

# TRANSFER PRICING APPLICATION OF THE ARM'S LENGTH PRINCIPLE (DRAFT)



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MALDIVES  
INLAND REVENUE  
AUTHORITY

## Contents

1. Introduction .....	3
2. Scope .....	4
3. Glossary .....	5
4. Meaning of Associate and Control .....	8
4.1 Meaning of Associate .....	8
4.2 Meaning of Control .....	8
5. Introduction to the Arm’s Length Principle .....	11
6. Basis for the arm’s length principle .....	11
7. Three-step approach to apply the arm’s length principle.....	11
8. Step 1 – Conduct comparability analysis.....	12
8.1 Identifying the actual controlled transaction .....	12
8.1.1 Contractual terms of the transaction .....	13
8.1.2 Characteristics of goods, services or intangible properties.....	14
8.1.3 Functional analysis on Functions performed, Assets used and Risks assumed.....	15
8.1.4 Economic circumstances.....	17
8.1.5 Business strategies.....	18
8.2 Comparing accurately delineated transaction with independent party transactions .....	18
8.2.1 Selecting comparable .....	19
8.2.2 Evaluating transactions on a separate or aggregate basis .....	20
8.2.3 Using multiple year data.....	20
9. Step 2 – Identify the most appropriate transfer pricing method and tested party.....	21
9.1 Comparable uncontrolled price (“CUP”) method.....	21
9.2 Resale price method .....	22
9.3 Cost plus method.....	23
9.4 Transactional Net Margin Method (“TNMM”) .....	24
9.4.1 Choice of net profit indicator or profit level indicator .....	25
9.5 Transactional profit split method.....	26
9.6 Choice of the tested party .....	27
9.7 Other Such Method .....	27
9.8 Choice of the most appropriate transfer pricing method.....	27
10. Step 3 – Determine the arm’s length results .....	29
10.1 Use of an arm’s length range.....	29

11. Arm's length adjustment by MIRA.....	32
12. Non-recognition of controlled transaction .....	32
13. Intra-group service transactions.....	33
13.1 Introduction .....	33
13.2 Determining whether intra-group services have been rendered (Benefit Test).....	33
13.3 Application of the arm's length principle to determine intra-group charge.....	34
13.4 Administrative practices for routine support services.....	35
14. Intra-group financing transactions.....	37
14.1 Introduction .....	37
14.2 Determination of whether a purported loan should be regarded as a loan .....	37
14.3 Application of Arm's Length Principle .....	38
14.4 Determination of arm's length interest.....	39
14.5 Administrative practice for indicative margins on intra-group loans.....	40
14.6 Domestic financing transaction between associated parties .....	40

Taxpayers can rely on this guide as to the MIRA's interpretation of the relevant tax laws and regulations. If you do not understand anything in this guide or have queries related to your particular circumstances, call 1415 or send an email to [1415@mira.gov.mv](mailto:1415@mira.gov.mv).

# PRELIMINARY

## I. Introduction

1. With the emergence of globalization, Multinational Enterprises (MNEs) are planning new foreign direct investments (FDI) and establishing new subsidiaries abroad which resulted in the volume and value of intra-group trade to grow exponentially.
2. MNEs tend to exploit different country taxation rules to erode the tax base and to shift profits in order to minimize overall group tax liability. Transfer pricing rules exist to address this issue and to ensure that profits are taxed where economic activities take place and value is created.
3. This guideline is largely based on the governing standard for transfer pricing which is the arm's length principle as set out under the Organization for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017). Although some parts of this guideline have been adopted directly from the OECD Transfer Pricing Guidelines, there may be areas which differ to ensure adherence to the Income Tax Act (Law No. 25/2019) and procedures of Maldives Inland Revenue Authority (MIRA), as well as domestic circumstances. In this regard, the guidelines may be reviewed from time to time.
4. Notwithstanding the aforementioned, the arm's length principle remains as the guiding principle throughout this guideline. Examples shown in this guideline are for illustrative purposes only, and in dealing with actual cases, the facts and circumstances of each case must be examined before deciding on the applicability of any of the methods described in these Guidelines.

## 2. Scope

5. The guideline intends to help taxpayers in:
  - a. understanding the meaning of control and associate;
  - b. applying the arm's length principle on controlled transactions with associated parties;
  - c. applying the arm's length principle on specific controlled transactions commonly identified in Maldives (i.e. intra-group services and intra- group financing transactions).

## 3. Glossary

### 1. Arm's length principle

The arm's length principle means the terms on which a transaction or an arrangement would have been made, or might reasonably be expected to have been made, if it had made between persons that are not associates and in comparable circumstances.

### 2. Arm's length range

A range of figures that are acceptable for establishing whether the conditions of a controlled transaction are arm's length and that are derived either from applying the same transfer pricing method to multiple comparable data or from applying different transfer pricing methods.

### 3. Associated parties

Two parties are treated as associates, where one party;

- (1) Controls, or is controlled by, the other or both parties are controlled by the same party; or
- (2) Is a relative of the other party; or
- (3) Is a partnership and the other party is a partner in that partnership; or
- (4) Is a partner in a partnership and the other party is a partner in the same partnership; or
- (5) Is a trust and other party is a beneficiary of that trust; or
- (6) Is a trust and the other party is a settlor of the trust
- (7) Is a head office and the other party is a permanent establishment in Maldives

### 4. Control

The circumstance where a person or any of its associates can be directly or indirectly required by another person to act in accordance with the directions of the second person, in which case the second person shall be treated as controlling the first person.

### 5. Comparability analysis

The process of identifying economically relevant characteristics in an associated party transaction (controlled transaction) and comparing such characteristics with those in independent party transactions. This involves an examination of the factors affecting the associated party transaction that are non-existent in transactions between independent parties and vice-versa.

### 6. Comparable uncontrolled price ("CUP") method

A comparable uncontrolled transaction is a transaction between two independent parties that is comparable to the controlled transaction under examination. It can be either a comparable transaction between one party to the controlled transaction and an independent party ("internal comparable") or between two independent parties, neither of which is a party to the controlled transaction ("external comparable").

### 7. Controlled transaction

Controlled transaction refers to transactions between associated parties.

## 8. Cost plus method

A transfer pricing method using the costs incurred by the supplier of property (or services) in a controlled transaction. An appropriate cost plus mark-up is added to this cost, to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as arm's length price of the original controlled transaction.

## 9. Cost sharing arrangement

Cost sharing arrangement refers to a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants.

## 10. Direct costs

Costs that are incurred specifically for producing a product or providing a service, such as the cost of raw materials.

## 11. Double taxation

Where two or more tax authorities take different positions in determining arm's length prices, double taxation may occur. Double taxation means that the same income is included in the tax base for the imposition of taxation by two or more tax authorities.

## 12. Functional analysis

A 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.

## 13. Gross profits

The amount computed by deducting from the gross receipts of a business transaction, the allocable purchases or production costs of sales, with due adjustment for increases or decreases in inventory or stock-in-trade, but without taking account of other expenses.

## 14. Independent parties

Two parties are independent parties with respect to each other if they are not associated parties with respect to each other.

## 15. Independent party transactions

Independent party transactions refer to transactions between independent parties.

## 16. Indirect costs

Costs of producing a product or service which, although closely associated to the production process, may be common to several products or services (for example, the costs of a repair department that services equipment used to produce different products).

### **17. Net profit indicator (or profit level indicator)**

The ratio of net profit to an appropriate base (for example, costs, sales, assets) as used in the transactional net margin method.

### **18. Person**

Person includes an individual, company, partnership, cooperative society, trust and body of persons, but, does not include any State office or any State institution.

### **19. Profit split method**

A transactional profit method that identifies the combined profit to be split for the associated parties from a controlled transaction and then split those profits between the associated parties based upon an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arms' length

### **20. Resale price margin**

A margin representing the amount out of which a reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit.

### **21. Resale price method**

A transfer pricing method where the resale price to the independent party is reduced by a comparable resale price margin to arrive at the arm's length price of the product transferred between the associated parties.

### **22. Tested party**

Tested party means the most suitable party to whom a transfer pricing method can be applied in the most reliable manner and most reliable comparable can be found. The use of resale price method, cost plus method or transactional net margin method requires a decision on which party to apply the transfer pricing analysis.

### **23. Transactional net margin method ("TNMM")**

A transactional profit method that examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that is realized from a controlled transaction;

### **24. Transfer pricing adjustment**

In the event the associated parties do not transact with each other at arm's length prices, MIRA may for tax purposes, substitute the price of the transaction with one that could have been charged if the parties were unassociated. The adjustment to arrive at that price is known as a transfer pricing adjustment.

## 4. Meaning of Associate and Control

### 4.1 Meaning of Associate

1. “Associate” means each of two persons where one person<sup>1</sup>:
  - a. controls, or is controlled by, the other, or both persons are controlled by the same person or persons; or
  - b. is a relative of the other person; or
  - c. is a partnership and the other person is a partner in that partnership; or
  - d. is a partner in a partnership and the other person is a partner in the same partnership; or
  - e. is a trust and the other person is a beneficiary of that trust; or
  - f. is a trust and the other person is a settlor of the trust.

### 4.2 Meaning of Control

2. Control means the circumstance where a person or any of its associates (herein referred to as the first person) can be directly or indirectly required by another person (herein referred to as the second person) to act in accordance with the directions of the second person, in which case the second person shall be treated as controlling the first person<sup>2</sup>; or
3. In relation to any person and a company<sup>3</sup>:
  - a. the circumstance in which a person or any person controlling such person holds the majority share capital of the company or majority of the issued share capital of the company or possesses the majority of voting rights of the company, or hold the right to possess the majority of voting rights of the company; or
  - b. the circumstance in which a person or any person controlling such person manages the operations of the company or may directly or indirectly manage the operations of the company or holds the right to directly or indirectly manage the operations of the company; or
  - c. where the total income of the company is distributed amongst all shareholders of the company, the circumstance in which a person derives or obtains the right to derive the majority of the distributed income of the company based on the number of shares of the company’s capital issued to such person, irrespective of any interest of such person in the company in respect of any loans that may have been issued to the company by such person; or

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<sup>1</sup> Definition given in Section 79(ss) of ITA

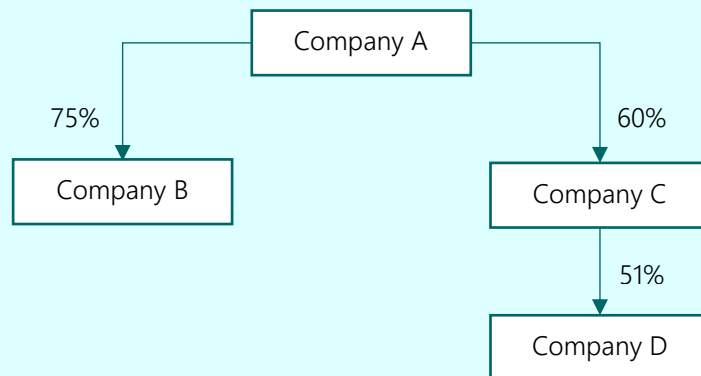
<sup>2</sup> Ibid, Section 79(l)

<sup>3</sup> Ibid,

- d. the circumstance in which a person acquires or obtains the right to acquire the majority of the capital of the company upon the dissolution of the company or in the event of any such occurrence.
4. Relative of a person means:
- a. the person's spouse;
  - b. child, parent, grandparent or sibling including their spouses.
5. A minor child shall be treated as being under the control of the child's parents or guardian<sup>4</sup>.

**EXAMPLE I – ASSOCIATE AND CONTROL – INDIRECT SHAREHOLDING**

Company A owns 75% shareholding of Company B and 60% shareholding of Company C. Further, Company C owns 90% shareholding of Company D.



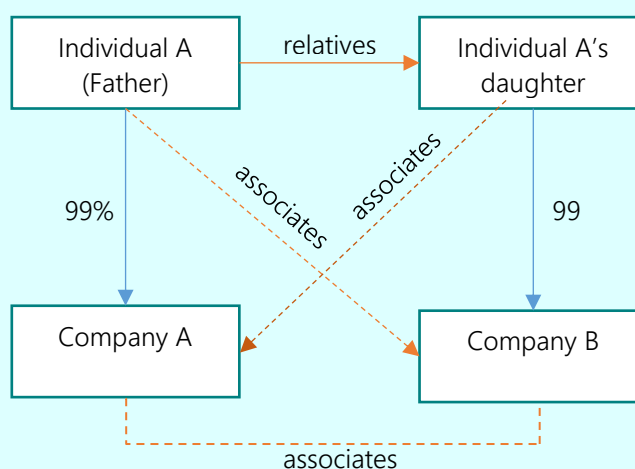
In this case, since Company A holds the majority share capital of Company B and Company C, both the companies are directly controlled by Company A. In addition, Company A also controls Company D indirectly through its control over Company C. Therefore, companies A, B, C and D are associated.

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<sup>4</sup> Section 79(l)(5) of ITA

#### EXAMPLE 2 – ASSOCIATE AND CONTROL – CONTROL THROUGH MINOR

An Individual, A, controls Company A by holding the majority share capital of the company; and A's daughter (a minor) controls Company B by holding the majority share capital of the company.



In this scenario, in addition to controlling Company A, individual A also controls Company B through his control over his daughter. Therefore, both A and B are associated.

#### EXAMPLE 3 – ASSOCIATE AND CONTROL – SUPPLY CONTRACT

Company X enters into a distribution agreement with an independent party, Company Y, under which Company X purchases goods from Company Y, and sells those goods to third party customers. The agreement might specify the retail price of the goods to be sold to third parties by Company X.

In this case, the arrangement is a commercial arrangement between independent parties, Company X and Company Y, and does not give Y the ability to control the business decisions of Company X.

#### EXAMPLE 4 – ASSOCIATE AND CONTROL: MANAGEMENT AGREEMENT

Company A has a management agreement with Company B. As per the terms of the agreement, Company B has the power to manage the relevant activities of the Company A and make key strategic decisions relating to the business of Company A.

In this case, since the agreement gives Company B the right to manage the operations of Company A, Company A and B are associated.

## PART II

# THE ARM'S LENGTH PRINCIPLE

### 5. Introduction to the Arm's Length Principle

1. When independent parties transact with each other, terms and conditions of their commercial and financial relations is ordinarily determined by market forces. In contrast, when associated parties transact with each other, the terms and conditions of their commercial and financial relations may not directly be affected by external forces in the same way due to their special relationship.
2. MIRA endorses the application of arm's length principle in determining an appropriate price in a controlled transaction. A proper application of arms' length principal would ensure profits are aligned with value creation.
3. The arms' length principal requires, in comparable circumstances, the transaction between associated parties to reflect the same or similar terms and conditions to those of an independent party transaction.
4. This section covers the three-step approach to apply the arm's length principle.

### 6. Basis for the arm's length principle

5. Section 68 of the ITA stipulates the use of the arm's length principle for related party transactions, i.e. the conditions made or imposed between related parties with regard to their transaction are those conditions which would be made or imposed if they were not related parties and dealing independently with one another in comparable circumstances ("arm's length conditions").

### 7. Three-step approach to apply the arm's length principle

6. MIRA recommends that taxpayers adopt the following three-step approach to apply the arm's length principle in their controlled transactions:
  - a. Step 1 - Conduct comparability analysis
  - b. Step 2 - Identify the most appropriate transfer pricing method and tested party
  - c. Step 3 - Determine the arm's length results
7. Judgment is required in any transfer pricing analysis. Ultimately, the main objective in any transfer pricing analysis is to present a logical, coherent and consistent basis to demonstrate that transfer prices set between related parties are at arm's length.

## PART III

# APPLYING THE ARM'S LENGTH PRINCIPLE

## 8. Step I – Conduct comparability analysis

1. 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. They are:
  2. Accurate delineation of the controlled transaction by identifying the commercial and financial relations between associated parties and economically relevant characteristics attached to it.
  3. Comparing the economically relevant characteristics of the controlled transaction as accurately delineated to that of the potential comparable independent transaction.
  4. By accurately delineating the actual transaction and comparing the accurately delineated transaction with the potential comparable independent transaction, taxpayers will have:
    - a. Set out the factual substance of the commercial or financial relations between the related parties and accurately delineated the actual transaction;
    - b. Compared the economically relevant characteristics of the actual related party transaction and independent party transactions;
    - c. Identified the differences (if any) in economically relevant characteristics between the associated party transaction and the independent party transactions which could materially affect the pricing.
    - d. Determined reasonably accurate adjustments that can be made to eliminate those differences.

### 8.1 Identifying the actual controlled transaction

The process of identifying the commercial or financial relations between the associated parties and economically relevant characteristics requires:

5. A broad-based understanding of the taxpayers' circumstances by analyzing the industry, competition, economic and regulatory factors and other elements affecting the taxpayer and its' environment.
6. The accurate delineation of the actual transaction or transactions between them. 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 categorized as follows:

- a. The contractual terms of the transaction;
- b. The characteristics of goods sold or purchased, services received or provided, or intangible properties used or transferred;
- c. The functions performed, assets used and risks assumed by the parties (FAR analysis);
- d. The economic circumstances of the parties and of the market in which the parties operate; and
- e. The business strategies pursued by the parties.

### 8.1.1 Contractual terms of the transaction

7. A contract can be verbally agreed or written. The terms of a transaction may also be found in communications between the parties other than a written contract. Where contracts are formalized by the associated parties through written contractual agreements, it provides a starting point for accurately delineating the actual transaction. The contract provides information on how the transaction is priced and on how the responsibilities and risk are split between the parties to the transaction at the time of entering into the contract.
8. Associated party agreements tend to be less formal and all the terms and conditions between the parties may not be agreed in writing. As such, written contracts may not provide all the information on the contractual terms. Further information will be required by taking into consideration the analysis of the other economically relevant characteristics. Taken together, the analysis provides evidence of the actual conduct of the related parties with regard to the transaction.
9. 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.
10. The conduct of the parties may not always be consistent with the contract. Hence, a functional analysis would be required to understand such differences. Where material differences are identified in the conduct to that agreed in the contracts, actual transaction should be determined based on the conduct. This comparison is not possible in absence of a written contract or other means to identify the contractual terms and conditions. In such instances, all aspects of the arrangement would need to be deduced from available evidence of the actual conduct.

#### EXAMPLE 5 – WRITTEN CONTRACT VERSUS ACTUAL CONDUCT

Company A is a multinational company incorporated in Maldives, producing and distributing Product X. Company A owns and operates a subsidiary Company B, in Sri Lanka. A production and distribution agreement is entered between Company A and Company B. Under the agreement Company B is responsible for following:

1. Labeling, packaging, storage, and distribution.
2. Marketing and promotional activities

Based on the analysis conducted the following observations were made.

1. Company B has no marketing department or staffs working under them, hence does not have capability to perform the marketing activities.
2. Company B doesn't own the plant required for labelling and packaging. The products delivered to Company B is the final product and no value addition is made in Sri Lanka.
3. Company B owns a warehouse where the Product X is stored and operates 3 distribution centers across the country.

It can be observed that, although the agreement specifies labelling, packaging and conducting marketing activities as responsibilities of company B, these functions are not performed by company B. Hence, the identification of the actual transaction should not be solely based on the written agreements.

### 8.1.2 Characteristics of goods, services or intangible properties

11. Differentiation is a common business strategy adopted to enter or sustain in a highly competitive market place. This process involves distinguishing a product or a service from others, to make it more appealing to a targeted group. Based on how successful the strategy works, it can lead to products been sold at higher prices than the competition.
12. The differentiation strategy can be changing the physical or functional features, adding additional features, how the product or service is marketed etc. each of which could play a significant part in pricing the product. Therefore, the similarities and difference in product, service or intangible in the controlled transaction to that of the independent transaction should be carefully examined.
13. Important characteristics to be examined include:

Nature of transaction	Possible comparisons
Transfer of goods	<ul style="list-style-type: none"> <li>▪ Physical features</li> <li>▪ Quality and reliability</li> <li>▪ Availability and volume of supply</li> </ul>
Provision of services	<ul style="list-style-type: none"> <li>▪ Nature and extent of the services</li> </ul>
Intangible properties	<ul style="list-style-type: none"> <li>▪ Form of transaction</li> <li>▪ Type and nature of the intangible property</li> <li>▪ Duration and extent of rights provided by the intangible property</li> <li>▪ Anticipated benefits from the use of the intangible property</li> </ul>

14. The significance of this step of accurately delineating a transaction depends on the transfer pricing method adopted. For instance, if CUP method is adopted, ensuring similarities in actual characteristics is the most critical step as opposed to other method which tends to compare profit margins correlating to functions performed, assets used and risks assumed which is less sensitive to the characteristics of the product or service. In either case, identifying the characteristics of good, service or intangible properties can provide valuable information in accurately pricing a transaction.

### 8.1.3 Functional analysis on Functions performed, Assets used and Risks assumed

15. In transactions between two independent parties, compensation usually will reflect the functions that each enterprise performs. Therefore, in delineating the controlled transaction and determining comparability between controlled and independent party transactions or parties, a functional analysis is necessary.

16. This functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by parties to the transaction.

17. The functional analysis is important as it provides an overview of value creation within the supply chain in general and the associated party transaction in particular. It provides an understanding of the relative contributions of the parties to the transaction and their roles in overall value creation.

18. The functional analysis should focus on what each of the parties actually does and the capabilities they provide. It is not the volume of functions an entity performs that is important for the analysis but rather the economic significance of those functions in terms of their frequency, nature and value to the respective parties to the transactions.

19. The functions and their significance should be viewed in light of the value drivers of the business. Performing or exercising control over the functions that contribute most

to value drivers has the most significant impact on overall value creation and, ultimately, profits from the transaction.

20. The analysis also considers the type of assets used (such as plant and equipment, valuable intangibles, financial assets, etc.) and the nature of the assets used (such as the age, market value, location, property right protections available, etc.).
21. It is crucial to identify and consider the material risks assumed by each party as the actual assumption of risks would have a significant impact on the price of the transaction between the associated parties.
22. 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 parties and accurately delineating the transaction.
23. Analyzing risks in a controlled transaction through a functional analysis involves, determining how the associated parties to the transaction operate in relation to assumption and management of the specific economically significant risks, and in particular which party performs control functions and risk mitigation functions, and which party has the financial capacity to assume the risk.
  - a. Risk management refer to the function of assessing and responding to risk associated with commercial activity and comprises of 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, i.e. the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.
  - b. 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 materializes. To assume a risk for transfer pricing purposes, the taxpayer needs to exercise control over the risk and has the financial capacity to assume the risk
  - c. Control over risk involves the first two elements of risk management. It is not necessary for a party to perform the risk mitigation element in order to have control of the risks which can be outsourced. However, even though such functions are outsourced, control of the risk would require capability to direct the functions 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.

- d. 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 materializes.
- e. Risk mitigation refers to measures taken that are expected to affect risk outcomes

24. Generally, the level of return derived by a taxpayer should be directly correlated to the FAR. For example, a branded product would likely yield a higher return compared to an unbranded product. This is because the intangible asset associated with the product enhances the value of the product and thus the arms' length price.

### 8.1.4 Economic circumstances

25. Arm's length prices may vary across different markets even for transactions involving the same property or services; therefore, economic circumstances must also be examined in delineating the actual transaction and in determining comparability for transfer pricing purposes.

26. Even the same property or service may have different arm's length prices in different markets. Hence to make a meaningful transfer pricing analysis, it is necessary that the markets in which associated party and independent parties operate do not have differences that have a material impact on price or that appropriate adjustments can be made to eliminate the effects of such differences.

27. Economic circumstances that may be relevant to determining market comparability include but not limited to:

- 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 of substitute goods and services;
- The levels of supply and demand in the market as a whole and in particular regions
- Consumer purchasing power;
- The nature and extent of government regulation of the market; c
- Costs of production, including the costs of land, labor, and capital;
- Transport costs;
- The level of the market (e.g. Retail or wholesale)
- Existence of a cycle

### 8.1.5 Business strategies

28. Business strategies must also be examined in delineating the transaction and in determining comparability for transfer pricing purposes. Business strategy can be understood as the course of action or set of decisions which assist the business in achieving specific business objectives. Business strategies would take into account many aspects of an enterprise, such as innovation, new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labor laws, duration of arrangements, and other factors bearing upon the daily conduct of business.
29. It would also encompass the pricing strategies of the business such as whether a penetration pricing (setting a low price to enter a competitive market and raising it later) or a price skimming (setting a high price and lowering it as the market evolves) is exploited. Taxpayers may be seeking to enter into new markets or increase (or defend) market shares which would affect the pricing of the product.

## 8.2 Comparing accurately delineated transaction with independent party transactions

30. Following the guidance in the foregoing sections, 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 analyzing the economically relevant characteristics.
31. The accurately delineated actual transaction then need to be compared with comparable independent party transaction in order to determine the arm's length price.
32. A comparable independent party transaction is a transaction between two independent parties that is comparable to the controlled transaction under examination. It can be either a comparable transaction between one party to the controlled transaction and an independent party ("internal comparable") or between two independent parties, neither of which is a party to the controlled transaction ("external comparable").
33. Differences in economically relevant characteristics between the controlled and independent party transaction need to be taken into account when establishing whether there is comparability between the situations being compared and what comparability adjustments are needed.
34. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the

methodology or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.

35. Whether comparability adjustments should be performed (and if so, what adjustments should be performed) in a particular case is a matter of professional judgment.
36. When making the comparison, below aspects of comparability analysis are relevant:
  - a. Selecting comparable;
  - b. Evaluating transactions on a separate or aggregate basis;
  - c. Using multiple year data.

## 8.2.1 Selecting comparable

37. Typically, internal comparable have a closer relationship with the transaction under review. It is easier to get the data on internal comparable as same accounting standards would be used in costing the transaction. However, internal comparable must also satisfy the five comparability factors in the same way as external comparable.
38. For example, a taxpayer may sell a significant volume of products to its foreign associated party and a much smaller volume to an independent party. The difference in sales volumes is likely to affect the comparability of the two transactions materially. In this case, it may be necessary to search for external comparable that are more comparable if reasonable adjustments cannot be made to the internal comparable.

### 8.2.1.1 Selection of external comparables

#### 8.2.1.1.1 Commercial databases

39. A common source of information is commercial databases, which have been developed by editors who compile accounts filed by companies with the relevant administrative bodies and present them in an electronic format suitable for searches and statistical analysis. Any particular commercial database can be used to search comparables as long as it provides a reliable source of information that assists taxpayers in performing comparability analysis. Whichever database the taxpayer chooses, transfer pricing documentation (Part 2) should be maintained to demonstrate the results of its comparability analysis.

#### 8.2.1.1.2 Non-local comparables

40. As far as possible, taxpayers should use local comparables in their comparability analysis. Generally, these comparables have a higher degree of comparability in terms of their market and economic circumstances compared to non-local comparables. When taxpayers are unable to find sufficiently reliable local comparables, they may expand their search to regional comparables which satisfy the five comparability factors and reasonable comparability adjustments can be made for any material differences.

### 8.2.1.1.3 Loss-generating comparables

41. In conducting the comparability analysis, taxpayers may come across independent parties which have sustained losses over a period of time. Generally speaking, a loss-making independent party transaction should trigger further investigation in order to establish whether or not it can be a comparable. For example, if it can be demonstrated that losses do not reflect normal business conditions, then the transaction/party can be excluded from the list of comparables.

## 8.2.2 Evaluating transactions on a separate or aggregate basis

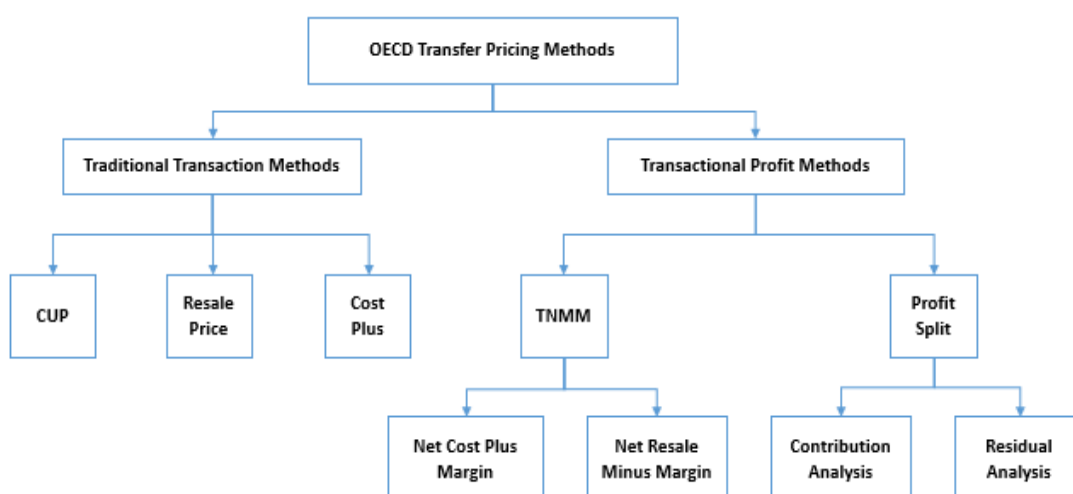
42. Ideally, the arm's length principal should be applied on a transaction by transaction basis. However, sometime separate transactions are so closely knitted that it is impossible to segregate the individual transactions. Examples may include the marketing and advertising services under a management agreement for which a fixed charge is accrued.
43. In these situations, if it can be demonstrated that independent parties in comparable circumstances would typically price the individual transactions on an aggregate basis, taxpayers may consider evaluating the transactions on an aggregate basis.

## 8.2.3 Using multiple year data

44. It is generally useful to examine data from the year under examination and prior years. The use of data from past years will show whether a taxpayer's reported loss on a transaction is part of a history of losses on similar transactions, the result of particular economic conditions in a prior year that increased costs in the subsequent year, or a reflection of the fact that a product is at the end of its life cycle

## 9. Step 2 – Identify the most appropriate transfer pricing method and tested party

45. There are several methods that taxpayers can use to determine accurate arm's length pricing for transactions between associated parties.
46. The OECD outlines five main transfer pricing methods that MNEs and tax administrations can use. The five methods are categorized into traditional transaction methods and transactional profit methods. Where traditional transaction methods rely on actual transactions, the transactional profits method rely on profit levels realized from an actual transaction.



### 9.1 Comparable uncontrolled price (“CUP”) method

47. The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable independent party transaction.
48. A difference between the two prices may suggest that the associated parties are not dealing at arm's length. Therefore, the price in the controlled transaction may need to be substituted with the price in the independent party transaction.
49. With the CUP method, taxpayers can use either internal comparables or external comparables.
50. As the CUP method is the most direct way to determine arm's length price, it should generally be preferred to the other methods.
51. Taxpayers can work out if an independent party transaction is comparable by asking two questions:
- d. Are there any differences between the transactions in comparison or the parties entering into those transactions that could materially affect the price,

by taking into account, the differences in; (i) product or services, (ii) contractual terms, (iii) economic circumstances; and (iv) business strategies?

- e. If there are material differences between the transactions, can reasonably accurate adjustments be made to eliminate the effects on the price charged in the open market?
52. If reasonably accurate adjustments cannot be made to eliminate the effects on the price charged in the open market, CUP method is not the most reliable method.

#### EXAMPLE 6: CUP METHOD

Company A sells 1000 tons of product X for \$80 per ton to an associated party Company B. And, at the same time sells 500 tons of the same product for \$100 per ton to an independent party Company C.

The transfer price between Company A and Company B can be determined based on the internal comparable Company C. However, this case requires an evaluation of whether the different volumes should result in an adjustment of the transfer price. The relevant market should be researched by analyzing transactions in similar products to determine typical volume discounts.

## 9.2 Resale price method

53. The resale price method starts by looking at the resale price of a product that has been purchased from an associated party and then sold to an independent party.
54. The price of the transaction where the item is resold to the independent party is called the resale price. The method then requires, the resale price margin to be identified.
55. Under arm's length conditions, the resale price margin should allow the reseller to recover its selling and operating costs, and earn a reasonable profit based on its FAR. This gross resale price margin is deducted from the resale price.
56. The amount that remains after the margin has been subtracted and fair adjustments have been made (e.g. expenses like customs duty have been taken into account), is the arm's length price of the original transaction between the associated entities.
57. The resale price method is most appropriate where the reseller adds relatively little value to the properties. The more value the reseller adds to the properties (for example, via complicated processing or assembly with other products), the harder it is to apply the resale price method. This is especially so where the reseller contributes significantly to creating or maintaining intangible properties, such as trademarks or trade names, in its activities.

#### EXAMPLE 7: RESALE PRICE METHOD

Company A sells product X to an associated party Company B, which resells the product X to independent party Company C.

Assume that all the material differences between the controlled and independent party transaction have been identified and adjusted for.

If the applicable resale price of the product X is \$100 and the appropriate gross profit margin is 20%, then an arm's length result of the controlled sale between Company A and Company B, is a price of \$80 ( $\$100 - (\$100 \times 20\%)$ ).

### 9.3 Cost plus method

58. The cost plus method compares gross profits to the cost of sales. The first step is to determine the costs incurred by the taxpayer in a controlled transaction for property transferred or service provided to an associated party. Secondly, an appropriate mark-up has to be added to this cost ("cost base"), to make an appropriate profit in light of the functions performed and market conditions. The combined price is the arm's length price for the controlled transaction.
59. This method probably is most useful where semi-finished goods are sold between associated parties, where associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.
60. In applying the cost plus method, direct and indirect costs of producing a good or providing a service are normally used to compute the cost base. Such costs are limited to the costs of the supplier of goods or services and should take into account an analysis of the supplier's FAR. The methods of determining the cost base should be consistent over time.
61. Applying the cost plus method requires the comparability of the gross mark up and cost base in the associated and independent party transactions. A reasonable number of adjustments may be made to compensate for the lack of comparability between controlled and uncontrolled transactions.

#### EXAMPLE 8: COST PLUS METHOD

Company A manufactures Product X for an associated party Company B. Company C manufactures a Product Y which is similar to Product X.

Company A is asked by Company B to manufacture 10,000 units of Product X at a markup of 10%. Company C is contracted by a third party client to manufacture same units of Product Y at a markup of 25%.

Under the Cost Plus Method, Company A should first compare its cost base with the cost base of Company C when manufacturing 10,000 units of Product Y. Provided, that the cost base is comparable, the next step is to identify the mark-up on costs applied by Company C i.e. 25%.

In order to determine the arm's length price of the controlled transaction, the markup applied is increased by 15% (25% - 10%). The arm's length result of the transaction between Company A and Company B is a cost plus mark-up of 25%.

## 9.4 Transactional Net Margin Method (“TNMM”)

62. The transactional net margin method examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction.
63. The transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied. This means in particular that the net profit indicator of the taxpayer from the controlled transaction should ideally be established by reference to the net profit indicator that the same taxpayer earns in comparable independent party transactions (internal comparable) or the net margin that would have been earned in comparable transactions by independent party (external comparable).
64. A functional analysis of the controlled and independent party transactions is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results. This may require an examination of factors affecting operating expenses such as management efficiencies, competitive positions, business experiences, varying cost structures etc.
65. Transactional net margin method is unlikely to be reliable if each party to a transaction makes unique and valuable contributions. In such a case, a transactional profit split method will generally be the most appropriate method.
66. The most crucial aspect of the TNMM is selecting the right net profit indicator. Commonly used net profit indicators are:
  - a. **Net cost plus margin:** The net cost plus margin is a measure of return on costs using the total operational expenses of the company. The ratio can allow for differences in functions by assuming that they are reflected in the level of total operating expenses, with many items able to be included in either cost of goods sold or other operating expenses.
  - b. **Net Resale minus margin:** The net resale minus margin is the ratio of Earnings before Interest and Tax (EBIT) to turnover. It basically measures the return on sales of a company. By using the net ratio, the comparison eliminates the differences resulting from categorizing sales under sales revenue or other revenues.

## 9.4.1 Choice of net profit indicator or profit level indicator

67. The selection of the most appropriate net profit indicator depends on the facts and circumstances of the transaction in question. It should take account of:
- a. respective strengths and weaknesses of the various possible indicators;
  - b. the appropriateness of the indicator considered in view of the nature of the controlled transaction, determined in particular through a functional analysis;
  - c. the availability of reliable information; and
  - d. the degree of comparability between the controlled and uncontrolled transactions, including the reliability of comparability adjustments.
68. Examples of net profit indicators or profit level indicators that may be used in applying the TNMM are as follows:
- a. Net profit margin
  - b. Full cost mark-up
  - c. Return on asset
  - d. Return on capital employed
  - e. Berry ratio

### 9.4.1.1 Berry ratio

69. The Berry Ratio is the ratio of gross profit to operating expenses. It represents a return on a company's value added functions and assumes that those functions are captured in its operating expenses.
70. For the calculation of berry ratio, interest and extraneous income are generally excluded from the gross profit determination; depreciation and amortization may or may not be included in the operating expenses, depending in particular on the possible uncertainties they can create in relation to valuation and comparability.

#### EXAMPLE 9: BERRY RATIO

Company A provides administrative support services such as invoicing and bookkeeping. Associated party Company B asks Company A to provide invoicing services. Company B thinks that they need about 1,000 hours of such services.

Company A knows that the total cost of 1,000 hour of services is \$125,000. There are many companies around that provide comparable services, including independent party Company C at a ratio of operating profit to total cost 0.25. Both companies have exactly the same business model.

To apply TNMM, Company A need to identify the right net profit indicator which is assumed to be full cost mark-up. To calculate the arm's length transfer price company A has to add

the full cost mark-up (0.25 i.e. operating profit / total cost of Company C) to the existing total cost.

The total cost of the services is \$125,000. The arm's length result is determined by increasing the total cost by 0.25 which gives a transfer price of \$156,250 ( $\$125,000 * 1.25$ ) or \$156.25 per hour ( $\$156,250/1000$  hours)

## 9.5 Transactional profit split method

71. Associated parties often engage in very inter-related transactions. Such transactions cannot be examined on separate basis, thus associated parties normally agree to split the profits. Accordingly, the profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction by determining the division of profits that independent would have expected to realize from engaging in the transaction.
72. The profit split method first identifies the profit to be split between the associated enterprises from the controlled transactions in which the associated enterprises are engaged. It then splits those profits between the associated enterprises on an economically valid basis that approximates the division of the profits that would have been anticipated and reflected in an agreement made at arm's length.
73. Generally, there are two approaches to applying the transactional profit split method:
  - a. **Residual analysis approach:** This approach looks at the total profits, removes the profit made by the routine functions of both parties, and the remaining profit is then split based on each party's contribution to the earnings of the non-routine profit, generally based on each party's investment and relative spending.
  - b. **Contribution analysis approach:** Under this approach, the total profit earned by the parties from a controlled transaction is divided based on the parties' relative financial or other contributions to the earning of that profit. This division can be supported by comparable data if available.
74. The Profit Split method is most often applied by companies in complex industries with relatively high profits, such as high technology and pharmaceutical organizations. It is especially useful when dealing with intangible goods, such as intellectual property, as these transactions are often too complex for the other methods to be applied.

#### EXAMPLE 10: PROFIT SPLIT METHOD

Company A (a manufacturing company) seeks help from an associated enterprise, Company B, with research and development (R&D) to bring a new product to market (Product X). Both companies engage in similar R&D activities and employ equally competent staffs. The two associates need to determine the right profit split terms to include in their agreement.

The two parties invested a total of \$500 million to bring the Product X to market. It's determined that the Company B contributed \$375 million of the total investment. Because \$375 million is 75% of \$500 million, the Company B will make 75% of future profits, with the Company B collecting the remaining 25%.

## 9.6 Choice of the tested party

75. When applying a cost plus, resale price or transactional net margin method, it is necessary to choose the party to the transaction for which a financial indicator (mark-up on cost, gross margin, or net profit indicator) is tested. The choice of the tested party should be consistent with the functional analysis.
76. Generally, the tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found, i.e. it will often be the one that has the less complex functional analysis.

## 9.7 Other Such Method

77. Apart from the aforementioned five OECD preferred methods, taxpayer may adopt a method that takes into account the price paid or payable in comparable circumstances to an independent party in comparable circumstances, considering all the relevant facts. Prior approval should be obtained from MIRA in applying such method.
78. Other such methods should however not be used in substitution for OECD-recognized methods where the latter are more appropriate to the facts and circumstances of the case.

## 9.8 Choice of the most appropriate transfer pricing method

79. The OECD Guideline prescribes that the taxpayers should select the most appropriate method. If a traditional transaction method and a transactional profit method are equally reliable, the traditional transaction method is preferred.
80. Ultimately, the most appropriate method shall be the method which is best suited to the facts and circumstances of each particular transaction, and which provides the most reliable measure of price, profit or income.

81. In selecting the most appropriate method, the following factors shall be taken into consideration:
- a. the nature of the controlled transaction, determined by conducting a functional analysis;
  - b. the degree of actual comparability when making comparisons with transactions between independent parties;
  - c. the completeness and accuracy of data in respect of the independent party transaction;
  - d. the reliability of any assumptions made; and
  - e. the degree to which the adjustments are affected if the data is inaccurate or the assumptions incorrect.
82. MIRA does not have a specific preference for any one method. Instead, the method that produces the most reliable results, taking into account the quality of available data and the degree of accuracy of adjustments, should be selected.
83. Whichever method the taxpayer chooses, transfer pricing documentation should be maintained to demonstrate that its transfer prices are established in accordance with the arm's length principle.

## 10. Step 3 – Determine the arm’s length results

84. Every taxpayer should endeavor to determine its transfer pricing for tax purposes in accordance with the arm’s length principle, based on information reasonably available at the time of the determination. Hence, once the most appropriate transfer pricing method has been identified, the method is applied on the data of comparable independent party transaction to arrive at the arm’s length result.

### 10.1 Use of an arm’s length range

85. In some cases, it will be possible to apply the arm’s length principle to arrive at a single figure (e.g. price or margin) that is the most reliable to establish whether the conditions of a transaction are arm's length. However, because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method produces a range of figures over a single or multiple financial years, all of which are equally reliable.

86. Where the application of the most appropriate method produces a range of figures, a substantial deviation among points in that range may indicate that the data used in establishing some of the points may not be as reliable as the data used to establish the other points in the range or that the deviation may result from features of the comparable data that require adjustments.

87. Every effort has to be made to exclude points that have a lesser degree of comparability. However, some comparability defects may still remain that cannot be identified and/or quantified, and are therefore not adjusted. In such cases, statistical tools that take account of central tendency to narrow the range (e.g. the interquartile range or other percentiles) might help to enhance the reliability of the analysis.

88. Where the comparable independent transaction has taken place in more than one financial year, weighted average of the prices of such transactions may be used to determine an arms’ length price. In doing so, weight should be assigned based on the transfer pricing method selected.

- a. For resale price method, the weighted average of the prices shall be computed with weights being assigned to the quantum of sales.
- b. For cost plus method, the weighted average of the prices shall be computed with weights being assigned to the quantum of costs
- c. For TNMM, the weighted average of the prices shall be computed with weights being assigned to either the quantum of sales, costs, or assets whichever was selected as the net profit indicator.

89. Where the analysis yields more than one comparable price, a dataset shall be constructed by placing those prices in an ascending order.

90. Where the most appropriate method applied is a CUP or resale price method or cost plus method or TNMM and the dataset constructed consists of six or more entries, an arm's length range beginning from the thirty-fifth percentile of the dataset and ending on the sixty-fifth percentile of the dataset shall be constructed and arm's length price shall be computed as follows:

- a. If the price of the controlled transaction falls within the arm's length range, then the price is deemed as arm's length price.
- b. If the price of the controlled transaction falls outside the arm's length range, then the arm's length price shall be taken to be the median of the dataset.
- c. If median is not applicable, the arm's length price shall be the arithmetical mean of all the values included in the dataset.

91. Where the variation between the arm's length price determined and price of the controlled transaction does not exceed three per cent of the latter, the price of controlled transaction shall be deemed to be at the arm's length term. However, in a case where the variation is more than the three percentage, the taxable profit shall be adjusted by the difference between arm's length price determined and the price of the controlled transaction

**Illustration:**

Based on the comparability analysis, taxpayer has identified seven comparables in the tax year. All the identified comparables have also undertaken independent party transactions in a period of two years preceding the tax year.

TNMM has been selected as the most appropriate transfer pricing method. The Profit Level Indicator (PLI) used is operating profit as compared to operating cost (OP/OC). The weighted average shall be based upon the weight of OC as computed below.

No.	Name	Details	Year 1	Year 2	Year 3 [Current Year]	Total	Weighted Average (Total OP / Total OC)
1	A	Operating cost (OC)	100.00	150.00	225.00	475.00	12%
		Operating profit (OP)	12.00	10.00	35.00	57.00	
2	B	Operating cost (OC)	80.00	125.00	100.00	305.00	8.2%
		Operating profit (OP)	10.00	5.00	10.00	25.00	
3	C	Operating cost (OC)	250.00	230.00	250.00	730.00	9%
		Operating profit (OP)	22.00	26.00	18.00	66.00	
4	D	Operating cost (OC)	180.00	220.00	150.00	550.00	6%
		Operating profit (OP)	(9.00)	22.00	20.00	33.00	
5	E	Operating cost (OC)	140.00	100.00	125.00	365.00	2.2%
		Operating profit (OP)	21.00	(8.00)	(5.00)	8.00	
6	F	Operating cost (OC)	160.00	120.00	140.00	420.00	11.9%
		Operating profit (OP)	21.00	14.00	15.00	50.00	
7	G	Operating cost (OC)	150.00	130.00	155.00	435.00	10.57%
		Operating profit (OP)	21.00	12.00	13.00	46.00	

From the above, the dataset will be constructed as follows:

No.	1	2	3	4	5	6	7
Values	2.2%	6%	8.2%	9%	10.57%	11.9%	12%

For construction of the arm's length range the data place of thirty-fifth and sixty-fifth percentile shall be computed in the following manner, namely:

Total no. of data points in dataset x (35/100)

Total no. of data points in dataset x (65/100)

Thus, the data place of the thirty-fifth percentile 2.45 ( $7 \times 0.35$ ). Since this is not a whole number, the next higher data place, i.e. the value at the third place would have at least thirty five per cent of the values below it. The thirty-fifth percentile is therefore value at the third place, i.e. 8.2%.

The data place of the sixty-fifth percentile is 4.55 ( $7 \times 0.65$ ). Since this is not a whole number, the next higher data place, i.e. the value at the fifth place would have at least sixty five per cent of the values below it. The sixty-fifth percentile is therefore value at fifth place, i.e. 10.57%.

The arm's length range will be beginning at 8.2% and ending at 10.57%.

Therefore, if the controlled transaction has a percentage which is equal to or more than 8.2% and less than or equal to 10.57%, it is within the arms' length range and no adjustment shall be required. However, if the controlled transaction has a percentage outside the arm's length range, say 6.2%, then for the purpose of determining the arm's length price the median of the dataset shall be determined in the following manner:

The data place of median is calculated by computing the total number of data point in the dataset x (50/100). In this case it is 3.5 ( $7 \times 0.5$ ).

Since this is not a whole number, the next higher data place, i.e. the value at the fourth place would have at least fifty per cent of the values below it (median).

The median is the value at fourth place, i.e., 9%. Therefore, the arm's length price shall be considered as 9% and adjustment shall be made accordingly.

## 11. Arm's length adjustment by MIRA

92. If the price is not determined in line with the arms' length principal, it would lead either party to the controlled transaction to derive profits at a level above or below the comparable market level. As such, MIRA may make necessary adjustment to taxable profits of the party operating in Maldives whose profits are being distorted due to an incorrect transfer price. Such an adjustment can lead to;
- a. an increase in the amount of income;
  - b. a reduction in the amount of deductions that may be allowed;
  - c. a reduction in the amount of loss.

## 12. Non-recognition of controlled transaction

93. Non-recognition of a transaction is a source of double taxation hence care must be given to conduct a meaningful transfer pricing analysis and to ensure that non-recognition is not used simply because determining an arm's length price is difficult. The mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognized.
94. 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 parties 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.

## PART IV

# INTRA-GROUP SERVICE TRANSACTIONS

## 13. Intra-group service transactions

### 13.1 Introduction

1. Intra-group services refer to activities that are performed by one or more members of group companies or businesses for its associates within the same group. Such services may include administrative, technical, financial, commercial, management, coordination and control functions.
2. Intra-group services often include those that are typically available externally from independent parties, in addition to those that are ordinarily performed internally.
3. There are two issues in the analysis of transfer pricing for intra-group services:
  - a. whether intra-group services have in fact been provided
  - b. what the intra-group charge for such services for tax purposes should be in accordance with the arm's length principle.

### 13.2 Determining whether intra-group services have been rendered (Benefit Test)

4. Under the arm's length principle, the question whether an intra-group service transaction has been rendered when an activity is performed for one or more group members by another group member should depend on whether the activity provides a respective group member with economic or commercial value to enhance or maintain its business position.
5. To determine whether intra-group services have been provided, taxpayers can apply the 'benefits test' to the facts and circumstances pertaining to their activities.
6. The benefits test requires consideration of the following factors:
  - a. whether activities are performed for another party which receives, or reasonably expects to receive, benefits from such activities. If so, there is a service provided even if the expected benefits do not eventually materialize;
  - b. whether objectively there is any commercial or practical necessity for the activities to be performed for the service recipient and an independent party would be willing to pay the service provider for the performance of those activities. If not, the benefit is too remote and there is no service provided;
  - c. whether the benefits have economic or commercial value such that an independent party would expect to pay to receive the benefits or be paid for providing the benefits. If not, there is no service provided; and

- d. whether the benefits are identifiable and capable of being valued. In other words, the benefits must be sufficiently direct and substantial. Otherwise, there is no service provided.
7. If a parent or holding company provides a service to one of the group members in its capacity as a shareholder, this would not be considered to be an intra-group service and thus would not justify a charge to other group members. Such an activity would be one that a group member (usually the parent company) performs solely because of its ownership interest, and the group members do not need the activity and would not be willing to pay for it, were they independent parties. Hence, this would be classified as a shareholder activity rather than an intra-group service transaction.
8. Generally, no intra-group service should be found for activities undertaken by one group member that merely duplicate a service that another group member is performing for itself, or that is being performed for such other group member by a third party. An exception may be where the duplication of services is only temporary and is undertaken to reduce the risk of a wrong business decision (e.g. by getting a second legal opinion on a subject). Any consideration of possible duplication of services needs to identify the nature of the services in detail, and the reason why the company appears to be duplicating costs contrary to efficient practices.
9. An associated party 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.
10. The fact that a payment was made to an associated party for purported services can be useful in determining whether services were in fact provided, but the mere description of a payment as, for example, 'management fees' should not be expected to be treated as prima facie evidence that such services have been rendered.

### 13.3 Application of the arm's length principle to determine intra-group charge

11. Once taxpayer has identified that an intra-group service has been provided, taxpayer then needs to determine whether the service fee charged was in line with the arm's length principle.
12. The first step in doing this is to identify whether the group charged the taxpayer directly or indirectly for the provision of services between them.
  - a. **Direct charge method:** A direct-charge method means that associated parties have charged each other directly for specific services. MNE groups may be able to adopt direct charge method in cases where services similar to those rendered to the associated parties are also rendered to independent parties. If

specific services are provided not only to associated parties but also to independent parties in a comparable manner and as a significant part of its business, it could be presumed that the MNE has the ability to demonstrate a separate basis for the charge. As a result, MNEs in such a case are encouraged to adopt the direct charge method in relation to their transactions with associated parties.

- b. **Indirect charge method:** MNE groups are not always able to apply direct charge method, particularly if the value of the service cannot be directly apportioned to each associated party. In such cases, they can use indirect charge methods to charge for intra-group services. These methods are usually based on cost allocation and distribution. Any indirect charge method should be sensitive to the commercial features of the individual case (e.g. selecting the appropriate allocation key), contain safeguards against manipulation and follow sound accounting principles, and be capable of producing charges or allocations of costs that commensurate with the actual or reasonably expected benefits to the recipient of the service.
13. To calculate the arm's length of intra-group services, taxpayer need to consider: (i) the value of the service to the receiving company; (2) the amount an independent party would be willing to pay for it in comparable circumstances; (3) and the service provider's costs.
  14. There are a number of transfer pricing methods taxpayers can use for pricing intra-group services. The most commonly used are the CUP method or a cost-based method such as the cost plus method or cost-based transactional net margin method.

### 13.4 Administrative practices for routine support services

15. It is common for parent companies or group service companies to provide certain routine services to associated parties. These services are usually:
  - a. supportive in nature;
  - b. not part of the core business of the group;
  - c. do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and
  - d. do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.
16. Strictly, taxpayers should perform a proper transfer pricing analysis to determine the arm's length remuneration for performing such routine support services. However, doing so could greatly increase administrative and compliance burdens for the taxpayers. It would also increase MIRA's administrative costs to evaluate them.
17. Taxpayer may apply the elective and simplified approach by OECD in applying and documenting the arm's length charges for routine support services. This approach

involves a simplified benefit test, a process for determining the costs associated with the routine support services, the ability to use general allocation keys and a standard profit mark-up of 5%.

18. Taxpayers can only elect the simplified approach if the services are provided solely within the group and taxpayers should:

- a. support their basis for classifying the service as a routine support service;
- b. apply the mark-up consistently year-after-year throughout the group until there are material changes to the circumstances or services provided; and
- c. review the mark-up regularly to ensure that it continues to reflect arm's length conditions in their situations.

## PART V

# INTRA-GROUP FINANCING TRANSACTIONS

## 14. Intra-group financing transactions

### 14.1 Introduction

1. Intra-group financing is another form of service between associated parties, in the form of financial assistance that include loans, interest bearing trade credits, advance or debt and the provision of any security or guarantee, etc.
2. 'Interest' means any payment (excluding the principal amount), under a debt security or loan or swap or derivative arrangement or a transaction in respect which a payment that is economically equivalent to interest is payable, and any commitment, guarantee or service fee paid in respect of a loan or swap or derivative arrangement, including discounts, premiums, passive interest and profit received in respect of any Islamic financial instrument.
3. In relation to intra-group financing transactions, the interest rate should be determined in accordance with arm's length principle. This means, taxpayers should charge or pay the associated party, interest at a rate which is consistent with the rate that would have been charged in a similar transaction between independent parties dealing at arm's length.
4. The arm's length interest rate for loans is usually made up of a base reference rate and a credit spread or margin. The base reference rate is usually a publicly available rate such as the London Inter Bank Offered Rate ("LIBOR") or prime rates offered by banks. The margin is mainly to compensate the lender for bearing the credit risk of the borrower defaulting on the loan.

### 14.2 Determination of whether a purported loan should be regarded as a loan

5. In analyzing the intra-group financing transactions, taxpayers are required to first determine whether the purported loan is in nature, a loan. A transaction needs to be accurately delineated in order to determine whether a loan can be regarded as a loan for tax purpose or whether it should be considered as some other kind of payment, in particular a contribution to equity capital.
6. In accurately delineating a financing transaction as equity or debt, the following economically relevant characteristics (but not limited to) may be useful indicators, depending on the facts and circumstances:
  - a. the presence or absence of a fixed repayment date;

- b. the obligation to pay interest;
- c. the right to enforce payment of principal and interest;
- d. the status of the funder in comparison to regular corporate creditors;
- e. the existence of financial covenants and security;
- f. the source of interest payments;
- g. the ability of the recipient of the funds to obtain loans from independent lending institutions;
- h. the extent to which the advance is used to acquire capital assets; and
- i. the failure of the purported debtor to repay on the due date or to seek a postponement

#### EXAMPLE 11: INTRA-GROUP FINANCING

Company B, a member of an MNE group, needs additional funding for its business activities. Company B receives an advance of funds from related Company C, which is denominated as a loan with a term of 10 years, without any security. Assume that, in light of all good-faith financial projections of Company B for the next 10 years, it is clear that Company B would be unable to service a loan of such an amount.

Based on facts and circumstances, it can be concluded that an independent party would not be willing to provide such a loan to Company B due to its inability to repay the advance. Further, in the event of a default Company C would be unable to recover the funds.

Accordingly, the accurately delineated amount of Company C's loan to Company B for transfer pricing purposes would be a function of the maximum amount that an independent lender would have been willing to advance to Company B, and the maximum amount that an independent borrower in comparable circumstances would have been willing to borrow from Company C, including the possibilities of not lending or borrowing any amount. Consequently, the remainder of Company C's advance to Company B would not be delineated as a loan and interest accrued will not be allowed for deduction for tax purposes.

### 14.3 Application of Arm's Length Principle

7. Once the taxpayer has determined that the purported loan is in fact in nature a loan, the next step is the application of arm's length principle. Section 4 of this guideline, provides a framework to guide taxpayers in the application of the arm's length principle. Taxpayers can apply this framework when analyzing and determining the arm's length interest rates for intra-group loans as well.
8. There are two key factors to delineate the financial transactions which are;
  - a. commercial or financial relations; and
  - b. economically relevant characteristics of actual transaction

9. In considering the commercial and financial relations between the associated borrower and lender, and in an analysis of the economically relevant characteristics of the transaction, both the lender's and borrower's perspectives should be taken into account, acknowledging that these perspectives may not align in every case.
10. Similar to other transfer pricing scenarios, it is important to determine whether the lender and the borrower assume risks related to intra-group loans. In particular, it is important to consider the risks that the funding arrangements carry for the party providing the funds, and the risks related to the acceptance and use of the funds from the perspective of the recipient. These risks will relate to repayment of the amount transferred, compensation expected for the use of that amount over time, and compensation for other associated risk factors.
11. An independent lender will carry out a thorough credit assessment of the potential borrower to enable the lender to identify and evaluate the risks involved and to consider methods of monitoring and managing these risks. That credit assessment will include understanding the business itself as well as the purpose of the loan, how it is to be structured and the source of its repayment which may include analysis of the borrower's cash flow forecasts and the strength of the borrower's balance sheet.
12. Once the actual transaction has been accurately delineated, arm's length interest rates can be sought based on consideration of the credit rating of the borrower or the rating of the specific issuance taking into account all of the terms and conditions of the loan and comparability factors.

#### 14.4 Determination of arm's length interest

13. The widespread existence of markets for borrowing and lending money and the frequency of such transactions between independent borrowers and lenders, coupled with the widespread availability of information and analysis of loan markets may make it easier to apply the CUP method to financial transactions than may be the case for other types of transactions. Information available often includes details on the characteristics of the loan and the credit rating of the borrower or the rating of the specific issuance. Characteristics which will usually increase the risk for the lender, such as long maturity dates, absence of security, subordination, or application of the loan to a risky project, will tend to increase the interest rate. Characteristics which limit the lender's risk, such as strong collateral, a high quality guarantee, or restrictions on future behavior of the borrower, will tend to result in a lower interest rate.
14. The arm's length interest rate for a tested loan can be benchmarked against publicly available data for other borrowers with the same credit rating for loans with sufficiently similar terms and conditions and other comparability factors.
15. In the search for comparability data, a comparable is not necessarily restricted to a stand-alone entity. In examining commercial loans, where the potentially comparable

borrower is a member of an MNE group and has borrowed from an independent lender, provided all other economically relevant conditions are sufficiently similar, a loan to a member of a different MNE group or between members of different MNE groups could be a valid comparable.

16. Arm's length interest rates can also be based on the return of realistic alternative transactions with comparable economic characteristics. Depending on the facts and circumstances, realistic alternatives to intra-group loans could be, for instance, bond issuances, loans which are uncontrolled transactions, deposits, convertible debentures, commercial papers, etc. In the evaluation of those alternatives as potential comparables it is important to bear in mind that, based on facts and circumstances, comparability adjustments may be required to eliminate the material effects of differences between the controlled intra-group loan and the selected alternative in terms of, for instance, liquidity, maturity, existence of collateral or currency.
17. As every intra-group loan can be different, taxpayers are to determine the arm's length interest rate for each loan individually. In addition, taxpayers are required to maintain transfer pricing documentation relating to their basis of determining the interest rates for the intra-group financing transactions.

#### 14.5 Administrative practice for indicative margins on intra-group loans

18. Taxpayers can choose to apply the indicative margin to each intra-group loan that does not exceed MVR 15 million at the time the loan is obtained or provided from 01 January 2020. The threshold is based on the loan committed and not the loan utilized.
19. The indicative margin is published on MIRA website and will be updated at the beginning of each year. If a taxpayer chooses to apply the indicative margin, the interest rate used should be the indicative policy rate published by the Maldives Monetary Authority plus the indicative margin.
20. The indicative margin is applicable to both Maldivian Rufiyaa denominated and foreign currency denominated intra-group loans. For intra-group loans denominated in foreign currencies, the threshold (in MVR) is to be determined based on the prevailing exchange rate at the time the loans are obtained or provided.

#### 14.6 Domestic financing transaction between associated parties

21. Although transfer pricing rules extend to domestic financing transactions, these transactions do not erode the tax base of the Maldives and the overall tax implications from these transactions are trivial.

22. As such, in the case of an intra-group domestic loan provided by a taxpayer who is not in the business of borrowing and lending, MIRA will be limiting the taxpayer's claim for interest expense to the interest charged on such loan.
23. While this does not exactly conform to the arm's length principle, it nonetheless serves as a close proxy. This is to facilitate taxpayers' efforts in complying with the arm's length principle for intra-group loans while keeping compliance cost low.
24. In all other cases, taxpayers should adhere to the arm's length principle to determine the interest charges.

#### EXAMPLE 12: DOMESTIC FINANCING TRANSACTIONS

Company A incorporated in Maldives is 99% owned by a Company B (incorporated in Maldives).

Company A obtained funding of \$20 Million from Company B. The interest charged by Company B in tax year 2020 was MVR 1,500 and the interest expense incurred by Company B in providing the loan in tax year 2020 was MVR 2,000.

In this scenario, Company B's interest expense claim of MVR 2,000 is limited to MVR 1,500.



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