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The First File

What a transfer pricing file is for, the five things it must establish, and how to build one for a group with a handful of intercompany transactions.

Your first transfer pricing file: what documentation has to prove

Transfer pricing documentation is not a formality. It is the evidence that the prices between your group companies are the prices independent parties would have agreed, prepared before the return is filed, and it shifts the argument from your word against the auditor's to a file against a file.

Who this is for

- Groups with their first related-party cross-border transaction: a service charge, a licence, an intercompany loan or goods.
- Finance leads who have been told the group "needs transfer pricing" and want to know what that actually means.
- Anyone facing a first information request about intercompany pricing.

What the file has to establish

Every transfer pricing file, however small the group, answers the same five questions. What did each entity actually do, and what risks did it actually bear? Which related-party transactions took place, and on what terms? Which pricing method is the most appropriate for each, and why? What arm's-length range does the evidence support? And does the price actually charged fall inside it?

The order matters, because each answer depends on the one before. A method chosen before the functional analysis is a guess. A benchmark run before the method is chosen is a search for a number to justify. A file that reads well and answers those five questions in order is worth several times one that is longer and does not.

The functional analysis is the load-bearing part

Functions, assets and risks decide the answer. The entity that performs the significant functions, owns the important assets and bears the real risks is the entity entitled to the residual profit; an entity that provides a routine service with no meaningful risk is entitled to a routine return. Everything else in the file follows from getting that description right.

It is also the part most often written from the organisation chart rather than from reality. Who actually decides pricing, hires staff, approves budgets, negotiates with customers, and carries the loss if a project fails? Interviews with the people doing the work produce a different and more defensible picture than a diagram does. Our page onfunctional and risk analysiscovers how it is done.

Choosing a method rather than defaulting to one

The recognised methods each fit a particular fact pattern. A comparable uncontrolled price works where a genuinely similar transaction between independent parties can be found. Resale price and cost plus fit distribution and routine service arrangements where a gross margin or a mark-up on cost is the natural measure. A transactional net margin approach, which tests a net profit indicator against comparable companies, is the workhorse for service and distribution entities because comparable data at that level is actually obtainable. A profit split fits where both sides make unique and valuable contributions.

The choice is documented with its reasons, including why the alternatives were rejected. An auditor who disagrees with a well-reasoned choice is having a technical argument; an auditor who finds no reasoning is making an adjustment.

Benchmarking, and its honest limits

A benchmarking study selects independent companies performing comparable functions, applies screening criteria, and produces a range of profit indicators. It is evidence, not arithmetic: the quality lies in the search strategy, the rejection reasons for companies screened out, and whether the accepted set genuinely resembles the tested party.

Two disciplines make a study defensible. Document the search — database, date, criteria, and why each rejected company was rejected — so it can be reproduced. And test the result against common sense: a routine service provider whose benchmark suggests a very high return usually indicates a comparability problem rather than a windfall. Our page on thebenchmarking studysets out the process.

What the local rules add on top

Canada expects documentation to exist contemporaneously — prepared by the filing deadline rather than assembled when asked — and requires an information return for transactions with non-arm's-length non-residents. The United States has its own documentation regime with penalty protection attached to having a file in place before the return is filed. India requires an accountant's report on international transactions with associated enterprises, filed with the return.

Larger groups also face the three-tiered international standard: a master file describing the group, a local file for each entity, and country-by-country reporting above a revenue threshold. A first-time filer is usually only in the local file layer, but knowing where the thresholds sit prevents an unpleasant discovery in a growth year. Our page ontransfer pricing for small and mid-size groupsis written for exactly this position.

Building a first file, in order

Six steps, and the first two take the longest for good reason.

1. **Inventory the related-party transactions** Every flow between group entities for the year, with amounts, counterparties and whether an agreement exists. Most groups find flows nobody had characterised.
2. **Do the functional analysis properly** Interview the people doing the work in each entity. Record functions performed, assets used and risks actually borne, with evidence rather than assertion.
3. **Select and justify a method per transaction** One method per transaction type, with the reasons for it and against the alternatives written down at the time.

4. **Run and document the benchmarking** Search strategy, screening criteria, rejection reasons and the resulting range, all reproducible from the file alone.
5. **Test the actual prices and adjust if needed** Compare what was charged with the range. Where it falls outside, adjust before filing rather than defending afterwards.
6. **Paper the arrangements and diarise the returns** Written intercompany agreements matching what actually happens, plus the information returns and accountant's reports each jurisdiction requires.

Papers to gather

What a first transfer pricing file is built from:

- Group structure chart and a short description of each entity's business.
- Trial balance and financial statements for each entity involved.
- A schedule of all related-party transactions with amounts by counterparty.
- Existing intercompany agreements, and a note of any flow with no agreement.
- Organisation charts with headcount by function, and where each person sits.
- Board minutes and delegated authority documents showing who decides what.
- Customer and supplier contracts for the business the tested entity supports.
- Any prior transfer pricing study, and any tax authority correspondence on pricing.

Where it goes wrong

- **Writing the file after the return is filed** Contemporaneous means before the deadline. In several jurisdictions the penalty protection depends on the file existing at that point, so a file prepared in response to a query does a fraction of the work.
- **Describing the group from the organisation chart** The functional analysis has to reflect who actually decides and who actually bears risk. A description that contradicts what employees say under interview is worse than no description.
- **Charging cost with no mark-up because it feels conservative** It is not conservative; it is a position that has to be justified like any other, and it is one of the most commonly adjusted. Routine services generally command a routine return, and the study is what establishes it.

Questions this raises

How small is too small to need transfer pricing documentation?

There is no universal exemption for being small: the requirement follows from having related-party cross-border transactions, and some jurisdictions add reporting thresholds on top. What scales is the depth of the file, not whether one is needed.

Can we use last year's benchmarking study again?

Often yes for a period, with an annual update of the financial data, provided the functions and the market have not changed materially. What is not defensible is reusing a study whose tested party now does something different.

What happens if the price we charged is outside the range?

You adjust, ideally before filing. An adjustment made voluntarily is a computation; an adjustment imposed on audit can bring penalties and a corresponding adjustment problem in the other country, which then has to be pursued through the treaty.

Do intercompany agreements matter if the pricing is right?

Yes. The agreement is the starting point for characterising the transaction, and an arrangement with no written terms invites the auditor to characterise it. The agreement should also match what actually happens, because a contradiction between the two is worse than either alone.

What to do next

The efficient first step is a materiality and scoping review: which transactions matter, which jurisdictions impose what, and whether a full study or a lighter file is proportionate. That prevents both over-documenting a trivial flow and under-documenting the one that matters.

We prepare first files, benchmarking studies and the local information returns as fixed-fee engagements agreed before work starts. See do I need transfer pricing documentation and the local file fee page.

Legal Quotient Consultants

Cross-border and international tax. Fixed fees agreed in writing before work starts, quoted from your own documents.

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