KINGDOM OF BAHRAIN

DMTT TRANSFER PRICING GUIDE

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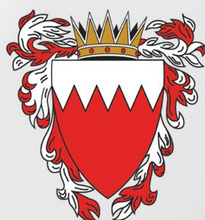

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National Bureau for Revenue

Preface

This guide sets out general principles relating to the scope of the Decree-Law No. 11 of 2024 on 1 September 2024 which introduces the global minimum tax (in the form of a domestic minimum top-up tax (DMTT) for Multinational Enterprises (DMTT Law).

This guide is intended to provide general information only and contains the current views of the National Bureau for Revenue (NBR) on the application of the DMTT Law and Executive Regulations. The content of this guide is not intended to be exhaustive and does not cover every matter that would need to be considered by a Multinational Enterprise Group when assessing the impact of the DMTT.

This guide should be read in conjunction with the DMTT Law and Executive Regulations. The Multinational Enterprise Group may also refer to the Model Rules, Administrative Guidance and Commentary issued by the Organisation for Economic Cooperation and Development (OECD) to date for any additional information.

This guide is not a legally binding document and does not commit the NBR or any other person, including a Multinational Enterprise Group, in respect of any transaction or treatment. This guide does not provide binding interpretative directions and is not a substitute for obtaining competent advice from a qualified professional.

The rules relating to the DMTT in Bahrain are set out in the DMTT Law and its Executive Regulations are available on the NBR's website, www.nbr.gov.bh.

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1 Introduction

1.1 Purpose of this Guide

The purpose of the Guide is to provide general guidance on the provisions of DMTT Law and Decision no. (172) of 2024 Issuance of the Executive Regulations for Decree-Law No. (11) of 2024 Regarding the Implementation of Tax on Multinational Enterprises (Executive Regulations) concerning transfer pricing matters, in particular:

- General guidance on the application of transfer pricing rules and matters relating to the application of the Arm's Length Principle, and
- Guidance on transfer pricing documentation requirements (including the local files and the master files).

The Guide provides a description of what should be included in the local file and the master file. While the local file should focus on providing information about a specific transaction and parties to that transaction, the master file should provide a comprehensive overview of the entire Multinational Enterprise Group.

The Guide reflects the approach taken in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Transfer Pricing Guidelines"[1]) which should provide further guidance for applying the concepts and mechanisms covered by the DMTT Law and Regulations on the Arm's Length Principle.

1.2 Overview of the scope of transfer pricing requirements

Under the DMTT Law and its Regulations, any transaction or arrangement between Constituent Entities of the same Multinational Enterprise Group or Joint Venture or Joint Venture Subsidiary, provided that the Ultimate Parent Entity of the Joint Venture or Joint Venture Subsidiary is an Ultimate Parent Entity of the same Multinational Enterprise Group, that is not recorded in the same amount in their financial accounts, should be adjusted for purposes of calculating the Constituent Entity Income or Loss.

Additionally, the Financial Accounting Net Income or Loss of Bahrain located Constituent Entity or Bahrain located Joint Venture or its Bahrain Located Joint Venture Subsidiaries (if any) should be adjusted to reflect the Arm's Length Principle when applicable.

The transfer pricing requirements concern members of Multinational Enterprise Groups that are in scope of the DMTT Law.

When a Constituent Entity is located in Bahrain and an adjustment is required for the purposes of applying the Arm's Length Principle, the Constituent Entity is required to make an adjustment to the amount recorded in its financial accounts in determining its Constituent

[1] OECD (2022), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, OECD Publishing, Paris, https://doi.org/10.1787/0e655865-en.

Entity Income or Loss. This ensures that the outcome of a transaction or an arrangement with another Constituent Entity located in a different jurisdiction, which is a member of the same Multinational Enterprise Group, is aligned across the Group members and is consistent with the Arm's Length Principle.

Where applicable, the same adjustments are required to be made respectively by a Joint Venture or Joint Venture Subsidiary located in Bahrain, as well as Permanent Establishments and the Main Entity, in order to allow an appropriate attribution of profit or loss among the entities for DMTT purposes.

For the purposes of the DMTT Law, the transactions or arrangements to be reviewed in light of the Arm's Length Principle should include all transactions and arrangements carried out by Constituent Entities with other Constituent Entities or with any Joint Ventures or Joint Venture Subsidiary located in different jurisdictions that are all members of the same Multinational Enterprise Group.

Transactions or arrangements between domestic entities are not within the scope of the transfer pricing requirements, unless the transaction or arrangement concerns a sale or transfer of an asset.

When Constituent Entities that are members of the same Multinational Enterprise Group are located in Bahrain, any loss from a sale or transfer of an asset between them should be adjusted based on the Arm's Length Principle for the purposes of determining the Constituent Entity income or loss of those Constituent Entities. The same obligation applies to a Joint Venture or Joint Venture Subsidiary located in Bahrain, as well as to the sale or transfer between a Constituent Entity and a Joint Venture or Joint Venture Subsidiary located in Bahrain, if they are members of the same Multinational Enterprise Group or the Ultimate Parent of the Joint Venture and its Joint Venture Subsidiaries, is a member of the same Multinational Enterprise Group.

The Constituent Entities, Joint Ventures and Joint Venture Subsidiaries, which are parties to a transaction or arrangement within the scope of the DMTT transfer pricing requirements, will be referred to as "related parties" in the remainder of this Guide. As well as Constituent Entities , Joint Ventures and Joint Venture Subsidiaries located in Bahrain, the term also includes Constituent Entities located in jurisdictions other than Bahrain where they are members of the same Multinational Enterprise Group, as well as Joint Ventures and Joint Venture Subsidiaries located in jurisdictions other than Bahrain, whose Ultimate Parent Entity is either the Ultimate Parent Entity or a member of the same Multinational Enterprise Group.

Detailed guidance on Constituent Entities, Multinational Enterprise Groups as well as other Entities within the scope of the DMTT Law is set out in the "Entities in scope of DMTT Guide", which is available on the NBR's website, https://www.nbr.gov.bh/.

2 Arm's Length Principle

2.1 General Remarks

The Constituent Entity Income or Loss of an Entity within the scope of the DMTT should reflect the Arm's Length Principle. This means that the results of the transactions or arrangements between Constituent Entities, Joint Ventures and Joint Venture Subsidiaries in the same Multinational Enterprise Group are taken into account in determining Constituent Entity Income or Loss and should be verified by reference to the conditions that would have been obtained between independent enterprises in comparable transactions and under comparable circumstances. The Arm's Length Principle requires that Constituent Entities, Joint Ventures and Joint Venture Subsidiaries from the same Multinational Enterprise Group should be treated as independent entities when it comes to determining the prices of transactions or arrangements between them for DMTT purposes.

Aligning the pricing of the transaction or arrangement between related parties with the Arm's Length Principle ensures that tax revenues accurately reflect where economic value is created, and risk is assumed.

In international tax law, the foundation of the Arm's Length Principle is primarily rooted in the OECD Model Convention that serves as a model for tax treaties signed by Bahrain. The OECD Transfer Pricing Guidelines[2] provide further explanations of this principle.

The Arm's Length Principle treats related parties as separate entities and examines whether their transactions differ from those in comparable, uncontrolled scenarios. Compliance with this Principle must be demonstrated by the following analysis:

1. Functional analyses are conducted to identify the economically significant activities, assets employed or contributed, and risks assumed by the parties in the accurately delineated transaction or arrangement.

2. Comparability analyses are central to applying the Arm's Length Principle and should be supported by selecting appropriate transfer pricing methods to determine whether the terms in commercial and financial dealings between related parties align with the Arm's Length Principle.

Both analyses must be thoroughly documented within the transfer pricing documentation, which should include both a local file and a master file.

[2] OECD (2022), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, OECD Publishing, Paris, https://doi.org/10.1787/0e655865-en.

2.2 Comparability Analysis

2.2.1 Overview

To apply the Arm's Length Principle in the context of the DMTT Law, Constituent Entities, Joint Ventures and Joint Venture Subsidiaries should ensure that the terms and conditions for the relevant transactions and arrangements reflect what would have been agreed upon by unrelated entities under similar circumstances. This can be achieved by conducting a comparability analysis and choosing the most appropriate Transfer Pricing Method taking into consideration the relevant facts and circumstances.

Applying the Arm's Length Principle requires examining the specifics of the transaction or arrangement between related parties (controlled transaction) and assessing whether these conditions differ from those that would exist in comparable situations between independent parties (uncontrolled transactions). This evaluation, known as a "comparability analysis", constitutes the core of the application of the Arm's Length Principle.

The comparability analysis has two main aspects:

1. To **identify the commercial or financial relations and circumstances** between related parties to accurately delineate the controlled transaction.

2. To **compare the conditions of the delineated transaction** with those of comparable independent transactions.

In order to accurately define a controlled transaction within a comparability analysis, specific characteristics, commercial or financial relationships between related parties, also known as "comparability factors", need to be identified. For this purpose, a comprehensive understanding of the industry sector in which the Multinational Enterprise Group operates is needed, together with the factors influencing its performance. This involves reviewing how the Multinational Enterprise Group addresses these factors through its business strategies, markets, products, supply chain and key functions, along with the assets used and risks assumed. The process involves examining the specific operations of each party to the controlled transaction, analysing their transactions, and accurately characterising these transactions by assessing economically relevant characteristics. These characteristics are crucial for applying the Arm's Length Principle, as they identify conditions that independent parties would accept in similar circumstances.

The comparability factors that can be used to accurately delineate the actual transaction can be broadly categorised as follows:

1. Contractual terms of the transaction or arrangement,

2. Functions performed, assets used, and risks assumed (Functional Analysis),

3. Characteristics of the property transferred or services provided,

4. Commercial and economic circumstances of the parties and of the market in which the parties operate, and

5. Business strategies pursued by the parties.

2.2.2 Contractual Terms of the Transaction

A transaction or arrangement results from the commercial or financial relationships between related parties. When, for example, Entities formalise a controlled transaction through written contracts, the agreement serves as the starting point for understanding the transaction's terms, pricing and the division of responsibilities and risks between the parties involved.

Contracts by themselves may not provide all the details needed for a transfer pricing analysis. In some situations, the intentions of the parties and key aspects of terms of the transactions or arrangements might be found outside of written contracts - for example, correspondence between the parties related to the negotiations, conclusion and, later, the execution of the contracts. Emphasis should also be placed on analysing the remaining comparability factors (set out at 2.2.1 above) to identify the actual nature of the transaction or arrangement and the responsibilities of the parties.

Where there is significant divergence between the written contract and the actual conduct of the parties, or where no contract was concluded, for the purposes of undertaking a transfer pricing analysis, the commercial and financial terms of the transaction or arrangement and mutual relations should be defined by the parties' actual behaviour.

2.2.3 Functional Analysis

A Functional Analysis provides a foundation for applying transfer pricing methods and applying the Arm's Length Principle for transactions or arrangements between related parties. This analysis focuses on appropriate distribution and allocation of functions, assets and risks between related parties to a particular transaction or arrangement.

A Functional Analysis aids in choosing the appropriate tested party or parties, selecting the most appropriate transfer pricing method, identifying suitable comparables and ultimately evaluating whether the profits (or losses) earned are consistent with the functions, assets and risks involved. Typically, a party that performs more valuable functions, uses more assets and assumes greater risks is expected to achieve a higher return (or face a higher potential loss). Thus, the return of a party in a transaction or arrangement should be directly linked to its functions, assets, and risks.

Example

Company A is incorporated in country A and provides an intercompany loan to its related entity, Company B, which is incorporated in Bahrain. The Functional Analysis to accurately set the interest rate on this loan, ensuring it adheres to the Arm's Length Principle can cover, but is not limited to, the following items:

Functional Analysis Components	***Company A (lender)***	***Company B (borrower)***
Functions performed	• *Capital Provision: Provide the necessary funds for the loan.* • *Monitoring and Risk Assessment: Conducts credit analysis and monitors the financial situation of Company B.* • *Documentation and Compliance: Manages loan documentation and compliance with regulatory requirements.*	• *Capital Utilisation: Use proceeds from the loan for business operations or investments.* • *Repayment Responsibility: Ensure timely repayment of principal and interest.*
Assets used	• *Access to financial markets or internal funds to provide the loan.* • *Use analytical tools for assessing creditworthiness.*	• *Utilisation of funds for enhancing operational capacity or capital investment.*
Risks assumed	• *Credit Risk: Risk of default by Company B.* • *Interest Rate Risk: Changes in the market interest rates could affect returns.* • *Currency Risk: If the loan is in a different currency, the risk of fluctuations in foreign currency exchange rates affects loan valuation and return.*	• *Liquidity Risk: Company B's ability to generate cashflow to service the loan.* • *Operational Risk: Effective use of funds by Company B without jeopardising repayment capacity.*

The example above highlights that Company A primarily incurs financial risks aligned with a typical lender, justifying an interest rate that compensates for these risks. Company B's effective utilisation

of the funds confirms the need for an economically sensible interest rate that corresponds with market standards for a borrower of a similar risk profile to Company B.

2.2.4 Characteristics of the Property Transferred or Services Provided

The distinct characteristics of specific properties (i.e. goods) or services significantly influence their market value. Variations in these specific characteristics frequently explain potential differences in market value. Careful examination of the nature and features of properties and services can aid in defining similarities, differences and assessing comparability between controlled and uncontrolled transactions.

The emphasis placed on this comparability factor may vary depending on the transfer pricing method applied. This is explained further in section 2.3 of this Guide.

2.2.5 Commercial and Economic Circumstances

When conducting a comparability analysis, the commercial and economic environment in which both related and independent parties operate should be analysed.

Prices can differ across various markets, even for transactions involving similar properties or services. Comparisons between the prices of margins achieved on related party transactions and those of independent parties should take into account the markets and economic conditions in which these parties operate.

Commercial and economic circumstances may include accessibility to particular goods or services, geographic location, market size, level of competition in the market, level of supply and demand, behaviors of the customers, government policies and regulations, assessment of political changes, innovation and new product development.

2.2.6 Business Strategies pursued by the parties

Business strategies describing related parties' actions and decisions made to meet their objectives play a significant role in comparability analysis. These strategies are important for understanding how businesses navigate their environments and allocate resources.

These strategies may encompass various elements, such as engagement in innovation, diversification, risk levels, political landscape assessments and labor law impact. They may also involve market penetration tactics, where a company might temporarily lower prices or incur higher costs to enhance market share.

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2.3 Transfer Pricing Methods

2.3.1 Selection of the most appropriate transfer pricing method to the circumstances

The Regulations (in line with the OECD Transfer Pricing Guidelines) set out specific methods for applying the Arm's Length Principle for the purposes of applying the DMTT Law, including:

- Comparable Uncontrolled Price ("CUP") method,
- Resale Price Method ("RPM"),
- Cost Plus Method ("CPM"),
- Transactional Net Margin Method ("TNMM"), and
- Profit Split Method ("PSM").

The above methods can be used to establish whether the conditions imposed in the commercial or financial relations between related parties are consistent with the Arm's Length Principle.

In applying the Arm's Length Principle, the Regulations follow the OECD Transfer Pricing Guidelines, which state that the most appropriate method should be used in consideration of the facts and circumstances of a transaction or an arrangement, and the most appropriate method should be one of the five methods listed above. This confirms that, for DMTT purposes, the Arm's Length Principle and the methods used should be applied in a manner consistent with the principle and the approach outlined in the OECD Transfer Pricing Guidelines.

When selecting the most appropriate transfer pricing method, the aim is always to identify the most suitable method for the specific facts and circumstances. This process should consider the various strengths and weaknesses of the methods, assess the appropriateness of the chosen method based on the nature of the controlled transaction (determined mainly through a Functional Analysis), and ensure the availability of reliable information, particularly regarding uncontrolled comparables, necessary to implement the chosen method or others. Additionally, the process should evaluate the degree of comparability between controlled and uncontrolled transactions, including the reliability of any comparability adjustments required to address significant differences. No single method is appropriate for every situation, nor is it necessary to demonstrate that a particular method is unsuitable for the circumstances.

CUP, RPM and CPM are regarded as traditional transaction methods and are seen as the most straightforward for determining if terms between related entities are at arm's length. This is because any variance in the price of a controlled transaction from that of a comparable uncontrolled transaction can usually be directly linked to the commercial and financial relations between the parties, allowing the arm's length conditions to be established by substituting the comparable uncontrolled transaction price for the controlled transaction price.

TNMM and PSM are transactional profit methods. For example, PSM is suitable when each party of a controlled transaction makes unique and valuable contributions to the transaction, or when activities are highly integrated, and there is little to no public data on third parties. In

these scenarios, where both parties contribute distinct and valuable functions, a two-sided method might be more appropriate than a one-sided method.

Where there is no or limited publicly available reliable gross margin information on third parties, applying traditional transaction methods can be challenging, except in situations where there are internal comparables. In such cases, a transactional profit method might be more suitable due to the accessible information. However, it is not appropriate to resort to a transactional profit method solely because data on uncontrolled transactions are hard to acquire or partially incomplete.

If both a traditional transaction method and a transactional profit method can be applied with equal reliability, it is preferable to use the traditional transaction method. Furthermore, if the CUP method and another transfer pricing method can be applied with equal reliability, the CUP method is favoured.

The Arm's Length Principle does not require applying more than one method to a transaction. Therefore, related parties are not obliged to conduct analyses using multiple methods.

More details and examples for application of each method are provided below.

2.3.2 The Comparable Uncontrolled Price Method

Under the CUP method, the price for property or services transferred between related parties is compared with the price charged for property and services transferred in the comparable uncontrolled transaction in comparable circumstances. If the prices align, the transaction can be considered as being at arm's length. Conversely, if there are significant pricing discrepancies, this could suggest that the controlled transaction price should be adjusted to mirror the price of the comparable uncontrolled transaction involving independent parties.

As the CUP method directly compares prices in related party transactions to third-party transactions in similar circumstances, it is often the most straightforward way to implement the Arm's Length Principle, provided suitable data are available. The effectiveness of this method depends heavily on the reliability and the comparability of the data related to analogous transactions.

While there is no rigid hierarchy for applying traditional transaction methods, these methods are considered the most direct way to ascertain whether transactions and arrangements between related parties meet the Arm's Length Principle. When analysing the comparability of controlled transactions, if both the CUP method and another method are equally reliable, the CUP method would be preferred for determining the arm's length outcome.

The CUP method allows for comparisons with either internal or external comparable uncontrolled transactions:

- **Internal CUP:** involves comparing a controlled transaction price to a similar transaction price between the tested Constituent Entity, Joint Venture or its Subsidiary and an independent party or parties.

- **External CUP:** involves comparing the controlled transaction price to that of a similar transaction price between two or more independent parties.

An uncontrolled transaction is deemed comparable to a controlled transaction if:

- Any differences between the controlled and uncontrolled transactions, or the parties involved, do not materially impact the market price in an open market; or
- Where such differences exist, reasonable adjustments can be made to remove any significant price impacts caused by these differences.

In this context, several factors should be taken into account when assessing the comparability between controlled and uncontrolled transactions. These factors may include, but are not limited to:

- The nature of the property or services involved;
- The timing of the transaction; and
- The contractual terms governing the transaction.

As indicated in the OECD Transfer Pricing Guidelines, the CUP method is a particularly reliable method where an independent enterprise sells the same product or service as is sold between two associated enterprises.

In particular, to reliably apply the CUP method to commodity transactions, the economically relevant characteristics of the controlled transaction must be comparable to those of the uncontrolled transactions or the arrangements represented by the quoted price. For commodities, these characteristics include factors such as physical features and quality of the commodity, and contractual terms of the controlled transaction like traded volumes, duration of agreements, delivery timing and terms, transportation, insurance, and foreign currency terms. In some cases, certain characteristics, such as prompt delivery, may result in a premium or discount.

If a quoted price is used as a benchmark for determining the arm’s length price or price range, standardised contracts that specify the trading specifications on an exchange, leading to a quoted price, may be relevant. When differences exist between the conditions of the controlled transaction and those of the uncontrolled transactions or the conditions determining the quoted price that materially affect the price of the commodity transactions under review, reasonably accurate adjustments should be made to ensure comparability in economically relevant characteristics. Contributions by other entities in the supply chain, in the form of functions performed, assets used, and risks assumed, should also be compensated in compliance with the Arm’s Length Principle.

The following examples illustrate the application of the CUP method, including situations where adjustments may need to be made to controlled transactions to make them comparable with uncontrolled transactions.

Example 1

The CUP method can be effectively applied to the valuation of oil and natural gas transactions, as there are market quotations available that serve as reliable external benchmarks.

Oil prices listed on exchanges such as the Dubai Mercantile Exchange provide transparent and up-to-date price information. Similarly, natural gas prices in Bahrain can be referenced through indices that are used in GCC markets. By using these quoted prices, which reflect transactions between independent parties, companies can benchmark their intercompany pricing of oil and natural gas transactions. This alignment with external market prices enables compliance with the Arm's Length Principle.

Example 2

Company A based in Bahrain sells 1,000 tonnes of a product for USD 80 per tonne to another Constituent Entity of the same Multinational Enterprise Group. At the same time, Company A sells 500 tonnes of the same product for USD 100 per tonne to an independent enterprise. The products are of the same type and quality.

This case requires an evaluation of whether the different volumes should result in an adjustment of the transfer price. Assuming that there is no difference in contractual terms in sale between related and non-related parties, an adjustment to the price of the controlled transaction could be appropriate. However, the relevant market should be researched by analysing transactions in similar products to determine whether volume discounts, or any other factors, could be applicable in the situation before confirming a price that complies with the Arm's Length Principle.

Example 3

Entity A provides specialised simultaneous translation services to its related party, Entity B. Since Entity A does not offer comparable services to unrelated entities, an external comparison was conducted. Entity A obtained data on translation service prices provided by a regular translation office (price of translation per page presented on a website). However, this external data cannot be deemed comparable due to the different nature and character of the translation services. The nature of translation services as expert services, whose quality depends on the level of professional knowledge and experience and are challenging to price, results in the inability to make reasonably accurate adjustments to eliminate significant effects of differences in the analysed example. As a result, the comparable uncontrolled price method cannot be applied in these circumstances.

2.3.3 The Resale Price Method

Under the RPM, a transfer price is set at the price at which a product that has been purchased from another related party of the same Multinational Enterprise Group is sold to an independent entity. This method is mainly used for distribution companies that purchase goods from related entities for the purpose of reselling them to third parties.

To establish the price under the RPM, the resale price is reduced by a gross profit margin representing the amount needed for the reseller to cover its operating expenses and earn an appropriate profit, considering the functions performed, the assets used and risks involved.

The RPM is generally applied to the reseller in a controlled transaction by comparing their margin to that earned in a similar uncontrolled transaction where the reseller adds value that is typical for someone in that role. However, if the reseller contributes significantly to increase the value of intangible assets like trademarks or marketing intangibles (e.g. trade names), the RPM may be less suitable. On this basis, the RPM is often most appropriate for distribution and marketing operations that do not involve ownership, development or maintenance of valuable marketing intangibles by the reseller.

The RPM can be applied using either internal or external comparables, as follows:

- **Internal comparable:** the arm's length gross profit margin is determined by comparing the reseller's gross profit margin in a controlled transaction with that in a transaction with an independent party.
- **External comparable:** the gross profit margin of the controlled transaction is assessed against comparable transactions between independent parties.

An uncontrolled transaction is considered comparable if differences between the controlled and uncontrolled transactions do not either materially affect the gross profit margin, or any observed differences can be reliably adjusted to eliminate the material impacts on the gross profit margin.

Example 1

Company A, located in a foreign jurisdiction, distributes goods to Company B, located in Bahrain. Company B acts as a distributor of those goods in Bahrain. Company A and Company B are unrelated. Company B was also appointed as a distributor of similar goods by Company C, a Constituent Entity located in a foreign jurisdiction and a member of the same Multinational Enterprise Group of as Company B. Company B is therefore related to Company C.

Company B sells the goods to final customers at a fixed price of BHD 100. However, the cost of those goods purchased from Company A is BHD 90, while the cost from Company C is BHD 95. The gross profit margin of Company B on transactions with Company A is 10%, whereas the margin with Company C is 5%.

Assuming that Company B performs comparable functions, uses comparable assets and assumes comparable risks with respect to the distribution of those goods from Company A and Company C, the difference in the gross profit margin on the transaction between Company B and Company C might indicate that the transactions with Company C are not at arm's length. However, the gross profit margin could be justifiable if, for example, Company B performs additional functions for Company A, such as logistics support, marketing and promotional support.

2.3.4 The Cost Plus Method

According to the CPM, a comparable cost-plus mark-up shall be added to appropriate direct and indirect costs incurred by a supplier of property or services in a transaction or an arrangement with another Constituent Entity of the same Multinational Enterprise Group. This method is particularly effective when semi-finished goods are traded, or services are being provided between related parties, or where joint facility agreements or long-term supply arrangements exist.

The CPM determines an arm's length price for a controlled transaction by taking into account the supplier's direct and indirect costs (without including operating expenses), adding a mark-up based on the supplier's functions and potential arm's length profit, and considering prevailing market conditions. The resulting price, derived from the sum of costs and mark-up, represents the arm's length price of the original transaction.

When applying the CPM, a controlled transaction can be compared to either an internal or external comparable uncontrolled transaction, depending on the specific circumstances:

- **Internal comparable:** The cost-plus mark-up in the controlled transaction is determined by comparing it to the mark-up earned by the same supplier in a similar transaction with an independent party.
- **External comparable:** The cost-plus mark-up in the controlled transaction is determined by comparing it to the mark-up that would have been earned in comparable transactions between two independent parties.

For an uncontrolled transaction to be considered comparable for the purposes of the CPM, either one of these two conditions must be met:

1. The differences between the controlled and uncontrolled transactions, or the parties involved, do not significantly affect the cost-plus mark-up in the open market, or

2. If differences exist, accurate adjustments are made to eliminate any material impact those differences might have on the comparison.

When applying the CPM, the following key factors must be considered to ensure accurate comparisons and adjustments:

- Similar to the RPM, the CPM often requires fewer adjustments for product or service differences compared to the CUP method.

- As with the RPM, all relevant comparability factors, including functions performed, assets used and risks assumed should be considered when using the CPM.

- When significant differences in these areas impact the cost-plus mark-up between controlled and uncontrolled transactions, reliable adjustments should be made to account for them.

- The CPM requires comparability in both the cost-plus mark-up and the cost base used in controlled and uncontrolled transactions. This means that a comparable mark-up should be applied to a comparable cost basis.

- If the controlled and uncontrolled transactions differ materially in their cost bases, adjustments should be made to eliminate the effects of those differences.

- If the independent party uses a different cost base definition or calculation method than the related party, the independent party's cost base should be adjusted to ensure comparability.
- When applying the CPM, the cost base is typically calculated using both direct and indirect costs associated with producing a good or providing a service. These costs should be limited to the costs incurred by the supplier and should reflect the supplier's functional analysis, which outlines the activities, assets, and risks associated with the transaction. The cost basis for the CPM should not cover the operating expenses of the enterprise as a whole, such as supervisory, general and administrative expenses.

- Similar to the RPM, it is crucial for the related party using the CPM to ensure consistent accounting practices between the controlled transaction and the chosen comparable uncontrolled transaction. If inconsistencies exist, appropriate adjustments should be made to account for these differences in both the controlled and uncontrolled transactions.

Example 1

Company A is a manufacturer of goods that are sold to a related party, Company B. Direct and indirect costs incurred by Company A during the production of goods amount to BHD 50,000. Company A sells the goods to Company B for a price of BHD 52,500, by applying a cost-plus mark-up of 5%.

At the same time, a non-related manufacturer, Company C, performs the role of a manufacturer of similar goods as Company A and has been identified as a potential comparative company. Company C applies a higher mark-up of 15% on costs for transactions with unrelated distributors.

The difference in the mark-up appears to suggest that the transaction between Company A and Company B did not occur at arm's length. Thus, the transaction between Company A and Company B should be benchmarked either against transactions between Company A and unrelated distributors (if such exist) or between Company C (or other comparable companies if available) and independent distributors.

Example 2

A is a domestic manufacturer of rechargeable batteries for consumer electronics. A sells these products to its foreign subsidiary B. A earns a 5% gross profit margin from its manufacturing activities. Companies L, M, and N are independent domestic manufacturers of rechargeable batteries for household appliances. L, M, and N sell to independent foreign buyers, earning gross profit margins ranging from 3% to 5% on their manufacturing operations.

A classifies supervisory, general, and administrative costs as operating expenses, which are not included in the cost of goods sold. In contrast, the gross profit margins of L, M, and N incorporate supervisory, general and administrative costs as part of the cost of goods sold.

Adjustments must be made to the gross profit margins of L, M, and N (i.e. direct and indirect costs without including the supervisory, general, and administrative expenses) to ensure accounting consistency.

Example 3

A Bahraini Constituent Entity, F BH, operates within the F group and manufactures products sold to both Constituent Entities of the F group and independent entities. The products from F BH serve as intermediate goods for further processing in production cycles by buyers.

A comparability analysis was conducted on the controlled and uncontrolled transactions entered into by F BH, considering the functions performed, assets used, risks assumed, and significant terms affecting the sale price, such as delivery method and payment conditions. The analysis found no significant differences between these transactions. It was also established that F BH uses the same cost-based approach for pricing in both controlled and uncontrolled transactions. Furthermore, the commercial transactions with both related and unrelated entities occur at a comparable market level (wholesale with similar volume). The sales market for F BH's products, whether to affiliated or independent buyers, is comparable, and geographical factors do not disrupt the comparability of these transactions. Thus, the transactions were deemed comparable.

F BH sells products to both related and unrelated entities and therefore has internal data on cost base calculations and profit margins for these transactions. It was also determined that F BH maintains the same functional profile in transactions with both unrelated and related parties. The profit margin in internal uncontrolled transactions ranges from 9% to 11%. Based on this internal comparison, F BH set a profit mark-up of 10% on products sold to affiliated entities. This margin falls within the range of mark-ups applied in uncontrolled transactions, allowing it to be deemed market-consistent under the circumstances. Thus, the transfer price, calculated based on a comparable cost base and a market-derived mark-up, can be considered consistent with the arm's length principle and established at a market level.

2.3.5 The Transactional Net Margin Method

The TNMM analyses the net profit generated from a controlled transaction relative to an appropriate base, such as costs, sales, or assets. The TNMM aims to determine an arm's length price by comparing the net profit margin of the controlled transaction to similar transactions involving independent parties.

When applying the TNMM, the net profit margin in the controlled transaction can be established by reference to either internal or external comparables:

- **Internal comparable:** The net profit margin is determined by comparing it to the net profit margin of a similar transaction between one of the related parties and an independent third party.
- **External comparable:** The net profit margin is determined by comparing it to the net profit margin of a similar transaction between two independent third parties.

The TNMM may not be reliable when each party to a transaction makes a unique and valuable contribution. In these situations, the transactional profit split method is typically the most suitable approach. However, the TNMM (as well as the traditional transaction methods, i.e. the CUP method, the RPM and the CPM) can be appropriate when a tested party can be identified that does not contribute uniquely or valuably to the transaction and the other party of transaction makes unique and valuable contributions in a controlled transaction. In such scenarios, the less complex party should be selected as the tested party.

One advantage of the TNMM is that net profit indicators, such as return on assets and operating income to sales, are less impacted by transactional differences compared to the price as in the CUP method. These indicators also accommodate functional differences between controlled and uncontrolled transactions better than gross profit margins do, as variations in operating expenses often reflect these differences. This can result in large variations in gross profit margins but similar net profit levels. Additionally, in some regions, unclear public data on expense classification can make gross margin comparability difficult, a problem avoided by using net profit indicators.

Another practical strength of the TNMM is its one-sided approach, requiring analysis of financial indicators for only one associated enterprise, being the "tested" party. This is beneficial in complex situations or where information about one party is difficult to obtain, unlike the transactional profit split method, which requires cost allocation across all participants. However, it is crucial to conduct comparability analysis, including functional analysis, to accurately characterise the transaction and select the appropriate transfer pricing method. This involves gathering information on the five comparability factors (see section 2.2) for both the tested and non-tested parties.

Example

A multinational company, Global Enterprises, has a subsidiary, Marketing Solutions Ltd, located in another country. Marketing Solutions Ltd provides marketing services to Global Enterprises. In order to ensure that the pricing for intragroup transactions is consistent with the Arm's Length Principle, Global Enterprises employs the TNMM.

The tested party is Marketing Solutions Ltd because it has a simpler functional profile. The chosen profit level indicator is the operating margin. Global Enterprises conducts a comparable search and identifies five companies in the same industry offering similar services. Adjustments are made to account for differences in geographic location and market conditions. The operating margins of these comparable companies range from 5% to 7%. Marketing Solutions Ltd's operating margin of 6% is within this arm's length range, indicating compliance with the Arm's Length Principle.

2.3.6 The Profit Split Method

According to the PSM, a relevant profit was identified and split between related parties from one or more transactions or arrangements between them based on economically valid criteria.

PSM aims to determine how profits would be divided between independent parties engaging in comparable transactions.

The PSM is based on the following principles:

- **Identification of combined profits:** The PSM first identifies the total profits generated by related parties from a controlled transaction (or series of transactions).
- **Split of profits:** These combined profits are then split on a basis that is economically sound and reflects the relative contributions of each party.

- **Arm's length approximation:** The resulting split should approximate the division of profits that independent parties would have agreed upon in an arm's length negotiation.

There are various ways to apply the transactional PSM based on the characteristics of the controlled transactions and available data. This method aims to divide relevant profits from controlled transactions on an economically sound basis, reflecting what independent enterprises would have achieved in similar circumstances. This can involve a "contribution analysis", focusing on the relative contributions of each party. If one party also makes less complex contributions that can be benchmarked against comparable uncontrolled transactions, a "residual analysis" might be suitable.

1. Contribution Analysis

   In a contribution analysis, total profits from controlled transactions are divided among associated enterprises to reasonably reflect the division that independent enterprises would have achieved in comparable situations. This division can be supported by comparable data where available, or by using internal Multinational Enterprise Group information to measure the relative value of each party's contributions involved in controlled transactions. If measurable, estimating the actual market value of each party's contributions may not be necessary. The method of evaluating contributions relies on the facts and circumstances of each case and may involve comparing the nature, scale, and type of contributions, such as services provided, expenses incurred, assets used, or capital invested.

2. Residual Analysis

   When some contributions can be reliably benchmarked using a one-sided method and others cannot, a residual analysis is appropriate. This approach divides the relevant profits into two categories. The first category includes profits related to contributions that can be benchmarked with comparables, usually simpler contributions. This initial remuneration is identified using traditional transaction methods or a transactional net margin method.

   The second category accounts for contributions that are unique, valuable, or involve significant integration or shared risks. Any residual profit is allocated based on the relative value of these more complex contributions, similar to the contribution analysis approach.

The PSM is particularly suitable in these situations:

- **Highly integrated business operations:** When related parties engage in highly integrated business operations, where one party's functions, assets, and risks are closely intertwined with and cannot be reliably evaluated independently of the other party.
- **Unique and valuable contributions:** When each party to a controlled transaction makes unique and valuable contributions or uses unique and valuable intangible assets.

- **Shared risk assumption:** When both parties to the controlled transaction share the responsibility for assuming one or more of the economically significant risks related to the transaction.

While the PSM can be used in the absence of suitable comparables for other transfer pricing methods, the lack of comparables alone is not sufficient justification for using the PSM. Each of the situations described above should be considered to determine if the PSM is the most appropriate method.

Example 1

ParentCo is the parent company of a multinational group in the pharmaceutical industry. ParentCo holds a patent for an innovative pharmaceutical formulation. It was responsible for designing clinical trials and conducting research and development functions during the early stages of the product's development, which eventually led to the patent's approval.

ParentCo enters into an agreement with its subsidiary, PharmaSub, under which ParentCo licenses the patent rights for the potential pharmaceutical product to PharmaSub. According to the agreement, PharmaSub takes on the subsequent development of the product and performs crucial enhancement functions. PharmaSub successfully obtains authorisation from the relevant regulatory authorities, and the product is launched in various markets.

The detailed delineation of the transaction reveals that both ParentCo's and PharmaSub's contributions are unique and vital to the pharmaceutical product's development.

In this scenario, the transactional PSM is likely to be the most suitable approach for determining the compensation for the patent rights licensed from ParentCo to PharmaSub.

Example 2

Company X, based in Country X, and Company Y, based in Country Y, along with Company Z in Country Z, are part of an international group. Companies X and Y handle product design and manufacturing, with their functions being highly integrated. They also take care of marketing and distribution to unrelated customers in their respective countries, X and Y. Company Z is responsible for marketing and distributing products purchased from Companies X and Y to unrelated customers in Country Z, with its value determined through comparable data.

Companies X and Y engage in transactions for the purchase and sale of parts and components necessary for product manufacturing, including intermediate goods, to efficiently meet customer needs. Due to their extensive industry experience, both have developed unique and valuable know-how and intangible assets.

In contrast, Company Z does not contribute unique value, only performing marketing and distribution roles that can be evaluated with comparables. Design and production are identified as key value drivers, and a functional analysis shows that the significant risks involved are strategic and operational, tied to these areas. The success of each company heavily depends on this interdependent relationship, with Companies X and Y sharing responsibility for the associated risks.

The PSM is deemed most appropriate for determining the remuneration for Companies X and Y, given their unique contributions. For Company Z, unilateral methods such as the RPM or TNMM may be more suitable to ensure a market return for its activities.

Under PSM, sales in Countries X, Y, and Z should factor into profit allocation. In Country Z, this involves calculating sales revenue minus the market return for Company Z's contributions. The residual PSM approach involves first determining market returns for simpler, comparable contributions, then subtracting these to identify residual profits distributed based on X's and Y's contributions to these profits.

3 Transfer Pricing Documentation

3.1 Overview

The aim of preparing the transfer pricing documentation is to help Constituent Entities and Joint Ventures and their Subsidiaries demonstrate their adherence to the Arm's Length Principle in transactions and arrangements with related parties. The Transfer Pricing documentation includes the local file and the master file.

A master file provides a comprehensive overview of the Multinational Enterprise Group's transfer pricing policies, while a local file offers more detailed, granular information specific to each transaction and arrangement.

Entities located in Bahrain which are party to a transaction or an arrangement with another related party of the same Multinational Enterprise Group should prepare and maintain the local file and the master file in the manner prescribed in the Executive Regulations and this Guide.

3.2 Local File

A local file is a type of transfer pricing documentation that delivers detailed insights into specific controlled transactions or arrangements for a relevant period. It focuses on transactions or arrangements conducted between Entities located in Bahrain which are party to a transaction or an arrangement with another related party of the same Multinational Enterprise Group, including Bahrain located Constituent Entities, where relevant. It should provide key details such as the identities of related parties, pertinent financial data regarding those transactions, a comparability analysis, and the choice and application of the most appropriate transfer pricing method.

A local file should include information in the following key categories:

1. Information about the Constituent Entity, Joint Venture and Joint Venture Subsidiary located in Bahrain

    - Description of the business activities and business strategy of each Constituent Entity, Joint Venture and Joint Venture Subsidiary located in Bahrain.

    - Description of past restructuring, including indication of whether the Constituent Entity, Joint Venture and Joint Venture Subsidiary located in Bahrain has been involved in or affected by a business restructuring or intangible asset transfer in the Fiscal Year or immediately preceding Fiscal Year together with an explanation of those aspects of such transaction affecting the Constituent Entity, Joint Venture and Joint Venture Subsidiary.

    - Description of the management structure of the Constituent Entity, Joint Venture and Joint Venture Subsidiary located in Bahrain, local organisation chart and a description of the natural persons to whom local management reports.

2. Information about controlled transactions

- Identification of the relevant transactions or arrangements of Constituent Entity, Joint Venture and Joint Venture Subsidiary located in Bahrain with other Constituent Entity, Joint Venture and Joint Venture Subsidiary of the same Multinational Enterprise Group (including those located in Bahrain when relevant).
- Description of all identified transactions or arrangements including the context in which such transaction or arrangement took place.
- Identification of other Constituent Entities, Joint Ventures and Joint Venture Subsidiaries of the same Multinational Enterprise Group involved in each of the identified transactions or arrangements and the relations among them.
- Detailed comparability and functional analysis of the Constituent Entities, Joint Ventures and Joint Venture Subsidiaries located in Bahrain and relevant other Constituent Entities, Joint Ventures and Joint Venture Subsidiaries with respect to each identified transaction or arrangement.
- Information on significant changes in intra-group transactions compared to prior Fiscal Years.
- List and description of selected internal or external comparable uncontrolled transactions or arrangements.
- Description of the transfer pricing policy in place.
- Indication of the most appropriate transfer pricing method with regard to the identified transaction or arrangement together with a descriptive explanation of the reasons for selecting the method and, if applicable, an explanation of the tested party.
- Copies of existing unilateral, bilateral or multilateral Advance Pricing Agreements (APAs) and other tax rulings which are related to identified transactions or arrangements.
- Copies of all material intercompany agreements concluded by the Constituent Entities, Joint Ventures and Joint Venture Subsidiaries located in Bahrain.

3. Financial information

- Information on relevant financial indicators for independent enterprises which has been relied on for the purposes of the transfer pricing analyses, including a description of the comparable search strategy and all the steps taken and the source of such information.
- Description of any comparability adjustments performed, and an indication of whether any adjustments have been made to the results of the tested party, the comparable uncontrolled transactions or arrangements, or both.

- Financial information of the Constituent Entities, Joint Ventures and Joint Venture Subsidiaries located in Bahrain including the annual financial accounts for the Fiscal Year.
- Information and allocation schedule showing how the financial data used in applying the transfer pricing method may be tied to the annual financial statements.

3.3 Master File

A master file is a component of transfer pricing documentation designed to give a comprehensive overview of a Multinational Enterprise Group's global business operations and transfer pricing policies. It includes insights into key value drivers and the worldwide distribution of income and economic activity. Its purpose is to provide information on the Multinational Enterprise Group's practices within its global economic, legal, financial, and tax frameworks.

A master file needs to be prepared for each Fiscal Year, reflecting the unique facts and circumstances of the Multinational Enterprise Group's global business during that particular period. A master file should include information in the following key categories:

1. The organisational structure of the Multinational Enterprise Group
    - An organisational structure illustrating the Multinational Enterprise Group's ownership structure and geographical location of operating entities.
2. A general description of the Multinational Enterprise Group's business(es), which includes all of the following:
    - Important drivers of business profit.
    - A description of the supply chain for the Multinational Enterprise Group's five largest products or service offerings based on turnover and any other products or service offerings which account for at least 5% of the Multinational Enterprise Group's turnover.
    - A list and description of important service arrangements between members of the Multinational Enterprise Group, except for research and development services.
    - A description of the main geographic markets for the Multinational Enterprise Group's products and services.
    - A functional analysis describing the principal contributions to value creation by individual Constituent Entities, Joint Ventures and Joint Venture Subsidiaries within the Multinational Enterprise Group.
    - A description of important business restructuring transactions, acquisitions and disposals which occurred during the Fiscal Year.

3. Description of the Multinational Enterprise Group's intangibles

   - A description of the Multinational Enterprise Group's overall strategy for the development, ownership and exploitation of intangibles, including the location of principal research and development facilities and location of research and development management.

   - A list of intangibles or groups of intangibles owned by the Multinational Enterprise Group that are important for transfer pricing purposes and information on which Constituent Entity, Joint Venture and Joint Venture Subsidiary legally owns them.

   - A description of the Multinational Enterprise Group's transfer pricing policies related to research and development and intangibles.

   - A description of any significant transfers of interest in intangible assets among Constituent Entities, Joint Ventures and Joint Venture Subsidiaries which are members of the same Multinational Enterprise Group during the Fiscal Year including the Constituent Entities and compensation involved.

4. The Multinational Enterprise Group's financial activities

   - A description of how the Multinational Enterprise Group is financed, including significant financing arrangements with unrelated lenders.

   - The identification of members of the Multinational Enterprise Group that provide a central financing function for the Group, including the country under whose laws the entity is organised and its place of effective management.

   - A description of the Multinational Enterprise Group's transfer pricing policies related to financing arrangements between Constituent Entities, Joint Ventures and Joint Venture Subsidiaries.

5. The Multinational Enterprise Group's financial and tax positions

   - The Multinational Enterprise Group's annual Consolidated Financial Statement for the Fiscal Year concerned, if prepared, for financial reporting, regulatory, internal management, tax or other purposes.

   - A list and brief description of the Multinational Enterprise Group's existing unilateral APAs and other tax rulings relating to the allocation of income among countries.

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