VERO SKATT

Memorandum (abbreviated version in English)

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TRANSFER PRICING DOCUMENTATION REQUIREMENTS

Table of contents

1 PREFACE

Taxpayer-submitted written documentation should prove the arm's length nature of prices used in intercompany cross-border transactions. The arm's length principle is the generally acceptable international standard governing pricing within a multinational company. The Finnish national legislation contains its basic definition of the arm's length principle in § 31, Act on Assessment Procedure. Other sections of Act on Assessment Procedure include rules governing documentation requirements (§ 14 a – § 14 c).

This memorandum discusses these requirements. Taxpayers are given guidance to help recognize the emergence of the obligation to submit documentation, and to comply with the rules. The questions answered in this memorandum include:
— Who is expected to submit documentation? — What transactions fall into the category of documented transactions? — How to ensure that company documentation reaches the acceptable level? Furthermore, this memorandum also discusses some of the established procedures of the tax authorities, and explains the consequences of non-compliance.

Note

The original Finnish version of this Memorandum includes a more extensive discussion of associated enterprises, the nature of association, small-scale transactions, and content of documentation in special circumstances. The present English version has been compiled for the purpose of facilitating the understanding of the Finnish tax system and legislation. The translation is unofficial. It must be pointed out that the translation has no legal force. Only the Finnish and Swedish texts constitute documents of legal reference.

List of required TP documentation content under § 14 b,
Act on Assessment Procedure:

(1) Description of business,
(2) Description of associated enterprises,
(3) Information on transactions between associated enterprises,
(4) Functional analysis of transactions between associated enterprises,
(5) Comparability analysis, including information on comparables, and
(6) Description of applied pricing policy.

The first four items deal with background. Tax authorities wish to gain an understanding of taxpayer's business so as to facilitate any comparisons that will later take place. Item (5) on the list relates to the comparative approach, in which taxpayer's transactions are compared with transactions taking place between independent companies. Item (6) refers to taxpayer's policy of transfer pricing. If a policy is in use, it should fulfill a set of requirements.

Reference is made to OECD Guidelines.

2 INTRODUCTION

2.1 Definitions

This memorandum includes the following special terms:

Documentation requirement
The entire requirement, considered as a whole, under §14 a – §14 c, Act on Assessment Procedure, setting out the obligation of taxpayer to prepare, submit, and as necessary, complement the documentation regarding transfer pricing.

Associated
To be 'associated' means the nonindependent, non-arm's-length relationship between taxpayer and the associated company within meaning of § 31.2 (and § 31.3), Act on Assessment procedure. This relationship exists if taxpayer company has an ownership interest exceeding 50% of either the shares and votes of another enterprise, or has direct or indirect rights to nominate more than half of the members of the board of directors of another enterprise, or is having a powerful position in respect of the other enterprise due to other circumstances. Thus, the associated relationship is in existence, and documentation is required, of a foreign company and its permanent establishment in Finland.

Associated enterprise, also known as a linked enterprise
The party associated with taxpayer. See previous.

Comparability analysis
Comparison of a controlled transaction (associated) with an uncontrolled transaction (independent, autonomous). Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology, or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences. As defined by OECD Guidelines, comparability analysis includes description of the associated transaction, and evaluation of whether or not it can be compared with a transaction between independent entities.

EU Code of Conduct
Document created by the European Commission and the official representatives of the member states participating in the meeting (Code of Conduct (2006/C 176/01) on Transfer Pricing Documentation in the European Union was issued 27 June 2006).

EU TPD
EU Transfer Pricing Documentation (EU TPD) is the model set of documentation compiled according to the EU Code of Conduct. It has been intended for the associated enterprises resident in various member states.

Functional analysis
An analysis of the functions performed (taking into account assets used and risks assumed) by associated enterprises in controlled transactions and by independent enterprises in comparable uncontrolled transactions. As defined by OECD Guidelines, functional analysis focuses on appraisal of business operations and activities, taking the relevant assets and risks

into consideration. Essentially, transactions between associated entities and transactions between comparable independent entities are compared with one another.

Government Proposal
The 2006 proposal of the Finnish Cabinet, presented to the Finnish Parliament, for passing the Act governing transfer pricing, and containing background facts about this Act. Abbreviated as GP/HE 107/2006 vp.

Recommendation of the Commission
The recommendation of the Commission (of 6 May 2003, 2003/361/EC) regarding the definition of small companies and SMEs.

Quartiles
Data can be regrouped statistically in quartiles. The midrange is usually the most relevant; being between the top quartile (with 75% of observations staying below) and bottom quartile (25% of observations staying below).

Arm's length principle
The arm's length principle has been defined in Article 9 of OECD Model Tax Convention. Associated companies should only enter into mutual agreements so that the terms and conditions are no different from the those between companies that are not associated with one another.

Median
The median is the ordinal middle value of any range of values that have been placed in consecutive order.

Mutual agreement procedure
A means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. This procedure, described and authorized by Art. 25 of the OECD Model Tax Convention, can be used to eliminate double taxation that could arise from a transfer pricing adjustment.

OECD Guidelines
Reference is made to the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD 1995. Several updates and further notes are included. This is the main source of commentary regarding the question of application of the arm's length principle.

Partner enterprise
This is a type of company affiliation within the context of small and medium-sized business. A company is considered 'partner' if the ownership interest is above 25 percent but below 50 percent (of equity/votes). 'Partner enterprises' are all enterprises which are not classified as linked enterprises, and between which there is the following relationship:
an enterprise (upstream enterprise) holds, either solely or jointly with one or more linked enterprises, 25% or more of the capital or voting rights of another enterprise (downstream enterprise).

SME
The Finnish definition of small and medium-sized companies is the same as that of the Commission Recommendation 2003/361/EC. It has been set out in § 14a, Act on Assessment Procedure.

Linked enterprise
This is a type of association with a company within the context of small and medium-sized business. A company is considered ‘linked’ if the ownership interest is above 50 percent. ‘Linked enterprises’ are enterprises which have any of the following relationships with each other:
(a) an enterprise has a majority of the shareholders' or members' voting rights in another enterprise;
(b) an enterprise has the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another enterprise;
(c) an enterprise has the right to exercise dominant influence over another enterprise pursuant to a contract entered into with that enterprise or to a provision in its memorandum or articles of association;
(d) an enterprise, which is a shareholder in or member of another enterprise, controls alone, pursuant to an agreement with other shareholders in or members of that enterprise, a majority of shareholders' or members' voting rights in that enterprise.

Dealings
Within the context of transfer pricing from the perspective of tax authorities, transactions (dealings) between the company itself and its permanent establishment in another country are treated the same.

Simultaneous tax examinations
A simultaneous tax examination, as defined in Part A of the OECD Model Agreement for the Undertaking of Simultaneous Tax Examinations, means an "arrangement between two or more parties to examine simultaneously and independently, each on its own territory, the tax affairs of taxpayer(s) in which they have a common or related interest with a view to exchanging any relevant information which they so obtain".

2.2 Documentation

2.2.1 Introduction

Documentation should be divided in two parts or stages: on the one hand, taxpayers are expected to submit a set of documents every year, and on the other hand, taxpayers should be prepared to hand in additional explanations and documents about any matters that require more study. The first stage represents the minimum level, and the tax authority can use the documentation for basic scrutiny. If necessary from the point of view of ensuring that the arm’s length principle has been followed, the tax authority will request taxpayer to submit second-stage documentation.

2.2.2 Principle of materiality

Documents do not have a statutory format in themselves. Accordingly, taxpayers are free to choose the most appropriate format. There is considerable variation in the facts and circumstances that are necessary for the tax authority to verify conformity to arm’s length principle.

The documentation will be considered sufficient whenever it fulfills the general requirements of § 14 b, Act on Assessment Procedure. This legal

provision discusses overall descriptions of the circumstances that prevail within the taxpayer organization, descriptions that show the usual framework pertaining to transfer pricing occurring in this organization. As required by each case, further documentation and copies are to be provided in addition. Nevertheless, the authority will consider a simple set of documents, which is more scarce than abundant, to be sufficient if the necessary facts and proof of arm's length principle are shown. On the other hand, a set of documents containing very many pages can be considered unsatisfactory, if material business issues of transfer pricing have been left out. Thus, the substance of the documentation will always prevail over its form.

It is permissible to deviate from the order outlined in § 14 b, Act on Assessment Procedure. The setup and content of the documentation do not necessarily have to follow the provisions of § 14 b, Act on Assessment Procedure, if another set of rules has been followed instead, including the EU TPD, and the transfer-pricing documentation rules of another country. Taxpayers are entitled to choose the method of presentation for a variety of reasons. Nevertheless, the facts and information are to be disclosed and reported as enumerated in §14 b, Act on Assessment Procedure.

2.2.3 Relative importance of documentation in respect of the arm's length principle

As it has been stated, the requirement to submit transfer pricing documentation not only includes some elements that are quite flexible, but also some exclusions and freedoms. Nevertheless, the flexibility, exclusions and freedoms only concern the documents, not the real meaning of whether or not intercompany cross-border transactions are at arm's length. All examined cases of transfer pricing are approached in exactly the same way as to the applicability of arm's length principle. For this reason, for example, even though the documentation were compiled exactly as required by law, but the pricing of the business transaction would deviate from market price as defined by § 31, Act on Assessment Procedure, the tax authority would proceed to demand reassessment of tax on grounds of violation.

2.2.4 Documentation language

Documents written in English, Finnish or Swedish are accepted. If necessary, the taxpayer should provide a Finnish/Swedish summary translation of documentation completely written in English.

Even though English is not an official language in the country, it will usually not be necessary for the tax authorities to demand a complete translation into Finnish/Swedish of the entire documentation, because many of the important documents include numbers, not words. Nevertheless, the part of the documentation **possibly** requiring translation can include any materially important explanation texts. This would take place especially if the subject matter seems to be leaving room for interpretation. Because the taxpayer's translation costs would be unreasonable and often unnecessary, tax authorities will not demand complete translations into Finnish/Swedish. The same approach is used by the authors of EU Code of Conduct.

Member states should accept as many documents as possible in English to keep translation costs in check.

2.2.5 Deadline information

Documentation is to be prepared and handed in, but no specific deadline has been set. Furthermore, there is no expectation of real-time transfer pricing documentation. Regarding deadlines, the only legal provision to be observed is § 14 c, Act on Assessment Procedure: "Taxpayer should present the documentation within 60 days on a request of the tax authorities. But the annual set of documentation for the tax year is not required earlier than 6 months after the end of the accounting period." The first accounting period to be covered by transfer pricing documentation is the period starting 1 January 2007 or later.

Taxpayers should remain aware of transfer pricing requirements and monitor the prices being charged during the tax year. This rule is valid even though there is no real-time requirement for documentation. It is important to constantly monitor the actual pricing, because after the close of the year, Finnish tax procedures do not permit companies to introduce corrections in their tax return form (and not the audited financial statements) that diminish taxable income. Nevertheless, corrections can be introduced in the statutory accounting in the course of the tax year, and in the course of the accounting period. Such corrections would be necessary to bring transfer pricing to arm's length levels. Assuming that the calculations have been made correctly, corrections are permitted even if they diminish taxable income (instead of increasing it). The cost would then be legally interpreted as a deductible expense, and not as a non-deductible expense under § 16.7, Act on the Taxation of Business Profits (EVL). In sum, taxpayer's own real-time approach to the monitoring of transfer prices will make it easier for taxpayer companies to avoid problems in this area.

2.3 Applicability of EU TPD

The EU Code of Conduct includes recommendations to multinational companies within the territory of the European Union. The model package of documentation is known as the EU TPD. However, it should be noted that the Code of Conduct should not be viewed as a binding legal instrument for member states to follow, because this would go against the national sovereignty principle that governs direct taxation. Nevertheless, the Finnish Tax Administration has taken account of the recommendations included in EU TPD.

The intent and purpose of EU TPD is to simplify the documentation requirement faced by a multinational company. This is achieved through harmonization, so that a multinational within the territory of the European Union needs no other system than the EU TPD package of documentation, which will cover all the associated enterprises, group companies and host countries of subsidiaries. From the perspective of the company, the decision to start utilizing EU TPD is optional and voluntary, but if EU TPD is in use, the company cannot deviate from it. It should be applied in a consistent manner, because the Code of Conduct requires that the transfer pricing documentation model should remain the same from one year to the next and cannot be changed.

EU TPD consists of two main elements. The *masterfile* has common standardized information relevant for all EU group members of a multi-national enterprise such as a general description of the business and business strategy, a general description of the transactions involving associated enterprises in the EU and the enterprise's transfer pricing policy. The *country-specific documentation* is a set standardized documentation for each of the specific Member State involved. Each set contains information relevant to that country only such as amounts of transaction flows within that country, contractual terms and the particular transfer pricing methods used.

Using EU TPD is certainly sufficient to meet the transfer pricing documentation requirements for Finland, because the overall scope of the Finnish requirements is smaller than that of the standardized *country-specific documentation*. If taxpayer uses EU TPD, and submits documentation to Finnish authorities, we will also request the *masterfile*, because it will be helpful in giving the tax officers a general description of the multinational company and its business.

If a taxpayer company decides to adopt EU TPD, there is no need to communicate this decision to the Finnish Tax Administration. The Finnish authorities do not require a specific announcement on the taxpayer’s part (although this is required by the Code of Conduct).

3 SCOPE OF APPLICATION OF THE DOCUMENTATION REQUIREMENT

3.1 General information about limitations

Whereas taxpayer is expected to prepare documentation, in which all business transactions are included within meaning of § 31, Act on Assessment Procedure, the requirement does not, however, concern all the dealings between associated companies covered by § 31. This legal provision determines the scope of tax adjustment after a transfer-pricing problem, and it has a very wide scope of application in this sense. Both domestic and cross-border transactions within the multinational are covered. However, compared to the wide scope of tax adjustment, the *scope of application of documentation requirement* is more narrow.

Pursuant to § 14, Act on Assessment Procedure, TP documentationrequirement concerns dealings of Finnish enterprises with a foreign counterpart. Furthermore, TP documentationrequirement also applies to foreign companies with a permanent establishment in Finland. But there is no need to prepare TP documentationfor transactions between companies located in Finland or for transactions between a Finnish company and its permanent establishment in another country. The reason for this limitation of scope is that tax authorities already have sufficient means to obtain facts about transactions between domestic companies. For the same reason, documentation requirement is also waived for transactions between a permanent establishment located in Finland of a foreign company, and a Finnish subsidiary of the same foreign company, even though the counterpart is formally and technically not Finnish.

The documentation requirement is also completely waived for SME companies, even if they have cross-border transactions. According to the Government proposal texts, the reason for this limitation is to avoid excessive costs for SMEs to carry, especially because these costs would probably be out of proportion considering the fiscal interest.

If dealings with associated entities are small in scale, less extensive documentation is required. This is the case if total transactions between two parties during a fiscal year stays below €500,000. According to the Government proposal texts, the reason for this limitation is that the relevant fiscal interest will remain small when the transactions remain small.

3.2 Definitions and examples of reportable intercompany transactions

The concept of ‘being associated’ is defined in § 31.2, Act on Assessment Procedure. Parties to a business transaction are associated if one of them is able to govern the other’s actions, or if a third party, either individually or jointly with the third party’s associates, is able to govern the actions of both parties to the business transaction. The definition given in § 31.2, Act on Assessment Procedure is similar to that of Finnish Accounting Act (KPL) and Companies Act (OYL) regarding the concept of ‘being associated’. Pursuant to Chapter 1, § 5 of Accounting Act, holding the majority of all shares or votes of another company means that the two companies are associated with each other. This relationship may be further defined by the Charter, the Articles of Association, Rules of Membership or similar document. Secondarily, one business company can govern the actions of another because the former has the right to nominate board members in the

latter. The right usually, but not always, exists because the majority of shares or votes belongs to the former. In addition, governing the other business company's actions may be based on the existence of common management according to group organization scheme, or based on other circumstances that indeed give control of the other company's actions.

Common or shared management, under the Government proposal HE 126/2004 may exist in situations where *special purpose entities have been established* to oversee financial arrangements, guarantee arrangements or other comparable setups. Special purpose entities are managed as if they were subsidiaries, even if the parent company has no ownership interest. Common or shared management also exists in the case of a joint venture, JV, where two companies, neither one having the majority of shares, are jointly in charge of the management. It is typical for JVs to have an agreement between the two shareholders. Specific rules regarding the powers and governance are set out in the shareholders' agreement. Legal examination of what has been agreed in the shareholders' agreement usually results a simple conclusion as to which one of the JV's shareholder companies actually governs the JV's actions.

The definition given in § 31.2, Act on Assessment Procedure is applicable even in situations where indirect ownership, right to vote or right to nominate board members is the reason for being associated. The text of the Government proposal treats § 31.2 as a provision that covers all typical forms of being associated, including intercompany transactions within a multinational, and including situations where a third party would have control over both parties to a business transaction. Furthermore, the Government proposal expressly states that this legal provision should be applied to transactions between a PE in Finland and any foreign subsidiary of a multinational enterprise.

Not only a parent or subsidiary of a multinational, but also a physical person can be in the position of a third party, having control over both parties to a business transaction. The physical person can be in this position alone, individually, or jointly with spouse or similar partner, brother or sister, half-brother, half-sister, parent, son or daughter of the person concerned or with spouse/similar partner of these. Furthermore, even the estate of a de-ceased person can be included in the physical person's sphere of influence, because upon death, the decedent's business-related rights and obligations are passed on to the estate.

It should be noted that the TP documentation requirement is not extended to transactions between the business company and the physical person who holds shares in it. These transactions are subject to other types of scrutiny within tax assessment. They include compensation based on employment, capital investments and sales and purchases of assets. However, if a Finnish self-employed individual has business income originating in foreign companies, controlled by the individual himself, transactions between the foreign companies and the individual should be reported according to the TP documentation requirement.

Please see below a collection of examples of intercompany cross-border transactions, dealings and situations.

Example 1: The foreign 'A Ltd' company with net sales reaching M€100, and balance sheet total at M€45, is the owner of 40% of votes and shares

in the Finnish 'B Oy', and furthermore, 'A Ltd' is entitled to nominate more than half of the board members of 'B Oy'. *Conclusion:* Dealings between 'B Oy' and 'A Ltd' are to be reported in transfer pricing documentation.

Example 2: The Finnish 'A Oy' with net sales reaching M€60, and balance sheet total at M€44, is the sole owner of the Finnish 'B Oy'. The latter has an ownership interest of 60% of the foreign 'C Ltd', and 40% of its votes. *Conclusion:* Both Finnish companies 'A Oy' and 'B Oy' have the obligation to submit transfer pricing documentation regarding their respective transactions with 'C Ltd'.

Example 3: As an individual physical person, Mr. F is the owner of all shares in the Finnish 'A Oy' and the foreign 'B Ltd'. *Conclusion:* Unless 'A Oy' is not a small or medium-sized enterprise within meaning of § 14 a, Act on Assessment Procedure, 'A Oy' has the obligation to submit transfer pricing documentation regarding transactions with 'B Ltd'.

Example 4: Family members build a pool of owners as follows: Mr. A and Mrs. B, mother and father, Mrs. C, mother of Mrs. B, Ms. D, the daughter, Mr. E, daughter's husband, and lastly, the children F, G and H, who are thus owners of 51% of the shares of the Finnish 'X Oy'. Moreover, the family is the owner of 51% of the foreign 'Y Ltd'. *Conclusion:* Unless 'X Oy' is not a small or medium-sized enterprise within meaning of § 14 a, transactions between 'X Oy' and 'Y Ltd' are to be documented.

Example 5: The Danish married couple Mr. B and Mrs. G are the sole owners of the company called 'Å A/S'. This company, 'Å A/S', has 40% of the shares of the Finnish 'P Oy', entitling to 25% of votes. Mr. B's father's nephew is the sole owner of the Finnish 'X Oy' that has constant business trading with both 'P Oy' and 'Å A/S'. *Conclusion:* Documentation will not be required for transactions between 'Å A/S', 'P Oy' and 'X Oy'.

3.3 Small and medium-sized enterprises

3.3.1 Applying the SME definition

For small and medium-sized enterprises, transfer pricing documentation obligations are waived. The European Commission's Recommendation on the definition of micro, small and medium-sized enterprises 2003/361/EC has been taken into account. According to the Government proposal texts, the reason for this limitation is to avoid excessive costs for SMEs to carry, especially because these costs would probably be out of proportion considering the fiscal interest.

§ 14 a, subsection 3 includes the following definition of a small or medium-sized enterprise:

1) Number of employees remains below 250;
2) Net sales is below €50 million, or balance-sheet total is below €43 million; and
3) SME criteria as enumerated in Recommendation 2003/361/EC are applicable to the enterprise.

All of the above three requirements are to be fulfilled, but the second requirement with maximum amounts of sales and balance-sheet total will

be considered fulfilled even if one or the other figure is above the limit. The enterprise will still be considered small or medium sized. However, if both amounts are above the limit, the enterprise will no longer be considered small or medium sized. The third requirement with its reference to the Commission Recommendation effectively narrows down the definition to other than group companies. In other words, if a small company is a subsidiary of a group, it cannot be considered a SME.

The following corollary definition concerns large companies:

1) Number of employees is at least 250; or
2) Net sales is more than €50 million and balance-sheet total is more than €43 million; or
3) the SME criteria as enumerated in Recommendation 2003/361/EC are not applicable.

Example 1: 'A Oy' has 200 employees. Its net sales is €40 million, and balance-sheet total €45 million. The major shareholder of 'A Oy' is Mr. Y, a physical person. 'A Oy' is the sole owner of 'X Ltd' (the foreign company called 'X Ltd' has sales of €5 million and a balance sheet of €5 million). → Conclusion: 'A Oy' will be considered a SME, and the documentation obligation will not apply.

Example 2: The company called 'B Oy' has 200 employees. Its net sales is €55 million, and balance sheet €45 million. The major shareholder of 'B Oy' is Mr. Y, a physical person. 'B Oy' is the sole owner of 'X Ltd' (the foreign company called 'X Ltd' has sales of €5 million and a balance sheet of €5 million). → Conclusion: 'B Oy' is a large enterprise, and will therefore have the obligation to submit transfer pricing documentation.

3.3.2 Thresholds of SME/non-SME in borderline cases

The SME definition focuses on number of employees/staff headcount, annual net sales/turnover and the total sum of the company's balance sheet. These facts should be updated to reflect the latest closing of an accounting year. If a start-up company is in question, no actual financial statements will be available, so reliable estimates will be used instead.

The concept of 'employees' covers all full-time and part-time employees on the payroll, including seasonal employees who do not work throughout the year. Persons comparable with wage earners (according to national legislation) are included. Moreover, in addition to the actual wage earners, the owner-managers who work for the company are included. Reference is made to the website of the European Commission http://europa.eu.int/comm/employment_social/esf2000/contacts-en.htm, where national legal definitions of wage earners and employees are displayed. The unit of measurement is FTE, full-time equivalent. In this way, one real full-time employee equals one FTE. Part-time, seasonal, and terminated employees are parts of one FTE on a pro rata basis according to their work efforts.

The concept 'net sales' means revenues from sales of goods and services, duly adjusted according to relevant accounting rules. Net sales is exclusive of VAT and other indirect taxes. Moving on to the balance sheet, the 'sum total' refers to the sum of assets rather than liabilities.

The Commission Recommendation points out that once an enterprise has exceeded the threshold values of an SME, it will lose its status of an SME. However, during the first year of exceeded thresholds, it will continue to be considered an SME. Where at the balance sheet date an enterprise goes over, or falls below, the employee or financial thresholds, this will not result in a change of status from SME to large company, or vice versa, until the position is repeated for the second consecutive year. Thus, if a company has been considered an SME in the beginning of the year, it will remain so for the entire year. In the following year, the company will cease to be an SME if the high values remain. Documentation will be required during the second year, not the first year. Similarly, to become a SME, a previously large company should have its critical values below the SME threshold for two consecutive years, not just one year.

If a company has previously been considered large, and then becomes smaller so that the SME threshold values are no longer reached, it will nevertheless continue to have the transfer pricing documentation obligation during the first year. But if the basic structural characteristics have remained the same, the documentation for the previous tax year can still be utilized and no updating of the comparables will be required. However, if the nature of the business has changed, and the changes include the emergence of new cross-border transactions, they should be documented according to the usual rules.

3.3.3 Treatment of thresholds in respect of partner and linked enterprises

The third paragraph of the SME Recommendation contains references to factors that determine the independence of an enterprise. The purpose of this article is to make sure that the companies for which the documentation obligation is waived indeed are SMEs. They are not supposed to be small companies within a large multinational group. Therefore, the Commission has defined three separate company types. Each type entails a different relationship with another company. According to the SME definition, an enterprise may not genuinely be an SME in the case of existence of certain relationships.

The three types of companies within the context of the SME definition are ‘autonomous’, ‘partner’ and ‘linked enterprise. **Autonomous** enterprises are either completely independent or they have one or several minority interests (each only amounting to 25% or less of equity or votes) in another enterprises. **Partner** enterprise means that an enterprise (upstream enterprise) holds, either solely or jointly with one or more linked enterprises, 25% or more of the capital or voting rights of another enterprise (downstream enterprise). If the ownership interest goes over 50%, the company falls in the category of **linked** enterprises. In this way, the degree of association — the quality of the relationship — is decisive when the tax authorities determine whether another company’s balance sheet total, number of employees, or net sales should be considered. Moreover, these facts also determine how the threshold values should be calculated so as to decide whether the documentation requirement is applicable.

If the company is autonomous, it will not have any associated transactions requiring transfer pricing documentation, even if its threshold values according to the SME definition were exceeded. However, the documentation should be supplied if the autonomous company were not an

SME and if it were to exercise control in another company (as shown above in Example 3 and Example 4 of the preceding section 3.2). But it should be noted that whenever the associated relationship is based on the ownership of physical persons, only the values of the enterprise itself are decisive. Thus, to determine whether or not a company is an SME, the values of an other associated company are not considered in the case of physical persons being the owners.

The information of another company is taken into account on a pro rata basis according to the ownership interest, when a **partner enterprise** relationship has been established. The pro rata adjustment is based on ownership of equity or votes, whichever is larger. However, if the partner enterprise also has other partner relationships with third companies, they will not be taken into consideration. From the perspective of taxpayer company, only one upstream and one downstream company are considered. Nevertheless, if a linked enterprise is in existence, information of the linked enterprise is taken into account on a pro rata basis according to 100 percent.

As noted above, a **linked enterprise** holds, directly or indirectly, a majority of the shares or votes in another company or if it otherwise exercises control in it. Information of the linked enterprise is taken into account on a pro rata basis according to 100 percent. In case the taxpayer company under examination does not have consolidated financial statements, and its linked enterprise is further linked to other companies, the information of **all the other linked companies** should, in this case, be taken into account on a pro rata basis according to 100 percent.

Example 1: 'B Oy' owns 30% of the shares in 'A Oy'. At the same time, 'A Oy' owns 25% of the shares and votes in 'C Ltd'. And in turn, 'C Ltd' owns 60% of the shares and votes in 'D Ltd'. *Conclusion:* 'B Oy' being a partner enterprise, information of 'B Oy' is taken into account on a pro rata basis when tax authorities are examining 'A Oy'. In addition 'C Ltd' is a partner enterprise of 'A Oy', so that information of 'C Ltd' and its linked company 'D Ltd' is taken into account on a pro rata basis. In this way, information will be added according to the following equation: 'A Oy total information' = 100% x A Oy + 30% x B Oy + 25% x C Ltd + 25% x D Ltd.

Example 2: 'A Oy' is the owner of 51% of shares and votes in 'C Ltd', and 100% of 'D Oy'. And in turn, 'B Oy' owns 40% of 'A Oy' shares and votes. *Conclusion:* 'C Ltd' and 'D Oy' are linked enterprises of 'A Oy', and 'B Oy' is a partner enterprise of 'A Oy'. In this way, for the purposes of determining whether 'A Oy' is an SME, information will be added according to the following equation: 'A Oy total information' = 100% x A Oy + 40% x B Oy + 100% x C Ltd + 100% x D Oy.

Example 3: 'A Oy' is owned by 'B Ltd' almost entirely, to 90%. Regarding 'B Ltd', its owners are 'C Ltd' — 40%, 'D Ltd' — 25% and 'E Ltd' — 20%. *Conclusion*: In light of these relationships, for the purposes of determining whether 'A Oy' is an SME, 'A Oy' is linked to 'B Ltd'. Furthermore, 'C Ltd' and 'D Ltd' are partner enterprises from the perspective of 'B Ltd'. However, 'E Ltd' is an autonomous enterprise. In this way, information will be added according to the following equation: 'A Oy total information' = 100% x A Oy + 100% x B Ltd + 40% x C Ltd + 25% x D Ltd.

3.4 Associated transactions of small scale

Small-scale transactions involve a less extensive documentation. The definition of § 14b.2, Act on Assessment Procedure, is applicable to the definition of 'small scale'. Thus, when the total amount of transactions between two parties during a tax year does not exceed €500,000, they are viewed as transactions of small scale. The Government proposal expressly points out that the market-based arm's length pricing should be in question when the threshold of €500,000 is being examined. In other words, the taxpayer is responsible for ensuring that arm's-length pricing is in use at all times, even if the less extensive documentation requirement does not include a complete explanation of the arm's length principle.

The less extensive documentation should include a description of business, including lists of associated companies and transactions with them. General and relatively short descriptions are acceptable. It is not necessary to document the rest of the facts and circumstances listed in § 14b.2, Act on Assessment Procedure. The three first sub-headings of the documentation will be sufficient for the tax authority to obtain a general understanding of the TP, and based on this, the authority will be able to appraise the situation and decide whether to perform closer scrutiny.

There are situations where the total amount of transactions between two parties during a tax year is not large, but put together with all group transactions, the total of small-scale transactions becomes important. This situation arises when the parent company sends invoices for intercompany service fees to several subsidiaries. Such a fee, priced according to the arm's length principle, may amount to €200,000 – €400,000 per subsidiary. If 15 receive the invoice, the service fees will result in a M€4 to M€5 business. For this reason, the question of service fees, from the parent company viewpoint, can cause a TP examination, because in totality, there may be a deviation from the arm's length principle. However, small-scale transactions and the less extensive documentation requirement usually concern one subsidiary at a time, and the overall situation of the parent company is not considered. All in all, small-scale transactions involve a less extensive documentation, and this is permitted when the total transactions between subsidiary and parent during a tax year does not exceed €500,000.

3.5 Dealings with a permanent establishment

When a foreign company has a head office outside Finland and a permanent establishment in Finland, the documentation obligation may be applicable. Cross-border transactions should be documented between head office and the Finnish permanent establishment, and between any associated enterprises and the Finnish permanent establishment. Consequently, the required documentation of the permanent establishment is no different from that of an independent subsidiary. In fact, the Finnish permanent establishment has to submit documentation with a scope even wider than an independent subsidiary, because it is required to include any other cross-border transactions that may take place between itself and the company's associated enterprises.

To be precise, 'transactions' in the ordinary sense do not take place between head office and the permanent establishment, because the latter is merely a department of the company itself. Nevertheless, the taxable income of the Finnish permanent establishment is calculated according to the arm's length principle. Article 7.2 of the OECD Model Tax Convention provides that the profits of a permanent establishment are to be determined as if it were an independent enterprise, "dealing wholly independently with the enterprise of which it is a permanent establishment".

However, if the company and its head office is domestic, and the permanent establishment is located in another country, not Finland, the Finnish tax authorities require no documentation. The necessary information is made available by other means. Reference is made to EU Code of Conduct and the Finnish Government proposal.

4 DOCUMENTATION CONTENT

4.1 Description of business

Taxpayer is expected to include an overall description of his business in the documentation. A more substantial discussion of the extent of this description is included in the original Finnish version of this Memorandum. It is emphasized that the requirement will vary case-by-case. The text of EU TPD contains a thorough discussion of the required business description in English.

The description can include statistical information and explanations of any special circumstances affecting taxpayer's business environment. Such special circumstances may typically be caused by price regulation, interest rate regulation, exchange rate policy or customs duty restrictions of the country where the subsidiary is located. A topical example is offered by the reduced European intervention prices of powdered milk and butter.

The description of taxpayer's business should give details on business strategy. Referring to EU TPD and especially to OECD Guidelines, section 1.31 in Chapter I, the Finnish Tax Administration recognizes that taxpayer may temporarily receive very little income and pay out great expenses. The important issue is how one should appraise whether a business strategy that temporarily decreases profits in return for higher long-run profits is consistent with the arm's length principle. The question is whether 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. For example, it would be expected that a company bearing the cost and risk of a market penetration strategy would, if successful, create a marketing intangible. The value of this intangible might then be expected to be reflected in future profit margins.

4.2 Description of relationships with associated enterprises

Under § 14 b, subsection 1.2, Act on Assessment Procedure, the documentation is to include a description of valid associations. When these relationships are being described, the relevant associated enterprises should be enumerated, including all enterprises with which taxpayer has had cross-border dealings and transactions, and also including the enterprises whose business has a direct or indirect impact on the pricing of taxpayer. Company names, identification codes, tax domiciles, and reasons for the associated relationship are to be specified. Moreover, this part of the description should also itemize any changes that have taken place during the latest tax year and the preceding tax year.

As noted above, the description of associated enterprises also includes any enterprises with business that has a direct or indirect impact on taxpayer's transfer pricing. This means that it will not be necessary for taxpayer to directly have any dealings with the enterprises in question, but under the circumstances, they should be included in the documentation.

Example: Taxpayer company 'A Oy' receives financing from the group finance company overseas called 'B Ltd'. The foreign partner enterprise

‘C Ltd’ issues a guarantee to the finance company. *Conclusion*: Taxpayer only has an associated transaction with the finance company ‘B Ltd’. The guarantee contract between partner enterprise ‘C Ltd’ and ‘B Ltd’ will be viewed as a separate business transaction. Nevertheless, the terms and conditions of financing received by ‘A Oy’ are influenced by the fact of the guarantee contract. For this reason ‘C Ltd’ is a partner enterprise, and this relationship has to be explained in ‘A Oy’s documentation.

The Government proposal refers to a general requirement of including a current, up-to-date organization scheme of the multinational group of companies. Therefore, to merely describe the nature of association with another entity is not enough — there should also be an overall description of the multinational group. Examples of such description include an organization scheme drawing, a list of owners and owner relationships, and enumeration of any functional arrangements that deviate from the legal arrangement of the group. Moreover, a history of recent changes in these matters and relationships can be useful and desirable.

Furthermore, taxpayer should explain the impact on TP of current business strategies and changes in them. The same requirement is included in EU TPD. Regarding this aspect, the documentation requirement, set out in § 14 b, Act on Assessment Procedure, has similar scope as EU TPD. The country-specific documentation prescribed by EU TPD is inclusive of a description of business and strategy, including any changes vis-à-vis the previous year. At the same time, the EU TPD masterfile should include a general description of the multinational corporation’s business and strategy. For reasons of convenience, it is sufficient to describe the business in the same terms as the masterfile describes it. The country-specific EU TPD documentation is very detailed, and it is more appropriate to present it later, at the stage when functions and processes are being appraised. This recommendation is very justifiable at least in cases where more than one business strategy has an impact on taxpayer’s actual dealings.

It is imperative that TP documentation includes a description of business, as prescribed in § 14 b, sub-paragraph 1.1, Act on Assessment Procedure. The purpose is to describe not only taxpayer’s but also parent multinational company’s business and market position.

Good TP documentation will be based on an understandable overview of the business and markets. However, the description of business and its various areas should not be too detailed at this stage, and should not include discussions of too many factors affecting the business, let alone separate business transactions. The purpose is to give an overview to help readers understand the circumstances of transfer pricing, and to understand taxpayer’s status and position in the multinational’s value chain.

At this stage, no discussions are necessary of business areas that may be relevant for the multinational corporation in other countries but have no important business connection with taxpayer. This situation arises when the corporation has several lines of business, but the local taxpayer company has little or no contact with the multinational conglomerate activities. Therefore, business description should be edited so as to contain only case-specific, relevant content. Nevertheless, it should cover taxpayer’s entire business. Furthermore, it should include not only the business where associated dealings are common, but also other transactions, because it should be a general overview. The business

description should give a good understanding of the taxpayer's activities, status and market position. It should include facts and information about products and services. Furthermore, it should include some information about customers or clients. It can be completed with a general description of the geographical market area and the prevailing competitive situation.

Statistical information regarding euro values of the entire market and competitor companies can be included. A discussion of current and future trends and developments would also be appropriate. Knowledge of where the market is headed has an effect on taxpayer's corporate-strategy choices. This discussion can be based on the three concepts of Growth Market, Mature Market and Declining Market. This is an appropriate place also to describe taxpayer's historical achievements in relevant market(s) (business history discussion) and to explain the features and characteristics that differentiate taxpayer's products from competitors' products.

Furthermore, the documentation should include a discussion of business performance of the associated company or companies that taxpayer has TP dealings with. This information is requested because it helps give a proper understanding of taxpayer's status and position in the multinational parent corporation's value chain.

Furthermore, other, external facts and circumstances can be explained in the business description text, where appropriate. The description can include statistical information and explanations of any special circumstances affecting taxpayer's business environment. Such special circumstances may typically be caused by price regulation, interest rate regulation, exchange rate policy or customs duty restrictions of the country where the subsidiary is located. A topical example is offered by the reduced European intervention prices of powdered milk and butter

Special attention should be paid to taxpayer's business strategy. OECD Guidelines give the following instruction in section 1.31: "Business strategies must also be examined 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, and other factors bearing upon the daily conduct of business." Furthermore, market penetration plans and schedules, and situations of active defense of historically gained market share are recommended by Guidelines, because taxpayers may, in these circumstances, temporarily receive low income or pay high expenses.

4.3 Transactions within sphere of influence

4.3.1 Introduction

The required documentation should contain sufficient specification, pursuant to § 14 b.1 of Act on Assessment Procedure, about the business transactions between entities not independent from one another, and similarly, the business transactions between the company and its permanent establishment in another country.

The concept of 'business transaction' includes a wide scope, and reference is made to Article 9, first paragraph of the OECD Model Tax Convention.

The specification text should contain a description of the type of transaction, parties to it, value in euros, invoicing, background consisting of other internal transactions, if any, and if necessary, applied terms and conditions of contract. The specification can be abbreviated by consolidating some business according to the instructions below and by thus supplying a consolidated specification. For this purpose, it is permissible to set up graphic tables. Similar business operations can be classified: goods, services, intangible rights, procurement of capital assets; financial operations such as borrowing, lending, leases, and various cost-distribution arrangements can be grouped together. Further classifications are permitted. As an example, regarding intangible assets, a 'licenses' category can be set up in this way, with its further subgroups of 'technology licenses', 'trademark licenses', and 'other licenses'.

Applied terms and conditions should be shown as necessary. If there are several transactions of the same type, there should be an analysis of whether or not they are comparable with one another. Furthermore, the background against other dealings between associated companies should also be shown. Example: see the presentation of a loan and its guarantee, as represented in section 4.2 above.

4.3.2 Setting up groups of business transactions

According to the OECD Guidelines, the approach to transfer pricing will always be transaction-specific. Consequently, arm's length should be applicable separately to each business transaction. However, many business transactions are recurring and closely related, so they cannot be kept separate (see section 1.42 of OECD Guidelines). Examples:

- Long-term procurement contracts of goods and services
- Licensing contracts to transfer the right to intangible assets
- Pricing of closely related products, if it is impractical to determine the unit price for a single item or business transaction
- Granting a manufacturing license to a manufacturer, and later selling product components to the same manufacturer

It makes sense to consolidate business transactions, if they have been made between the same contracting parties under the same conditions over time. Similarity of business transactions can be assessed on the same grounds as comparability is assessed. Taxpayer is expected to specify reasons for consolidating the transactions in documentation.

Example: There is a local selling company based in the local country. It purchases goods from an associated company and resells them to customers. Customers are independent. In the course of the year, there is a large number of purchase transactions, which do certainly not have to be scrutinized separately one-by-one to determine conformity to arm's length pricing. The purchase transactions can be consolidated into one single transaction to be examined.

4.3.3 Agreements and contracts

Taxpayers are also requested to supply a list of contracts between associated companies, identifying both specific contracts that are valid and types and categories of contracts. If tax authorities were to request an explanation of a contract that taxpayer has made, a complete explanation should be provided. The explanation will give details and relevant facts that either back up or undermine taxpayer's transfer pricing policies as they are being applied. Thus, the actual policies and the represented policies can be compared with one another. Furthermore, the usual terms and conditions of valid contracts should also be explained during the stage where various business operations are being appraised. Thus, the authority can obtain an understanding of the operations and their business risks. The Finnish Government proposal includes a list of contract types that should always be explained and specified: cost-sharing contracts, advance rulings from authorities, and foreign advance rulings received from the tax authority of another country. Advance rulings concerning operations between associated companies should be listed. The same requirement is included in the collective section of EU TPD. This especially concerns the companies located within EU territory.

4.4 Functional analysis

4.4.1 Documentation requirement

Pursuant to § 14 b, subsection 1.4, Act on Assessment Procedure, the documentation is to include a functional analysis of the business transactions taking place between associated enterprises and, if the specific conditions are fulfilled, between head office and a permanent establishment. The concept 'functional analysis' essentially means a description of the operations within the course of business, explanation of the business assets involved, and the business risks taken.

4.4.2 Purpose and intent

Reference is made to OECD Guidelines, especially its sections discussing functional analysis. In dealings between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, comparison of the functions taken on by the parties is necessary. This comparison is based on a functional analysis, which seeks to identify and to compare the economically significant activities and responsibilities undertaken or to be undertaken by the independent and associated enterprises. For this purpose, particular attention should be paid to the structure and organization of the group. It will also be relevant to determine in what juridical capacity the taxpayer performs its functions.

4.4.3 Functional analysis only concerns associated transactions

While functional analysis is necessary to determine comparability, the required documentation only concerns dealings between associated enterprises. Actual comparison will not take place until the comparative analysis stage. However, it should be noted that foreign companies with permanent establishments located in Finland are referred to in § 14 b, Act on Assessment Procedure.

4.4.4 Significance of functional analysis

As noted above, according to OECD Guidelines, in dealings between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, comparison of the functions taken on by the parties is necessary. For this reason, functional analysis is an important issue within transfer pricing.

4.4.5 Description of operations within the course of business

The functions that taxpayers might need to identify and compare include design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing,

and management. Even quality control, packaging, warehousing, wholesale business, and administration can be viewed as functions suitable for analysis. The principal functions performed by the party under examination should be identified. Adjustments should be made for any material differences from the functions undertaken by any independent enterprises with which that party is being compared. 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.

It may also be useful in identifying and comparing the functions performed to consider the assets that are employed or to be employed. This analysis should consider the type of assets used, such as plant and equipment, the use of valuable intangibles, etc., and the nature of the assets used, such as the age, market value, location, property right protections available.

Example: If a party involved in a cross-border transaction is a factory producer, then manufacturing and research & development may be the important functions worthy of closer attention. Consequently, such functions as warehousing and packaging are undoubtedly less important in this particular enterprise.

4.4.6 Considering the assets used

The original Finnish version of this Memorandum includes a more extensive discussion of the business assets of the parties and their uses. Please see below some examples of using tangible and intangible assets.

Example 1: The technology, production know-how and the proprietary manufacturing network can be understood as a business intangible asset. If it were to be transferred to another party, it should be examined as a whole. Thus, it will not only be the patented technological inventions of the company that constitute its intangible assets. All income-producing assets, which could be sold against payment to an outside enterprise, should be included in intangible assets.

Example 2: The documentation and functional analysis of a sales company should include a statement as to whether the sales company uses a brand, a trade mark, or other intangible asset that helps it achieve its sales target. Such an intangible asset can be constituted by a historical marketing effort that has never been compensated or credited by the opposite party in the associated transaction. On the other hand, it sometimes happens that a sales company merely fulfills the simple task of selling and does not assume any risks. Then, the opposite party in the associated transaction has fully compensated the sales company’s costs, and no intangible assets have been formed.

4.4.7 Considering the risks assumed

The original Finnish version of this Memorandum includes a more extensive discussion of the business risks. Risks can be divided into market risk, strategic risk, production risk and financial risk etc. Reference is made to OECD Guidelines.

It is relevant to consider the risks assumed by the respective parties. In the open market, the assumption of increased risk will also be compensated by an increase in expected return. Therefore, controlled and uncontrolled transactions and entities are not comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made. Functional analysis is incomplete unless the material risks assumed by each party have been considered since the assumption or allocation of risks would influence the conditions of transactions between the associated enterprises. Theoretically, in the open market, the assumption of increased risk must 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 realized.

4.4.8 Description of changes taking place

The original Finnish version of this Memorandum includes a more extensive discussion of changes. Reference is made to OECD Guidelines. See below for an example of dealing with changes.

Example: The parent company called 'A Oy' is a manufacturing and sales company. Due to a functional change, its invoicing function is transferred to its contract-manufacturer subsidiary called 'B Ltd'. The transfer pricing practices between these two enterprises will thus undergo changes. Previously, 'A Oy' has always sold its own goods, and the goods manufactured by 'B Ltd', to outside customers. And previously, 'A Oy' has been the owner of all intangible business assets and been responsible for almost all the business risks. Consequently, 'A Oy' has been entitled to all the residual profits after having paid 'B Ltd' the current market price for the manufacturing service. But after the changes, 'B Ltd' will sell the goods to outside customers, and 'A Oy' will produce intra-group services to 'B Ltd'. Such intra-group services include administrative and contract-manufacturing services. *Conclusion*: After the changes, the transfer pricing outlook has an inverse character if compared with the earlier situation. Now, 'B Ltd' will be entitled to receive the residual profits, after having paid 'A Oy' for services rendered. *Documentation*: The business functions, assets and risks of the parties have to be covered by the documentation so that both earlier and current situations are clearly explained.

4.4.9 Other factors affecting comparability

Reference is made to Government proposal, page 16.

4.4.10 Categorization of parties involved in transactions

Parties to a controlled/associated transaction can be divided in categories according to the results of the functional analysis. Categorization can sometimes help tax officers to understand the general outline of the business environment. It is a tool that can sometimes be very useful for in preventing a completely erroneous conclusion from developing, but the categories or classes themselves have no significance.

OECD Guidelines sets no specific framework for categorization. However, a typical set of categories could include parties such as a manufacturer, a distributor and a service provider. Further classifications can be made so as to define some manufacturers as full-risk producers, others as contract manufacturers (with less risk), depending, in this example, on the amount of assets used for production and the business risks taken. Full-risk business would mean the use of unique intangible assets, and full responsibility for all business risks inherent in the production activity. And correspondingly, contract-based business would entail manufacturing that only takes place because another enterprise has ordered all produced goods to be delivered to the other enterprise. Thus there would be little or no business risk. Similarly, a distributor can fall into the categories of full-risk distributor, low-risk distributor, commission-based distributor, and agent.

Categories can sometimes be formed on the basis of a master-servant viewpoint. Many business setups have an entrepreneur or principal, who perhaps owns tangible or intangible assets and carries responsibility for several business risks. He can engage the services of a servant, a service provider company, who takes care of manufacturing or marketing and sales. The expectation is that the entrepreneur or principal will pay a market price for the services rendered. In this setup, the entrepreneur or principal is entitled to any residual profits. On the other hand, he is also the major carrier of business risks. The residual profits will accumulate in the hands of the entrepreneur or principal, because the service providers will only receive an arm’s length price for services rendered.

The above model has many applications when transfer pricing within a multinational enterprise is being examined.

Categorization of the parties should only be carried out in situations where the object of comparison has sufficient economic substance. Therefore, it is understood that the master-servant categorization scheme will not always be successful. Unsuitable cases include shared ownership of business assets, that is, if both of the two parties are joint owners of an intangible asset used in the business.

It should be noted that categorization will only be feasible if the functional analysis stage has been carried out successfully. If errors have been made in the functional analysis, the resulting categories will very likely be wrong. In conclusion, categorization should by no means be treated as a replacement of the functional analysis, which should always be performed. All transfer pricing arrangements should be studied in respect of the functions that each enterprise performs, taking into account assets used and risks assumed. Only then can the controlled, associated transaction be compared with a transaction between independent parties.

4.4.11 Test party

The party selected for testing is usually the one with more simple business activities and less assets in possession. This is because it is usually easier to find comparable transactions between independent enterprises for parties, which have less assets, especially unique intangible assets, than for those that have a complicated business model, several connections and important assets. Going back to the master-servant scheme, the master (main entrepreneur/principal) will usually not have many comparable counterparts, while it will be easier to find them for the servant (see 4.4.10 above).

Reference is made to EU TPD and OECD Guidelines.

4.4.12 Examples

Functional analysis can be based on following types of information:

Research and development
Activities: basic research, product development, design, technology improvement, patent improvement, licensing;
Assets: patents, licenses, technology, know-how;
Risks: unsuccessful research, market risk, patent disputes.

Manufacturing
Activities: purchase of raw materials, components, assembly, packaging, quality control;
Assets: patents, licenses, production know-how, brands, machinery and equipment, plants, factories, buildings;
Risks: investment risk, capacity risk, market risk, environmental risk, quality risk, product liability risk, credit risk, legal risk.

Distribution
Activities: marketing, sales, finance, customs procedure, warehousing, assembly, transport, technical support, customer service;
Assets: brands, distribution rights, distribution channels, clientele;
Risks: market risk, inventory risk, pricing risk, guarantee risk, credit risk, foreign currency risk, transportation risk.

Administration
Activities: management, strategic planning, coordination, control, finance, invoicing, credit management, human resources management, training, information technology management;
Assets: software, business models, offices, premises, buildings;
Risks: business risk, market risk, liquidity risk.

The above considerations are intended as an example. Many other issues are relevant when functional analyses are being performed. The facts and circumstances are case-specific, and the business transaction examined and the relevant facts will determine the actual subject matter to be included in the documentation.

4.5 Comparability analysis

Reference is made to OECD Guidelines, EU TPD and the Code of Conduct. Materially important associated transactions merit comparison.

Application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable. 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 (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. In determining the degree of comparability, including what adjustments are necessary to establish it, an understanding of how unrelated companies evaluate potential transactions is required.

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 is clearly more attractive. For example, one enterprise is unlikely to accept a price offered for its product by an independent enterprise if it knows that other potential customers are willing to pay more under similar conditions.

This point is relevant to the question of comparability, since independent enterprises would generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk or other comparability factors discussed below) when valuing those options. Therefore, when making the comparisons entailed by application of the arm's length principle, taxpayers should also take these differences into account when establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability.

All methods that apply the arm's length principle can be tied to the concept that independent enterprises consider the options 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 the same product at a lower price from another party. Therefore, a comparison method called 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 dealings 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 are based on comparisons of profit rates or margins between independent and associated enterprises as a means to estimate the profits that one or both 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.

In all cases, adjustments must be made to account for differences between the controlled and uncontrolled situations that would significantly affect the price charged or return required by independent enterprises. Therefore, in no event can unadjusted industry average returns themselves establish arm's length conditions.

As noted above, in making these comparisons, material differences between the compared transactions or enterprises should be taken into account. In order to establish the degree of actual comparability and then to make appropriate adjustments to establish arm's length conditions (or a range thereof), it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm's length dealings. Attributes that may be important include the characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties.

The extent to which each of these factors matters in establishing comparability will depend upon the nature of the controlled transaction and the pricing method adopted. 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 determining the comparability of controlled and uncontrolled transactions. In general, similarity in the characteristics of the property or services transferred will matter most when comparing prices of controlled and uncontrolled transactions and less when comparing profit margins. Characteristics that it 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 (such as a patent, trademark, brand or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property.

4.6 Taxpayer's actual transfer pricing policy

Reference is made to OECD Guidelines, EU TPD and the Code of Conduct. Taxpayers are expected to explain whether a set of rules or any system amounting to a 'policy' has been utilized.

Transfer pricing documentation should include, pursuant to § 14 b, sub-paragraph 1.6, Act on Assessment Procedure, a description of the transfer pricing method and its application. The choice of the method, as well as the application of the method can both be discussed in terms of economic analysis. Methods to arrive at correct transfer pricing should be based on the methods outlined by OECD Guidelines.

5 EXAMINATION BY TAX AUTHORITY

5.1 Submittal of documentation

5.1.1 Deadlines

Pursuant to § 14 c, Act on Assessment Procedure, taxpayers should submit the documentation for a specific fiscal year within 60 days on a request of the tax authorities, but not earlier than six months after the end of the accounting period. Any additional explanations concerning the documentation have to be submitted within 90 days of request.

Reference is made to the Code of Conduct.

5.1.2 Rules on recordkeeping

Taxpayer is expected to present the documentation if prompted to do so by the tax authority. Considering that retroactive adjustments to taxation are possible, pursuant to § 56, Act on Assessment Procedure, during the five years following the end of the tax year, the period for keeping records will extend to the same length of time. Nevertheless, we recommend taxpayers to keep the documentation updated even after the end of this period, because the question of transfer pricing can be brought up not only by the Finnish but also by the other tax authority, representing the state of the other associated enterprise. The existence of documentation may then be a helpful factor if a *mutual agreement procedure* is implemented between the two tax administrations.

Taxpayer is free to choose the recordkeeping methodology and also the place where documentation is kept. Use of printed-paper documents, electronic files and other methods are equally permissible. There is no requirement to store the documentation in Finland, but it is important to have it ready within the specified time to show the Finnish authorities if requested or prompted.

5.1.3 Request or prompting by tax authority

Tax authorities may ask taxpayer to prepare a complete transfer pricing documentation when target companies for audit are being selected, when tax audits of various types are conducted, when income tax returns are being processed, when a tax-treaty country has negotiations with Finland under a *mutual agreement procedure*, or when any other measures connected with taxation are taking place.

If taxpayer submits an application for an advance ruling, it will be understood that the documentation cannot always be enclosed with such an application, if it has not been prepared or updated. Nevertheless, taxpayer will be expected to give a statement or an explanation regarding his transfer pricing documentation when submitting the application. Probably the most common situation where tax authorities will ask taxpayers to present documentation will be a tax audit. From the tax authority’s point of view, tax audits offer very good opportunities to examine the documentation in detail.

Taxpayer is not expected to enclose the documentation with the income tax return form. If the documentation requirement is applicable, taxpayer should tick box 182 (form for the 2007 fiscal year) on the form.

5.2 Additional explanations

5.2.1 Deadline

(The original Finnish version of this Memorandum includes a more extensive discussion of additional explanations and enclosures).

Any additional explanations concerning the documentation have to be submitted within 90 days of request.

5.2.2 Issues and problems requiring additional explanation

Reference is made to the Code of Conduct. The Finnish legal provision in § 14 c, Act on Assessment Procedure, is similar to the corresponding stipulation of the Code of Conduct governing additional explanation.

5.2.3 Duty of parties to submit explanations in case of waived documentation obligation

The current rules governing transfer pricing documentation do not apply to parties for whom the documentation obligation has been waived. These parties include SMEs, domestic subsidiaries, and Finnish companies with a permanent establishment in another country. Nevertheless, the mere fact that the documentation obligation has been waived does not mean that the arm's length principle would not apply. For this reason, if such a taxpayer has intercompany transactions, he should make sure that the arm's length principle is being respected. Moreover, tax authorities can ask for written explanations regarding transfer pricing, especially in the case of permanent establishments of a taxpayer company. In December 2006, the OECD has published a report treating the same subject (Report on the Attribution of Profits to Permanent Establishments).

5.3 Explanation of the surtax penalty

5.3.1 Legal authority

The legislator has recently added the new subsection 4 to §32, Act on Assessment Procedure. This subsection provides that if taxpayer has "failed to submit, within the deadline specified in § 14 c, sufficient documentation regarding taxpayer's transfer pricing, or alternatively, has submitted documentation, explanation or enclosures that contain insufficient information or errors of content, surtax of maximally €25,000 can be charged of the taxpayer." This rule is applicable for the first time during the tax year beginning 1 January 2007.

5.3.2 Rules regarding applicability

To discourage non-compliance with the requirement to submit documentation regarding transfer prices, tax authorities can charge surtax. Each regional tax authority is empowered to decide independently on the cases where surtax is being charged. Sometimes, surtax may be applicable even if taxpayer's transfer pricing turns out to be at arm's length. If taxpayer fails to submit documentation or submits insufficient documentation, surtax can be charged. Regarding the obligation to submit documentation, no importance is attached to the actual transfer pricing. Furthermore, taxpayer who must pay surtax on grounds of a transfer pricing adjustment (penalty according to subsection 3) may also have to pay surtax on grounds of insufficient documentation. Separate amounts of surtax are sometimes applicable if taxpayer neglects to submit documentation on several occasions. The tax authority will consider non-compliance as an aggregate problem consisting of various components such as lateness, complete failure, and insufficient information content. This has an effect on the decision on surtax.

In the case of non-compliance with the requirement to submit documentation, a tax audit has usually been performed, so the legal authority for tax adjustment will be based on § 56, Act on Assessment Procedure. Surtax can be charged of a taxpayer who has been first prompted, but has later failed, to deliver additional information, explanations and enclosures.

Nevertheless, during the first years of application of surtax, the authorities are to handle the matter with great care. The procedure is new, and taxpayers are still in the learning phase. Nevertheless, failure to submit information and facts about the arm's-length-price level should always fall in the category of serious negligence. The possible forms of non-compliance include the leaving out of taxpayer's *intangible assets* in the submitted documentation. Similarly, if taxpayer completely fails to submit documentation, it will fall in the category of serious negligence, and there will, under the circumstances, be no particular reason for approach with great care (in reference to the above). If taxpayer fails to submit additional explanations or enclosures, but has submitted basic documentation, seriousness of the negligence will depend on whether or not taxpayer otherwise has given sufficient details and information.

5.3.3 Amount of surtax

The authorities are expected to keep the amounts of surtax within reasonable limits. The amount should obviously reflect the seriousness of taxpayer's negligence. As a suggested minimum amount, a surtax of €1,000 could be applicable if taxpayer delivers the required documentation slightly late, for example 1-2 weeks past the deadline. And reciprocally, a suggested maximum surtax could be €25,000 in the case of complete negligence, where taxpayer completely fails to submit documentation. Nevertheless, during the first years of application of the surtax scale as explained in this section, the authorities are to handle the matter of sanctions or penalties with great care.

Taxpayer delivers required documentation past the deadline
→ applicable surtax range: €1,000 – €5,000.

Taxpayer delivers important additional explanation or enclosures to documentation past the deadline → applicable surtax range: €1,000 – €5,000.

Taxpayer fails to deliver complete required documentation or leaves important gaps in it → applicable surtax range: €5,000 – €10,000.

Taxpayer delivers additional explanation or enclosures, but there are errors or important gaps → applicable surtax range: €1,000 – €5,000.

Taxpayer fails to deliver acceptable additional explanation or enclosures to documentation within or past the deadline during the audit or examination → applicable surtax range: €5,000 – €10,000.

Regarding an important matter, taxpayer fails to deliver acceptable additional explanation or enclosures within or past the deadline during the audit or examination → applicable surtax range: €10,000 – €25,000.

Taxpayer completely fails to deliver the required documentation within or past all deadlines during the audit or examination → applicable surtax range: €10,000 – €25,000.

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