their resources in the controlled transaction. Where there are differences between the situations being compared that could materially affect the comparison, comparability adjustments must be made, where possible, to improve the reliability of the comparison. Therefore, in no event can unadjusted industry average returns themselves establish arm's length prices.

1.41. For a discussion of the relevance of these factors for the application of particular pricing methods, see the consideration of those methods in Chapter II.

D.1.1. The contractual terms of the transaction

1.42. A transaction is the consequence or expression of the commercial or financial relations between the parties. The controlled transactions may have been formalised in written contracts which may reflect the intention of the parties at the time the contract was concluded in relation to aspects of the transaction covered by the contract, including in typical cases the division of responsibilities, obligations and rights, assumption of identified risks, and pricing arrangements. Where a transaction has been formalised by the associated enterprises through written contractual agreements, those agreements provide the starting point for delineating the transaction between them and how the responsibilities, risks, and anticipated outcomes arising from their interaction were intended to be divided at the time of entering into the contract. The terms of a transaction may also be found in communications between the parties other than a written contract.

1.43. However, the written contracts alone are unlikely to provide all the information necessary to perform a transfer pricing analysis, or to provide information regarding the relevant contractual terms in sufficient detail. Further information will be required by taking into consideration evidence of the commercial or financial relations provided by the economically relevant characteristics in the other four categories (see paragraph 1.36): the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, together with the characteristics of property transferred or services provided, the economic circumstances of the parties and of the market in which the parties operate, and the business strategies pursued by the parties. Taken together, the analysis of economically relevant characteristics in all five categories provides evidence of the actual conduct of the associated enterprises. The evidence may clarify aspects of the written contractual arrangements by providing useful and consistent information. If the contract neither explicitly nor implicitly (taking into account applicable principles of contract interpretation) addresses characteristics of the transaction that are economically relevant, then any information provided by the contract should be supplemented for purposes of the transfer pricing analysis by the evidence provided by identifying those characteristics.

1.44. The following example illustrates the concept of clarifying and supplementing the written contractual terms based on the identification of the actual commercial or financial relations. Company P is the parent company of an MNE group situated in Country P. Company S, situated in Country S, is a wholly-owned subsidiary of Company P and acts as an agent for Company P's branded products in the Country S market. The agency contract between Company P and Company S is silent about any marketing and advertising activities in Country S that the parties should perform. Analysis of other economically relevant characteristics and in particular the functions performed, determines that Company S launched an intensive media campaign in Country S in order to develop brand awareness. This campaign represents a significant investment for Company S. Based on evidence provided by the conduct of the parties, it could be concluded that the written contract may not reflect the full extent of the commercial or financial relations between the parties. Accordingly, the analysis should not be limited by the terms recorded in the written contract, but further evidence should be sought as to the conduct of the parties, including as to the basis upon which Company S undertook the media campaign.

1.45. If the characteristics of the transaction that are economically relevant are inconsistent with the written contract between the associated enterprises, the actual transaction should generally be delineated for purposes of the transfer pricing analysis in accordance with the characteristics of the transaction reflected in the conduct of the parties.

1.46. In transactions between independent enterprises, the divergence of interests between the parties ensures (i) that contractual terms are concluded that reflect the interests of both of the parties, (ii) that the parties will ordinarily seek to hold each other to the terms of the contract, and (iii) that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties. The same divergence of interests may not exist in the case of associated enterprises or any such divergences may be managed in ways facilitated by the control relationship and not solely or mainly through contractual agreements. It is, therefore, particularly important in considering the commercial or financial relations between associated enterprises to examine whether the arrangements reflected in the actual conduct of the parties substantially conform to the terms of any written contract, or whether the associated enterprises' actual conduct indicates that the contractual terms have not been followed, do not reflect a complete picture of the transactions, have been incorrectly characterised or labelled by the enterprises, or are a sham. Where conduct is not fully consistent with economically significant contractual terms, further analysis is required to identify the actual transaction. Where there are material differences between contractual terms and the conduct of the associated enterprises in their relations with one another, the functions they actually perform, the assets they actually use, and the risks they actually assume, considered in the context of the contractual terms, should ultimately determine the factual substance and accurately delineate the actual transaction.

1.47. Where there is doubt as to what transaction was agreed between the associated enterprises, it is necessary to take into account all the relevant evidence from the economically relevant characteristics of the transaction. In doing so one must bear in mind that the terms of the transaction between the enterprises may change over time. Where there has been a change in the terms of a transaction, the circumstances surrounding the change should be examined to determine whether the change indicates that the original transaction has been replaced through a new transaction with effect from the date of the change, or whether the change reflects the intentions of the parties in the original transaction. Particular care should be exercised where it appears that any changes may have been triggered by knowledge of emerging outcomes from the transaction. Changes made in the purported assumption of a risk when risk outcomes are known do not involve an assumption of risk since there is no longer any risk, as discussed in paragraph 1.78.

1.48. The following example illustrates the concept of differences between written contractual terms and conduct of the parties, with the result that the actual conduct of the parties delineates the transaction. Company S is a wholly-owned subsidiary of Company P. The parties have entered into a written contract pursuant to which Company P licenses intellectual property to Company S for use in Company S's business; Company S agrees to compensate Company P for the licence with a royalty. Evidence provided by other economically relevant characteristics, and in particular the functions performed, establishes that Company P performs negotiations with third-party customers to achieve sales for Company S, provides regular technical services support to Company S so that Company S can deliver contracted sales to its customers, and regularly provides staff to enable Company S to fulfil customer contracts. A majority of customers insist on including Company P as joint contracting party along with Company S, although fee income under the contract is payable to Company S. The analysis of the commercial or financial relations indicates that Company S is not capable of providing the contracted services to customers without significant support from Company P, and is not developing its own capability. Under the contract, Company P has given a licence to Company S, but in fact controls the business risk and output of Company S such that it has not transferred risk and function consistent with a licensing arrangement, and acts not as the licensor but the principal. The identification of the actual transaction between Company P and Company S should not be defined solely by the terms of the written contract. Instead, the actual transaction should be determined from the conduct of the parties, leading to the conclusion that the actual functions performed, assets used, and risks assumed by the parties are not consistent with the written licence agreement.

1.49. Where no written terms exist, the actual transaction would need to be deduced from the evidence of actual conduct provided by identifying the economically relevant characteristics of the transaction. In some circumstances the actual outcome of commercial or financial relations may not have been identified as a transaction by the MNE, but nevertheless may result in a transfer of material value, the terms of which would need to be deduced from the conduct of the parties. For example, technical assistance may have been granted, synergies may have been created through deliberate concerted action (as discussed in Section D.8), or know-how may have been provided through seconded employees or otherwise. These relations may not have been recognised by the MNE, may not be reflected in the pricing of other connected transactions, may not have been formalised in written contracts, and may not appear as entries in the accounting systems. Where the transaction has not been formalised, all aspects would need to be deduced from available evidence of the conduct of the parties, including what functions are actually performed, what assets are actually used, and what risks are actually assumed by each of the parties.

1.50. The following example illustrates the concept of determining the actual transaction where a transaction has not been identified by the MNE. In reviewing the commercial or financial relations between Company P and its subsidiary companies, it is observed that those subsidiaries receive services from an independent party engaged by Company P. Company P pays for the services, the subsidiaries do not reimburse Company P directly or indirectly through the pricing of another transaction and there is no service agreement in place between Company P and the subsidiaries. The conclusion is that, in addition to a provision of services by the independent party to the subsidiaries, there are commercial or financial relations between Company P and the subsidiaries, which transfer potential value from Company P to the subsidiaries. The analysis would need to determine the nature of those commercial or financial relations from the economically relevant characteristics in order to determine the terms and conditions of the identified transaction.

D.1.2. Functional analysis

1.51. In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in delineating the controlled transaction and determining comparability between controlled and uncontrolled transactions or entities, a functional analysis is necessary. This functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions. The analysis focuses on what the parties actually do and the capabilities they provide. Such activities and capabilities will include decision-making, including decisions about business strategy and risks. For this purpose, it may be helpful to understand the structure and organisation of the MNE group and how they influence the context in which the MNE operates. In particular, it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the associated enterprises with the rest of the group, and the contribution that the associated enterprises make to that value creation. It will also be relevant to determine the legal rights and obligations of each of the parties in performing their functions. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.

1.52. The actual contributions, capabilities, and other features of the parties can influence the options realistically available to them. For example, an associated enterprise provides logistics services to the group. The logistics company is required to operate warehouses with spare capacity and in several locations in order to be able to cope in the event that supply is disrupted at any one location. The option of greater efficiency through consolidation of locations and reduction in excess capacity is not available. Its functions and assets may, therefore, be different to those of an independent logistics company if that independent service provider did not offer the same capabilities to reduce the risk of disruption to supply.

1.53. Therefore, the process of identifying the economically relevant characteristics of the commercial or financial relations should include consideration of the capabilities of the parties, how such capabilities affect options realistically available, and whether similar capabilities are reflected in potentially comparable arm's length arrangements.

1.54. The functional analysis should consider the type of assets used, such as plant and equipment, the use of valuable intangibles, financial assets, etc., and the nature of the assets used, such as the age, market value, location, property right protections available, etc.

1.55. The functional analysis may show that the MNE group has fragmented highly integrated functions across several group companies. There may be considerable interdependencies between the fragmented activities. For example, the separation into different legal entities of logistics, warehousing, marketing, and sales functions may require considerable co-ordination in order that the separate activities interact effectively. Sales activities are likely to be highly dependent on marketing, and fulfilment of sales, including the anticipated impact of marketing activities, would require alignment with stocking processes and logistics capability. That required co-ordination may be performed by some or all of the associated enterprises performing the fragmented activities, performed through a separate co-ordination function, or performed through a combination of both. Risk may be mitigated through contributions from all the parties, or risk mitigation activities may be undertaken mainly by the co-ordination function. Therefore, when conducting a functional analysis to identify the commercial or financial relations in fragmented activities, it will be important to determine whether those activities are highly interdependent, and, if so, the nature of the interdependencies and how the commercial activity to which the associated enterprises contribute is co-ordinated.

D.1.2.1. Analysis of risks in commercial or financial relations[1]

1.56. A functional analysis is incomplete unless the material risks assumed by each party have been identified and considered since the actual assumption of risks would influence the prices and other conditions of

1. The guidance in this chapter, and in this section on risk in particular, is not specific to any particular industry sector. While the basic concept that a party bearing risks must have the ability to effectively deal with those risks applies to insurance, banking, and other financial services businesses, these regulated sectors are required to follow rules prescribing arrangements for risks, and how risks are recognised, measured, and disclosed. The regulatory approach to risk allocation for regulated entities should be taken into account and reference made as appropriate to the transfer pricing guidance specific to financial services businesses in the *Report on the Attribution of Profits to Permanent Establishments* (OECD, 2010).

transactions between the associated enterprises. Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised. The level and assumption of risk, therefore, are economically relevant characteristics that can be significant in determining the outcome of a transfer pricing analysis.

1.57. Risk is inherent in business activities. Enterprises undertake commercial activities because they seek opportunities to make profits, but those opportunities carry uncertainty that the required resources to pursue the opportunities either will be greater than expected or will not generate the expected returns. Identifying risks goes hand in hand with identifying functions and assets and is integral to the process of identifying the commercial or financial relations between the associated enterprises and of accurately delineating the transaction or transactions.

1.58. The assumption of risks associated with a commercial opportunity affects the profit potential of that opportunity in the open market, and the allocation of risks assumed between the parties to the arrangement affects how profits or losses resulting from the transaction are allocated at arm's length through the pricing of the transaction. Therefore, in making comparisons between controlled and uncontrolled transactions and between controlled and uncontrolled parties it is necessary to analyse what risks have been assumed, what functions are performed that relate to or affect the assumption or impact of these risks and which party or parties to the transaction assume these risks.

1.59. This section provides guidance on the nature and sources of risk relevant to a transfer pricing analysis in order to help identify relevant risks with specificity. In addition, this section provides guidance on risk assumption under the arm's length principle. The detailed guidance provided in this section on the analysis of risks as part of a functional analysis covering functions, assets, and risks, should not be interpreted as indicating that risks are more important than functions or assets. The relevance of functions, assets and risks in a specific transaction will need to be determined through a detailed functional analysis. The expanded guidance on risks reflects the practical difficulties presented by risks: risks in a transaction can be harder to identify than functions or assets, and determining which associated enterprise assumes a particular risk in a transaction can require careful analysis.

1.60. The steps in the process set out in the rest of this section for analysing risk in a controlled transaction, in order to accurately delineate the actual transaction in respect to that risk, can be summarised as follows:

1. Identify economically significant risks with specificity (see Section D.1.2.1.1).

2. Determine how specific economically significant risks are contractually assumed by the associated enterprises under the terms of the transaction (see Section D.1.2.1.2).

3. Determine through a functional analysis how the associated enterprises that are parties to the transaction operate in relation to assumption and management of the specific, economically significant risks, and in particular which enterprise or enterprises perform control functions and risk mitigation functions, which enterprise or enterprises encounter upside or downside consequences of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk (see Section D.1.2.1.3).

4. Steps 2-3 will have identified information relating to the assumption and management of risks in the controlled transaction. The next step is to interpret the information and determine whether the contractual assumption of risk is consistent with the conduct of the associated enterprises and other facts of the case by analysing (i) whether the associated enterprises follow the contractual terms under the principles of Section D.1.1; and (ii) whether the party assuming risk, as analysed under (i), exercises control over the risk and has the financial capacity to assume the risk (see Section D.1.2.1.4).

5. Where the party assuming risk under steps 1-4(i) does not control the risk or does not have the financial capacity to assume the risk, apply the guidance on allocating risk (see Section D.1.2.1.5).

6. The actual transaction as accurately delineated by considering the evidence of all the economically relevant characteristics of the transaction as set out in the guidance in Section D.1, should then be priced taking into account the financial and other consequences of risk assumption, as appropriately allocated, and appropriately compensating risk management functions (see Section D.1.2.1.6).

1.61. In this section references are made to terms that require initial explanation and definition. The term “risk management” is used to refer to the function of assessing and responding to risk associated with commercial activity. Risk management comprises three elements: (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function, (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function, and (iii) the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.

1.62. Some risk management functions can be undertaken only by the party performing functions and using assets in creating and pursuing commercial opportunities, while other risk management functions can be undertaken by a different party. Risk management should not be thought of as necessarily encompassing a separate function, requiring separate remuneration, distinct from the performance of the activities that optimise profits. For example, the development of intangibles through development activities may involve mitigating risks relating to performing the development according to specifications at the highest possible standards and on time; the particular risks might be mitigated through the performance of the development function itself. For example, if the contractual arrangement between the associated enterprises is a contract R&D arrangement that is respected under the requirements of this section, remuneration for risk mitigation functions performed through the development activity would be incorporated into the arm's length services payment. Neither the intangible risk itself, nor the residual income associated with such risk, would be allocated to the service provider. See also Example 1 in paragraph 1.83.

1.63. Risk management is not the same as assuming a risk. Risk assumption means taking on the upside and downside consequences of the risk with the result that the party assuming a risk will also bear the financial and other consequences if the risk materialises. A party performing part of the risk management functions may not assume the risk that is the subject of its management activity, but may be hired to perform risk mitigation functions under the direction of the risk-assuming party. For example, the day-to-day mitigation of product recall risk may be outsourced to a party performing monitoring of quality control over a specific manufacturing process according to the specifications of the party assuming the risk.

1.64. Financial capacity to assume risk can be defined as access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materialises. Access to funding by the party assuming the risk takes into account the available assets and the options realistically available to access additional liquidity, if needed, to cover the costs anticipated to arise should the risk materialise. This assessment should be made on the basis that the party assuming the risk is operating as an unrelated party in the same circumstances as the associated enterprise, as accurately delineated under the principles of this section. For example, exploitation of rights in an income-generating asset could open up funding possibilities for that party. Where a party assuming risk receives intra-group funding to meet the funding demands in relation to the risk, the party providing the funding may assume financial risk but does not, merely as a consequence of providing funding, assume the specific risk that gives rise to the need for additional funding. Where the financial capacity to assume a risk is lacking, then the allocation of risk requires further consideration under step 5.

1.65. Control over risk involves the first two elements of risk management defined in paragraph 1.61; that is (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function. It is not necessary for a party to perform the day-to-day mitigation, as described in (iii) in order to have control of the risks. Such day-to-day mitigation may be outsourced, as the example in paragraph 1.63 illustrates. However, where these day-to-day mitigation activities are outsourced, control of the risk would require capability to determine the objectives of the outsourced activities, to decide to hire the provider of the risk mitigation functions, to assess whether the objectives are being adequately met, and, where necessary, to decide to adapt or terminate the contract with that provider, together with the performance of such assessment and decision-making. In accordance with this definition of control, a party requires both capability and functional performance as described above in order to exercise control over a risk.

1.66. The capability to perform decision-making functions and the actual performance of such decision-making functions relating to a specific risk involve an understanding of the risk based on a relevant analysis of the information required for assessing the foreseeable downside and upside risk outcomes of such a decision and the consequences for the business of the enterprise. Decision-makers should possess competence and experience in the area of the particular risk for which the decision is being made and possess an understanding of the impact of their decision on the business. They should also have access to the relevant information, either by gathering this information themselves or by exercising authority to specify and obtain the relevant information to support the decision-making process. In doing so, they require capability to determine the objectives of the gathering and analysis of the information, to hire the party gathering the information and making the analyses, to assess whether the right information is gathered and the analyses are adequately made, and, where necessary, to decide to adapt or terminate the contract with that provider, together with the performance of such assessment and decision-making. Neither a mere formalising of the outcome of decision-making in the form of, for example, meetings organised for formal approval of decisions that were made in other locations, minutes of a board meeting and signing of the documents relating to the decision, nor the setting of the policy environment relevant for the risk (see paragraph 1.76), qualifies as the exercise of a decision-making function sufficient to demonstrate control over a risk.

1.67. References to control over risk should not necessarily be taken to mean that the risk itself can be influenced or that the uncertainty can be nullified. Some risks cannot be influenced, and are a general condition of commercial activity affecting all businesses undertaking that activity. For example, risks associated with general economic conditions or commodity price cycles are typically beyond the scope of an MNE group to influence. Instead control over risk should be understood as the capability and authority to decide to take on the risk, and to decide whether and how to respond to the risk, for example through the timing of investments, the nature of development programmes, the design of marketing strategies, or the setting of production levels.

1.68. Risk mitigation refers to measures taken that are expected to affect risk outcomes. Such measures may include measures that reduce the uncertainty or measures that reduce the consequences in the event that the downside impact of risk occurs. Control should not be interpreted as requiring risk mitigation measures to be adopted, since in assessing risks businesses may decide that the uncertainty associated with some risks, including risks that may be fundamental to their core business operations, after being evaluated, should be taken on and faced in order to create and maximise opportunities.

1.69. The concept of control may be illustrated by the following examples. Company A appoints a specialist manufacturer, Company B to manufacture products on its behalf. The contractual arrangements indicate that Company B undertakes to perform manufacturing services, but that the product specifications and designs are provided by Company A, and that Company A determines production scheduling, including the volumes and timing of product delivery. The contractual relations imply that Company A bears the inventory risk and the product recall risk. Company A hires Company C to perform regular quality controls of the production process. Company A specifies the objectives of the quality control audits and the information that Company C should gather on its behalf. Company C reports directly to Company A. Analysis of the economically relevant characteristics shows that Company A controls its product recall and inventory risks by exercising its capability and authority to make a number of relevant decisions about whether and how to take on risk and how to respond to the risks. Besides that Company A has the capability to assess and take decisions relating to the risk mitigation functions and actually performs these functions. These include determining the objectives of the outsourced activities, the decision to hire the particular manufacturer and the party performing the quality checks, the assessment of whether the objectives are adequately met, and, where necessary, to decide to adapt or terminate the contracts.

1.70. Assume that an investor hires a fund manager to invest funds on its account. Depending on the agreement between the investor and the fund manager, the latter may be given the authority to make portfolio investments on behalf of the investor on a day-to-day basis in a way that reflects the risk preferences of the investor, although the risk of loss in value of the investment would be borne by the investor. In such an example, the investor is controlling its risks through four relevant decisions: the decision about its risk preference and therefore about the required diversification of the risks attached to the different investments that are part of the portfolio, the decision to hire (or terminate the contract with) that particular fund manager, the decision of the extent of the authority it gives to the fund manager and objectives it assigns to the latter, and the decision of the amount of the investment that it asks this fund manager to manage. Moreover, the fund manager would generally be required to report back to the investor on a regular basis as the investor would want to assess the outcome of the fund manager's activities. In such a case, the fund manager is providing a service and managing his business risk from his own perspective (e.g. to protect his credibility). The fund manager's operational risk, including the possibility of losing a client, is distinct from his client's investment risk. This illustrates the fact that an investor who gives to another person the authority to perform risk mitigation activities such as those performed by the fund manager does not necessarily transfer control of the investment risk to the person making these day-to-day decisions.

D.1.2.1.1. Step 1: Identify economically significant risks with specificity

1.71. There are many definitions of risk, but in a transfer pricing context it is appropriate to consider risk as the effect of uncertainty on the objectives of the business. In all of a company's operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed. A company is likely to direct much attention to identifying uncertainties it encounters, in evaluating whether and how business opportunities should be pursued in view of their inherent risks, and in developing appropriate risk mitigation strategies which are important to shareholders seeking their required rate of return. Risk is associated with opportunities, and does not have downside connotations alone; it is inherent in commercial activity, and companies choose which risks they wish to assume in order to have the opportunity to generate profits. No profit-seeking business takes on risk associated with commercial opportunities without expecting a positive return. Downside impact of risk occurs when the anticipated favourable outcomes fail to materialise. For example, a product may fail to attract as much consumer demand as projected. However, such an event is the downside manifestation of uncertainty associated with commercial opportunities. Companies are likely to devote considerable attention to identifying and managing economically significant risks in order to maximise the positive returns from having pursued the opportunity in the face of risk. Such attention may include activities around determining the product strategy, how the product is differentiated, how to identify changing market trends, how to anticipate political and social changes, and how to create demand. The significance of a risk depends on the likelihood and size of the potential profits or losses arising from the risk. For example, a different flavour of ice-cream may not be the company's sole product, the costs of developing, introducing, and marketing the product may have been marginal, the success or failure of the product may not create significant reputational risks so long as business management protocols are followed, and decision-making may have been effected by delegation to local or regional management who can provide knowledge of local tastes. However, ground-breaking technology or an innovative healthcare treatment may represent the sole or major product, involve significant strategic decisions at different stages, require substantial investment costs, create significant opportunities to make or break reputation, and require centralised management that would be of keen interest to shareholders and other stakeholders.

1.72. Risks can be categorised in various ways, but a relevant framework in a transfer pricing analysis is to consider the sources of uncertainty which give rise to risk. The following non-exclusive list of sources of risk is not intended to suggest a hierarchy of risk. Neither is it intended to provide rigid categories of risk, since there is overlap between the categories. Instead, it is intended to provide a framework that may assist in ensuring that a transfer pricing analysis considers the range of risks likely to arise from the commercial or financial relations of the associated enterprises, and from the context in which those relations take place. Reference is made to risks that are externally driven and those that are internally driven in order to help clarify sources of uncertainty. However, there should be no inference that externally driven risks are less relevant because they are not generated directly by activities. On the contrary, the ability of a company to face, respond to and mitigate externally driven risks is likely to be a necessary condition for a business to remain competitive. Importantly, guidance on the possible range of risk should assist in identifying material risks with specificity. Risks which are vaguely described or undifferentiated will not serve the purposes of a transfer pricing analysis seeking to delineate the actual transaction and the actual allocation of risk between the parties.

a) Strategic risks or marketplace risks. These are largely external risks caused by the economic environment, political and regulatory events, competition, technological advance, or social and environmental changes. The assessment of such uncertainties may define the products and markets the company decides to target, and the capabilities it requires, including investment in intangibles and tangible assets, as well as in the talent of its human capital. There is considerable potential downside, but the upside is also considerable if the company identifies correctly the impact of external risks, and differentiates its products and secures and continues to protect competitive advantage. Examples of such risks may include marketplace trends, new geographical markets, and concentration of development investment.

b) Infrastructure or operational risks. These are likely to include the uncertainties associated with the company's business execution and may include the effectiveness of processes and operations. The impact of such risks is highly dependent on the nature of the activities and the uncertainties the company chooses to assume. In some circumstances breakdowns can have a crippling effect on the company's operations or reputation and threaten its existence; whereas successful management of such risks can enhance reputation. In other circumstances, the failure to bring a product to market on time, to meet demand, to meet specifications, or to produce to high standards, can affect competitive and reputational position, and give advantage to companies which bring competing products to market more quickly, better exploit periods of market protection provided by, for example, patents, better manage supply chain risks and quality control. Some infrastructure risks are externally driven and may involve transport links, political and social situations, laws and regulations, whereas others are internally driven and may involve capability and availability of assets, employee capability, process design and execution, outsourcing arrangements, and IT systems.

c) Financial risks. All risks are likely to affect a company's financial performance, but there are specific financial risks related to the company's ability to manage liquidity and cash flow, financial capacity, and creditworthiness. The uncertainty can be externally driven, for example by economic shock or credit crisis, but can also be internally driven through controls, investment decisions, credit terms, and through outcomes of infrastructure or operational risks.

d) Transactional risks. These are likely to include pricing and payment terms in a commercial transaction for the supply of goods, property, or services.

e) Hazard risks. These are likely to include adverse external events that may cause damages or losses, including accidents and natural disasters. Such risks can often be mitigated through insurance, but insurance may not cover all the potential loss, particularly where there are significant impacts on operations or reputation.

1.73. Determining the economic significance of risk and how risk may affect the pricing of a transaction between associated enterprises is part of the broader functional analysis of how value is created by the MNE group, the activities that allow the MNE group to sustain profits, and the economically relevant characteristics of the transaction. The analysis of risk also helps to determine comparability under the guidance in Chapter III. Where potential comparables are identified, it is relevant to determine whether they include the same level of risks and management of risks. The economic significance of risk may be illustrated by the following two situations.

1.74. In the first situation the MNE group distributes heating oil to consumers. Analysis of the economically relevant characteristics establishes that the product is undifferentiated, the market is competitive, the market size is predictable, and players are price-takers. In such circumstances, the ability to influence margins may be limited. The credit terms achieved from managing the relationship with the oil suppliers fund working capital and are crucial to the distributor's margin. The impact of the risk on cost of capital is, therefore, significant in the context of how value is created for the distribution function.

1.75. In the second situation, a multinational toy retailer buys a wide range of products from a number of third-party manufacturers. Most of its sales are concentrated in the last two months of the calendar year, and a significant risk relates to the strategic direction of the buying function, and in making the right bets on trends and determining the products that will sell and in what volumes. Trends and the demand for products can vary across markets, and so expertise is needed to evaluate the right bets in the local market. The effect of the buying risk can be magnified if the retailer negotiates a period of exclusivity for a particular product with the third-party manufacturer.

1.76. Control over a specific risk in a transaction focusses on the decision-making of the parties to the transaction in relation to the specific risk arising from the transaction. This is not to say, however, that in an MNE group other parties may not be involved in setting general policies that are relevant for the assumption and control of the specific risks identified in a transaction, without such policy-setting itself representing decision making. The board and executive committees of the group, for example, may set the level of risk the group as a whole is prepared to accept in order to achieve commercial objectives, and to establish the control framework for managing and reporting risk in its operations. Line management in business segments, operational entities, and functional departments may identify and assess risk against the commercial opportunities, and put in place appropriate controls and processes to address risk and influence the risk outcomes arising from day-to-day operations. The opportunities pursued by operational entities require the ongoing management of the risk that the resources allocated to the opportunity will deliver the anticipated return. For example, finished product inventory risk in a supply transaction between two associated enterprises may be controlled by the party with the capability to determine the production volumes together with the performance of that decision-making. The way that inventory risk in the transaction between two associated enterprises is addressed may be subject to policy-setting elsewhere in the MNE group about overall levels of working capital tied up in inventory, or co-ordination of appropriate minimum stocking levels across markets to meet strategic objectives. This wider policy-setting however cannot be regarded as decisions to take on, lay off, decline, or mitigate the specific inventory risk in the example of the product supply transaction in this paragraph.

D.1.2.1.2. Step 2: Contractual assumption of risk

1.77. The identity of the party or parties assuming risks may be set out in written contracts between the parties to a transaction involving these risks. A written contract typically sets out an intended assumption of risk by the parties. Some risks may be explicitly assumed in the contractual arrangements. For example, a distributor might contractually assume accounts receivable risk, inventory risk, and credit risks associated with the distributor's sales to unrelated customers. Other risks might be implicitly assumed. For example, contractual arrangements that provide non-contingent remuneration for one of the parties implicitly allocate the outcome of some risks, including unanticipated profits or losses, to the other party.

1.78. A contractual assumption of risk constitutes an *ex ante* agreement to bear some or all of the potential costs associated with the *ex post* materialisation of downside outcomes of risk in return for some or all of the potential benefit associated with the *ex post* materialisation of positive outcomes. Importantly, *ex ante* contractual assumption of risk should provide clear evidence of a commitment to assume risk prior to the materialisation of risk outcomes. Such evidence is a very important part of the tax administration's transfer pricing analysis of risks in commercial or financial relations, since, in practice, an audit performed by the tax administration may occur years after the making of such up-front decisions by the associated enterprises and when outcomes are known. The purported assumption of risk by associated enterprises when risk outcomes are certain is by definition not an assumption of risk, since there is no longer any risk. Similarly, *ex post* reallocations of risk by a tax administration when risk outcomes are certain may, unless based on the guidance elsewhere in these Guidelines and in particular Section D.1.2.1, be inappropriate.

1.79. It is economically neutral to take on (or lay off) risk in return for higher (or lower) anticipated nominal income as long as the net present value of both options are equal. Between unrelated parties, for example, the sale of a risky income-producing asset may reflect in part a preference of the seller to accept a lower but more certain amount of nominal income and to forego the possibility of higher anticipated nominal income it might earn if it instead retained and exploited the asset. In a without-recourse debt factoring arrangement between independent enterprises, for example, the seller discounts the face value of its receivables in return for a fixed payment, and so accepts a lower return but has reduced its volatility and laid off risk. The factor will often be a specialised organisation which has the capability to decide to take on risk and to decide on how to respond to the risk, including by diversifying the risk and having the functional capabilities to mitigate the risk and generate a return from the opportunity. Neither party will expect to be worse off as a result of entering into the arrangement, essentially because they have different risk preferences resulting from their capabilities in relation to the specific risk. The factor is more capable of managing the risk than the seller and terms acceptable to both parties can be agreed.

1.80. However, it does not follow that every contractual exchange of potentially higher but riskier income for lower but less risky income between associated enterprises is automatically arm's length. The rest of the steps set out in this section describe the information required to determine how the associated enterprises operate in relation to the assumption and management of risk leading to the accurate delineation of the actual transaction in relation to risk.

1.81. The assumption of risk has a significant effect on determining arm's length pricing between associated enterprises, and it should not be concluded that the pricing arrangements adopted in the contractual arrangements alone determine which party assumes risk. Therefore, one may not infer from the fact that the price paid between associated enterprises for goods or services is set at a particular level, or by reference to a particular margin, that risks are borne by those associated enterprises in a particular manner. For example, a manufacturer may claim to be protected from the risk of price fluctuation of raw material as a consequence of its being remunerated by another group company on a basis that takes account of its actual costs. The implication of the claim is that the other group company bears the risk. The form of remuneration cannot dictate inappropriate risk allocations. It is the determination of how the parties actually manage and control risks, as set out in the remaining steps of the process of analysing risk, which will determine the assumption of risks by the parties, and consequently dictate the selection of the most appropriate transfer pricing method.

D.1.2.1.3. Step 3: Functional analysis in relation to risk

1.82. In this step the functions in relation to risk of the associated enterprises that are parties to the transaction are analysed. The analysis provides information about how the associated enterprises operate in relation to the assumption and management of the specific, economically significant risks, and in particular about which enterprise or enterprises perform control functions and risk mitigation functions, which enterprise or enterprises encounter upside or downside consequences of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk. This step is illustrated by the following examples and conclusions are drawn from these examples in subsequent paragraphs of Section D.1.2.

Example 1

1.83. Company A seeks to pursue a development opportunity and hires a specialist company, Company B, to perform part of the research on its behalf. Under step 1 development risk has been identified as economically significant in this transaction, and under step 2 it has been established that under the contract Company A assumes development risk. The functional analysis under step 3 shows that Company A controls its development risk through exercising its capability and authority in making a number of relevant decisions about whether and how to take on the development risk. These include the decision to perform part of the development work itself, the decision to seek specialist input, the decision to hire the particular researcher, the decision of the type of research that should be carried out and objectives assigned to it, and the decision of the budget allocated to Company B. Company A has mitigated its risk by taking measures to outsource development activities to Company B which assumes the day-to-day responsibility for carrying out the research under the control of Company A. Company B reports back to Company A at predetermined milestones, and Company A assesses the progress of the development and whether its ongoing objectives are being met, and decides whether continuing investments in the project are warranted in the light of that assessment. Company A has the financial capacity to assume the risk. Company B has no capability to evaluate the development risk and does not make decisions about Company A's activities. Company B's risk is mainly to ensure it performs the research activities competently and it exercises its capability and authority to control that risk through making decisions about the processes, expertise, and assets it needs. The risk Company B assumes is distinct from the development risk assumed by Company A under the contract, and which is controlled by Company A based on the evidence of the functional analysis.

Example 2

1.84. Company B manufactures products for Company A. Under step 1 capacity utilisation risk and supply chain risk have been identified as economically significant in this transaction, and under step 2 it has been established that under the contract Company A assumes these risks. The functional analysis under step 3 provides evidence that Company B built and equipped its plant to Company A's specifications, that products are manufactured to technical requirements and designs provided by Company A, that volume levels are determined by Company A, and that Company A runs the supply chain, including the procurement of components and raw materials. Company A also performs regular quality checks of the manufacturing process. Company B builds the plant, employs and trains competent manufacturing personnel, and determines production scheduling based on volume levels determined by Company A. Although Company B has incurred fixed costs, it has no ability to manage the risk associated with the recovery of those costs through determining the production units over which the fixed costs are spread, since Company A determines volumes. Company A also determines significant costs relating to components and raw materials and the security of supply. The evaluation of the evidence concludes that Company B performs manufacturing services. Significant risks associated with generating a return from the manufacturing activities are controlled by Company A. Company B controls the risk that it fails to competently deliver services. Each company has the financial capacity to assume its respective risks.

Example 3

1.85. Company A has acquired ownership of a tangible asset and enters into contracts for the use of the asset with unrelated customers. Under step 1 utilisation of the tangible asset, that is the risk that there will be insufficient demand for the asset to cover the costs Company A has incurred, has been identified as an economically significant risk. Under step 2 it is established that Company A has a contract for the provision of services with another group company, Company C; the contract does not address the assumption of utilisation risk by the owner of the tangible asset, Company A. The functional analysis under step 3 provides evidence that another group company, Company B, decides that investment in the asset is appropriate in light of anticipated commercial opportunities identified and evaluated by Company B and its assessment of the asset's anticipated useful life; Company B provides specifications for the asset and the unique features required to respond to the commercial opportunities, and arranges for the asset to be constructed in accordance with its specifications, and for Company A to acquire the asset. Company C decides how to utilise the asset, markets the asset's capabilities to third-party customers, negotiates the contracts with these third party customers, assures that the asset is delivered to the third parties and installed appropriately. Although it is the legal owner of the asset, Company A does not exercise control over the investment risk in the tangible asset, since it lacks any capability to decide on whether to invest in the particular asset, and whether and how to protect its investment including whether to dispose of the asset. Although it is the owner of the asset, Company A does not exercise control over the utilisation risk, since it lacks any capability to decide whether and how to exploit the asset. It does not have the capability to assess and make decisions relating to the risk mitigation activities performed by other group companies. Instead, risks associated with investing in and exploiting the asset, enhancing upside risk and mitigating downside risk, are controlled by the other group companies. Company A does not have control over the economically significant risks associated with the investment in and exploitation of the asset. The functional contribution of the legal owner of the asset is limited to providing financing for an amount equating to the cost of the asset. However, the functional analysis also provides evidence that Company A has no capability and authority to control the risk of investing in a financial asset. Company A does not have the capability to make decisions to take on or decline the financing opportunity, or the capability to make decisions on whether and how to respond to the risks associated with the financing opportunity. Company A does not perform functions to evaluate the financing opportunity, does not consider the appropriate risk premium and other issues to determine the appropriate pricing of the financing opportunity, and does not evaluate the appropriate protection of its financial investment. Companies A, B and C all have financial capacity to assume their respective risks.

D.1.2.1.4. Step 4: Interpreting steps 1-3

1.86. Carrying out steps 1-3 involves the gathering of information relating to the assumption and management of risks in the controlled transaction. The next step is to interpret the information resulting from steps 1-3 and to determine whether the contractual assumption of risk is consistent with the conduct of the parties and the other facts of the case by analysing (i) whether the associated enterprises follow the contractual terms under the principles of Section D.1.1; and (ii) whether the party assuming risk, as analysed under (i), exercises control over the risk and has the financial capacity to assume risk.

1.87. The significance of step 4 will depend on the findings. In the circumstances of Examples 1 and 2 above, the step may be straightforward. Where a party contractually assuming a risk applies that contractual assumption of risk in its conduct, and also both exercises control over the risk and has the financial capacity to assume the risk, then there is no further analysis required beyond step 4(i) and (ii) to determine risk assumption. Companies A and B in both examples fulfil the obligations reflected in the contracts and exercise control over the risks that they assume in the transaction, supported by financial capacity. As a result step 4(ii) is satisfied, there is no need to consider step 5, and the next step to consider is step 6.

1.88. In line with the discussion in relation to contractual terms (see Section D.1.1), it should be considered under step 4(i) whether the parties' conduct conforms to the assumption of risk contained in written contracts, or whether the contractual terms have not been followed or are incomplete.

Where differences exist between contractual terms related to risk and the conduct of the parties which are economically significant and would be taken into account by third parties in pricing the transaction between them, the parties' conduct in the context of the consistent contractual terms should generally be taken as the best evidence concerning the intention of the parties in relation to the assumption of risk.

1.89. Consider for example, a manufacturer, whose functional currency is US dollars, that sells goods to an associated distributor in another jurisdiction, whose functional currency is euros, and the written contract states that the distributor assumes all exchange rate risks in relation to this controlled transaction. If, however, the price for the goods is charged by the manufacturer to the distributor over an extended period of time in euros, the currency of the distributor, then aspects of the written contractual terms do not reflect the actual commercial or financial relations between the parties. The assumption of risk in the transaction should be determined by the actual conduct of the parties in the context of the contractual terms, rather than by aspects of written contractual terms which are not in practice applied. The principle can be further illustrated by Example 7 in the Annex to Chapter VI, where there is an inconsistency between the contractual assumption of risk and the conduct of the parties as evidenced by the bearing of costs relating to the downside outcome of that risk.

1.90. Under step 4(ii) it should be determined whether the party assuming the risk under the contract, taking into account whether the contractual terms have been applied in the conduct of the parties under step 4(i), controls the risk and has the financial capacity to assume the risk. If all the circumstances set out in Example 1 remain the same except for the fact that the contract between Company A and Company B allocates development risk to Company B, and if there is no evidence from the conduct of the parties under step 4(i) to suggest that the contractual allocation of risk is not being followed, then Company B contractually assumes development risk but the facts remain that Company B has no capability to evaluate the development risk and does not make decisions about Company A's activities. Company B has no decision-making function which allows it to control the development risk by taking decisions that affect the outcomes of that risk. Based on the information provided in Example 1, the development risk is controlled by Company A. The determination that the party assuming a risk is not the party controlling that risk means that further consideration is required under step 5.

1.91. If the circumstances of Example 2 remain the same except for the fact that, while the contract specifies that Company A assumes supply chain risks, Company B is not reimbursed by Company A when there was a failure to secure key components on time, the analysis under step 4(i) would show that contractual assumption of risk has not been followed in practice in regard to that supply chain risk, such that Company B in fact assumes the downside consequences of that risk. Based on the information provided in Example 2, Company B does not have any control over the supply chain risk, whereas Company A does exercise control. Therefore, the party assuming risk as analysed under step 4(i), does not under step 4(ii) exercise control over that risk, and further consideration is required under step 5.

1.92. In the circumstances of Example 3, analysis under step 4(i) shows that the assumption of utilisation risk by Company A is consistent with its contractual arrangements with Company C, but under step 4(ii) it is determined that Company A does not control risks that it assumes associated with the investment in and exploitation of the asset. Company A has no decision-making function which allows it to control its risks by taking decisions that affect the outcomes of the risks. Under step 4(ii) the party assuming risk does not control that risk, and further consideration is required under step 5.

1.93. In some cases, the analysis under step 3 may indicate that there is more than one MNE that is capable of exercising control over a risk. However, control requires both capability and functional performance in order to exercise control over a risk. Therefore, if more than one party is capable of exercising control, but the entity contractually assuming risk (as analysed under step 4(i)) is the only party that actually exercises control through capability and functional performance, then the party contractually assuming the risk also controls the risk.

1.94. Furthermore, in some cases, there may be more than one party to the transaction exercising control over a specific risk. Where the associated enterprise assuming risk (as analysed under step 4(i)) controls that risk in accordance with the requirements set out in paragraphs 1.65-1.66, all that remains under step 4(ii) is to consider whether the enterprise has the financial capacity to assume the risk. If so, the fact that other associated enterprises also exercise control over the same risk does not affect the assumption of that risk by the first-mentioned enterprise, and step 5 need not be considered.

1.95. Where two or more parties to the transaction assume a specific risk (as analysed under step 4(i)), and in addition they together control the specific risk and each has the financial capacity to assume their share of the risk, then that assumption of risk should be respected. Examples may include the contractual assumption of development risk under a transaction in which the enterprises agree jointly to bear the costs of creating a new product.

1.96. If it is established that the associated enterprise assuming the risk as analysed under step 4(i) either does not control the risk or does not have the financial capacity to assume the risk, then the analysis described under step 5 needs to be performed.

1.97. In light of the potential complexity that may arise in some circumstances when determining whether an associated enterprise assuming a risk controls that risk, the test of control should be regarded as being met where comparable risk assumptions can be identified in a comparable uncontrolled transaction. To be comparable those risk assumptions require that the economically relevant characteristics of the transactions are comparable. If such a comparison is made, it is particularly relevant to establish that the enterprise assuming comparable risk in the uncontrolled transaction performs comparable risk management functions relating to control of that risk to those performed by the associated enterprise assuming risk in the controlled transaction. The purpose of the comparison is to establish that an independent party assuming a comparable risk to that assumed by the associated enterprise also performs comparable risk management functions to those performed by the associated enterprise.

D.1.2.1.5. Step 5: Allocation of risk

1.98. If it is established in step 4(ii) that the associated enterprise assuming the risk based on steps 1-4(i) does not exercise control over the risk or does not have the financial capacity to assume the risk, then the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk. If multiple associated enterprises are identified that both exercise control and have the financial capacity to assume the risk, then the risk should be allocated to the associated enterprise or group of associated enterprises exercising the most control. The other parties performing control activities should be remunerated appropriately, taking into account the importance of the control activities performed.

1.99. In exceptional circumstances, it may be the case that no associated enterprise can be identified that both exercises control over the risk and has the financial capacity to assume the risk. As such a situation is not likely to occur in transactions between third parties, a rigorous analysis of the facts and circumstances of the case will need to be performed, in order to identify the underlying reasons and actions that led to this situation. Based on that assessment, the tax administrations will determine what adjustments to the transaction are needed for the transaction to result in an arm's length outcome. An assessment of the commercial rationality of the transaction based on Section D.2 may be necessary.

D.1.2.1.6. Step 6: Pricing of the transaction, taking account of the consequences of risk allocation

1.100. Following the guidance in this section, the accurately delineated transaction should then be priced in accordance with the tools and methods available to taxpayers and tax administrations set out in the following chapters of these Guidelines and taking into account the financial and other consequences of risk-assumption, and the remuneration for risk management. The assumption of a risk should be compensated with an appropriate anticipated return, and risk mitigation should be appropriately remunerated. Thus, a taxpayer that both assumes and mitigates a risk will be entitled to greater anticipated remuneration than a taxpayer that only assumes a risk, or only mitigates, but does not do both.

1.101. In the circumstances of Example 1 in paragraph 1.83, Company A assumes and controls the development risk and should bear the financial consequences of failure and enjoy the financial consequences of success. Company B should be appropriately rewarded for the carrying out of its development services, incorporating the risk that it fails to do so competently.

1.102. In the circumstances of Example 2 in paragraph 1.84, the significant risks associated with generating a return from the manufacturing activities are controlled by Company A, and the upside and downside consequences of those risks should therefore be allocated to Company A. Company B controls the risk that it fails to competently deliver services, and its remuneration should take into account that risk, as well as its funding costs for the acquisition of the manufacturing plant. Since the risks in relation to the capacity utilisation of the asset are controlled by Company A, Company A should be allocated the risk of under-utilisation. This means that the financial consequences related to the materialisation of that risk including failure to cover fixed costs, write-downs, or closure costs should be allocated to Company A.

1.103. The consequences of risk allocation in Example 3 in paragraph 1.85 depend on analysis of functions under step 3. Company A does not have control over the economically significant risks associated with the investment in and exploitation of the asset, and those risks should be aligned with control of those risks by Companies B and C. The functional contribution of Company A is limited to providing financing for an amount equating to the cost of the asset that enables the asset to be created and exploited by Companies B and C. However, the functional analysis also provides evidence that Company A has no capability and authority to control the risk of investing in a financial asset. Company A does not have the capability to make decisions to take on or decline the financing opportunity, or the capability to make decisions on whether and how to respond to the risks associated with the financing opportunity. Company A does not perform functions to evaluate the financing opportunity, does not consider the appropriate risk premium and other issues to determine the appropriate pricing of the financing opportunity, and does not evaluate the appropriate protection of its financial investment. In the circumstances of Example 3, Company A would not be entitled to any more than a risk-free return[2] as an appropriate measure of the profits it is entitled to retain, since it lacks the capability to control the risk associated with investing in a riskier financial asset. The risk will be allocated to the enterprise which has control and the financial capacity to assume the risk associated with the financial asset. In the circumstances of example, this would be Company B. Company A does not control the investment risk that carries a potential risk premium. An assessment may be necessary of the commercial rationality of the transaction based on the guidance in Section D.2 taking into account the full facts and circumstances of the transaction.

1.104. Guidance on the relationship between risk assumption in relation to the provision of funding and the operational activities for which the funds are used is given in paragraphs 6.60-6.64. The concepts reflected in these paragraphs are equally applicable to investments in assets other than intangibles.

1.105. A party should always be appropriately compensated for its control functions in relation to risk. Usually, the compensation will derive from the consequences of being allocated risk, and therefore that party will be entitled to receive the upside benefits and to incur the downside costs. In circumstances where a party contributes to the control of risk, but does not assume the risk, compensation which takes the form of a sharing in the potential upside and downside, commensurate with that contribution to control, may be appropriate.

1.106. The difference between *ex ante* and *ex post* returns discussed in particular in Section D of Chapter VI arises in large part from risks associated with the uncertainty of future business outcomes. As discussed in paragraph 1.78 the *ex ante* contractual assumption of risk should provide clear evidence of a commitment to assume risk prior to the materialisation of risk outcomes. Following the steps in this section, the transfer pricing analysis will determine the accurate delineation of the transaction with respect to risk, including the risk associated with unanticipated returns. A party which, under these steps, does not assume the risk, nor contributes to the control of that risk, will not be entitled to unanticipated profits (or required to bear unanticipated losses) arising from that risk. In the circumstances of Example 3 (see paragraph 1.85), this would mean that neither unanticipated profits nor unanticipated losses will be allocated to Company A. Accordingly, if the asset in Example 3 were unexpectedly destroyed, resulting in an unanticipated loss, that loss would be allocated for transfer pricing purposes to the company or companies that control the investment risk, contribute to the control of that risk and have the financial capacity to assume that risk, and that would

2. Company A could potentially be entitled to less than a risk-free return if, for example, the transaction is disregarded under Section D.2.

be entitled to unanticipated profits or losses with respect to the asset. That company or companies would be required to compensate Company A for the return to which it is entitled as described in paragraph 1.103.

D.1.2.2. Risk-free and risk-adjusted rates of return

1.107. This section of Chapter I provides guidance on how to determine a risk-free rate of return and a risk-adjusted rate of return in those situations where an associated enterprise is entitled to any of those returns under the guidance in this chapter and Chapter VI of these Guidelines.

D.1.2.2.1. Determining a risk-free rate of return

1.108. Where, in accordance with the guidance in this chapter, the accurate delineation of the actual transaction shows that a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, it will be entitled to no more than a risk-free return as an appropriate measure of the profits it is entitled to retain (see paragraph 1.103 and its footnote). In this context, the funder's costs related to the borrowing associated to the funding should be taken into account in determining the risk-free rate of return, and subject to other constraints, the funded party would still be entitled to a deduction up to an arm's length amount in respect of the funding. The difference between those amounts would be allocable to the party exercising control over the investment risk in accordance with the guidance in this chapter.

1.109. A risk-free rate of return is the hypothetical return which would be expected on an investment with no risk of loss. Ultimately, there is no investment with zero risk, and the reliability of available proxies for approximating a risk-free rate of return will depend on prevailing facts and circumstances.

1.110. An approach which is widely used in practice is to treat the interest rate on certain government issued securities as a reference rate for a risk-free return, as these securities are generally considered by market practitioners not to carry significant default risk. The intention of the guidance in this section is to outline an approach for reference purposes without suggesting that a particular government security should always be used to determine a risk-free rate.

1.111. To eliminate currency risk, the reference security for determining the risk-free rate would need to be a security issued in the same currency as the investor's cash flows, i.e. the functional currency of the investor rather than its jurisdiction of domicile. When there are multiple jurisdictions issuing bonds in the same currency, the reference point for the risk-free rate of return should be the government security with the lowest rate of return as any difference in rate must be due to differences in risk between the issuers (see paragraph 10.33).

1.112. Another relevant aspect in determining the risk-free rate of return will be the temporal proximity of the reference security to the tested transaction. The security should ideally be issued at the time, or have a similar remaining maturity, as the controlled transaction was entered into to eliminate the effect of differences which may be present between securities issued at different times (see paragraph 10.32).

1.113. Another key consideration would be the maturity of the financial instrument. The duration of the reference security should match the duration of the investment since the duration of an investment will usually affect its price. The duration of the controlled investment should be determined as part of the process of accurate delineation of the actual transaction. For example, a financial instrument which is short-term under the written contractual terms between the parties but which is consistently replaced with a new instrument may, depending upon the exact facts and circumstances, be accurately delineated as a long-term investment.

1.114. Due to difficulties in practice, practical solutions might be considered for estimating the risk-free rate of return. For instance, assume a situation where Company A, a member of an MNE group, is not entitled to any more than a risk-free return under the guidance in this chapter in relation to an advance of funds with a term of one year to an associated enterprise, Company B. In approximating that return, the starting point would be to identify a security issued at the time of the provision of the funding in the same currency as Company A’s functional currency. Assume that the tax administration of Country X, where Company A is resident, identifies three securities issued in Company A’s functional currency by the governments of Country X, Country Y and Country Z with a term of one year. The credit ratings of the issuing governments are A for Country X, B for Country Y and AA for Country Z. In specifying a minimum credit rating for the issuing government to consider the issued security as a risk-free investment comparable to the controlled financial transaction, the tax administration of Country X may select the security issued by Country Z as a reference for the risk-free rate of return since it represents the lowest rate of return available at the time of the provision of the funding on all outstanding government bonds in the relevant currency with a term of one year.

1.115. To approximate risk-free rate of returns, highly rated government issued securities are not the only reference, and other alternatives may be considered on prevailing facts and circumstances of each case, for instance interbank rates, interest rate swap rates or repurchase agreements of highly rated government issued securities.

1.116. The risk-free rate of return may be relevant, for example, as a component in calculating a risk-adjusted rate of return on an investment or as the return allocable to an investor who has provided funding but has not assumed any of the risks related to the funding.

D.1.2.2.2. Determining a risk-adjusted rate of return

1.117. As stated in paragraph 6.61, "where a party providing funding exercises control over the financial risk associated with the provision of funding, without the assumption of, including the control over, any other specific risk, it could generally only expect a risk-adjusted rate of return on its funding." (See paragraphs 1.85 and 1.103).

1.118. Therefore, in determining the risk-adjusted rate, it is important to identify and differentiate the financial risk which is assumed by the funder in carrying on its financing activity, and the operational risk that is assumed by the funded party and is connected to the use of the funds, e.g. for developing an intangible asset. Guidance on the relationship between risk assumption in relation to the provision of funding and the operational activities for which the funds are used is given in paragraphs 6.60-6.64.

1.119. For instance, consider a situation where Company F advances a loan to an associated enterprise, Company D, which undertakes the development of an intangible. Consider further that, under the guidance in this chapter, it is determined that Company F controls and consequently is allocated the financial risk associated with funding the development of the intangible, including the potential risk of Company D failing to develop the intangible and therefore being unable to repay the loan. However, Company F does not assume the risk of developing the intangible, which is entirely assumed by Company D under the accurate delineation of the actual transaction. Accordingly, in the event that the *ex post* results derived from the exploitation of the developed intangible were higher (or lower) than the results calculated on an *ex ante* basis, Company F would not be entitled to that difference but to a risk-adjusted rate of return as described in this section.

1.120. In general, the expected risk-adjusted rate of return on a funding transaction can be considered to have two components, i.e. the risk-free rate and a premium reflecting the risks assumed by the funder.

1.121. When the funder is assuming the financial risk under the guidance in this chapter and is therefore exposed to the potential playing out of that risk, it will encounter the upside and downside consequences of that risk outcome. Therefore, the assumption of that risk will warrant an expected remuneration higher than a risk-free rate of return.

1.122. A risk-adjusted rate of return can be determined under different approaches, for example, based on the return of a realistic alternative investment with comparable economic characteristics or the cost of funds (see Section C.1.2 in Chapter X).

1.123. It may be possible to find a reasonable indicator of a risk-adjusted rate of return from comparable uncontrolled transactions or by considering realistically available alternative investments reflecting the same risk profile. Depending on the facts and circumstances, realistic alternatives to an intra-group loan could be bond issuances or loans which are uncontrolled transactions (see paragraph 10.93).

1.124. Another approach to determining the risk-adjusted rate of return would be to add a risk premium to the risk-free return, based on the information available in the market on financial instruments issued under similar conditions and circumstances.

1.125. For instance, consider the same fact pattern as described in paragraph 1.114 but, in this particular scenario, assume that Company A is found to be entitled to a risk-adjusted rate of return under this chapter. To determine that return, the tax administration of Country X considers adding a risk premium to the risk-free rate of return, i.e. the security issued by the government in Country Z with a term of one year. To estimate the risk-adjusted return, Country X's tax administration considers that corporate bonds issued by independent parties resident in Country X operating in the same industry as Company B yield a return comparable to the one that an independent party would have expected had it invested its funds in Company B under comparable circumstances.

1.126. Under an approach based on the cost of funds, the controlled transaction would be priced by adding a profit margin to the costs incurred by the lender to raise the funds advanced to the borrower. That mark-up should be proportionate to the risk assumed by the lender and calculated according to the guidance provided in paragraphs 10.97-10.100.

D.1.3. Characteristics of property or services

1.127. Differences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market. Therefore, comparisons of these features may be useful in delineating the transaction and in determining the comparability of controlled and uncontrolled transactions. Characteristics that may be important to consider include the following: in the case of transfers of tangible property, the physical features of the property, its quality and reliability, and the availability and volume of supply; in the case of the provision of services, the nature and extent of the services; and in the case of intangible property, the form of transaction (e.g. licensing or sale), the type of property (e.g. patent, trademark, or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property. For further discussion of some of the specific features of intangibles that may prove important in a comparability analysis involving transfers of intangibles or rights in intangibles, see Section D.2.1 of Chapter VI.

1.128. Depending on the transfer pricing method, this factor must be given more or less weight. Among the methods described at Chapter II of these Guidelines, the requirement for comparability of property or services is the strictest for the comparable uncontrolled price method. Under the comparable uncontrolled price method, any material difference in the characteristics of property or services can have an effect on the price and would require an appropriate adjustment to be considered (see in particular paragraph 2.16). Under the resale price method and cost plus method, some differences in the characteristics of property or services are less likely to have a material effect on the gross profit margin or mark-up on costs (see in particular paragraphs 2.29 and 2.47). Differences in the characteristics of property or services are also less sensitive in the case of the transactional profit methods than in the case of traditional transaction methods (see in particular paragraph 2.75). This however does not mean that the question of comparability in characteristics of property or services can be ignored when applying transactional profit methods, because it may be that product differences entail or reflect different functions performed, assets used and/or risks assumed by the tested party. See paragraphs 3.18-3.19 for a discussion of the notion of tested party.

1.129. In practice, it has been observed that comparability analyses for methods based on gross or net profit indicators often put more emphasis on functional similarities than on product similarities. Depending on the facts and circumstances of the case, it may be acceptable to broaden the scope of the comparability analysis to include uncontrolled transactions involving products that are different, but where similar functions are undertaken. However, the acceptance of such an approach depends on the effects that the product differences have on the reliability of the comparison and on whether or not more reliable data are available. Before broadening the search to include a larger number of potentially comparable uncontrolled transactions based on similar functions being undertaken, thought should be given to whether such transactions are likely to offer reliable comparables for the controlled transaction.

D.1.4. Economic circumstances

1.130. Arm's length prices may vary across different markets even for transactions involving the same property or services; therefore, to achieve comparability requires that the markets in which the independent and associated enterprises operate do not have differences that have a material effect on price or that appropriate adjustments can be made. As a first step, it is essential to identify the relevant market or markets taking account of available substitute goods or services. Economic circumstances that may be relevant to determining market comparability include the geographic location;

the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers; the availability (risk thereof) of substitute goods and services; the levels of supply and demand in the market as a whole and in particular regions, if relevant; consumer purchasing power; the nature and extent of government regulation of the market; costs of production, including the costs of land, labour, and capital; transport costs; the level of the market (e.g. retail or wholesale); the date and time of transactions; and so forth. The facts and circumstances of the particular case will determine whether differences in economic circumstances have a material effect on price and whether reasonably accurate adjustments can be made to eliminate the effects of such differences. More detailed guidance on the importance in a comparability analysis of the features of local markets, especially local market features that give rise to location savings, is provided in Section D.6 of this chapter.

1.131. The existence of a cycle (e.g. economic, business, or product cycle) is one of the economic circumstances that should be identified. See paragraph 3.77 in relation to the use of multiple year data where there are cycles.

1.132. The geographic market is another economic circumstance that should be identified. The identification of the relevant market is a factual question. For a number of industries, large regional markets encompassing more than one jurisdiction may prove to be reasonably homogeneous, while for others, differences among domestic markets (or even within domestic markets) are very significant.

1.133. In cases where similar controlled transactions are carried out by an MNE group in several jurisdictions and where the economic circumstances in these jurisdictions are in effect reasonably homogeneous, it may be appropriate for this MNE group to rely on a comparability analysis that covers multiple jurisdictions to support its transfer pricing policy towards this group of jurisdictions. But there are also numerous situations where an MNE group offers significantly different ranges of products or services in each jurisdiction, and/or performs significantly different functions in each of these jurisdictions (using significantly different assets and assuming significantly different risks), and/or where its business strategies and/or economic circumstances are found to be significantly different. In these latter situations, the recourse to a multiple-jurisdictional approach may reduce reliability.

D.1.5. Business strategies

1.134. Business strategies must also be examined in delineating the transaction and in determining comparability for transfer pricing purposes. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws, duration of arrangements, and other factors bearing upon the daily conduct of business. Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions and enterprises.

1.135. Business strategies also could include market penetration schemes. A taxpayer seeking to penetrate a market or to increase its market share might temporarily charge a price for its product that is lower than the price charged for otherwise comparable products in the same market. Furthermore, a taxpayer seeking to enter a new market or expand (or defend) its market share might temporarily incur higher costs (e.g. due to start-up costs or increased marketing efforts) and hence achieve lower profit levels than other taxpayers operating in the same market.

1.136. Timing issues can pose particular problems for tax administrations when evaluating whether a taxpayer is following a business strategy that distinguishes it from potential comparables. Some business strategies, such as those involving market penetration or expansion of market share, involve reductions in the taxpayer's current profits in anticipation of increased future profits. If in the future those increased profits fail to materialise because the purported business strategy was not actually followed by the taxpayer, the appropriate transfer pricing outcome would likely require a transfer pricing adjustment. However legal constraints may prevent re-examination of earlier tax years by the tax administrations. At least in part for this reason, tax administrations may wish to subject the issue of business strategies to particular scrutiny.

1.137. When evaluating whether a taxpayer was following a business strategy that temporarily decreased profits in return for higher long-run profits, several factors should be considered. Tax administrations should examine the conduct of the parties to determine if it is consistent with the purported business strategy. For example, if a manufacturer charges its associated distributor a below-market price as part of a market penetration strategy, the cost savings to the distributor may be reflected in the price charged to the distributor's customers or in greater market penetration expenses incurred by the distributor. A market penetration strategy of an MNE group could be put in place either by the manufacturer or by the distributor acting separately from the manufacturer (and the resulting cost borne by either of them), or by both of them acting in a co-ordinated manner. Furthermore, unusually intensive marketing and advertising efforts would often accompany a market penetration or market share expansion strategy. Another factor to consider is whether the nature of the relationship between the parties to the controlled transaction would be consistent with the taxpayer bearing the costs of the business strategy. For example, in arm's length transactions a company acting solely as a sales agent with little or no responsibility for long-term market development would generally not bear the costs of a market penetration strategy. Where a company has undertaken market development activities at its own risk and enhances the value of a product through a trademark or trade name or increases goodwill associated with the product, this situation should be reflected in the analysis of functions for the purposes of establishing comparability.

1.138. An additional consideration is whether there is a plausible expectation that following the business strategy will produce a return sufficient to justify its costs within a period of time that would be acceptable in an arm's length arrangement. It is recognised that a business strategy such as market penetration may fail, and the failure does not of itself allow the strategy to be ignored for transfer pricing purposes. However, if such an expected outcome was implausible at the time of the transaction, or if the business strategy is unsuccessful but nonetheless is continued beyond what an independent enterprise would accept, the arm's length nature of the business strategy may be doubtful and may warrant a transfer pricing adjustment. In determining what period of time an independent enterprise would accept, tax administrations may wish to consider evidence of the commercial strategies evident in the jurisdiction in which the business strategy is being pursued. In the end, however, the most important consideration is whether the strategy in question could plausibly be expected to prove profitable within the foreseeable future (while recognising that the strategy might fail), and that a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions.

D.2. Recognition of the accurately delineated transaction

1.139. Following the guidance in the previous section, the transfer pricing analysis will have identified the substance of the commercial or financial relations between the parties, and will have accurately delineated the actual transaction by analysing the economically relevant characteristics.

1.140. In performing the analysis, the actual transaction between the parties will have been deduced from written contracts and the conduct of the parties. Formal conditions recognised in contracts will have been clarified and supplemented by analysis of the conduct of the parties and the other economically relevant characteristics of the transaction (see Section D.1.1). Where the characteristics of the transaction that are economically significant are inconsistent with the written contract, then the actual transaction will have been delineated in accordance with the characteristics of the transaction reflected in the conduct of the parties. Contractual risk assumption and actual conduct with respect to risk assumption will have been examined taking into account control over the risk (as defined in paragraphs 1.65-1.68) and the financial capacity to assume risk (as defined in paragraph 1.64), and consequently, risks assumed under the contract may have been allocated in accordance with the conduct of the parties and the other facts on the basis of steps 4 and 5 of the process for analysing risk in a controlled transaction as reflected in Sections D.1.2.1.4 and D.1.2.1.5. Therefore, the analysis will have set out the factual substance of the commercial or financial relations between the parties and accurately delineated the actual transaction.

1.141. Every effort should be made to determine pricing for the actual transaction as accurately delineated under the arm's length principle. The various tools and methods available to tax administrations and taxpayers to do so are set out in the following chapters of these Guidelines. A tax administration should not disregard the actual transaction or substitute other transactions for it unless the exceptional circumstances described in the following paragraphs 1.142-1.145 apply.

1.142. This section sets out circumstances in which the transaction between the parties as accurately delineated can be disregarded for transfer pricing purposes. Because non-recognition can be contentious and a source of double taxation, every effort should be made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and to ensure that non-recognition is not used simply because determining an arm's length price is difficult. Where the same transaction can be seen between independent parties in comparable circumstances (i.e. where all economically relevant characteristics are the same as those under which the tested transaction occurs other than that the parties are associated enterprises) non-recognition would not apply. Importantly, the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised. Associated enterprises may have the ability to enter into a much greater variety of arrangements than can independent enterprises, and may conclude transactions of a specific nature that are not encountered, or are only very rarely encountered, between independent parties, and may do so for sound business reasons. The transaction as accurately delineated may be disregarded, and if appropriate, replaced by an alternative transaction, where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to each of them at the time of entering into the transaction. It is also a relevant pointer to consider whether the MNE group as a whole is left worse off on a pre-tax basis since this may be an indicator that the transaction viewed in its entirety lacks the commercial rationality of arrangements between unrelated parties.

1.143. The key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties. The non-recognition of a transaction that possesses the commercial rationality of an arm's length arrangement is not an appropriate application of the arm's length principle. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured. It should again be noted that the mere fact that the transaction may not be seen between independent parties does not mean that it does not have characteristics of an arm's length arrangement.

1.144. The structure that for transfer pricing purposes, replaces that actually adopted by the taxpayers should comport as closely as possible with the facts of the actual transaction undertaken whilst achieving a commercially rational expected result that would have enabled the parties to come to a price acceptable to both of them at the time the arrangement was entered into.

1.145. The criterion for non-recognition may be illustrated by the following examples.

Example 1

1.146. Company S1 carries on a manufacturing business that involves holding substantial inventory and a significant investment in plant and machinery. It owns commercial property situated in an area prone to increasingly frequent flooding in recent years. Third-party insurers experience significant uncertainty over the exposure to large claims, with the result that there is no active market for the insurance of properties in the area. Company S2, an associated enterprise, provides insurance to Company S1, and an annual premium representing 80% of the value of the inventory, property and contents is paid by Company S1. In this example S1 has entered into a commercially irrational transaction since there is no market for insurance given the likelihood of significant claims, and either relocation or not insuring may be more attractive realistic alternatives. Since the transaction is commercially irrational, there is not a price that is acceptable to both S1 and S2 from their individual perspectives.

1.147. Under the guidance in this section, the transaction should not be recognised. S1 is treated as not purchasing insurance and its profits are not reduced by the payment to S2; S2 is treated as not issuing insurance and therefore not being liable for any claim.

Example 2

1.148. Company S1 conducts research activities to develop intangibles that it uses to create new products that it can produce and sell. It agrees to transfer to an associated company, Company S2, unlimited rights to all future intangibles which may arise from its future work over a period of twenty years for a lump sum payment. The arrangement is commercially irrational for both parties since neither Company S1 nor Company S2 has any reliable means to determine whether the payment reflects an appropriate valuation, both because it is uncertain what range of development activities Company S1 might conduct over the period and also because valuing the potential outcomes would be entirely speculative. Under the guidance in this section, the structure of the arrangement adopted by the taxpayer, including the form of payment, should be modified for the purposes of the transfer pricing analysis. The replacement structure should be guided by the economically relevant characteristics, including the functions performed, assets used, and risks assumed, of the commercial or financial relations of the associated enterprises. Those facts would narrow the range of potential replacement structures to the structure most consistent with the facts of the case (for example, depending on those facts the arrangement could be recast as the provision of financing by Company S2, or as the provision of research services by Company S1, or, if specific intangibles can be identified, as a licence with contingent payments terms for the development of those specific intangibles, taking into account the guidance on hard-to-value intangibles as appropriate).

D.3. Losses

1.149. When an associated enterprise consistently realises losses while the MNE group as a whole is profitable, the facts could trigger some special scrutiny of transfer pricing issues. Of course, associated enterprises, like independent enterprises, can sustain genuine losses, whether due to heavy start-up costs, unfavourable economic conditions, inefficiencies, or other legitimate business reasons. However, an independent enterprise would not be prepared to tolerate losses that continue indefinitely. An independent enterprise that experiences recurring losses will eventually cease to undertake business on such terms. In contrast, an associated enterprise that realises losses may remain in business if the business is beneficial to the MNE group as a whole.

1.150. The fact that there is an enterprise making losses that is doing business with profitable members of its MNE group may suggest to the taxpayers or tax administrations that the transfer pricing should be examined. The loss enterprise may not be receiving adequate compensation from the MNE group of which it is a part in relation to the benefits derived from its activities. For example, an MNE group may need to produce a full range of products and/or services in order to remain competitive and realise an overall profit, but some of the individual product lines may regularly lose revenue. One member of the MNE group might realise consistent losses because it produces all the loss-making products while other members produce the profit-making products. An independent enterprise would perform such a service only if it were compensated by an adequate service charge. Therefore, one way to approach this type of transfer pricing problem would be to deem the loss enterprise to receive the same type of service charge that an independent enterprise would receive under the arm's length principle.

1.151. A factor to consider in analysing losses is that business strategies may differ from MNE group to MNE group due to a variety of historic, economic, and cultural reasons. Recurring losses for a reasonable period may be justified in some cases by a business strategy to set especially low prices to achieve market penetration. For example, a producer may lower the prices of its goods, even to the extent of temporarily incurring losses, in order to enter new markets, to increase its share of an existing market, to introduce new products or services, or to discourage potential competitors. However, especially low prices should be expected for a limited period only, with the specific object of improving profits in the longer term. If the pricing strategy continues beyond a reasonable period, a transfer pricing adjustment may be appropriate, particularly where comparable data over several years show that the losses have been incurred for a period longer than that affecting comparable independent enterprises. Further, tax administrations should not accept especially low prices (e.g. pricing at marginal cost in a situation of underemployed production capacities) as arm's length prices unless independent enterprises could be expected to have determined prices in a comparable manner.

D.4. The effect of government policies

1.152. There are some circumstances in which a taxpayer will consider that an arm's length price must be adjusted to account for government interventions such as price controls (even price cuts), interest rate controls, controls over payments for services or management fees, controls over the payment of royalties, subsidies to particular sectors, exchange control, anti-dumping duties, or exchange rate policy. As a general rule, these government interventions should be treated as conditions of the market in the particular jurisdiction, and in the ordinary course they should be taken into account in evaluating the taxpayer's transfer price in that market. The question then presented is whether in light of these conditions the transactions undertaken by the controlled parties are consistent with transactions between independent enterprises.

1.153. One issue that arises is determining the stage at which a price control affects the price of a product or service. Often the direct impact will be on the final price to the consumer, but there may nonetheless be an impact on prices paid at prior stages in the supply of goods to the market. MNEs in practice may make no adjustment in their transfer prices to take account of such controls, leaving the final seller to suffer any limitation on profit that may occur, or they may charge prices that share the burden in some way between the final seller and the intermediate supplier. It should be considered whether or not an independent supplier would share in the costs of the price controls and whether an independent enterprise would seek alternative product lines and business opportunities. In this regard, it is unlikely that an independent enterprise would be prepared to produce, distribute, or otherwise provide products or services on terms that allowed it no profit. Nevertheless, it is quite obvious that a jurisdiction with price controls must take into account that those price controls will affect the profits that can be realised by enterprises selling goods subject to those controls.

1.154. A special problem arises when a jurisdiction prevents or "blocks" the payment of an amount which is owed by one associated enterprise to another or which in an arm's length arrangement would be charged by one associated enterprise to another. For example, exchange controls may effectively prevent an associated enterprise from transferring interest payments abroad on a loan made by another associated enterprise located in a different jurisdiction. This circumstance may be treated differently by the two jurisdictions involved: the jurisdiction of the borrower may or may not regard the untransferred interest as having been paid, and the jurisdiction of the lender may or may not treat the lender as having received the interest. As a general rule, where the government intervention applies equally to transactions between associated enterprises and transactions between independent enterprises (both in law and in fact), the approach to this problem where it occurs between associated enterprises should be the same for tax purposes as that adopted for transactions between independent enterprises. Where the government intervention applies only to transactions between associated enterprises, there is no simple solution to the problem. Perhaps one way to deal with the issue is to apply the arm's length principle viewing the intervention as a condition affecting the terms of the transaction. Treaties may specifically address the approaches available to the treaty partners where such circumstances exist.

1.155. A difficulty with this analysis is that often independent enterprises simply would not enter into a transaction in which payments were blocked. An independent enterprise might find itself in such an arrangement from time to time, most likely because the government interventions were imposed subsequent to the time that the arrangement began. But it seems unlikely that an independent enterprise would willingly subject itself to a substantial risk of non-payment for products or services rendered by entering into an arrangement when severe government interventions already existed unless the profit projections or anticipated return from the independent enterprise's proposed business strategy are sufficient to yield it an acceptable rate of return notwithstanding the existence of the government intervention that may affect payment.

1.156. Because independent enterprises might not engage in a transaction subject to government interventions, it is unclear how the arm's length principle should apply. One possibility is to treat the payment as having been made between the associated enterprises, on the assumption that an independent enterprise in a similar circumstance would have insisted on payment by some other means. This approach would treat the party to whom the blocked payment is owed as performing a service for the MNE group. An alternative approach that may be available in some jurisdictions would be to defer both the income and the relevant expenses of the taxpayer. In other words, the party to whom this blocked payment was due would not be allowed to deduct expenses, such as additional financing costs, until the blocked payment was made. The concern of tax administrations in these situations is mainly their respective tax bases. If an associated enterprise claims a deduction in its tax computations for a blocked payment, then there should be corresponding income to the other party. In any case, a taxpayer should not be permitted to treat blocked payments due from an associated enterprise differently from blocked payments due from an independent enterprise.

D.5. Use of customs valuations

1.157. The arm's length principle is applied, broadly speaking, by many customs administrations as a principle of comparison between the value attributable to goods imported by associated enterprises, which may be affected by the special relationship between them, and the value for similar goods imported by independent enterprises. Valuation methods for customs purposes however may not be aligned with the OECD's recognised transfer pricing methods. That being said, customs valuations may be useful to tax administrations in evaluating the arm's length character of a controlled transaction transfer price and vice versa. In particular, customs officials may have contemporaneous information regarding the transaction that could be relevant for transfer pricing purposes, especially if prepared by the taxpayer, while tax authorities may have transfer pricing documentation which provides detailed information on the circumstances of the transaction.

1.158. Taxpayers may have competing incentives in setting values for customs and tax purposes. In general, a taxpayer importing goods may be interested in setting a low price for the transaction for customs purposes so that the customs duty imposed will be low. (There could be similar considerations arising with respect to value added taxes, sales taxes, and excise taxes.) For tax purposes, however, a higher price paid for those same goods would increase the deductible costs in the importing jurisdiction (although this would also increase the sales revenue of the seller in the jurisdiction of export). Co-operation between income tax and customs administrations within a jurisdiction in evaluating transfer prices is becoming more common and this should help to reduce the number of cases where customs valuations are found unacceptable for tax purposes or vice versa. Greater co-operation in the area of exchange of information would be particularly useful, and should not be difficult to achieve in jurisdictions that already have integrated administrations for income taxes and customs duties. Jurisdictions that have separate administrations may wish to consider modifying the exchange of information rules so that the information can flow more easily between the different administrations.

D.6. Location savings and other local market features

1.159. Paragraphs 1.130, 1.132 and 6.120 indicate that features of the geographic market in which business operations occur can affect comparability and arm's length prices. Difficult issues can arise in evaluating differences between geographic markets and in determining appropriate comparability adjustments. Such issues may arise in connection with the consideration of cost savings attributable to operating in a particular market. Such savings are sometimes referred to as location savings. In other situations comparability issues can arise in connection with the consideration of local market advantages or disadvantages that may not be directly related to location savings.

D.6.1. Location savings

1.160. Paragraphs 9.126-9.131 discuss the treatment of location savings in the context of a business restructuring. The principles described in those paragraphs apply generally to all situations where location savings are present, not just in the case of a business restructuring.

1.161. Pursuant to the guidance in paragraphs 9.126 – 9.131, in determining how location savings are to be shared between two or more associated enterprises, it is necessary to consider (i) whether location savings exist; (ii) the amount of any location savings; (iii) the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and (iv) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings.

1.162. Where the functional analysis shows that location savings exist that are not passed on to customers or suppliers, and where comparable entities and transactions in the local market can be identified, those local market comparables will provide the most reliable indication regarding how the net location savings should be allocated amongst two or more associated enterprises. Thus, where reliable local market comparables are available and can be used to identify arm's length prices, specific comparability adjustments for location savings should not be required.

1.163. When reliable local market comparables are not present, determinations regarding the existence and allocation of location savings among members of an MNE group, and any comparability adjustments required to take into account location savings, should be based on an analysis of all of the relevant facts and circumstances, including the functions performed, risks assumed, and assets used of the relevant associated enterprises, in the manner described in paragraphs 9.126-9.131.

D.6.2. Other local market features

1.164. Features of the local market in which business operations occur may affect the arm's length price with respect to transactions between associated enterprises. While some such features may give rise to location savings, others may give rise to comparability concerns not directly related to such savings. For example, the comparability and functional analysis conducted in connection with a particular matter may suggest that the relevant characteristics of the geographic market in which products are manufactured or sold, the purchasing power and product preferences of households in that market, whether the market is expanding or contracting, the degree of competition in the market and other similar factors affect prices and margins that can be realised in the market. Similarly, the comparability and functional analysis conducted in connection with a particular matter may suggest that the relative availability of local country infrastructure, the relative availability of a pool of trained or educated workers, proximity to profitable markets, and similar features in a geographic market where business operations occur create market advantages or disadvantages that should be taken into account. Appropriate comparability adjustments should be made to account for such factors where reliable adjustments that will improve comparability can be identified.

1.165. In assessing whether comparability adjustments for such local market features are required, the most reliable approach will be to refer to data regarding comparable uncontrolled transactions in that geographic market between independent enterprises performing similar functions, assuming similar risks, and using similar assets. Such transactions are carried out under the same market conditions as the controlled transaction, and, accordingly, where comparable transactions in the local market can be identified, specific adjustments for features of the local market should not be required.

1.166. In situations where reasonably reliable local market comparables cannot be identified, the determination of appropriate comparability adjustments for features of the local market should consider all of the relevant facts and circumstances. As with location savings, in each case where reliable local market comparables cannot be identified, it is necessary to consider (i) whether a market advantage or disadvantage exists, (ii) the amount of any increase or decrease in revenues, costs or profits, *vis-à-vis* those of identified comparables from other markets, that are attributable to the local market advantage or disadvantage, (iii) the degree to which benefits or burdens of local market features are passed on to independent customers or suppliers, and (iv) where benefits or burdens attributable to local market features exist and are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate such net benefits or burdens between them.

1.167. The need for comparability adjustments related to features of the local market in cases where reasonably reliable local market comparables cannot be identified may arise in several different contexts. In some circumstances, market advantages or disadvantages may affect arm's length prices of goods transferred or services provided between associated enterprises.

1.168. In other circumstances, a business restructuring or the transfer of intangibles between associated enterprises may make it possible for one party to the transaction to gain the benefit of local market advantages or require that party to assume the burden of local market disadvantages in a manner that would not have been possible in the absence of the business restructuring or transfer of the intangibles. In such circumstances, the anticipated existence of local market advantages and disadvantages may affect the arm's length price paid in connection with the business restructuring or intangible transfer.

1.169. In conducting a transfer pricing analysis it is important to distinguish between features of the local market, which are not intangibles, and any contractual rights, government licences, or know-how necessary to exploit that market, which may be intangibles. Depending on the circumstances, these types of intangibles may have substantial value that should be taken into account in a transfer pricing analysis in the manner described in Chapter VI, including the guidance on rewarding entities for functions, assets and risks associated with the development of intangibles contained in Section B of Chapter VI. In some circumstances, contractual rights and government licences may limit access of competitors to a particular market and may therefore affect the manner in which the economic consequences of local market features are shared between parties to a particular transaction. In other circumstances, contractual rights or government licences to access a market may be available to many or all potential market entrants with little restriction.

1.170. For example, a country may require a regulatory licence to be issued as a pre-condition for conducting an investment management business in the country and may restrict the number of foreign-owned firms to which such licences are granted. The comparability and functional analysis may indicate that qualifying for such a licence requires demonstrating to appropriate government authorities that the service provider has appropriate levels of experience and capital to conduct such a business in a reputable fashion. The market to which such a licence relates may also be one with unique features. It may, for example be a market where the structure of pension and insurance arrangements gives rise to large cash pools, a need to diversify investments internationally, and a resulting high demand for quality investment management services and knowledge of foreign financial markets that can make the provision of such services highly lucrative. The comparability analysis may further suggest that those features of the local market may affect the price that can be charged for certain types of investment management services and the profit margins that may be earned from providing such services. Under these circumstances, the intangible in question (i.e. the regulatory licence to provide investment management services) may allow the party or parties holding the licence to extract a greater share of the benefits of operating in the local market, including the benefits provided by unique features of that market, than would be the case in the absence of the licensing requirement. However, in assessing the impact of the regulatory licence, it may be important in a particular case to consider the contributions of both the local group member in the local market and other group members outside the local market in supplying the capabilities necessary to obtain the licence, as described in Section B of Chapter VI.

1.171. In a different circumstance, the comparability and functional analysis may suggest that a government issued business licence is necessary as a pre-condition for providing a particular service in a geographic market. However, it may be the case that such licences are readily available to any qualified applicant and do not have the effect of restricting the number of competitors in the market. Under such circumstances, the licence requirement may not present a material barrier to entry, and possession of such a licence may not have any discernible impact on the manner in which the benefits of operating in the local market are shared between independent enterprises.

D.7. Assembled workforce

1.172. Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group may affect the arm's length price for services provided by the employee group or the efficiency with which services are provided or goods produced by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis. Where it is possible to determine the benefits or detriments of a unique assembled workforce *vis-à-vis* the workforce of enterprises engaging in potentially comparable transactions, comparability adjustments may be made to reflect the impact of the assembled workforce on arm's length prices for goods or services.

1.173. In some business restructuring and similar transactions, it may be the case that an assembled workforce is transferred from one associated enterprise to another as part of the transaction. In such circumstances, it may well be that the transfer of the assembled workforce along with other transferred assets of the business will save the transferee the time and expense of hiring and training a new workforce. Depending on the transfer pricing methods used to evaluate the overall transaction, it may be appropriate in such cases to reflect such time and expense savings in the form of comparability adjustments to the arm's length price otherwise charged with respect to the transferred assets. In other situations, the transfer of the assembled workforce may result in limitations on the transferee's flexibility in structuring business operations and create potential liabilities if workers are terminated. In such cases it may be appropriate for the compensation paid in connection with the restructuring to reflect the potential future liabilities and limitations.

1.174. The foregoing paragraph is not intended to suggest that transfers or secondments of individual employees between members of an MNE group should be separately compensated as a general matter. In many instances the transfer of individual employees between associated enterprises will not give rise to a need for compensation. Where employees are seconded (i.e. they remain on the transferor's payroll but work for the transferee), in many cases the appropriate arm's length compensation for the services of the seconded employees in question will be the only payment required.

1.175. It should be noted, however, that in some situations, the transfer or secondment of one or more employees may, depending on the facts and circumstances, result in the transfer of valuable know-how or other intangibles from one associated enterprise to another. For example, an employee of Company A seconded to Company B may have knowledge of a secret formula owned by Company A and may make that secret formula available to Company B for use in its commercial operations. Similarly, employees of Company A seconded to Company B to assist with a factory start-up may make Company A manufacturing know-how available to Company B for use in its commercial operations. Where such a provision of know-how or other intangibles results from the transfer or secondment of employees, it should be separately analysed under the provisions of Chapter VI and an appropriate price should be paid for the right to use the intangibles.

1.176. Moreover, it should also be noted that access to an assembled workforce with particular skills and experience may, in some circumstances, enhance the value of transferred intangibles or other assets, even where the employees making up the workforce are not transferred. Example 23 in Annex I to Chapter VI illustrates one fact pattern where the interaction between intangibles and access to an assembled workforce may be important in a transfer pricing analysis.

D.8. MNE group synergies

1.177. Comparability issues, and the need for comparability adjustments, can also arise because of the existence of MNE group synergies. In some circumstances, MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies amongst group members that would not generally be available to similarly situated independent enterprises. Such group synergies can arise, for example, as a result of combined purchasing power or economies of scale, combined and integrated computer and communication systems, integrated management, elimination of duplication, increased borrowing capacity, and numerous similar factors. Such group synergies are often favourable to the group as a whole and therefore may heighten the aggregate profits earned by group members, depending on whether expected cost savings are, in fact, realised, and on competitive conditions. In other circumstances such synergies may be negative, as when the size and scope of corporate operations create bureaucratic barriers not faced by smaller and more nimble enterprises, or when one portion of the business is forced to work with computer or communication systems that are not the most efficient for its business because of group wide standards established by the MNE group.

1.178. Paragraph 7.13 of these Guidelines suggests that an associated enterprise should not be considered to receive an intra-group service or be required to make any payment when it obtains incidental benefits attributable solely to its being part of a larger MNE group. In this context, the term incidental refers to benefits arising solely by virtue of group affiliation and in the absence of deliberate concerted actions or transactions leading to that benefit. The term incidental does not refer to the quantum of such benefits or suggest that such benefits must be small or relatively insignificant. Consistent with this general view of benefits incidental to group membership, when synergistic benefits or burdens of group membership arise purely as a result of membership in an MNE group and without the deliberate concerted action of group members or the performance of any service or other function by group members, such synergistic benefits of group membership need not be separately compensated or specifically allocated among members of the MNE group.

1.179. In some circumstances, however, synergistic benefits and burdens of group membership may arise because of deliberate concerted group actions and may give an MNE group a material, clearly identifiable structural advantage or disadvantage in the marketplace over market participants that are not part of an MNE group and that are involved in comparable transactions. Whether such a structural advantage or disadvantage exists, what the nature and source of the synergistic benefit or burden may be, and whether the synergistic benefit or burden arises through deliberate concerted group actions can only be determined through a thorough functional and comparability analysis.[3]

1.180. For example, if a group takes affirmative steps to centralise purchasing in a single group company to take advantage of volume discounts, and that group company resells the items it purchases to other group members, a deliberate concerted group action occurs to take advantage of group purchasing power. Similarly, if a central purchasing manager at the parent company or regional management centre performs a service by negotiating a group wide discount with a supplier on the condition of achieving minimum group wide purchasing levels, and group members then purchase from that supplier and obtain the discount, deliberate concerted group action has occurred notwithstanding the absence of specific purchase and sale transactions among group members. Where a supplier unilaterally offers one member of a group a favourable price in the hope of attracting business from other group members, however, no deliberate concerted group action would have occurred.

1.181. Where corporate synergies arising from deliberate concerted group actions do provide a member of an MNE group with material advantages or burdens not typical of comparable independent companies, it is necessary to determine (i) the nature of the advantage or disadvantage, (ii) the amount of the benefit or detriment provided, and (iii) how that benefit or detriment should be divided among members of the MNE group.

1.182. If important group synergies exist and can be attributed to deliberate concerted group actions, the benefits of such synergies should generally be shared by members of the group in proportion to their contribution to the creation of the synergy. For example, where members of the group take deliberate concerted actions to consolidate purchasing activities to take advantage of economies of scale resulting from high volume purchasing, the benefits of those large scale purchasing synergies, if any exist after an appropriate reward to the party co-ordinating the purchasing activities, should typically be shared by the members of the group in proportion to their purchase volumes.

1.183. Comparability adjustments may be warranted to account for group synergies.

3. In light of differences in local law, some jurisdictions consider a deliberate concerted action to always constitute a transaction, while others do not. However, the consensus view is that, in either scenario, a deliberate concerted action involves one associated enterprise performing functions, using assets, or assuming risks for the benefit of one or more other associated enterprises, such that arm's length compensation is required. See, e.g. Example 5 in paragraphs 1.190-1.193.

Example 1

1.184. P is the parent company of an MNE group engaging in a financial services business. The strength of the group's consolidated balance sheet makes it possible for P to maintain an AAA credit rating on a consistent basis. S is a member of the MNE group engaged in providing the same type of financial services as other group members and does so on a large scale in an important market. On a stand-alone basis, however, the strength of S's balance sheet would support a credit rating of only Baa. Nevertheless, because of S's membership in the P group, large independent lenders are willing to lend to it at interest rates that would be charged to independent borrowers with an A rating, i.e. a lower interest rate than would be charged if S were an independent entity with its same balance sheet, but a higher interest rate than would be available to the parent company of the MNE group.

1.185. Assume that S borrows EUR 50 million from an independent lender at the market rate of interest for borrowers with an A credit rating. Assume further that S simultaneously borrows EUR 50 million from T, another subsidiary of P, with similar characteristics as the independent lender, on the same terms and conditions and at the same interest rate charged by the independent lender (i.e. an interest rate premised on the existence of an A credit rating). Assume further that the independent lender, in setting its terms and conditions, was aware of S's other borrowings including the simultaneous loan to S from T.

1.186. Under these circumstances the interest rate charged on the loan by T to S is an arm's length interest rate because (i) it is the same rate charged to S by an independent lender in a comparable transaction; and (ii) no payment or comparability adjustment is required for the group synergy benefit that gives rise to the ability of S to borrow from independent enterprises at an interest rate lower than it could were it not a member of the group because the synergistic benefit of being able to borrow arises from S's group membership alone and not from any deliberate concerted action of members of the MNE group.

Example 2[4]

1.187. The facts relating to S's credit standing and borrowing power are identical to those in the preceding example. S borrows EUR 50 million from Bank A. The functional analysis suggests that Bank A would lend to S at an interest rate applicable to A rated borrowers without any formal guarantee.

4. Example 2 should not be viewed as providing comprehensive transfer pricing guidance on guarantee fees in respect of financial transactions. For further guidance on the transfer pricing aspects of financial transactions, see Chapter X of these Guidelines.

However, P agrees to guarantee the loan from Bank A in order to induce Bank A to lend at the interest rate that would be available to AAA rated borrowers. Under these circumstances, S should be required to pay a guarantee fee to P for providing the express guarantee. In calculating an arm's length guarantee fee, the fee should reflect the benefit of raising S's credit standing from A to AAA, not the benefit of raising S's credit standing from Baa to AAA. The enhancement of S's credit standing from Baa to A is attributable to the group synergy derived purely from passive association in the group which need not be compensated under the provisions of this section. The enhancement of S's credit standing from A to AAA is attributable to a deliberate concerted action, namely the provision of the guarantee by P, and should therefore give rise to compensation.

Example 3

1.188. Assume that Company A is assigned the role of central purchasing manager on behalf of the entire group. It purchases from independent suppliers and resells to associated enterprises. Company A, based solely on the negotiating leverage provided by the purchasing power of the entire group is able to negotiate with a supplier to reduce the price of widgets from USD 200 to USD 110. Under these circumstances, the arm's length price for the resale of widgets by Company A to other members of the group would not be at or near USD 200. Instead, the arm's length price would remunerate Company A for its services of co-ordinating purchasing activity. If the comparability and functional analysis suggests in this case that in comparable uncontrolled transactions involving a comparable volume of purchases, comparable co-ordination services resulted in a service fee based on Company A's costs incurred plus a mark-up equating to a total service fee of USD 6 per widget, then the intercompany price for the resale of the widgets by Company A would be approximately USD 116. Under these circumstances, each member of the group would derive benefits attributable to the group purchasing power of approximately USD 84 per widget. In addition, Company A would earn USD 6 per widget purchased by members of the group for its service functions.

Example 4

1.189. Assume facts similar to those in Example 3, except that instead of actually purchasing and reselling the widgets, Company A negotiates the discount on behalf of the group and group members subsequently purchase the widgets directly from the independent supplier. Under these circumstances, assume that the comparability analysis suggests that Company A would be entitled to a service fee of USD 5 per widget for the co-ordinating services that it performed on behalf of other group members. (The lower assumed service fee in Example 4 as compared to Example 3 may reflect a lower level of risk in the service provider following from the fact that it does not take title to the widgets or hold any inventory.) Group members purchasing widgets would retain the benefit of the group purchasing discount attributable to their individual purchases after payment of the service fee.

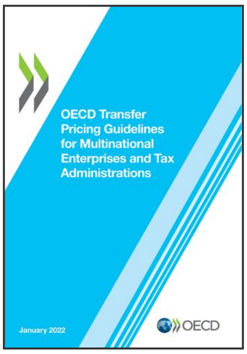
Example 5

1.190. Assume a multinational group based in Country A, has manufacturing subsidiaries in Country B and Country C. Country B has a tax rate of 30% and Country C has a tax rate of 10%. The group also maintains a shared services centre in Country D. Assume that the manufacturing subsidiaries in Country B and Country C each have need of 5 000 widgets produced by an independent supplier as an input to their manufacturing processes. Assume further that the Country D shared services company is consistently compensated for its aggregate activities by other group members, including the Country B and Country C manufacturing affiliates, on a cost plus basis, which, for purposes of this example, is assumed to be arm’s length compensation for the level and nature of services it provides.

1.191. The independent supplier sells widgets for USD 10 apiece and follows a policy of providing a 5% price discount for bulk purchases of widgets in excess of 7 500 units. A purchasing employee in the Country D shared services centre approaches the independent supplier and confirms that if the Country B and Country C manufacturing affiliates simultaneously purchase 5 000 widgets each, a total group purchase of 10 000 widgets, the purchase discount will be available with respect to all of the group purchases. The independent supplier confirms that it will sell an aggregate of 10 000 widgets to the MNE group at a total price of USD 95 000, a discount of 5% from the price at which either of the two manufacturing affiliates could purchase independently from the supplier.

1.192. The purchasing employee at the shared services centre then places orders for the required widgets and requests that the supplier invoice the Country B manufacturing affiliate for 5 000 widgets at a total price of USD 50 000 and invoice the Country C manufacturing affiliate for 5 000 widgets at a total price of USD 45 000. The supplier complies with this request as it will result in the supplier being paid the agreed price of USD 95 000 for the total of the 10 000 widgets supplied.

1.193. Under these circumstances, Country B would be entitled to make a transfer pricing adjustment reducing the expenses of the Country B manufacturing affiliate by USD 2 500. The transfer pricing adjustment is appropriate because the pricing arrangements misallocate the benefit of the group synergy associated with volume purchasing of the widgets. The adjustment is appropriate notwithstanding the fact that the Country B manufacturing affiliate acting alone could not purchase widgets for a price less than the USD 50 000 it paid. The deliberate concerted group action in arranging the purchase discount provides a basis for the allocation of part of the discount to the Country B manufacturing affiliate notwithstanding the fact that there is no explicit transaction between the Country B and Country C manufacturing affiliates.



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