Transfer Pricing

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1. Introduction[1]

This introduction aims at providing the background of transfer pricing rules, both from a theoretical and a practical standpoint. This entails first describing the arm's length principle, the key pillar of the set of rules against double taxation embodied in article 9 of the OECD Model Tax Convention on Income and Capital (OECD Model), as well as in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) and in article 9 of the United Nations Model Double Taxation Convention between Developed and Developing Countries (UN Model). Moreover, the United Nations Practical Manual on Transfer Pricing for Developing Countries (the UN TP Manual) expressly endorses the application of the arm's length principle. In this regard, this introduction will focus first on analysing the arm's length principle as embodied in article 9 of the OECD Model and the UN Model. First, a genesis of the arm's length principle as an income allocation rule will be presented. Then, a current analysis of the very same principle will be provided, as its actual interpretation as an income allocation rule is under pressure. Such reconsideration stems from a new approach in which the use of the arm's length principle is treated in different regions of the world as a by-product of the implementation of the OECD/G20 BEPS Project. In addition, the comparability analysis and the application of transfer pricing methods will be discussed in detail.

An overview of the most relevant issues encountered when dealing with transfer pricing in practice will also be provided by means of examples, as well as reference to best practices and case law of various countries, when necessary. Reference will also be made to transfer pricing issues surrounding transactions between associated enterprises involving the use of intangible property, the key features of the transfer pricing consequences arising from business restructuring transactions and the practical issues related to comparability searches. The discussion will be framed in the context of the revised OECD Guidelines (2010 version) and in the context of the UN TP Manual, launched at the end of May 2013 in New York and updated in April 2017 by the SubCommittee on Transfer Pricing.[2] The above-mentioned documents reflect the views among member countries and have largely been followed in

1. **For a comprehensive bibliography of transfer pricing, *see* the IBFD library catalogue at www.ibfd.org. Reference can be made to among others: Vögele, Borstell & Engler, *Handbuch der Verrechnungspreise* (2nd ed., Beck 2004) (in German); and L. Eden, *Transfer Pricing and Corporate Income Taxation in North America* (University of Toronto Press, Toronto, Buffalo London 1998). Leading transfer pricing journals are: *International Transfer Pricing Journal* (Intl. Transfer Pricing J.), IBFD, Amsterdam (bimonthly); *Tax Management Transfer Pricing Report*, Tax Management Inc., Washington DC; and *Tax Planning International – Transfer Pricing*, BNA International Inc., Washington DC. *See also* A. Bullen, *Arm's Length Transaction Structures: Recognizing and Restructuring Controlled Transactions in Transfer Pricing* (IBFD 2011), Online Books IBFD.**
2. *See* United Nations Practical Manual on Transfer Pricing, 2017 update. A digital version is available at http://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf.

the domestic transfer pricing regulations, not only of OECD member countries, but also of relevant non-OECD member countries (such as China, India, Indonesia, Mexico Russia and South Africa). Reference will be made when necessary to the US transfer pricing regulations and to how the position of the United States has influenced the origin of transfer pricing guidance at the OECD level, including how the Unites States' views have been influencing the debate of large portions of Actions 8-10 on transfer pricing, although substantial differences between the two systems remain, as will be shown in the course of this chapter.[3]

This introductory chapter reflects the significant changes in the application and implementation of transfer pricing rules that took place because of the implementation of the OECD/G20 Base Erosion and Profit Shifting Project[4] (hereinafter referred to as "BEPS"). BEPS indeed impacted (i) the way in which multinational enterprises (MNEs) will have to take into account their transfer pricing policies with respect to the value-creation activities carried out by the legal entities part of the group, (ii) the documentation process to be implemented to reflect the allocation of revenue, income, taxes and economic activities, and eventually (iii) the opportunities provided to tax administrations to use transfer pricing rules either as a valuation provision instrumental to the allocation of income to various jurisdictions or as a tool to counter aggressive income-shifting strategies. In particular, the BEPS transfer pricing reports address a number of topics. However, they are directed toward one overarching objective: the alignment of the jurisdiction where income is reported for tax purposes with the place where value is created.

Lastly, specific considerations are submitted regarding the initiatives by the joint project of the World Bank Group, IMF, UN and OECD on the creation of a Platform for Collaboration on Tax,[5] and by the European Commission, in determining how the arm's length principle is of relevance as the policy instrument to determine whether an undue tax advantage has been conferred.[6] This initiative has to be coupled by the ongoing activities of the European Joint Transfer Pricing Forum (the EUJTPF), which – within its domain of activities – has carried out some significant studies which will be referred to later on in this introductory chapter.[7]

In order to explain the subject matter from an international tax policy perspective, international developments are discussed in chronological order.

2. The Relevance of Transfer Pricing in International Taxation

Transfer pricing is nowadays perceived as the most important international tax issue by both taxpayers and tax authorities. The increased integration of national economies and technological progress, particularly in the area of communications, has provided MNEs the opportunity to broadly expand

3. The Platform for Collaboration on Tax is a joint effort launched in April 2016 by the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD), the United Nations (UN) and the World Bank Group (WBG). The Platform is designed to intensify the cooperation between these international organizations on tax issues. It formalizes regular discussions between the four international organizations on the design and implementation of standards for international tax matters, strengthens their ability to provide capacity-building support to developing countries, and helps them deliver jointly developed guidance. It also increases their ability to share information on operational and knowledge activities around the world. Arguably, transfer pricing is one the key pillars of such initiative, due to the fact that the latter legislation, if properly designed and implemented, may be used as a significant tool to mobilize revenue as well as to preserve double taxation to occur.
4. *See* the OECD February 2013 Report, *Addressing Base Erosion and Profit Shifting* , February 2013, and the *Action Plan on Base Erosion and Profit Shifting*, July 2013, available at www.oecd.org.
5. *See supra* n. 2.
6. *See* the European Commission Notice on the notion of State aid as referred to in art. 107 (1) Treaty on the Functioning of the European Union (TFEU), 2016/C 262/01, in the Official Journal of 19 July 2016. The Notice, the Working Paper and the Commission's final decisions in Belgian Excess Profit Rulings, Fiat, Starbucks and Apple; and the Commission's opening decisions in Amazon, McDonald's and GDF Suez are all available on DG Comp's tax rulings website: http//ec.europa.eu/competition/state_aid/tax_rulings/index_en-html.
7. *See* the EUJTPF Final Report of Mar. 2017 on *Report on the Use of Comparables in the EU*; and *Study on the Application of Economic Valuation Techniques for Determining Transfer Prices of Cross Border Transactions between Members of Multinational Enterprise Groups in the EU.*

their activities beyond their national or regional borders so as to effectively look at the world as a single market. It therefore comes as no surprise that estimates suggest that approximately about two-thirds of all business transactions take place within an MNE group[8] This is particularly relevant for developing countries as their economies have recently opened up or are in the process of opening up, attracting large amounts of foreign direct investment (FDI) from MNEs. In the absence of transfer pricing legislation, both tax administrations and MNEs have only limited guidance they can refer to when determining transfer pricing in related-party transactions. To this end, OECD studies in the field value chain[9] prove that certain industries do not present any independent player active in the sector (e.g. wholesale distribution in the automotive or pharmaceutical industries). In this context, the term "MNE" covers not only large corporate conglomerates, but also small and medium-sized enterprises with activities overseas involving one or more subsidiaries or permanent establishments (PEs) in countries other than those where the parent company or head office is located. This holds true particularly for regions such as the European Union or Southeast Asia, where small and medium-sized enterprises are rapidly expanding their business activities outside their home base, as well as for Africa, which is becoming a very favourable location for setting up operations in the oil and other extractive industries.

From an international tax perspective, transfer pricing policies of MNEs have largely been affected not only by changes in technology, which opened avenues for a reorganization of supply chain activities within various groups, but also by the increased attention that tax administrations worldwide have begun to give to the transfer pricing decisions of MNEs that affect the taxable base of the group in the country concerned. In particular, in a situation where public balances are strained by the financial crisis, transfer pricing is considered by a number of tax administrations as a risk factor that needs to be properly managed and scrutinized before it negatively impacts the taxable base of a number of jurisdictions. In this context, it is worth noting that a number of tax administrations, particularly those representing the interests of developing and transitioning economies, have scrutinized transactions between associated enterprises as potentially leading to the improper shifting of profits towards tax havens or low-cost jurisdictions. This led to the creation of the label "transfer mispricing" by civil society and non-governmental organizations (NGOs), which brought the discussion regarding the application of transfer pricing methods to the level of tax justice and tax equality, at times, according to the author, disregarding the technical merits of the discussion. Using this line of reasoning, the report Calling Time [10] by the NGO ActionAid pointed at the aggressive tax planning structures set up by the MNE SABMiller in stripping profits out of a developing country (in this case, Ghana).

Indeed, political considerations, in particular those arising from developed as well as developing countries and NGOs, are also having an impact on the repositioning of the relevance of transfer pricing in an international tax context. As regards industrialized countries, as will be stated below, US politicians alleged that either foreign enterprises active in the United States paid substantially less income tax than comparable US groups or that US groups diverted the highest stake of their profits overseas by means of CCAs or business restructurings, thereby leading to the migration of high value-adding intangibles. More specifically, although the reason for tightening transfer pricing legislation in 1986 was a domestic

8. For these statistics, reference is given to the World Bank report, *Transfer Pricing Technical Assistance Global Tax Simplification Program*, presentation given by R. Awasthi in Brussels, 24 Feb. 2011.
9. *See* http://www.oecd.org/industry/ind/measuringtradeinvalue-addedanoecd-wtojointinitiative.htm, accessed 9 Jan. 2017.
10. *See* ActionAid, Calling Time: Why SABMiller Should Stop Dodging Taxes in Africa (Apr. 2012), available at http://www.actionaid.org.uk/doc_lib/calling_time_on_tax_avoidance.pdf, accessed 9 Jan. 2017. ActionAid's investigation used published financial information, interviews with government officials and undercover research to ascertain how SABMiller avoids tax across Africa and India. The cost to the governments affected may be as much as GBP 20 million per year. *See also* ActionAid, *Sweet Nothings: The Human Cost of a British Sugar Giant Avoiding Taxes in Southern Africa* (Feb. 2013), available at http://www.actionaid.org.uk/sites/default/files/publications/sweet_nothings.pdf, accessed 15 Jan. 2018.

one in the United States (tax planning by US groups involving the transfer of US-developed intangibles to related companies in tax havens such as Puerto Rico), the political emphasis has been on foreign-owned US companies.

3. Transfer Pricing from a Business Economics Perspective

As transfer pricing is an economics term, it should be useful to consider how economists define it. In business economics, a transfer price is considered as the amount that is charged by a part or segment of an organization for a product, asset or service that it supplies to another part or segment of the same organization.

The term "transfer price" for business economics purposes has been defined as follows: [11] "[T]he amount charged by one segment of an organization for a product or service that it supplies to another segment of the same organization." One – if not the main – economic reason for charging transfer prices is to be able to evaluate the performance of the group entities concerned. It is not the case that from the beginning of the 21st century, the modern corporate governance structure of first-tier MNEs (ranging from the electronics industry to the pharmaceutical industry, to the automotive industry) tend to place the transfer pricing function within the range of activities that need to be monitored and included in the risk management department. This holds true if one looks at the phenomenon from the other side of the coin. For example, assume that a company is caught in a tax evasion scandal triggered by aggressive transfer pricing planning. The day after the scandal is reported in the specialized press, the share value of the MNE concerned drops, say, 20%. This unfortunate (yet frequent) scenario shows the linkage between corporate governance, risk management and the transfer pricing function.

Transfer pricing is also regarded as a part of the management control system of an MNE or a multi-divisional company, having two main objectives: the promotion of goal consistency and the design of a suitable system for performance measurement and evaluation. [12]

In addition, by charging prices for goods and services transferred within a group, managers of group entities are able to make the best possible decisions as to whether to buy or sell goods and services inside or outside the group. But particularly, via transfer pricing, financial means are allocated in a reasonable way to the various segments of a group. This stems from the circumstance, reported in economic literature, [13] that MNE groups tend to arrange their manufacturing, R&D and distribution activities not by approaching the structuring in terms of separate legal entities, but rather MNEs tend to organize their business activities by distinguishing between profit centres, cost centres and investment centres. As concerns profit centres, normally, the key entrepreneurial risks are located therein and they are generally located in low-tax jurisdictions, whereas cost centres and investment centres tend to be located, respectively, where the cost of labour is lower or where incentives for R&D activities are identified.

More specifically, cost-based systems for the transfer of goods and the rendering of services internally have always been very popular among MNEs. Some MNEs use only variable costs; others use full costs; still others use full costs plus a profit markup (cost-plus method). Some use standard costs; others use actual costs when charging for goods sold or services rendered. If there is a competitive open market for

11. *See* R.G. Eccles, *The Transfer Pricing Problem* (D.C. Heath and Company 1985); C.T. Horngren, W.O. Stratton & G.L. Sundem, *Introduction to Management Accounting* 396-403 (Prentice Hall International Inc. 2002).
12. M. Cools, *Increased Transfer Pricing Regulations: What about the Managerial Role of Transfer Pricing?* , 10 Intl. Transfer Pricing J. 4, p. 134 (2003), Journals IBFD.
13. *See* D. Besanko et al., *Economics of Strategy* 360-363 (4th ed., John Wiley and Sons, 2007).

the products or services transferred internally, a sound solution from a business economics perspective is to use the market price as a transfer price. The market price may be derived from published price lists for similar products or services, or it may be the price charged by a group entity to its (non-related) customers, depending on the industry sector concerned (the possibility of finding a market price is quite frequent for the commodities markets, for example). The latter may be the basis for the transfer price in an earlier stage of production by subtracting costs and a reasonable profit in the last internal stage from the price (the resale price method).

Apart from the cost-based methods and transfer prices based on open-market prices, another approach may be distinguished. In various MNEs with a typical profit centre structure, group entities usually negotiate with each other like independent parties because they have their own profit responsibility. The transfer price resulting from such negotiations is valid from a business economics perspective and should, in the author's opinion, [14] also be acceptable for tax purposes, provided that the negotiations with the group indeed take place in the same free circumstances as among unrelated parties. In 1990, 12.7% of US companies with foreign activities still used this "negotiated transfer price method" [15] for both commercial and tax purposes.

In other words, one possible reason for associated entities to charge transfer prices for the intra-group trade of goods or services is to be able to measure the performance of the individual entities in a multinational group. The individual entities within a multinational corporate group are often treated as separate, cost profit or investment centres for management accounting purposes and, therefore, transfer prices are required in order to assess the economic and financial performance of the entities involved. Such an approach explains why contractual terms, within a functional analysis, are to be seen (*see* chapter I and part I of chapter IX) only as the starting point of any comparability (including functional) analysis. In other words, for example, internal management manuals, are representing in a more accurate manner the business behaviour of multinational enterprises. Rationally, an entity having a view to its own interests as a distinct legal entity would acquire products or services from an associated entity only if the purchase price were equal to, or less than, prices being charged by unrelated suppliers. This principle applies, conversely, in relation to an entity providing a product or service; it would rationally sell products or services to an associated entity only if the sale price were equal to, or more than, prices paid by unrelated purchasers. Prices determined on this basis should gravitate towards the so-called "arm's length price", i.e. the price at which two unrelated parties would agree to a transaction.

Since the mid-1990s, new tax legislation has had a strong impact on commercial transfer pricing approaches. If the commercial system is in conflict with the applicable tax rules, companies may either adopt the fiscally correct system (which reduces the relevance for general business economics and managerial purposes) or – if allowed – maintain two systems (one for commercial purposes, the other for tax purposes).

As a negative consequence of the stricter transfer pricing rules applicable since 1994, which emphasized external benchmarks, the negotiated transfer pricing method seems to have disappeared as a tax method.

The above definition of transfer pricing is also valid for tax purposes. The term "transfer pricing" is, however, sometimes used, incorrectly, in a pejorative sense, to refer to the shifting of taxable income

14. H.M.A.L. Hamaekers, *Can the Free Negotiation of Prices within a Multinational Enterprise Serve as a Primary Transfer Pricing Method?*, 4 Intl. Transfer Pricing J. 1, p. 2 (1997), Journals IBFD.
15. R.Y.W. Tang, *Transfer Pricing in the 1990s: Tax and Management Perspectives* (Quorum Books 1993).

from a company, belonging to an MNE, located in a high-tax jurisdiction, to a company belonging to the same group in a low-tax jurisdiction through incorrect transfer prices in order to reduce the overall tax burden of the group.

Paragraph 3 of the Preface of the 1979 OECD Report on Transfer Pricing and Multinational Enterprises explained that the term "transfer pricing" is, by definition, neutral: "the consideration of transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes". The 1995 OECD Guidelines, as confirmed in their major revision in 2010, make this concept even clearer by using the title Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, so as to highlight that no differences should arise, in terms of results, if both taxpayers and tax administrations apply the principle correctly.

Indeed, transfer pricing provides opportunities for MNEs to shift profits from a high-tax country to a country with a low corporate tax rate or with tax incentives for certain activities. One should realize, however, that tax planning is only one of several different considerations taken into account by MNEs in this context. Many large groups indeed prefer to maintain a good relationship with the tax authorities of the countries where they are active. Certainty about the amount of tax to be paid is a top priority for large companies and they usually operate a well-documented, straightforward transfer pricing system, which is – as explained above – in the first place a requirement of sound business economics.

Against this background, it is interesting to note that part of relevant literature[16] is pointing out that transfer pricing legislation was originally conceived as an anti-avoidance mechanism. In particular, transfer pricing legislation has been defined as "one of the simplest ways to avoid taxation" and "one of the most common techniques of tax avoidance".[17] In reality, it seems that since their very origin transfer pricing rules were solely designed to exclude from the tax system a distortion triggered by common control in the definition of taxable income. Viewed in this context, transfer pricing rules have been regarded as a necessary component of any international tax law as such legislation would stop MNEs from easily avoiding or significantly reducing profits by shifting them towards low- or no-tax jurisdictions. Therefore, to summarize what "transfer pricing" is from a definitional perspective, the following conclusions can be drawn:

- transfer prices are any prices or other consideration (or the absence thereof) with respect to a single transaction or series of transactions or dealings between associated enterprises or segments of the same enterprise (the latter are normally referred to as permanent establishments). Throughout this introduction, the terms "transfer prices" and "transfer pricing" include all types of consideration in transactions between related parties, namely: prices for finished goods; components; raw materials or any other tangible property (which may not embody intangibles); charges for services; royalties for the use of intangibles; rents for the use of property; and interest and other payments for the use of money. Accordingly, royalties for the use of patents, trademarks and other intangibles are transfer prices to the same extent as are prices for finished goods. In addition, a cost sharing arrangement for the joint development of intangibles serves the same function as transfer prices, such that the use of the terms "transfer prices" and "transfer pricing" aims to include the possibility of cost sharing, as well; and

16. *See* L. Schoueri, *Arm's Length: Beyond the Guidelines of the OECD* , 69 Bull. Intl. Taxn. 12 (2015), Journals IBFD.
17. In this line of reasoning, *see* R.S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in Evolution of US International Taxation*, Oub. & Leg. Theory Working Series Papers, No. 92 (Sept. 2007) and Y. Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 Va. Tax Rev., p. 86 (2008).

- from a purely tax perspective, transfer pricing refers to the consideration paid in transactions between separate entities that are related. As a result, each time an MNE sets transfer prices, as it must when members of the group in different countries do business with each other, the group is determining the income subject to the corporate income tax of each country involved, and for that very reason transfer prices are subject to adjustment by tax authorities. In other words, transfer prices serve the function of dividing the profits of a multinational group between countries.

The above means that a relatively small percentage change in the transfer prices of a large volume of exports or imports can make a significant difference in a country's tax base. Therefore, under the laws of most countries, the tax administration is given the authority to review and, if appropriate, adjust the transfer prices of their taxpayers for the purpose of determining the income subject to tax

In adjusting transfer prices for tax purposes, a tax authority is effectively reallocating income to the associated enterprises entitled to it based on an arm's length outcome. Indeed, some tax authorities may reallocate income from a foreign related party to its taxpayer. Throughout this introduction, those types of reallocations are referred to as "transfer pricing adjustments".

4. The Arm's Length Principle and the Origin of the Transfer Pricing Guidelines[18]

Prices set for transactions between group entities should – for tax purposes – be derived from prices which would have been applied by unrelated parties in similar transactions under similar conditions on the open market. [19] This is what is normally referred to as the arm's length principle, which is the internationally accepted standard for the allocation of taxable income to associated enterprises. Almost all countries have domestic tax provisions, either general or specific, endorsing this standard and which allow the tax authorities to adjust transfer prices that deviate from this principle.

More specifically, the arm's length principle is based on the so-called "separate entity approach", as endorsed in the OECD Guidelines, whereby an associated enterprise or a PE (as defined in the following paragraphs) is to be treated as dealing with another related party (being another associated enterprise or a part of the same enterprise) as if it were independent.

The adoption of the arm's length principle in the 1920s and 1930s was intertwined with the development of the foundational principles of modern international tax systems.

In particular, by seeking to adjust profits by reference to the conditions which would have been obtained between independent enterprises in comparable transactions and comparable circumstances (i.e. so-called comparable uncontrolled transactions), the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. As the separate entity approach treats the members of an MNE group as if they were independent entities, attention is then focused on the nature of the transactions between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions.

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18. For the history of the arm's length principle, *see* H.M.A.L. Hamaekers, *Arm's Length – How Long?*, in Staaten und Steuern, *Liber Amicorum Klaus Vogel* (C.F. Müller Verlag 2000) and 8 Intl. Transfer Pricing J. 2, p. 30 (2001), Journals IBFD.

19. D.L.P. Francescucci, *The Arm's Length Principle and Group Dynamics*, 11 Intl. Transfer Pricing J. 2 (part 1), p. 55 and 6 (part 2), p. 235 (2004), Journals IBFD.

The key question to be addressed when transfer pricing provisions do apply is whether the conditions of enterprises which are part of the same group (referred to as "associated enterprises") mirror those entered into by independent enterprises in their commercial or financial relations. This entails that, unlike what mainstream media communication tends to stress, transfer pricing rules tend to focus on behavioural activities of MNEs in setting up their commercial or financial relations rather than focus only on the price attached to their intercompany transactions. In particular, associated enterprises sometimes make or impose special conditions in their commercial or financial relations (the so-called "controlled transactions") which differ from the ones that comparably placed unrelated enterprises would have made. When this is the case, the arm's length principle may authorize a domestic tax administration to include in the profits of the enterprise, and tax accordingly, any profits which would have accrued to this enterprise absent such special conditions. As a result, such special conditions are not only limited to question the conditions attached to the price, but may also extend to question the structure of the related-party agreement.

The key question that any tax administration faces in practice when considering the application of the arm's length principle revolves around guaranteeing its workability in light of the objectives it intends to achieve.[20]To this end, the following considerations always have to be factored in:

- *Ease of administration*. What is the level of technical difficulty for applying the arm's length principle by both taxpayers and tax administrations?
- *Economic efficiency as a tool to boost investment and international trade.* How much can the arm's length principle affect or distort the level of investment or location where the investment is made or capital is located?
- *Robustness to pathological tax planning situations*. Can the arm's length principle be treated as a disguised anti-avoidance rule to challenge transactions where a manipulation or erosion of the tax base occurs?
- *Systemic consistency*. How does the arm's length principle fit into the overall pillars of a domestic tax system?
- *Fairness*. Does the arm's length principle allow for an equitable allocation of income tax bases or may better mechanisms be employed by states?

As it will be stressed thoroughly in the section dedicated to comparability issues, a proper application of the arm's length principle entails a comparison between conditions (including prices) made or imposed between associated enterprises and those which would be made between independent enterprises, in order to determine whether an adjustment of the accounts for purposes of calculating the tax liabilities of the associated enterprises is authorized under article 9-type clauses included in bilateral income tax treaties.

Historically, the arm's length principle embodying the separate entity approach has two different origins:

- at the very beginning, specific transfer pricing provisions with an international focus were first introduced during World War I in the United Kingdom and the United States. These anti-tax avoidance provisions aimed to deter companies from shifting profits to associated companies

20. *See* along the same line of reasoning the thorough academic analysis carried out by J. Andrus & R. Collier, *Transfer Pricing and the Arm's Length principle after BEPS* (Oxford Press 2017).

overseas through under-pricing or over-pricing of cross-border transactions among related parties; and

- currently, in several continental European countries the arm's length principle may be used as the underlying basis for the adjustment of income of shareholders who have received extraordinary benefits from a company which have not officially been declared as dividends. Majority shareholders may be able to derive benefits as a result of their special position. The adjustment in such cases is made by deeming the benefits to be dividends, known as "constructive dividends" or "hidden profit distributions", which are not deductible for the company concerned. The focus in this regard was originally domestic.

Both approaches are based on the concept of equal treatment or the neutrality principle, i.e. shareholders with a controlling interest in a company are placed in the same position as other shareholders and controlled taxpayers are placed on a parity with uncontrolled taxpayers through application of the arm's length principle, which neutralizes the advantage of the former. [21]

The arm's length principle was implicitly included in treaties concluded by France, the United Kingdom and the United States as early as the 1920s and 1930s.

In a multilateral context, the arm's length principle was formulated for the first time in article 3 of the League of Nations Draft Convention on the Allocation of Profits and Property of International Enterprises in 1933. The term "dealing at arm's length" was used only in the context of the relationship between a PE and its head office (separate entity approach). Article 5 of the Draft, dealing with associated enterprises, referred to "conditions different from those which would have been made by independent enterprises".

The latter formula was included in article VII in the Mexico Draft of 1943 and in the London Draft of 1946. These articles are substantially similar to article 9 of the 1963 OECD Draft Convention and article 9(1) of the present OECD and UN Models. Article 9 is identical in the OECD and UN Models. The explicit use of the term "dealing at arm's length" did not return in drafts and models after 1933.

In a nutshell, article 9 confirms in a treaty context the (domestic) right of a contracting state to adjust the profits of an enterprise located in its territory which is managed, held or controlled, directly or indirectly, by an enterprise of the other contracting state if the conditions in their relationship differ from those which would have been stipulated between independent enterprises.

A first clarification of the scope of the provision of article 9 of the OECD Model (in this regard, no substantial differences with the UN Model exist, as the latter reproduces the wording of the former) occurred in 1979, when the OECD CFA released the report, Transfer Pricing and Multinational Enterprises, followed by the 1984 report, Transfer Pricing and Multinational Enterprises: Three Taxation Issues (commonly referred to in literature as the Mutual Agreement Report). These two reports (as expressly acknowledged by paragraph 13 of the 2010 OECD Guidelines) laid the groundwork for the 1995 and the 2010 revisions of the OECD Guidelines, which somehow crystallized the view around the arm's length principle as embodied in article 9 of the OECD Model. For the sake of clarity, the discussion here will focus only on the OECD version of the article.

In particular, before 1979, administrative guidance on the application of legal provisions relating to the application of the arm's length principle was scarcely available. From a comparative perspective, in

21. H.M.A.L. Hamaekers, *The Arm's Length Principle and the Role of Comparables*, 46 Bull. Intl. Fiscal Docn. 12, pp. 602-605 (IBFD 1992).

1968 the US Treasury issued elaborate regulations for specific types of intercompany transactions. These regulations had a great influence on the discussions in the OECD on transfer pricing in the 1970s.

Because of the increase in the number of MNEs and the increase of transactions within MNEs since the 1960s, the OECD member countries considered it necessary to produce guidelines for their respective tax administrations on how to deal with transfer pricing. It was also regarded as useful to elaborate further on the purpose of article 9 of the OECD Model and its Commentary. As one of the two main goals was the avoidance of double taxation, the multilateral framework of the OECD was chosen for developing a consensus on the topic of transfer pricing.

Working Party No. 6, which is a subgroup of the OECD CFA, produced an authoritative report by the end of the 1970s. The 1979 OECD Report, Transfer Pricing and Multinational Enterprises, was not intended to establish a detailed standard of transfer pricing, but rather to set out the problems and considerations to be taken into account, and to describe which methods and practices were acceptable from a tax perspective in determining transfer prices.

In 1984, the OECD published a second report that addressed three topics: the mutual agreement procedure, transfer pricing in the banking sector and the allocation of central costs. This report was a particularly useful elaboration of the 1979 Report.

The 1979 OECD Report established what would have then become the building blocks for developing appropriate guidance for domestic transfer pricing regulations, the main conclusions of which would then be used as the starting point for the revision of the OECD Guidelines that took place in 1995. It is interesting to notice how nowadays some of the conclusions reached in the 1979 Report with respect to certain cornerstones of transfer pricing (e.g. the rather negative wording adopted on the profit split method) are now receiving closer consideration for a more widespread and effective adoption by the BEPS Project. In this regard, in 1979, consensus was reached on the following:

- the arm's length principle is the appropriate legal tool to adopt in arriving at a fair allocation of profits between related entities for tax purposes;
- the analysis of transfer pricing issues should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes;
- the dual purpose of the report is to enable the protection of the interests of the national tax authorities involved, and to enable prevention of double taxation of the enterprises involved;
- the "ideal" method, to be hierarchically preferred over the others, is the comparable uncontrolled price (CUP) method;
- if no useful evidence for CUPs is available, the cost-plus or resale price methods are acceptable from an arm's length perspective;
- other methods are not excluded, but with respect to these other methods, the 1979 Report expressed vague and negative views:
    - the profit split method is necessarily arbitrary; profit comparison is only an indication for further investigation; the return on capital invested presents difficulties; and net yield expectations are too imprecise. Such methods may be used as a double check (profit comparison) or as a solution in bilateral negotiations among countries (profit split); and

    - global methods, such as formulary methods for allocating profits to affiliates, are not endorsed, as they are incompatible with articles 7 and 9 of the OECD Model; they are arbitrary, disregard market conditions, ignore the management's own allocation of resources, do not bear a sound relationship to the economic facts and carry the risk of double taxation;[22]
- it is always useful to begin the selection of a transfer pricing method with a comparability analysis, stressing in particular the importance of the functional analysis (identifications of actual functions, responsibilities, risks, etc.) in order to properly allocate the residual profits;
- the approach of the 1979 Report is to recognize the actual transaction as undertaken by the parties, not to substitute another transaction for it; (if required) the price for the actual transaction should be adjusted to an arm's length price; and
- transfer pricing policies of MNEs may in fact be market-oriented and, where the different entities within such groups have their own profit responsibility, they may be free to contract either with an associated enterprise or with a third party, with the result that there is a degree of bargaining within the group which produces a price effectively indistinguishable from an arm's length price.

The objective scope of article 9(1) is defined in terms of "commercial or financial relations", a concept that is not defined in article 9(1) or elsewhere, or in the OECD or UN Models. Under article 9(1), the profits of an enterprise may be adjusted, and the adjusted profit may "be included in the profits of that enterprise and taxed accordingly". Article 9(1) is thus concerned with the taxation of profits of enterprises and it focuses primarily on a correct allocation of taxing rights between two residence states. [23]

Article 9, the heading of which is "Associated Enterprises", is a provision in a category of its own within the OECD Model. In this regard, the distributive articles allocating the right to tax profits of enterprises are articles 7(1) and 8. Thus, article 9(1) generally functions as a supplement to article 7(1) by providing for a quantification of the income between associated enterprises to which the contracting states are ascribed taxing rights under article 7(1). However, a major difference exists; article 7, which embeds the clear wording of the arm's length principle in paragraph 2, clearly distinguishes between a residence state and a source state, while article 9 does not allocate any taxing right as it refers to two residence states where the associated enterprises are located.

4.1. Conceptual differences in applying the arm's length principle in an article 7 vis-à-vis an article 9 approach

As a result, it is important to bear in mind that although articles 7 and 9 move from the same premise, i.e. the arm's length principle, the outcome may be different for the following reasons:

- article 7 refers legally to a single entity, whereas article 9 refers to two separate legal entities. This is confirmed in the relevance of the contractual agreements in carrying out a comparability analysis under article 9, whereas contractual terms do not exist in the article 7 scenario; and
- business profits of article 7(1) may logically be the result of internal dealings of an enterprise, transactions with independent enterprises, and transactions with associated enterprises covered

22. The profit split method is recognized as a transfer pricing method which allocates the joint profit of usually two related entities on the basis of functions and risks of each entity. Formulary apportionment essentially differs from profit split in that it uses predetermined factors.
23. *See* J. Wittendorff, *The Object of Art. 9(1) of the OECD Model Convention: Commercial or Financial Relations*, 17 Intl. Transfer Pricing J. 3 (2010), Journals IBFD.

> by article 9(1). Because, under article 7(1), business profits, in an associated enterprise context, are the result of commercial or financial relations referred to in article 9(1), article 3(2) and the context also require this concept to be interpreted on the basis of domestic law. Accordingly, the existence, form and content of a controlled transaction under article 9(1) should be determined on the basis of domestic law. The object qualification under domestic law must therefore be made prior to the application of the arm's length principle of article 9(1).

The distinction between the two provisions is further exacerbated by reference to the notion of (i) "significant people functions" (SPFs) in the context of the (revised) 2010 Report on the Attribution of Profits to Permanent Establishments and that of (ii) economic ownership within the same report. In this document, SPFs relate to those functions relevant to the assumption of risk and the SPFs relevant to the economic ownership of assets will vary from business sector to business sector (e.g. such functions are unlikely to be the same for an oil extraction company and a bank) and from enterprise to enterprise within sectors (e.g. not all oil extraction companies or all banks are the same). In other words, SPFs are the proxy necessary to replace the application of the arm's length principle and hypothesize the PE as if it were a separate and distinct enterprise. This means that the application, by analogy, of the OECD Guidelines (with a full implementation of the arm's length principle) comes only after the various stages of step 1 have been completed. A similar line of reasoning can be followed with the notion of economic ownership, the exact meaning of which has been detailed in endnote 4, which stipulates that "As used in this Report, the economic ownership of assets in the article 7 context means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the income attributable to the ownership of the asset, such as royalties; the right to depreciate a depreciable asset; and the potential exposure to gains or losses from the appreciation or depreciation of the asset)."

It should be noted that the conceptual differences in applying the arm's length principle in articles 7 and 9 of the OECD Model are minimized in the post-BEPS international tax world. As pointed out above, the main conceptual difference is the existence of the contracts in the context of article 9 of the OECD Model, while such contracts cannot be present in the case of article 7 of the OECD Model due to the simple fact that no separate legal entities exist. As a consequence, within the framework of article 9, taxpayers can allocate the rights and obligations including the related risks by means of the contract. Therefore, from a transfer pricing perspective, an arm's length remuneration would have to be determined taking into account the terms of the contracts concluded between the associated enterprises. On the contrary, article 7 of the OECD Model bases the application of the arm's length principle solely on SPFs, e.g. the risks are attributed to the PE taking into account the functions carried out through that PE. After the the OECD BEPS Project, the application of the arm's length principle in article 9 of the OECD Model changed significantly. In particular, currently more importance is given to the actual conduct of the parties than before. The OECD BEPS Actions 8-10 Final Reports emphasize the importance of analyzing the actual conduct of the parties in order to accurately delineate the controlled transaction under consideration.[24] In accordance to the updated guidance, the actual conduct of the parties can be used to clarify or complete the existing contractual agreement. It further provides that where the terms of the contract between the associated enterprises is inconsistent with their actual conduct, the latter should take precedence over the contractual terms.[25] Hence, the approach chosen in the new guidance implies that MNE groups will not be able to allocate the functions and risks between

24. OECD BEPS Actions 8-10 Final Reports, at paras. 1.42-1.50.
25. Id., at para. 1.45.

the associated enterprises solely based on the contracts. The MNE groups would have to ensure that the written contracts are consistent with the actual conduct of the parties. This means that even under article 9 of the OECD Model, the application of the arm's length principle is currently more heavily based on the actual conduct of the parties rather than on written contracts.

Another important amendment made within the framework of the OECD BEPS Project relates to the allocation of the risks between the associated enterprises engaged in the controlled transaction. The OECD introduced the concept of "risk management" and provided a more detailed definition of the concepts of "control over risk" and "financial capacity to assume risk". In accordance to the new transfer pricing guidance, the risks shall be allocated between the associated enterprises taking into account the concepts of control over risk and financial capacity to assume the risk. In this regard, it is important to provide a definition of risk management as stated in the new OECD guidance:

> [r]isk management comprises three elements: (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function, (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function, and (iii) the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.[26]

The control over risk concept comprises the first two elements of the risk management definition. As per the new OECD guidance, the risk is allocated to the associated enterprise exercising the control over the risk and having the financial capacity to assume the risk. The associated enterprise will meet the requirement of control over risk where it can make a decision to take on or decline the risk bearing opportunity and actually carries out the functions related to such decision. Further, the enterprise is also capable to decide whether or not to respond to the risks and actually carries out those functions. As regards the day-to-day risk mitigation activities, the associated enterprise is permitted to outsource them.[27]

The requirement to have control over the risk and the definition of the latter clarifies that in the post-BEPS world the application of the arm's length principle under article 9 is more dependent on the functions carried out by the associated enterprises. Hence, the MNE groups cannot allocate the risks based on the contractual agreements only. The associated enterprise shall be capable of carrying out risk controlling functions for the risk to be allocated to it, and shall actually carry out these functions. This resembles the approach taken in the AOA. In particular, within the framework of article 7 of the OECD Model, the risks are allocated based on the SPFs carried out through the PE.

Taking into account the above analysis, one could conclude that the discrepancy in the application of the arm's length principle in article 7 and article 9 of the OECD Model is significantly reduced after the the OECD BEPS Project.

In the wake of the follow-up work required by the Final Report of the BEPS Project, whereby the work on "related profit attribution issues" has to be carried out on top of the amendments to the permanent establishment definition, some doubts arise, at least by some member countries, as to whether the

26. Id., at para. 1.61.
27. Id., at para. 1.65.

distinction between the above-mentioned provisions still has some underlying rationale or whether it is better to consider a more radical economic alignment of outcomes. In particular, the 2017 OECD discussion draft on the attribution of profit to permanent establishments (the 2017 AOA Draft)[28] seems, according to the vast majority of commentators, to have casted some doubts on the clear distinction between the two provisions. It is the author's view that, at least conceptually, some differences exist, for a number of reasons.

Firstly, all four examples referred to in the 2017 AOA Draft use the same key wording to describe the framework of profit attribution in paragraphs 25, 30, 34, 48 and 49. The most problematic wording is used in parentheses in step (1), which requires the PE to be attributed "ownership of the assets [of the non-resident company] related to such functions, and assumption of the risks related to such functions." The words "such functions" seem to refer, in the commissionaire example, to the selling of goods to an unrelated party performing the same or similar activities under the same or similar conditions that the intermediary performs. The footnote indicates that the outcome is conceptually equivalent to the amount paid by the PE for the inventory "purchased" from the non-resident and which would correspond to a "dealing" under the AOA. However, the AOA is fairly clear about how to attribute assets and risks within an enterprise. The new draft guidance is far from clear. All the steps referring to profit attribution in the 2017 AOA Draft are to be determined in accordance with article 9 and the OECD Guidelines. Article 9 does determine risk assumption, and so that part of step (1) which attributes assumption of risks seems to be governed by the OECD Guidelines. Does this mean that the attribution of risks to the PE under step 1 is not automatic, but needs to be determined by principles analogous to the risk control framework in Chapter I? Such an approach makes sense, but if that is what the draft intends, then it could have been expressed more clearly.

Step (2) refers to attribution of expenses, but the OECD Guidelines are focussed on arm's length pricing. There can be a significant difference between an allocation of expenses and an arm's length price. The footnote refers to both expenses and a dealing, with a dealing being subject to arm's length pricing. Does the requirement to use article 9 in determining the deduction under step (2) extend to using an arm's length price? The combination of attributing risks under an article 9 control framework and using arm's length pricing for the intra-enterprise dealings will tend to have a big impact on the resulting attribution of profits, and so how article 9 and the OECD Guidelines are intended to apply requires explanation.

In conclusion, it is the author's view that the differences between articles 7 and 9 of the OECD Model are a by-product of the historical evolution (and pressure) received by the arm's length principle in the approach to income allocation for permanent establishments (article 7) vis-à-vis subsidiaries. Whereas initially the arm's length principle was deemed to be the appropriate approach for dealing with both branches and separate entity situations, more recent thinking, namely due to the BEPS outcome, seems to have led articles 7 and 9 to different conclusions. In particular, the treatment of capital under the two sets of provisions seems central to such divergence.

4.1.1. OECD approach versus UN approach

The OECD has always been a major player in devising technically sound transfer pricing policy for governments while being open to listening to the voice of multinationals. On the other hand, the voice of emerging and least developed economies increased dramatically due to the inclusiveness required by a proper implementation of the BEPS Project.

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28. For a reference to the 2017 OECD Public Discussion Draft on Attribution of Profits to Permanent Establishments, *see* http://www.oecd.org/tax/transfer-pricing/beps-discussion-draft-additional-guidance-attribution-of-profits-to-permanent-establishments.pdf.

The above-mentioned phenomenon may explain the increasing input by the United Nations, as well as regional organizations (such as the CIAT for Latin America or CREDAF for Africa) on the transfer pricing discussion and representation of the transfer pricing needs of both emerging and developing economies.

One of the key elements highlighted in the 2017 update of the United Nations Practical Manual on Transfer Pricing Manual for Developing Countries (UN TP Manual) is, as the title suggests, complementing in a practical and coherent manner the principles designed within the framework of the 2017 OECD Guidelines.

In order to better understand how these two living documents are somehow "made for each other", let us look at the analysis on intangibles, which has been one of the major improvements within the UN TP Manual. None of the documents, in particular, any longer refers to the notion of "economic ownership" to elaborate on return attributable to the use or commercial exploitation of intangible property.

To this end, the 2010 version of the OECD Guidelines makes only an implied reference to the notion of "economic ownership" in chapter VI, where, in paragraphs 6.36 to 6.39, a discussion on the "marketing activities undertaken by enterprises not owning trademarks or trade names" [29] takes place. But a clear definition of what economic ownership entails does not arise. In the 2017 update of the OECD Guidelines, reference to economic ownership has been subtly replaced by the introduction of the notion of "DEMPE" analysis, which is relevant for transactions involving intangibles.[30]

On the other hand, the UN TP Manual discusses the return attributable to intangibles when it discusses the concept of marketing intangibles. In particular, the UN TP Manual states[31] that when looking at local marketing activities undertaken by a distributor, it should be determined whether or not the marketing activities of a certain entity (e.g. Distributor X) create a separate intangible distinct from the foreign-owned brand, irrespective of the answer to the first question, whether or not the marketing activities of Distributor X that are in excess of those of comparable uncontrolled distributors should attract a return greater than those comparables. Depending on the facts and circumstances of the case, the broader marketing activities of the distributor may give rise to differing outcomes:

- the activities may lead to the creation of a local marketing intangible but not attract a return greater than the return of otherwise comparable uncontrolled distributors, for instance if the resulting intangible is not unique, despite the expenses incurred being greater than those of comparable uncontrolled distributors;
- the activities may lead to the creation of a local marketing intangible (distinct from the foreign-owned brand) and attract a return greater than the one of otherwise comparable uncontrolled distributors, for instance if the resulting intangible is unique and valuable;
- the activities may not lead to the creation of a local marketing intangible and not attract a return greater than the return of otherwise comparable uncontrolled distributors, for instance if the additional value created is captured by the distributor through anticipated increased sales volumes; and

29. *See* sec. D, ch. VI 2010 OECD Guidelines.
30. *See* para. 6.54 2017 update new TP Guidelines, ch. 6.
31. *See* para. B.5.2.16. new Intangibles Chapter UN TP Manual.

- the activities may not lead to the creation of a local marketing intangible but may attract a return greater than that of otherwise comparable uncontrolled distributors, for instance if the distributor's marketing activities are a valuable contribution to the foreign-owned brand.

In light of the BEPS Project, however, the boundaries between an article 7 and an article 9 approach seems to be narrower as the OECD is taking a more "substantive" or economic stance in the approach to transfer pricing issues, as further elaborated below.

In this respect, these changes to the OECD Guidelines state how to determine the appropriate return connected with funding activities in developing intangible property. The Final Report on Actions 8-10 stipulates that when assessing the appropriate return to funding in such circumstances, it should be recognized that in arm's length transactions a party that provides funding, but does not control the risks or perform other functions associated with the funded activity, generally does not receive returns equivalent to those received by an otherwise similarly situated investor who also performs and controls *important functions* and bears and controls *important risks* associated with the funded activity. In this context, the "importance" of functions performed and risks assumed relate to the need of carrying out a thorough functional analysis in order to determine an arm's length remuneration, but it should not be confused with the notion of SPFs that serve the different purpose of hypothesizing the PE as a separate legal entity.

It is worth noting that the OECD has proposed revisions to portions of chapters I, II, VI and VIII of the OECD Guidelines under the Final Report on Actions 8-10.

The Final Report on Actions 8-10 provides the following special measures with respect to the intangible property:

- providing tax administrations with authority in appropriate instances to apply rules based on actual results to price transfers of hard-to-value intangibles and potentially other assets;
- limiting the return to entities whose activities are limited to providing funding for the development of the intangibles (so-called "cash box" entities), and potentially other activities, e.g. by treating such entities as lenders rather than equity investors under certain circumstances; and
- requiring contingent payment terms for certain transfers of hard-to-value intangibles.

> When an MNE enters a new market with its product or expands market share of its product in an existing market through its subsidiary, questions of the creation of marketing intangibles and increases in the value of product-related intangibles such as trade-marks, trade names, etc. follow closely behind. Therefore, it is important to examine and follow the process of creation of intangibles in a market, as well as the legal ownership of such intangibles and the right to share in the return from such intangibles (the notion which some countries refer to as "economic ownership"). It is recognized that market research; designing or planning products suitable to market needs, advertising, marketing and sales promotion strategies; after-sale services and networks of dealers and sales/commission agents may contribute to the creation of marketing intangibles depending on the facts and circumstances of each case.

To this end, it is worth mentioning here that another area where the OECD and the United Nations are pursuing two different approaches related to the notion of (i) location savings (defined now by the

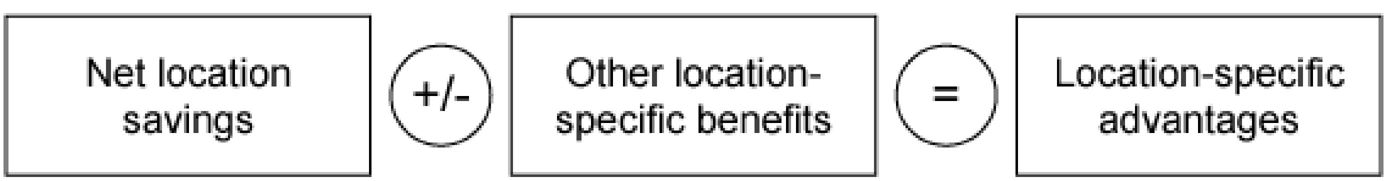
OECD in the newly introduced section D.6 of chapter I of the OECD Guidelines, as part of the action 8 deliverable in the context of the intangibles project) and the definition of "location rents" and "location specific advantages" discussed in the UN TP Manual.

With respect to the former, the OECD made clear in the 2015 update of the Guidelines that location savings, group synergies, other market features and assembled workforce are *not* intangibles, but have to be treated as comparability factors.[32]

As regards the latter, the UN TP Manual adopts an economic approach in defining location savings, by stating that such a concept arises when relocating certain functions (e.g. manufacturing) from a high-cost to a low-cost environment as the difference between input cost (e.g. labour cost) in a specific location, compared to an alternative location or locations.

The UN TP Manual further elaborates on the definition by stating a notion of "location specific advantages" (LSAs). To this end, paragraphs B.2.3.2.53 and B.2.3.2.54. state the following:

> B.2.3.2.53. Location-specific advantages and location savings are defined as a type of benefit related to geographical location. The relocation of a business may in addition to location savings give some other location-specific advantages (LSAs). These LSAs could be, depending on the circumstances of the case:
>
> - Highly specialized skilled manpower and knowledge;
> - Proximity to growing local/regional market;
> - Large customer base with increased spending capacity;
> - Advanced infrastructure (e.g. information/communication networks, distribution system); or
> - Market premium.
>
> Taken together, location savings and each of the other types of benefit related to geographical location are called location-specific advantages (LSAs). LSAs may play a very important role both in increasing the profitability of the MNE and in determining the bargaining power of each of the associated enterprises. It should be noted that the term LSA includes sources of value that are discussed elsewhere in the Manual, and should not be double-counted in assessing arm's length outcomes.
>
> LSAs can be measured as follows:



> B.2.3.2.54. The incremental profit, if any, derived from the exploitation of LSAs is known as "location rent". Thus, the term "location savings" represents "cost savings" whereas "location rent" represents

32. *See* new paras. 1.139-1.163, ch. I 2015 update OECD Guidelines.

the incremental profits derived from LSAs. The value of “location rent” is at most equal to, or less than, the value of LSAs.

As a result, a number of developing economies tend to acknowledge the extra premium associated with the existence of LSAs within a jurisdiction, approaching it as an intangible and *not* a comparability factor.

For instance, in chapter X of the UN TP Manual (referring to the country transfer pricing experiences of Brazil, China, India and South Africa), it is interesting to underline the approach of the Chinese tax administration with respect to LSAs. In particular, chapter X (*see* China chapter, section 10.3.3.1.) stipulates that, “LSAs are advantages for production arising from assets, resource endowments, government industry policies and incentives, etc., which exist in specific localities.”

Moreover, the same chapter outlines in paragraph D.2.4.4.5. that “in dealings” with Chinese taxpayers, the Chinese tax administration has adopted a four-step approach on the issue of LSAs:

- identify if an LSA exists;
- determine whether the LSA generates additional profit;
- quantify and measure the additional profits arising from the LSA; and
- determine the transfer pricing method to allocate the profits arising from the LSA.

Let us analyse in the table below how the approach to LSAs works according to the approach of the Chinese tax administration.

	Steps	**Calculations**
1.	Calculate the arm’s length range of FCMUs based on foreign comparables, mostly in developed countries	Assume the median FCMU is 8% FCMU= full cost markup
2.	Calculate the difference between the cost base of the Chinese taxpayer (e.g. 100) and the average cost base of the foreign companies (e.g. 150)	150 – 100 = 50
3.	Multiply the arm’s length FCMU (e.g. 8% by the difference in the cost bases (50))	0.08 x 50 = 4
4.	The resulting profit is the additional profit (i.e. 4) attributable to China for location savings	4
5.	Determine the total arm’s length profit for the Chinese taxpayer	4 + 0.08 x 100 = 12
6.	Determine the adjusted arm’s length FCMU for the Chinese taxpayer	12/100 = 12%

In analysing the above chart, it is assumed that the Chinese taxpayer's cost base was 100, the average cost base for the company's R&D centres in developed countries was 150 and the median FCMU of the comparables was 8%. The comparison of the cost base between the Chinese taxpayer and that of the foreign companies is measured on an equal platform, such as the total costs (labour, raw materials, land and rent, etc.) per unit of output. So, the examples show the situation of a Chinese taxpayer performing contract research and development (R&D) services for an offshore affiliate and the full cost markup (FCMU) as the profit level indicator for a comparable set comprising of foreign companies located in developed countries (and hence incurring higher costs). The subsequent example outlines the steps used to calculate the adjusted FCMU taking into consideration the location savings.

For all the above-mentioned reasons, the provisions of articles 7 and 9 of the OECD and UN Models serve two different purposes, although both Action Item No. 7 on preventing the artificial avoidance of the PE status and especially Action 10 considering the development of special measures for dealing with high-risk transactions might reconsider whether or not the underlying boundaries of the two provisions blurred.

Coming back to the analysis of article 9, the provision is composed of two paragraphs. Article 9(1) provides that the profits made by one enterprise from dealings with an associated enterprise may be increased to the level they would have been if the enterprises had been independent and dealing at arm's length. Article 9(2) then provides for a corresponding adjustment if, as a result, the same profits would be taxable in both states.

From a historical perspective, the exact purpose of article 9(1) is unclear. There is a fundamental issue whether the provision itself authorizes contracting states to make adjustments on an arm's length basis, or whether it merely allows states to enact and apply separate domestic legislation allowing for an arm's length adjustment. To this end, consider two decisions of the German Federal Tax Court (*Bundesfinanzhof*, 12 March 1980 and 21 January 1981) which held that a tax treaty does not provide an independent legal basis for increasing a tax liability. Rather, a tax treaty merely authorizes the legislature of each contracting state to enact legislation allowing such adjustments.

If one takes the view expressed by the noted German jurisprudence, i.e. that article 9(1) does not of itself guarantee the adjustment of profits by associated enterprises, the issue that arises is then what purpose, if any, does article 9(1) fulfil. In answering this question, the majority view seems to converge toward the three following answers:

(1) the paragraph endorses the arm's length principle as the tool which will inform profit adjustment activities between associated enterprises;

(2) article 9(1) provides the necessary link for the international resolution of transfer pricing issues; and

(3) article 9(1) constitutes the legal basis for the functioning of the mechanism of corresponding adjustments as provided for in article 9(2).

Closer consideration of functions (1) and (2) will aid in a better understanding of the relevance of the arm's length principle in selecting the "most appropriate" transfer pricing method and applying the mechanism of transfer pricing adjustments.

The 1979 OECD Report made it absolutely clear that, in the view of the CFA, dealing at "arm's length" was the only approach acceptable under article 9(1) of the OECD Model. In particular, paragraph 3 of the Report stated:

> It is generally acknowledged that, in taxing the profits of an enterprise which engages in transactions with associated enterprises outside the jurisdiction of the relevant taxing authority, the profits should be calculated on the assumption that the prices charged in these transactions are arm's length prices. This is the underlying assumption in article 9(1).

5. Other Approaches for Apportioning Taxable Income to Associated Enterprises

An alternative to determine the transfer price by applying the arm's length principle is the so-called "formulary apportionment" approach, which has been put forward as an alleged better instrument to protect the interest of developing countries. Lately, a number of NGOs have been using the argument of "formulary apportionment" to move away from the alleged difficulties in the application of the arm's length principle.[33] This system takes the consolidated income of the associated entities within a group, or of associated enterprises within one (federal) jurisdiction, as a base.

From a historical standpoint, the system used to apportion corporate profits is probably the most-described apportionment system worldwide. It is used by many as a basis of discussion when contemplating the use of formulary apportionment within the European Community. It is also from the starting point of the unitary taxation systems of certain states that some authors suggested replacing separate accounting in international tax law with worldwide unitary combination. However, it is important to bear in mind that the conditions in the European Community (let alone the worldwide tax arena) for implementing such a system differ substantially from the historical and current situation in the United States.

In the United States, both the federal government and most states levy some form of corporate income tax. Whereas the states always had generally unlimited taxing powers, the federal government was legally only able to introduce the corporation tax after the 16th Amendment was added to the US Constitution in 1913. Today, the federal tax on corporate income accounts for between 10% and 15% of total federal revenues; the top rate is 35%.

From 1972 until 1986, the United States operated a system of revenue sharing, but since then, the main mechanism of interstate redistribution has been a system of federal grants-in-aid for specific services rendered by the states, which amounted to 17% of state and local government revenues in 1989.

None of the US states applies separate accounting for determining the corporate profits earned within their jurisdiction. They use formulary apportionment as a protection against profit shifting between the states because they presumably would not be able to administer transfer pricing satisfactorily and because the federal practice of transfer pricing is perceived as not being very successful.

33. *See* e.g. the TJN Statement on Transfer Pricing, available at: http://taxjustice.blogspot.de/2012/03/tjn-statement-on-transfer-pricing.html, published 21 Mar. 2012.

The formulaic allocation of a tax base seems to have been first used in the 1870s in the context of property taxation. Some states derived the value of the railway network located within their jurisdiction by multiplying the value of the whole interstate network of the railway taxpayer by the fraction of track mileage located within the state. This practice was based on the “unit rule”, which implied that the property of an enterprise that is located in several states could be valued as a unit and each state could tax a fair portion of that aggregate value. Later extending this rule to cases in which property was not connected physically across state borders, the states and the Supreme Court justified it with the reasoning that the “unity of use and management” of property warranted taking into account property located in other states in the valuation of in-state property, as it was not the separate assets in each jurisdiction but the property of the business as a whole that produced returns.

As regards income taxes, the diverse practice of formulary apportionment by the states developed in the context of broad general constitutional restrictions on the states’ taxing powers and the self-restraint of Congress, which has power under the Commerce Clause of the US Constitution to legislate on the state taxation of businesses and require the states to apply uniform rules on tax base division, but has rarely done so. The only significant exception is Public Law 86-272 preventing taxation of taxpayers whose only activity in a state is solicitation for the sale of tangible products.

State cooperation also did not lead to a uniform apportionment system. As early as 1922, a Committee of the National Tax Association proposed applying a common formula, but without success. In 1957, the National Conference of Commissioners on Uniform State Laws drafted the Uniform Division of Income for Tax Purposes Act (UDITPA), a model statute that lays down rules for the division of the corporation tax base but does not deal with the composition of that tax base, corporate groups or with administrative cooperation. About half of the states levying a corporation tax roughly follow the UDITPA proposals, but sometimes with substantial departures. In 1967, the states agreed upon the Multistate Tax Compact, which established the Multistate Tax Commission (MTC) as a forum for cooperation. As of January 2009, 19 states and the District of Columbia are members of the Multistate Compact, and 28 other states additionally participate in some form in the Multistate Tax Commission.

From a technical standpoint, three factors are usually selected for applying the formula, namely (i) joint sales, (ii) the joint value of assets and (iii) joint payroll. Before adding up these factors, a certain weight may be given to individual factors, e.g. for a capital-intensive group, a factor of two may be given to the value of assets. Next, the same factors are taken for the entity of which the taxable income must be calculated. The resulting fraction is applied to the consolidated income, producing the taxable income of the entity concerned.

Example 1

	Worldwide profit	1,000,000		
	Worldwide sales	20,000,000		
	Value of worldwide assets	2,000,000		25,000,000
	Worldwide payroll	3,000,000		
	Profit of Company A in Country A?			
	Sales A	4,000,000		
	Value of assets A	200,000		5,000,000

	Payroll A	800,000		
	Profit of Company A is 20% of worldwide profit of 1,000,000 = 200,000			

Traditionally, this system has been optional under the tax laws of many countries for establishing the taxable income of a PE as a fraction of the income of the enterprise of which it is part. As a secondary method to the separate entity approach, it is still included in article 7(4) of the OECD Model.

In federal countries, such as Canada, Switzerland and, as seen earlier, the United States, formulary apportionment is used to apportion taxable income of associated enterprises among the members of the federation for provincial, cantonal and state tax purposes, respectively. Some US states, including California, apply formulary apportionment on a worldwide basis, rather than only within the United States (unitary taxation). California levies a corporate franchise tax, using worldwide combined reporting as a basis for taxing foreign MNEs active in that state (*see* above example). Foreign MNEs have challenged this system since the late 1970s. Arguments against unitary taxation have included that it is unconstitutional, it taxes profits not earned in that state and it results in double taxation. However, the US Supreme Court held in June 1994 that unitary taxation was not unconstitutional and did not expose foreign multinationals to constitutionally intolerable levels of multiple taxation. [34]

Although the OECD rejects worldwide (global) formulary apportionment as an alternative to arm's length transfer pricing, [35] several scholars prefer formulary apportionment, asserting that it would overcome the shortcomings of the arm's length principle, particularly in the type of related-party transactions where comparables are very unlikely to be found (e.g. intra-group transactions with a high level of integration or intra-group transactions involving the transfer or license of intangible property). [36]

In the 2010 revision of chapters I-III of the OECD Guidelines, Working Party No. 6 strongly expressed a bias against recourse to a formulary apportionment methodology for a number of reasons. In particular, in paragraphs 1.21 to 1.32, the OECD member countries have stated that global formulary apportionment is not a realistic alternative to the arm's length principle and this assertion stems from the following major reasons:

- the most significant concern is the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation. In this regard, there would have to be common agreement on the predetermined formulas to be used, and this has already been a task difficult to overcome at the European Union level in the context of the project on the common corporate consolidated tax base (CCCTB), which is proceeding slowly because of difficulties in finding common agreements on the formulas;
- the transition to global formulary apportionment would present enormous political and administrative complexity, and would require a level of international cooperation that is unrealistic to expect in the field of international taxation; and

34. *Barclays Bank PLC v. Franchise Tax Bd. of California*, 512 US 298 (1994).
35. OECD Guidelines 1995 paras. 3.58-3.74.
36. E.g. S.I. Langbein, *The Unitary Method and the Myth of Arm's Length*, Tax Notes 625 (1986); W. Hellerstein, *The Case for Formulary Apportionment*, 12 Intl. Transfer Pricing J. 3, p. 103 (2005), Journals IBFD; R. Bird, *Shaping a New International Tax Order*, 42 Bull. Intl. Fiscal Docn. 7 (1988), Journals IBFD. *See also* J. Martens Weiner, *The European Union and Formula Apportionment: Caveat Emptor*, 41 Eur. Taxn. 10, p. 380 (2001), Journals IBFD.

- systems based on formulas present a major obstacle, i.e. they are arbitrary and disregard market conditions, the particular circumstances of the individual enterprises and the management's own allocation of resources, thus producing an allocation of profits that may bear no sound relationship to the specific facts surrounding the transaction.

In the European Union, formulary apportionment is on the agenda because of European Commission proposals concerning the CCCTB project for groups active in more than one Member State. A similar project is arising with the so-called "home state taxation" system; the latter is meant for small and medium-sized enterprises active in more than one Member State. [37] Reference can be made to chapter 4, EU Policy Framework, in Transfer Pricing and Business Restructuring section 1.2.

6. Transfer Pricing in the 21st Century: A New Approach to the Arm's Length Principle? The OECD BEPS Project and Its Impact on the Current Transfer Pricing Regulatory Framework

Against the above background, it must be pointed out that transfer pricing exists due to the very fact that transactions between associated enterprises occur and they need to be priced, irrespective of the differences in effective tax rates amongst the jurisdictions involved. Hence, the arm's length principle in its application is neutral, i.e. it applies following the same mechanics in well-developed, transitioning or developing countries. This implies that, depending on the domestic tax provisions eventually applicable, transfer pricing rules can also be applied to counter artificial profit-shifting transactions carried out by associated enterprises. A startling example in this respect is the recent focus on the tax planning activities – including the transfer pricing policies – implemented by corporate moguls such as Amazon, Google and Starbucks, which fell under the spotlight of the UK HMRC. [38] Most notably, public interest over the structuring of intercompany transactions was sparked even earlier, when the United States published, in November 2007, a report to the Congress titled, Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties. [39] This report focused first on areas of improvement such as the rules for cost sharing arrangements, intercompany services, marketing intangibles and global financial dealings. After an initial study focusing on the overall structure of the US domestic transfer pricing provisions, in 2010 and September 2012, respectively, the US tax administration began a closer investigation on the planning policies – including transfer pricing – of a number of major US multinationals. In particular, on 20 July 2010, the Staff of the Joint Committee on Taxation submitted to the House Committee on Ways and Means a detailed report titled, Present Law and Background Related to Possible Income Shifting and Transfer Pricing. In this detailed document, the US tax administration selected six US-based multinational corporations to study, in part, on the basis of reports to their shareholders that each of the corporations had an effective (i.e. average) tax rate on worldwide income of less than 25% during at least one multi-year period since 1999. To this end, the report focussed in particular on business restructuring transactions, whereby a realignment of functions and risks between various entities in the supply chain takes place, often accompanied by a reallocation of the profit potential associated with any of those functions, assets and risks. It is apparent that these relocation activities, as further explained below, may well fall within the array of commercial decisions that businesses may take to optimize their activities. However, the report was targeting those purely tax-driven reorganizations that in a number of instances,

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37. J. Martens Weiner & J. Mintz, *An Exploration of Formula Apportionment in the European Union*, 42 Eur. Taxn. 8, p. 346 (2002), Journals IBFD.
38. *See*, in this regard, the report by the UK Public Accounts Committee under the heading *Tax avoidance by multinational companies*, available at: http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/71602.htm, accessed 9 Jan. 2017.
39. The report is available at: https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Earnings-Stripping-Transfer-Pricing-2007.pdf, accessed 9 Jan. 2017.

led to a steep fall in the net profit to be taxed in the United States (hence the reference to possible unacceptable income shifting related to transfer pricing). This way of approaching the application of the transfer pricing rules gained momentum so as to lead, on 20 September 2012, to a hearing on Offshore Profit Shifting and the US Tax Code by the Senate Permanent Subcommittee on Investigations. In his opening statement, Senator Carl Levin, acting as Chairman of the Subcommittee, pointed out that out of the four primary issues that the Subcommittee analysed from its most recent investigations into US MNEs' foreign activities, [40] areas relating to "transfer pricing abuse" were identified, particularly in the licensing and/or selling of intangible property between associated enterprises, some of which were located in low-tax jurisdictions.

In the wake of this new "suspicious approach" towards the potential (mis)-use of transfer pricing rules, in June 2014, the European Commission launched three in-depth investigations into the tax affairs of Apple in Ireland, Starbucks in the Netherlands and Fiat Finance and Trade in Luxembourg.[41] In October 2014, it announced the opening of an in-depth investigation into the corporate tax affairs of Amazon in Luxembourg. In parallel to these formal investigations, the European Commission is continuing a wider inquiry into tax rulings, which covers more member states. It has also announced that it is broadening the scope of an ongoing in-depth investigation opened in October 2013 into Gibraltar's corporate tax regime to cover tax rulings.

Since the June announcements, the European Commission has published a letter to Ireland setting out its preliminary findings in relation to the arrangements with Apple,[42] a letter to Luxembourg in connection with its arrangements with Fiat,[43] and a letter to the Netherlands with regard to the arrangements with Starbucks.[44] These letters give further details of the Commission's reasons for kicking off the investigations and give its preliminary views – in each case that there has been illegal State aid.

In the letter to Ireland, the European Commission said that there were "several inconsistencies" in the way in which transfer pricing rules were applied to Apple that did not appear to comply with the arm's length principle. It cited tax talks between Ireland and Apple in 1990 which it said indicated that quoted profit margins had been "reverse engineered" without economic basis and tied to concerns about local jobs. It said that there was "no indication" that the arrangements could be "considered compatible with the internal market"; particularly given the fact that the agreement lasted 16 years, compared to arrangements in other European countries that typically last for no more than 5 years. On 30 August 2016, the European Commission issued the final conclusion that the tax benefits granted by Ireland to Apple through two tax rulings constituted illegal State aid as it allowed Apple to pay substantially less tax than other businesses on a selected basis. The tax rulings issued by Ireland to Apple allowed the majority profits earned by two Irish incorporated companies of the Apple group (Apple Sales International and Apple Operations Europe) to be attributed to the "head office" of each company which were effectively not subject to any taxation. According to the Commission, such attribution did not correspond to economic reality, as the "head office" had no operating capacity to handle or manage any substantive business. The arrangement resulted in an effective corporate income tax rate of 1% that the two Irish companies were subject to in 2003, which decreased to 0.005% on 2014. In order to remove the distortion of competition generated by the illegal State aid, Ireland shall recover from

40. The other three areas were: (i) subpart F using check-the-box and CFC legislation; (ii) repatriation techniques to avoid US taxes; and (iii) manipulating earnings through Accounting Principles Board (APB) 23.
41. *See* the European Commission Press Release at http://europa.eu/rapid/press-release_IP-14-1105_en.htm.
42. *See* http://ec.europa.eu/competition/state_aid/cases/253200/253200_1582634_87_2.pdf, accessed 9 Jan. 2017.
43. *See* http://ec.europa.eu/competition/state_aid/cases/253203/253203_1590108_107_2.pdf, accessed 15 Jan. 2018.
44. *See* http://ec.europa.eu/competition/state_aid/cases/253201/253201_1596706_60_2.pdf, accessed 15 Jan. 2018.

Apple the unpaid tax for a 10-year period preceding the Commission's first request for information in this matter – i.e. from 2003 until 2013 – which amounts to up to EUR 13 billion plus interest.[45]

The Fiat investigation relates to a decision in 2012 by Luxembourg to approve a transfer pricing arrangement by Fiat Finance and Trade (Fiat Luxembourg), which lends money to other Fiat companies. The Luxembourg authorities signed a 5-year agreement with Fiat Luxembourg, which resulted in it paying a 10% tax rate on around EUR 2.542 million compared with the standard rate of 28.8%. On 21 October 2015,[46] the European Commission concluded that the ruling given by Luxembourg to Fiat Luxembourg constituted illegal State aid as it substantially and artificially lowered the company's tax burden by applying extremely complex methodology that did not reflect economic reality. More specifically, the capital base used in calculating the taxable amount of the company was much lower than the company's actual capital and the remuneration on capital was also much lower than market rates. The decision obliges Luxembourg to recover the unpaid tax from Fiat Luxembourg by applying the methodology set out by the European Commission and the amount is around EUR 20-30 million. The European Commission released the final conclusion in relation to Starbucks at the same day, concluding that the individual ruling issued by the Dutch tax authorities on the calculation of the taxable basis in the Netherlands for manufacturing activities of Starbucks Manufacturing EMEA BV constituted illegal State aid. Both of these two cases have been appealed before the European Court of Justice, which are still pending.

The Commission's investigations follow widespread public debate in some EU Member States about tax avoidance by certain multinational companies. Fighting tax evasion has also been made a priority for Margrethe Vestager, the competition commissioner of the European Commission.

Although the European Commission does not have direct authority over national direct tax systems, it can investigate whether certain advantageous fiscal regimes would constitute "unjustifiable State aid" to companies. It has been investigating certain tax practices in several Member States following media reports alleging that some companies have received what it described as "significant tax reductions" by way of "tax rulings" issued by national tax authorities. Tax rulings are used in particular to confirm transfer pricing arrangements.[47] The Commission's State aid investigations into transfer pricing rulings did not end with the cases of Apple, Fiat and Starbucks, as it continued opening new investigations into the tax rulings issued by Member States, e.g. the European Commission initiated investigations into the tax rulings given by Luxembourg to Amazon[48] and McDonald's[49] in October 2014 and December 2015 respectively. The European Commission concluded in October 2017 that Luxembourg gave illegal tax benefits to Amazon worth around EUR 250 million. On 7 June 2016, the European Commission released the non-confidential version of its decision to investigate whether a tax ruling granted by the Luxembourg tax authorities to Luxembourg subsidiaries of the McDonalds group entailed State aid. Based on the above, it became apparent that international tax rules in general, and transfer pricing provisions in particular, are subjected to a heightened scrutiny due to the exploitation schemes that large MNEs may have put in place to divert profits towards low- or no-tax jurisdictions. Arguably, many of the principles

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45. *See* Commission decision of 30 Aug. 2016 on State aid, SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP), implemented by Ireland to Apple, press release of the European Commission of 30 Aug. 2016, http://europa.eu/rapid/press-release_IP-16-2923_en.htm, accessed 15 Jan. 2018.
46. *See* Commission decision of 21 Oct. 2015 on State aid SA.38375 (2014/C ex 2014/NN) which Luxembourg granted to Fiat, available at http://ec.europa.eu/competition/state_aid/cases/253203/253203_1757564_318_2.pdf, accessed 13 Jan. 2018.
47. To this end, the European Commission expressly stated that: "Tax rulings as such are not problematic. They are comfort letters by tax authorities giving specific company clarity on how its corporate tax will be calculated or on the use of special tax provisions. However, tax rulings may involve State aid within the meaning of EU rules if they are used to provide selective advantages to a specific company or group of companies."
48. *See* http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38944, accessed 13 Jan. 2018.
49. *See* http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38945, accessed 15 Jan. 2018.

currently applied were first designed over a century ago and have failed to keep up with globalization and technological change. Today, they have begun to reveal loopholes that legally allow companies to record profits, and consequently their taxes, in lower-tax jurisdictions than where their businesses are actually run. Accordingly, the profit-shifting phenomenon has eroded sovereign tax bases and weakened the hand of already struggling public authorities. It must be noted that businesses have an obligation to maximize profits for their shareholders, so the burden of action falls on governments to fix their tax systems and work together to forge a global approach that reflects today's financial world. At the request of G20 finance ministers, the OECD produced its 15-point Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan),[50] in July 2013 that will help ensure that multinationals pay their fair share of taxes (*see* the OECD report, Addressing Base Erosion and Profit Shifting, published on 12 February 2013,[51] and the Action Plan on Base Erosion and Profit Shifting, published on 19 July 2013).[52]

During the G20 meeting held in Australia in September 2014, the OECD submitted its first batch of deliverables (hereinafter referred to as the "2014 deliverables"). On 5 October 2015[53], the second package of BEPS reports was released (the so-called "2015 deliverables"). Since then, the OECD has continued to update some of the BEPS Action Plans, i.e. Actions 2, 4, 5, 6, 7, 8-10, 13, 14, and 15, either to provide further theoretical interpretation or to issue practical guidance for implementation. This chapter will only deal with Actions 1, 4, 5, 7, 8-10, 13 and 14.

The 2015 deliverables as supplemented by any later developments include work to develop recommendations on the following areas:

Action 1: to complete the rules to combat BEPS with regard to the digital economy, especially rules developed in other Action Plans in the 2015 deliverables, including Action 7 concerning the exceptions to the definition of permanent establishment, Action 8-10 concerning the alignment of transfer pricing outcomes with value creation and Action 3 concerning CFC rules.

Action 4: regarding rules that limit base erosion via interest deductions and other financial payments. A discussion draft has been issued in July 2016 particularly dealing with BEPS issues involving interest in banking and insurance sectors.[54]

Action 5: to continue work on preventing harmful tax practices, with a specific focus on preferential intellectual property regimes. More guidance has also been provided with regard to transparency rules in the area of preferential regimes, for which purpose an OECD-standardized IT-format for the exchange of tax rulings between jurisdictions has been published in July 2016.

Action 7: on preventing the artificial avoidance of PE status. This is an issue of particular importance for developing and emerging economies. The further issue of attribution of profits to PEs under the new PE definition has been addressed in a discussion draft released in July 2016.

Actions 8-10: on ensuring that outcomes from transfer pricing rules are in line with value creation, relating to intangibles, risks and capital and other high-risk transactions. New guidance has been released on applying the CUP method to commodities transactions, special issues on low-value-adding intra-group services and cost contribution arrangements; lately, the rules on how to apply the

50. OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, http://www.oecd.org/ctp/BEPSActionPlan.pdf.
51. OECD (2013), *Addressing Base Erosion and Profit Shifting,* OECD Publishing, http://www.oecd.org/ctp/BEPSActionPlan.pdf.
52. OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, http://www.oecd.org/ctp/BEPSActionPlan.pdf.
53. *See* http://www.oecd.org/ctp/beps/oecd-presents-outputs-of-oecd-g20-beps-project-for-discussion-at-g20-finance-ministers-meeting.htm, accessed 9 Jan. 2017.
54. *See* http://www.oecd.org/tax/aggressive/discussion-draft-beps-action-4-banking-and-insurance-sector.pdf, accessed 9 Jan. 2017.

transactional profit split method have also been contemplated in a discussion draft published in July 2016.

Action 13: more guidance on the country-by-country (CbC) reporting, especially concerning the protection of confidential information and the need for making the information available on a timely basis. The OECD has also issued practical guidance on the implementation of the CbC report, including a User Guide for the OECD's standardized electronic format for the exchange of CbC reports between jurisdictions, published in March 2016, and practical guidance, published in June 2016, on the issue of how to apply the implementation package.

Action 14: on enhancing the effectiveness of dispute resolution mechanisms among tax administrations. For this purpose, a peer review and monitoring process has begun in October 2016 and the first batch of reviews is expected to be launched by December 2016.

Action 15: on developing a multilateral instrument to modify bilateral tax treaties. The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) will facilitate the implementation of the amendments in the existing bilateral treaties resulting from the OECD BEPS Project.

The actions will be addressed in sections 6.1.-6.6.

Following the release of the BEPS package in October 2015, G20 leaders urged its timely implementation and called on the OECD to develop a more inclusive framework with the involvement of interested non-G20 countries and jurisdictions, including developing economies. In this respect, monitoring implementation and the impact of the different BEPS measures is a key element of the work ahead. Members of the inclusive framework will develop a monitoring process for the four minimum standards, namely Action 5 (harmful tax practices), Action 6 (countering treaty abuse), Action 13 (country-by-country reporting) and Action 14 (making dispute resolution mechanisms more effective), and put in place the review mechanisms for other elements of the BEPS package. The monitoring of the four minimum standards will ensure that all members, as well as jurisdictions of relevance, will comply with the standards in order to ensure a level playing field. Monitoring mechanisms will be developed in order to monitor jurisdictions' compliance with their commitments. These mechanisms will ensure the effectiveness of the filing and dissemination of the country-by-country reports, as provided for by the review of the country-by-country standard by 2020. In regards to review mechanisms, they may differ depending on the Actions and will take into account countries' specific circumstances. All countries and jurisdictions joining the framework will participate in this review process, which allows members to review their own tax systems and to identify and remove elements raising BEPS risks.

The inclusive framework will also support the development of the toolkits for low-capacity developing countries. The G20 Development Working Group (G20 DWG) has requested the IMF, the OECD, the UN and the World Bank Group to work together on the development of toolkits and guidance to support low-capacity developing countries to address BEPS issues. The toolkits are being prepared to help developing countries implement measures to tackle BEPS as well as other issues that they have identified as priorities during the regional consultations. The inclusive framework will allow members to add their views to the toolkit work, and likewise the toolkit work might impact the remaining BEPS standard-setting work. The involvement of the international organizations as observers in the inclusive framework will facilitate their collaboration. It will offer participants the opportunity to receive coordinated and targeted capacity building support in the implementation of the BEPS outcomes.

6.1. 2015 BEPS deliverables – Action 1: Addressing the tax challenges of the digital economy

The first Action item of the BEPS Action Plan required the creation of a dedicated Task Force that analysed issues raised by the digital economy and possible actions to address them. The outcome of the work has been an intermediate Report released in September 2014,[55] where the Task Force mandated Working Party No. 1 (Tax Treaties) and Working Party No. 6 (Taxation of Multinational Enterprises) to discuss some of the key features of enterprises operating in the world of the digital economy. The Task Force's focus was on a thorough analysis of the different business models, the ever-changing business landscape and a better understanding of the generation of value in this sector, including from an indirect tax point of view.

This means that the goals of the Task Force in the 2014 Report have been threefold:

- to develop detailed options to address problems rather than proposing a recommendation for implementation;
- to review the main difficulties in a holistic manner, i.e. by considering both direct and indirect taxation issues; and
- to require a thorough analysis of the various business models in the sector.

The digitization of the economy refers to the increasing use of digital technology by modern businesses as a key element in their value creation process and business models. A feature of the digital business model is the mobility of such factors and actors as capital, product, supply chain and customer. This mobility creates an immediate challenge for tax systems that were designed around fixed locations and within borders. As the international community seeks to address the challenges that the digitization of the global economy presents to the existing international tax structure, a principled framework will be essential in working through these challenges. A key task is to identify those principles that will effectively form the basis of this framework. However, it should be noted that the fundamental principles of taxation still work reasonably well in allocating taxing rights to the non-digital aspects of the economy. Therefore, the challenge is to determine how these existing principles relate to the digital economy, and whether new principles need to be developed in order to ensure that double non-taxation does not occur. Indeed, one of the main challenges currently faced by the task force is to properly factor in what is meant by e-commerce or digital economy. In fact, most media attention, both specialized and mainstream, has focused on the tax affairs of large corporate moguls such as Apple, Google, Amazon and Facebook. [56] However, a number of companies active in a number of different industries (e.g. Zara, BMW, Volvo) make use of digital services.

On 5 October 2015, a Final Report was issued[57] which, in addition to the above, provides evaluation results to the options put forward in the 2014 Report and recommends only those adopted in other

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55. OECD (2014), *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, http://www.oecd-ilibrary.org/docserver/download/2314251e.pdf?expires=1450784333&id=id&accname=guest&checksum=FE29FE2914C082B7CCE2BC0E04E6DA61.
56. *See How Apple Sidesteps Billions in Taxes*, available at http://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html?pagewanted=all&_r=0. For more reference on Apple, *see also* www.hsgac.senate.gov/subcommittees/investigations/media/subcommittee-to-examine-offshore-profit-shifting-and-tax-avoidance-by-apple-inc; on Microsoft: http://www.hsgac.senate.gov/subcommittees/investigations/media/subcommittee-hearing-to-examine_billions-of-dollars-in-us-tax-avoidance-by-multinational-corporations-; on Amazon, Google and Starbucks: www.theguardian.com/business/2012/nov/12/amazon-google-starbucks-diverting-uk-profits.
57. *Addressing the Tax Challenges of the Digital Economy – Action 1 Final Report* , OECD/G20 Base Erosion and Profit Shifting Project OECD 2015), International Organizations' Documentation IBFD.

Action items of the BEPS Project, namely Action 7 concerning preventing artificial avoidance of PE status, Actions 8-10 concerning aligning transfer pricing outcomes with value creation and Action 3 concerning effective CFC rules.

On the basis of the above, it is useful to summarize the key findings of the 2014 interim Report and 2015 Final Report.

From a general standpoint, it was highlighted in the two reports that because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. Attempting to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is digital and what is not. As a result, the tax challenges and BEPS concerns raised by the digital economy are better identified and addressed by analysing existing structures adopted by MNEs together with new business models and by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges or BEPS concerns. Although many digital economy business models have parallels in traditional business, modern advances in ICT have made it possible to conduct many types of business at substantially greater scale and over longer distances than was previously possible. These include several varieties of e-commerce, online payment services, app stores, online advertising, cloud computing, participative networked platforms and high-speed trading.

From a purely transfer pricing standpoint, the digital economy and its business models present some key features that are potentially relevant from a tax perspective. These features include mobility, with respect to:

- the intangibles on which the digital economy relies heavily;
- users; and
- business functions; reliance on data, the massive use of which has been facilitated by an increase in computing power and storage capacity and a decrease in data storage cost; network effects, which refer to the fact that decisions of users may have a direct impact on the benefit received by other users; the spread of multi-sided business models, in which multiple distinct groups of persons interact through an intermediary or platform, and the decisions of each group of persons affects the outcome for the other groups of persons through a positive or negative externality; tendency toward monopoly or oligopoly in certain business models relying heavily on network effects; and volatility due to lower barriers to entry into markets and rapidly evolving technology, as well as the speed with which customers can choose to adopt new products and services at the expense of older ones.

The digital economy has also accelerated and changed the spread of global value chains in which MNEs integrate their worldwide operations. In the past, it was common for an MNE group to establish a subsidiary in each country in which it did business to manage the group's business in that country. This structure was dictated by a number of factors, including slow communications, currency exchange rules, customs duties and relatively high transportation costs that made integrated global supply chains difficult to operate. Advances in ICT, reductions in many currency and custom barriers, and the move to digital products and a service-based economy, however, combined to break down barriers to integration, allowing MNE groups to operate much more as global firms. This integration has made it easier for business to adopt global business models that centralize functions at a regional or global level, rather than at a country-by-country level.

Even for SMEs, it has now become possible to be “micro-multinationals” that operate and have personnel in multiple countries and continents. ICT technologies have been instrumental in this major trend, which was further exacerbated by the fact that many of the major digital companies are young and were designed from the beginning to operate on an integrated basis at a global scale.

As a result of the above, the Task Force highlighted that while the digital economy does not generate unique BEPS issues, some of its key features exacerbate BEPS risks.

In particular, the Task Force discussed a number of tax and legal structures that can be used to implement business models in the digital economy. These structures highlight existing opportunities to achieve BEPS to reduce or eliminate tax in jurisdictions across the whole supply chain, including both market and residence countries. For example, the importance of intangibles in the context of the digital economy, combined with the mobility of intangibles for tax purposes under existing tax rules, generates substantial BEPS opportunities in the area of direct taxes.

Furthermore, the ability to centralize infrastructure at a distance from a market jurisdiction and conduct substantial sales of goods and services into that market from a remote location, combined with increasing ability to conduct substantial activity with minimal use of personnel, generates potential opportunities to achieve BEPS by fragmenting physical operations to avoid taxation.

Some of the key characteristics of the digital economy also exacerbate risks of BEPS in the context of indirect taxation, in particular in relation to businesses that perform VAT-exempt activities (exempt businesses).

Based on the above, the Task Force discussed several potential options in the 2014 interim Report, which were received from a variety of sources, including proposals from country delegates, proposals from stakeholders, discussions at meetings of the Task Force and discussions of other working groups.

In the final 2015 Report, it has been concluded that out of these proposed solutions, only the one of modifying the list of exceptions of PE status should be adopted. The other options analysed by the Task Force to address the broader direct tax challenges, namely (i) the new nexus in the form of a significant economic presence, (ii) the withholding tax on certain types of digital transactions and (iii) the equalization levy, would require substantial changes to key international tax standards and it is unclear at this stage whether these changes are warranted to deal with the changes brought about by the advances in ICT.

The denial of the other three options is also due to the fact that the measures developed in the BEPS Project will have a substantial impact on BEPS issues in the digital economy, that certain BEPS measures will mitigate some aspects of the broader tax challenges in the digital economy and that consumption taxes will be levied effectively in the market country. To this aim, a quick implementation of the BEPS Project, together with a mechanism to monitor its impact in the long run is needed. Nevertheless, countries could introduce any of the options in their domestic law or bilateral tax treaties as additional safeguards against BEPS, provided they respect existing treaty obligations. The conclusion in the 2015 Report may evolve as the digital economy continues to develop. The Task Force will continue to review and analyse the data that will be available along the time, on the basis of which a determination will also be made as to whether further work on the three options that are not adopted currently should be carried out. This future work will be done in consultation with a broad range of stakeholders and on the basis of a detailed mandate to be developed during 2016 in the context of designing an inclusive post-BEPS monitoring process. A report reflecting the outcome of the continued work in relation to the digital economy should be produced by 2020.These potential options and their technical details were discussed and analysed by the Task Force and are outlined below in simplified form.

For the sake of this contribution, only direct tax options triggering a transfer pricing implication will be taken into account.

I. Modifications to the exemptions from permanent establishment status

One potential option discussed by the Task Force would modify the exceptions contained in article 5(4) of the OECD Model. As the economy has evolved, some of the activities described in paragraph 4(a) through (d) that were previously preparatory or auxiliary in the context of conventional business models (such as sales through a storefront) may have become core functions of certain businesses. Where the exceptions to the permanent establishment definition contained in paragraph 4 no longer serve their intended purpose as a result of that evolution, they should not be available. Several variations of this potential option could be considered. One possible option would be to eliminate paragraph 4 entirely. Other possible options would be to eliminate subparagraphs (a) through (d), or make their availability subject to the condition that the character of the activity conducted be preparatory or auxiliary in nature, rather than one of the core activities of the enterprise in question. Another would eliminate the word “delivery” in article 5(4)(a) and (b) in order to exclude from these subparagraphs certain types of warehouses. The 2015 Final Report incorporated the result in the 2015 Action 7 report, adopting the approach that requires each of the exceptions under article 5(4) to be restricted to activities that are otherwise of a “preparatory or auxiliary” character. In addition, a new anti-fragmentation rule was introduced to ensure that it is not possible to benefit from these exceptions through the fragmentation of business activities among closely related enterprises.

II. A new nexus based on significant digital presence

Another potential option discussed by the Task Force in the 2014 Report focuses on establishing an alternative nexus to address situations in which certain business activities are conducted wholly digitally. Under such a proposal, an enterprise engaged in certain “fully dematerialised digital activities” could be deemed to have a taxable presence in another country if it maintained a “significant digital presence” in the economy of that country. Focusing on “fully dematerialised digital activities” is intended to target only those businesses that require minimal physical elements in the market jurisdiction for the performance of their core activities, regardless of the fact that physical elements (such as offices, buildings or personnel) may be present in the market jurisdiction to conduct secondary functions.

Potential elements of a test for when a “fully dematerialised digital activity” was conducted could include the following:

- the core business of the enterprise relies completely or in a considerable part on digital goods or digital services;
- no physical elements or activities are involved in the actual creation of the goods or services and their delivery other than the existence, use or maintenance of servers and websites or other IT tools and the collection, processing and commercialization of location-relevant data;
- contracts are generally concluded remotely via the Internet or by telephone;
- payments are made solely through credit cards or other means of electronic payments using online forms or platforms linked or integrated to the relative websites;

- websites are the only means used to enter into a relationship with the enterprise; no physical stores or agencies exist for the performance of the core activities other than offices located in the parent company or operating company countries;
- all or the vast majority of profits are attributable to the provision of digital goods or services;
- the legal or tax residence and physical location of the vendor are disregarded by the customer and do not influence its choices; and
- the actual use of the digital good or the performance of the digital service do not require physical presence or the involvement of a physical product other than the use of a computer, mobile devices or other IT tools.

Under this potential option, to address administrative concerns, businesses performing such "fully dematerialised digital activities" would be deemed to have a PE only if they exceeded certain thresholds that would indicate a substantial ongoing interaction with the economy of the market country. These thresholds could include, for example, measures of total contracts for digital goods and services that are concluded remotely, the active engagement of substantial numbers of users (e.g. the number of active accounts for social platforms, the number of visitors to websites or the number of users of online tools) as well as the overall level of consumption of the digital goods or services of the enterprise in the market country. As regards practicalities, this variation would rely on relevant provisions regarding protection of personal data.

Therefore, for an enterprise engaged in a fully dematerialized business, a significant digital presence could be deemed to exist in a country when, for example:

- a significant number of contracts for the provision of fully dematerialized digital goods or services are remotely signed between the enterprise and a customer that is resident for tax purposes in the country;
- digital goods or services of the enterprise are widely used or consumed in the country;
- substantial payments are made from clients in the country to the enterprise in connection with contractual obligations arising from the provision of digital goods or services as part of the enterprise's core business; or
- an existing branch of the enterprise in the country offers secondary functions such as marketing and consulting functions targeted at clients resident in the country that are strongly related to the core business of the enterprise.

III. Digital tax presence

The Task Force also discussed in the 2014 Report a variation of this potential option to create a new tax nexus for enterprises engaged in "fully dematerialised digital activity" where the entity does a significant business in the country using personal data obtained by regular and systematic monitoring of Internet users in that country, generally through the use of multi-sided business models. This variation was proposed in order to address concerns that the existing tax rules do not adequately address the challenges posed by increased reliance on data and users participation in the digital economy, particularly where users provide personal data that can then be used to attract revenue from other users through multi-sided business models.

IV. Replacing permanent establishment with significant presence

One potential option proposed in public comments at the time when the 2014 Report was released would be to replace the existing PE concept with a "significant presence" test intended to respond to the changing nature of customer relationships in the digital economy while continuing to rely in part on physical presence. The criteria for this test intend to reflect the contribution to value of these closer, more interactive customer relationships.

V. New concept of "significant economic presence" in the 2015 Report

In the 2015 Report, a new concept of "significant economic presence" was put forwarded, which combines the elements of options II, III and IV above. This concept is intended to reflect situations where an enterprise leverages digital technology to participate in the economic life of a country in a regular and sustained manner without having a physical presence in that country. Although the new concept of "significant economic presence" has not been adopted by the 2015 Report, it indicates a potential development in future. It is therefore worthwhile to take a closer look at the concept.

Whether a non-resident enterprise has significant economic presence in a country should be evidenced through certain factors, which include a revenue-based factor, digital factors and user-based factors. Among them, the revenue-based factor is the clearest potential indicator of the existence of a significant economic presence. However, the revenue in isolation is not sufficient to establish nexus. In order to establish nexus in the form of a significant economic presence in the country concerned, the revenue factor should be combined with one or more other factors, with the choice of other factors depending on unique features and economic attributes of each market (e.g. size, local language, currency restrictions and banking system).

- Revenue-based factor: The core element of the revenue factor could be the gross revenues generated from remote transactions concluded with customers in the country concerned. The level of revenue threshold should be set high enough so as to minimize administrative burden for tax administrations as well as compliance burden for taxpayers, while ensuring that nexus is less likely to be established where minimum tax revenue may be collected.
- Digital factors: The 2015 Report lists a range of digital factors based on the current development of the digital economy, including a local domain name, a local digital platform and local payment options.
- User-based factors: There are three types of user-based factors included in the 2015 Report. Firstly, the "monthly active users (MAU)", which refers to the registered users who logged in and visited a company's digital platform in the 30-day period ending on the date of measurement; secondly, the number of contracts concluded online by the habitual resident in the relevant country; and thirdly, the volume of digital data collected by the non-resident enterprise through a digital platform from users and customers habitually resident in the relevant country in a taxable year.

The 2015 Report also provides guidance on how to attribute income to the significant economic presence. In this regard, three potential alternatives are considered.

- Adjustment to existing principles and rules: The Task Force considered several possible adjustments to the existing rules of profit attribution, including allocation of business functions to the significant business presence, treating customers as performing certain functions on behalf of the enterprise and functional analysis with an analysis based on game theory that would allocate profits by analogy with a bargaining process within a joint venture. Since all these methods would require substantial departures from existing standards of profit attribution, the Report did not adopt this catalogue of approaches.

- Methods based on fractional apportionment: This method allows apportioning profit to the significant economic presence by selecting and weighing certain allocation keys. Considering that most of the countries use profit attribution methods rather than fractional apportionment, that application of this method would be a departure of current international standards and will result in different results for physical presence and digital presence. This catalogue was also rejected by the Task Force.
- Modified deemed profit methods: Traditionally, the deemed profits methods have been used, for example, in the insurance industry, by applying a coefficient based on the ratio of profit to gross premiums of resident insurance companies to gross premiums received from policyholders in the source country. The 2015 Report suggests adopting a similar method on the basis of the ratio of presumed expenses to the non-resident enterprise's revenue derived from transactions concluded with in-country customers. The disadvantage of this method is that digital business models may have different expenditure structures compared with traditional business models. It may also lead to tax liability for the non-resident enterprise when there is no actual profit generated by the significant economic presence. The Report suggested making use of a rebuttable presumption that is limited to the situations where taxpayers can demonstrate that they are in a loss-making situation at the end of the fiscal year.

6.1.1. The transfer pricing aspects of the digital economy: A common BEPS structure

This section discusses a common structure that may raise BEPS concerns and also the potential solutions reflected in the 2015 deliverables. Note that such a structure, as submitted in Annex B of the 2015 Report, reflects the observations submitted by many tax administrations and although acceptable from a legal and a tax standpoint, is currently considered to put pressure on the existing international tax and transfer pricing principles governing these intercompany transactions.

Structure concerning online retail activities

Assume that RCo Group is an MNE engaged in the online sale of physical goods and digital products. The websites of the group display the products offered in the markets that they serve in local languages and allow customers to acquire these products online through credit card payments.

Physical products are delivered through independent courier services. Digital products are downloaded from one of RCo Group's websites to the consumer's computer.

RCo Group collects data on customer preferences on the basis of goods purchased, added to a list of "favourites", or browsed by customers. Using sophisticated proprietary software, RCo Group analyses the data it collects in order to make recommendations of goods to its potential customers and provide personalized advertising.

All the intangible property used in operating the RCo Group websites and fulfilling orders is developed by employees of RCo, a company resident in State R. RCo also remotely coordinates the procurement and sale activities of the group to minimize purchasing costs, maintain consistency among the various businesses and websites, improve efficiency of inventory management, and minimize overhead on the payment processing and back office functions. These coordination services are generally provided to regional operating lower-tier sales subsidiaries in return for a management service fee covering related expenses plus a markup.

Rights to existing and future intangibles used in operating the websites serving customers in a region that includes, inter alia, State T and State S (the State T/S region) are held by RCo Regional Holding, a subsidiary resident in State T.

RCo Regional Holding acquired the rights through a cost-sharing arrangement in which it made a “buy in” payment to RCo equal to the value of the existing intangibles and agreed to share the cost of future development (to be performed exclusively by RCo personnel in State R) on the basis of the anticipated future benefit from the use of the technology in the State T/S region.

RCo remains the legal owner of the intangibles from the MNE group and is responsible for functions pertaining to the registration and defence of intellectual property, RCo Regional Holdings only acquires the rights to commercially exploit the IP and not the legal ownership of the intangibles. In practice, RCo Regional Holding does not perform any supervision of the development activities carried out by RCo in State R. RCo Regional Holding acts as an IP manager for the State T/S region and sublicenses the intangibles necessary for its various subsidiaries to operate their various country- or region-targeted websites. RCo Regional Holding also acts as a holding company for all subsidiaries in the State T/S region, although in practice most coordination services continue to be performed at the level of RCo, and RCo Regional Holding’s involvement with the subsidiaries is very limited. RCo Regional Holding has only one employee on its payroll and the premises are limited to an “office hotel” where the company regularly rents different offices for the purpose of organizing board meetings.

Orders from customers in State S, State T and the rest of the State T/S region are handled by a subsidiary of RCo Regional Holding, RCo Regional OpCo, also resident in State T. RCo Regional OpCo is a hybrid entity that is treated as a company for tax purposes under the domestic law of State T and as a transparent entity under the domestic law of State R. RCo Regional OpCo handles the sales, payment processing and settlement and has legal title to the physical and digital products sold on the websites serving customers in the State T/S region. Changes and updates to the websites are done from State T by employees of RCo Regional OpCo, who have overall responsibility for managing the various websites serving customers in the region. These functions are performed with minimal skilled personnel. Other functions related to the online sale activity rely on automated processes conducted by sophisticated Internet-powered software applications regularly upgraded by employees of RCo in State R. Orders and sales are concluded electronically by customers in the State T/S region on the basis of standardized contracts, the terms of which are set by RCo and require no intervention from RCo Regional OpCo. Mirrors of the websites are hosted on servers in a number of countries in the region. RCo Regional OpCo staff very rarely has any contact with customers in the local market jurisdiction.

SCo, a subsidiary of RCo Regional OpCo resident in State S, provides services to RCo Regional OpCo in respect of logistics and after-sales support with respect to orders from customers in State S. Orders for physical goods placed by customers in State S via the website managed by RCo Regional OpCo are generally fulfilled from a warehouse located in State S owned and operated by SCo. Where products are not available in a State S warehouse, the order is generally fulfilled from the closest warehouse to the customer. After-sales support is handled by SCo through a call centre. Orders for digital products placed by State S customers are generally downloaded from servers located in State S or in neighbouring countries, depending on network traffic at the time of the transaction. These servers are owned and operated by third parties through hosting arrangements with RCo Regional OpCo. SCo is remunerated on a cost-plus basis by RCo Regional OpCo.

The manner in which RCo Group's business activity is structured as a legal matter has significant consequences for the group's worldwide tax burden.

Indeed, due to the legally binding contractual arrangements transferring and assigning the intangibles for the State T/S region (and related returns) to RCo Regional Holding and the lack of taxable presence of RCo Regional Holding or RCo Regional OpCo in State S, most of the taxable income generated by the group is concentrated in State T. The 2015 Report on Action 1 does not make any further analysis concerning the tax consequences of this example. Considering the developments in all the Action items in the 2015 deliverables, the following observations can be made:

- CCA between RCo and RCo Regional Holding: As per the updated guidance of chapter VIII of the 2010 OECD Guidelines presented in the 2015 BEPS Report on Actions 8-10, since RCo is not involved in any R&D activities of the intangibles under the CCA (which is what the CCA is established for), nor does it have any supervisory power over the activities carried out by RCo, it can only be entitled to a risk-adjusted remuneration under the CCA, provided that RCo Regional Holding has control over the risk of its funding commitment under the CCA. Whether RCo Regional Holding can share the benefit of exploiting the developed IP depends on whether it has assumed the functions and relevant risks with regard to the development, enhancement, maintenance, protection or exploitation of the intangibles. From the facts of the example above, RCo Regional Holding is hardly performing any of the listed functions and therefore the royalties it receives from RCo Regional OpCo shall be very limited, if any.
- CFC rules in State R: From the perspective of State R, RCo Regional OpCo is a transparent entity and hence the royalties it pays to RCo Regional Holding are not recognized for the CFC legislation purpose in State R. According to the CFC rules suggested in the 2015 BEPS Report on Action 3, State R should design its CFC rules in such a way to include the royalties paid by RCo Regional OpCo to RCo Regional Holding in the CFC income of the latter, as long as such payment is deductible in State T.
- RCo Regional Holding's economic presence in State S: As mentioned above, the 2015 Report on Action 1 does not adopt the new concept of "significant economic presence" as a sourcing rule for the host state, but only adds more restrictive requirements to the exceptions listed in article 5(4). In this specific example, without physical presence in State S, the profit of RCo Regional OpCo is not subject to taxation in State S. However, subject to the 2020 review in this regard, if the threshold of "significant economic presence" were to be adopted in future, RCo Regional OpCo is very likely to have sufficient taxable presence in State S since it has revenue and a server in State S, as well as customers that are habitual residents in State S.

From the analysis above, the developments in the 2015 BEPS Deliverables have already addressed issues of base erosion and profit shifting quite effectively. However, as per the current development under Action 1, not all the issues of the digital economy have been solved. Future developments are expected in this regard.

6.2. 2015 BEPS deliverables – Action 13: Guidance on transfer pricing documentation and country-by-country reporting

Action 13 focuses on the need of reconsidering transfer pricing documentation. While taxpayers are often required to produce voluminous documents regarding their transfer pricing arrangements, the information in many situations does not help tax administrators develop a "big picture" of a taxpayer's global arrangements. This action will result in rules regarding transfer pricing documentation that enhance transparency for tax administrations while taking into account compliance costs for business and will include a requirement that MNEs provide all relevant governments with needed information on their global allocation of income, economic activity and taxes paid on a country-by-country basis.

Action 13 is arguably the most important action point of the BEPS Project as far as transfer pricing issues are concerned.[58] Indeed, the action follows up the work undertaken by the OECD in the area of documentation with the publication of both the White Paper on Transfer Pricing Documentation [59] and the Memorandum on Transfer Pricing Documentation and Country-by-Country Reporting.[60] To this end, documentation is particularly important because (i) it provides relevant information needed to apply the most appropriate transfer pricing methodology to the case under audit (e.g. for the application of the profit split method) and (ii) allows a disclosure of taxes paid and activities actually performed in a certain country.

The increasing relevance of the role of documentation can be explained by the core use that tax administrations make of it, which is to obtain information relevant for risk assessment purposes. From a definitional standpoint,[61] transfer pricing risk assessment is the process of identifying the risk to the tax administration from the taxpayer's transfer pricing arrangements and determining whether the risk is worthwhile by conducting a resource-intensive audit.

Unlike the former version of chapter V of the OECD Guidelines, the new language clearly outlines the threefold objectives of transfer pricing documentation requirements, which may be summarized as follows:

- to ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from such transactions in their tax returns;
- to provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment; and
- to provide tax administrations with useful information to employ in conducting and appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction, although it may be necessary to supplement the documentation with additional information as the audit progresses.

The OECD recommends a three-tiered approach to transfer pricing documentation consisting of[62]:

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58. Such a position has been acknowledged by the current Head of the OECD Transfer Pricing Unit, Joe Andrus, during the OECD 18th Annual Tax Treaty Meeting, 26-27 Sept. 2013.
59. OECD, *White Paper on Transfer Pricing Documentation*, 30 July 2013.
60. OECD, *Memorandum on Transfer Pricing Documentation and Country-by-Country Reporting*, 3 Oct. 2013.
61. *See* para. 14 *OECD Draft Handbook on Transfer Pricing Risk Assessment*, presented during the OECD Global Forum on Transfer Pricing in Mar. 2013.
62. OECD, *Transfer Pricing Documentation and Country-by-Country Reporting – Action 13 Final Report* , OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), International Organizations' Documentation IBFD.

- a Master File, which must contain high-level standardized information relevant for all MNE group members;
- a Local File, referring specifically to material transactions of the local taxpayer; and
- a country-by-country (CbC) report containing certain information relating to the global allocation of the MNE's income and taxes paid together with certain indicators of the location of economic activity within the MNE group.

It is worth noting that the vast majority of OECD countries have opted to characterize the new documentation toolkit as a risk assessment tool, rather than a cluster of relevant information to be used during the course of audit activities. The express bias towards the risk assessment rationale has been justified by the fact that the OECD wanted to avoid the use of the CbC reporting template as a means to carry out unjustified adjustments based on formulaic approaches.

Looking in more depth at the key features of each set of the new three-tiered documentation package, it is worth highlighting the following:[63]

- As to the Master File, such a document will have to provide a high-level description of the organizational structure of the MNE's overall business, providing information on the legal and ownership structure and the geographical location of operating entities. In describing the general features of the MNE's business, the new documentation guidance requires including a description of the so-called "important drivers of business profits", therefore linking the analysis required in the context of the Master File with the undergoing scrutiny that the OECD is placing in Action 10 to clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains. Moreover, the Master File seems to infer the need of already providing to tax administrations a mapping of the MNE's intangibles as defined in the new guidance of chapter VI of the OECD Guidelines and, as regards the MNE's group financial and tax position, a list and brief description of the MNE's existing group unilateral advance pricing agreements (APAs) and other tax rulings relating to the allocation of income among countries. This latter point seems to coincide with the previously mentioned initiative, aimed at achieving a more international tax world in the future wake of the BEPS era, at the European Union level, where the granting of unilateral tax rulings in the area of transfer pricing might relate to potentially fall within the scope of unlawful State aid.
- As regards the Local File, the focus has been on including all the relevant information concerning the so-called "material" category of controlled transactions in which the entity at the local level is involved. Interestingly, the OECD provides a sort of boundary in determining the threshold above which a transaction may be deemed "material", listing (in a non-exhaustive manner) certain types of arrangements, such as e.g. procurement of manufacturing services, purchase of goods, provision of services, loans, financial and performance guarantees and licences of intangibles, together with the context in which such transactions take place. Moreover, the OECD mirrored the information required at the Master File level as to the need of filing, at the local level, a copy of existing unilateral and bilateral/multilateral APAs and other tax rulings to which the local jurisdiction is *not* a party and that are related to the controlled transactions described above.

63. *See* Annexes I, II and III, respectively, new chapter V *OECD Guidelines*, *see* OECD, *Transfer Pricing Documentation and Country-by-Country Reporting – Action 13 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), International Organizations' Documentation IBFD.

- Lastly, as concerns the CbC reporting template, it requires aggregate tax jurisdiction-wide information to be reported by the ultimate parent company in the MNE group relating to the global allocation of the income, taxes paid and accrued as well as to the listing of certain indicators of the location of economic activity among tax jurisdictions in which the MNE group operates. The report also requires a listing of all the constituent entities for which financial information is reported, including the tax jurisdiction of incorporation, where different from the tax jurisdiction of residence, as well as the nature of the main business activities carried out by the constituent entity.

In the Final Report on Action 13 released on 5 October 2015,[64] detailed guidance is given concerning the implementation of the three-tier transfer pricing documentation mechanism, with special regard being given to the implementation of the CbC report. The working group will continue monitoring the implementation by member countries and issue a review report in 2020. Below is the essential clarification and guidance provided in the 2015 Final Report with regard to the implementation of the CbCR:

- Timing of implementation: it is recommended that the first CbC report be required to be filed for MNE fiscal years beginning on or after 1 January 2016, and no later than 31 December 2017. Considering some countries need to modify their domestic laws in order to carry out the country-by-country reporting, the 2015 Report also provides a model legislation to assist an expedite legislation process.
- Special considerations for SMEs: the 2014 interim Report has already confirmed that SMEs are exempted from the CbCR obligation. The 2015 Final Report further specifies that this exemption applies to SMEs with annual consolidated group revenue in the immediately preceding fiscal year of less than EUR 750 million or a near equivalent amount in domestic currency as of January 2015. The exemption for SMEs is considered an appropriate balancing of the reporting burden and the benefit to tax administrations.
- Confidentiality: the 2015 Final Report provides that jurisdictions should have in place and enforce legal protections of the confidentiality of the reported information to an extent at least equivalent to the protections provided under the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, a tax information exchange agreement (TIEA) or a tax treaty that meets the internationally agreed standard of information upon request as reviewed by the Global Forum on Transparency and Exchange of Information for Tax Purposes.
- Constituent Entity: with respect to the CbC reporting template, it is worth noting that one of the most critical issues for its successful implementation will revolve around the definition of what is meant by "constituent entity". To this end, the OECD provided some guidance by adding a definition in the General Instructions for Annex III to chapter V, where it is stipulated that a constituent entity "is any separate unit of the MNE Group (company, corporation, trust, partnership) that is included in the consolidated group for financial reporting purposes." As a result, some tax planning avenues might arise in the event any entity owning valuable assets for the group (e.g. intangibles) fall out of the scope of consolidation for financial reporting purposes. The 2015 Final Report broadens the concept of "constituent entity" and specifies three catalogues of constituent entities: (i) any separate business unit of an MNE group that is included

64. OECD, *Transfer Pricing Documentation and Country-by-Country Reporting – Action 13 Final Report* , OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), International Organizations' Documentation IBFD.

in the consolidated financial statements of the MNE group for financial reporting purposes or would be so included if equity interests in such business unit of the MNE group were traded on a public securities exchange; (ii) any such business unit that is excluded from the MNE group's consolidated financial statements solely on size or materiality grounds and (iii) any PE of any separate business unit of the MNE group included in (i) or (ii) above, provided the business unit prepares a separate financial statement for such PE for financial reporting, regulatory, tax reporting or internal management control purposes. The broader scope of constituent entities reduces the possibility for MNEs to escape the CbCR obligation by using, for example, entities that exercise less material functions or entities that do not have separate personality.

- Implementation of the CbC report in a timely manner: The 2015 Final Report provides a government-to-government approach as a primary mechanism to implement the CbCR, whereby each requiring tax administration will file a request for the CbC report based on the currently existing network of bilateral tax treaties, TIEAs or any new multilateral instrument. In case a jurisdiction fails to provide information because (i) it has not required CbC reporting from the ultimate parent entity of such MNE groups, (ii) no competent authority agreement has been agreed in a timely manner under the current international agreements or (iii) it has been established that there is a failure to exchange the information in practice with a jurisdiction after agreeing with that jurisdiction to do so, a secondary mechanism would be accepted as appropriate through local filing or through filing of the CbC report by a designated member of the MNE group acting in place of the ultimate parent entity and automatic exchange of these reports by its country of tax residence.

So far, the CbC report has been widely implemented around the world. According to the data available up to 21 October 2016, 49 jurisdictions have signed the Multilateral Competent Authority Agreement on the Exchange of CbC Reports, which, by way of article 6 of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, will effectuate the automatic exchange of information with regard to CbC reports among the signatories.[65] Furthermore, there has been uniform implementation of CbC reporting at the level of the European Union carried out by amending the EU Directive on Administrative Cooperation in the field of taxation,[66] which, irrespective of some fierce discussions on whether to make public the information collected under the CbC reporting mechanism, in the end follows the model suggested in the 2015 Report of BEPS Action 13. In addition to the implementation at the multilateral and regional levels, many countries have effectuated the automatic exchange of CbC reports bilaterally, through the exchange of information mechanisms either under bilateral tax treaties or under Tax Information Exchange Agreements (TIEAs).

Lastly, from an objective standpoint, it will be interesting to see how countries – having developed mechanisms for implementing the new documentation standards – will make use of them and process the relevant information collected therein. There is much political interest in this Action item and expectations are high. It is also interesting to see how the practice of CbC reporting will shape the future regulation framework of TP, bearing in mind the increasing emphasis put on the global value chain analysis.

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65. For a full list of the signatories, *see* http://www.oecd.org/tax/beps/CbC-MCAA-Signatories.pdf.
66. Council Directive (EU) 2016/881 of 25 May 2016 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation, EU Law IBFD and http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016L0881&from=EN.

6.3. 2015 BEPS deliverables – Action 7: Artificial avoidance of PE status

Under the international standard, a country may not tax the business profits of a foreign company unless the company has a PE in that country. If the company is not taxed on those profits in its jurisdiction of residence, double non-taxation results may arise. Action 7 will result in changes to the definition of permanent establishment to prevent the artificial avoidance of PE status in relation to BEPS. This Action item is indirectly linked with Action 1 regarding the taxation of the digital economy. To this end, from the beginning of 2000, a number of multinationals have converted, within their supply chain model, their distribution operations, transforming their local distribution subsidiaries into commissionaire structures. By means of these civil law arrangements, commissionaires may facilitate structured sales of goods or services in an international context. It is common knowledge that this business model can often be advantageous from a tax perspective, including to avoid the accumulation of passive income (such as under US tax rules), particularly given that commissionaires are typically paid a limited commission fee that is commensurate with the limited functions they perform, the few assets they deploy and the reduced risks they take.

Lately, a flurry of interesting decisions has been focusing on whether commissionaire activities are deemed as a PE of the foreign principal, with the aim of attributing an additional part of profits to the local activities of the commissionaire on top of the commissionaire's routine remuneration and levying taxes accordingly. Although from a strictly fiscal perspective, identifying the taxable presence of a foreign legal entity and the issue of artificial profit-shifting are two separate topics, it is apparent that the application by analogy of transfer pricing methodology plays a key role in determining the attribution of profits based on the 2008 (and revised 2010) OECD Report on Attribution of Profits to Permanent Establishments.

Under the Final Report on Action 7,[67] the OECD introduced the changes to be made to the current article 5 of the OECD Model in order to limit the tax avoidance by MNE groups through artificially avoiding taxable presence in countries where they make sales. In particular, MNE groups may artificially avoid taxable presence without substantively changing the functions performed in those countries. The Final Report on BEPS Action 7 states three main sources for such tax avoidance and provides solutions to them. According to the mentioned Report, the existence of a PE could artificially be avoided by using commissionaire or similar strategies, by specific exceptions under article 5(4) of the OECD Model and by splitting up contracts among closely related parties. Consequently, in the Final Report on Action 7, the OECD details the changes to be made to article 5(5) and (6) of the OECD Model and to the Commentary in order to ensure the creation of the PE in cases where the MNE groups use commissionaire and similar structures for tax avoidance. Moreover, according to OECD, the exceptions under article 5(4) of the OECD Model were considered to be preparatory and auxiliary in nature when they were introduced. However, after the first introduction of these exceptions, a lot has changed in the way MNEs conduct their businesses and these exceptions can turn out to be core business activities for certain enterprises. Therefore, the OECD decided to explicitly restrict these exceptions under article 5(4) of the OECD Model to the activities that are of a preparatory or auxiliary nature. Furthermore, the OECD introduced an anti-fragmentation rule in order to ensure that MNEs do not split the activities into several small operations and argue that each of these activities fall under the exceptions of article 5(4) of the OECD Model. Moreover, the OECD considers that the principle purpose test that is to be added to the OECD Model as a consequence of BEPS Action 6 will deal with situations where the MNEs split construction contracts among closely related parties in order to avoid the creation of the PE. For this purpose, the

67. OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7 Final Report* , OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), International Organizations' Documentation IBFD.

OECD will add an example to the Commentary on the principle purpose test and clarify that this test is supposed to deal with the instances of splitting construction contracts.

On 4 July 2016, the OECD issued a discussion draft aimed at providing additional guidance on the attribution of profits to permanent establishments.[68] This discussion draft presents two main fact patterns, i.e. (i) dependent agent PEs, including those created through commissionaire and similar arrangements, and (ii) warehouses as fixed-place–of-business PEs. Under the first fact pattern, the most significant issue is the application and interaction between article 9 and article 7 of the OECD Model where activities performed by an associated enterprise amount to a dependent agent PE, as well as the potential difference or similarity between the arm's length principle in the context of article 9 and the Authorized OECD Approach (AOA) in the context of article 7 of the OECD Model, in particular in light of the developments of transfer pricing rules under BEPS Action Plans 8-10. Furthermore, the OECD discussed the application of the AOA under the fact pattern of warehouses amounting to fixed-place-of-business PEs according to revised article 5(4) of the OECD Model, distinguishing between two scenarios, i.e. (i) warehousing as the core business of the enterprise, and (ii) warehousing as an internal function of the business. A public consultation on this discussion draft was held on 11-12 October 2016 and the final guidance in this regard is still pending.

On 22 June 2017, the OECD published a public discussion draft on BEPS Action 7 – Additional Guidance on Attribution of Profits to Permanent Establishments (2017 Discussion Draft). This discussion draft takes into account comments received on the previous discussion draft as well as the positions of countries in this regard. Accordingly, the Working Party No. 6 has developed this new discussion draft, which replaces the 2016 Discussion Draft.

The 2017 Discussion Draft clarifies that while the changes made to article 5(5) and 5(6) of the OECD Model by the OECD BEPS Report on Action 7 modified the threshold for the existence of a deemed PE under article 5(5), they did not modify the nature of the deemed PE. Therefore, any approach on how to attribute profits to a PE that is deemed to exist under the pre-BEPS version of article 5(5) should consequently be applicable to a PE that is deemed to exist under the post-BEPS version of article 5(5). The new guidance on profit attribution to PEs also takes into account the work performed in relation to transfer pricing under BEPS Actions 8-10. The profits to be attributed to a PE as per the 2017 Discussion Draft are those that the PE would have derived if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions. In accordance with the 2017 Discussion Draft, the above principle applies regardless of whether a tax administration adopts the AOA contained in article 7 of the 2010 OECD Model, or any other approach used to attribute profits to the PE. The 2017 Discussion Draft further states that there is no preference with respect to the order of the application of article 9 or article 7 of the OECD Model. However, it also provides that many countries prefer the application of article 9 first and then article 7.

As opposed to the 2016 Discussion Draft, the new discussion draft does not include numerical examples in order to avoid drawing conclusions from the guidance on the level of profitability of the intermediary or the PE. In addition, the 2017 Discussion Draft provides an example on procurement activities. This new discussion draft sets out high-level general principles for the attribution of profits to the PEs. Importantly, countries agree that these principles are relevant and applicable in attributing profits to PEs.

68. OECD, *Base Erosion and Profit Shifting Public Discussion Draft – BEPS Action 7 – Additional Guidance on the Attribution of Profits to Permanent Establishments* (OECD 4 July-5 Sept. 2016), http://www.oecd.org/tax/transfer-pricing/BEPS-discussion-draft-on-the-attribution-of-profits-to-permanent-establishments.pdf.

The amendments to article 5 of the OECD Model are included in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS, in brief, the multilateral instrument, constituting Part IV (articles 12-15) of the said instrument.[69] Should the new definition of a PE be widely accepted and applied through the entry into force of the multilateral instrument, the next question is how much profit may be attributed to the "post-BEPS types of PEs", which may arguably generate a large number of controversies, especially considering the fact that currently only a limited number of countries have adopted the AOA.

6.4. 2015 BEPS deliverables – Actions 8-10: Value creation

From a conceptual standpoint, Actions 8, 9 and 10 need to be read together, as they all pursue the common goal of assuring that the transfer pricing policies are in line with value creation.

As a result, Actions 8, 9 and 10 are the most relevant Action items when it comes to transfer pricing issues, as they are targeted at ensuring that transfer pricing outcomes are in line with value creation in respect of intangibles, risks and capital and other high-risk transactions. Taking into account that Actions 8 and 13 are further discussed in more detail below, it is worth highlighting the key features of Action 9, as it focuses on determining a clear understanding on the notion of risk from a transfer pricing standpoint.

BEPS deliverable – Action 8: New guidance on comparability factors in chapter I of the OECD Guidelines

One relevant aspect of Action 8, which is only indirectly associated with the guidance on the transfer pricing aspects of intangibles, refers to the amendments applied to chapter I of the OECD Guidelines with respect to the treatment of location savings and other local market features, assembled workforce and MNE group synergies.[70]

These amendments are welcome, as they clearly delineate the OECD's position with respect to items that some tax administrations (particularly those representing fast-growing economies) have been treating as intangible property per se.

From a general standpoint, the OECD concluded that the above-mentioned factors should ordinarily be taken into account in a transfer pricing comparability analysis. In particular, the most controversial issue where different positions may be recorded among developed and developing tax administrations is that referable to location savings and other local market features. With respect to such a notion, the underlying principle reflecting the OECD view is the one included in the new paragraph 1.42 of the Final Report on Actions 8-10 whereby, if the functional analysis shows that location savings exist that are not passed on to customers or suppliers, and where comparable entities and transactions in the local market may be identified, those local market comparables will provide the most reliable indication regarding how the net location savings should be allocated among two or more associated enterprises.

Similarly, features of the local market in which business operations occur may affect the arm's length price with respect to transactions between associated enterprises. Indeed, while some features may give rise to location savings, others may give rise to comparability concerns not directly related to such savings.

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69. *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (24 Nov. 2016), Treaties IBFD.
70. *See* sections D.6, D.7 and D.8 of chapter I, the language of which has been inserted immediately following paragraph 1.79 of the OECD Guidelines (*see* paragraphs from 1.80 to 1.114).

Similar considerations apply for assembled workforce and group synergies. With regard to assembled workforce, the existence of a value-adding employee group may affect the arm's length price for services provided by the employee group or the efficiency with which services are provided or goods are produced by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis.

Similarly, in certain circumstances, MNE groups and associated enterprises that comprise such groups may benefit from interactions or synergies among group members that would not generally be available to similarly situated independent enterprises. For instance, group synergies can arise as a result of combined purchasing power or economies of scale, integrated telecommunications systems or integrated leadership management functions, etc. In this respect (*see* the new paragraph 1.158 of the Final Report on Actions 8-10), the current chapter VII on intra-group services suggests that an associated enterprise should not be considered to have received an intra-group service or be required to make any payment when it obtains "incidental benefits" attributable solely to its being part of a larger MNE concern. Within this line of reasoning, the term "incidental benefits" does not refer to any potential amount of such benefits or suggest that such benefits should be small or non-existent. By the same token, when MNE synergies arise purely because of the fact that an associated enterprise is benefiting from its membership to an MNE group, without any deliberate concerted action of group members, such synergistic benefits need *not* in principle be separately compensated nor allocated among other members of the MNE group.

The approach to risk in the context of the BEPS Action Plan

Certain literature indeed[71] rightly pointed out the fact that a proper application of the arm's length principle entails a thorough understanding of the supply and value chain within an MNE. In this conceptual process, the identification of the relevant risks involved, together with an understanding of how risks are effectively managed from a responsibility standpoint, both from a short- and longer term standpoint is the tipping point for a successful outcome of any transfer pricing analysis.

From a business management standpoint, all businesses operate in a world of volatility, i.e. the business outcomes of an enterprise are heavily dependent on how their strategic choices expose them to certain types of volatility, e.g. fluctuations in the upside or downside of any given entrepreneurial direction. As a result, accepting and managing risks is the essence of an enterprise, as each MNE chooses which risks it wants to face strategically (or the lack of incentive to guard against risks, despite taking into account its consequences)[72] in order to participate in society with the view of generating profits and thereby secure its continuity.

Against this background, the current framework of the OECD Guidelines seems to depict the notion of risk, within the context of the functional analysis, in a rather static rather than dynamic vision of what actually matters when looking at risk in an MNE context. In particular, the current version of chapter I enumerates notions such as "market risk", "operational risk", "credit risk", etc. as if all of them have a similar impact in the risk management activity (and consequent sharing of responsibilities) between the associated enterprises part of the same group in order to mitigate and control volatility phenomena that may affect the profitability of the business operator.

71. *See* P. Fris, S. Gonnet & R. Meghames, *Understanding Risk in the Enterprise: The Key to Transfer Pricing for Today's Business Models* , 21 Intl. Transfer Pricing J. 6 (2014), Journals IBFD.
72. This latter concept is normally referred to as "moral hazard" and it will be taken into account by WP6 in the context of Actions 9 and 10 with respect to understanding its interaction with the contractual allocation of risks.

As a result, in the current way in which MNEs operate, risk management is about dealing with the impact of volatility in generating profits. Therefore, in order to achieve an effective risk management framework, it seems necessary to:

- identify the source of volatility; and
- assess its impact on the business activity.

In order to be successfully completed, the above process seems to require introducing respectively a definition of risk and a categorization of the various types of risks. In a transfer pricing context risk may be defined as the effect of uncertainty on the profit-making objectives of a business. Risk in itself does not present negative features, i.e. it is inherent in any commercial activity and companies choose which risk they wish to seek out in order to have the opportunity to generate profits.

Risks may be categorized according to various criteria, but the following outline may prove helpful in understanding where risk management activities may intervene, as they serve the purpose of a proper transfer pricing analysis seeking to delineate the actual transaction and the actual allocation of risk between the parties:

- *Strategic risks:* These are the risks that can offer a significant downside potential, such as the competition, market environments, etc. In the event an MNE can acknowledge and manage such events as they are about to occur, it can differentiate itself and the change can be turned into a competitive advantage.
- *Intellectual capital risks:* These (including human capital risks) arise from challenges related to a company's talent leadership and its choices to differentiate itself from the competition.
- *Financial risks:* These risks translate in the form of fluctuations in financial market prices, which often have a negative impact.
- *Operational risks:* E.g. internal process breakdowns impairing a company's supply chain, customer service or manufacturing operations.
- *Moral hazard risks:* These arise from external events, with respect to which the company is aware of, and translate into risks resulting in liabilities of various kinds.

With respect to the above-mentioned categorization, risk management does not eliminate risk, but it assesses it with the performance of actual decision-making functions regarding the determination of appropriate risk mitigation strategies. A clearer definition of such a notion would also be helpful in better framing the risk/return trade-off issue, which is touched upon in a rather ambiguous manner in both paragraphs 1.45 and 9.10 of the OECD Guidelines.

These two paragraphs recall an underlying economic concept whereby, in recognition of a person's aversion to risk, an equivalence is established between a higher-but-less-certain stream of income and a lower-but-more-certain stream of income. Such an economic principle supports the associated notion that it is economically rational to take on (or lay off) risk in return for higher (or lower) anticipated nominal income. For instance, between unrelated parties, the sale of a risky income-producing asset (such as an intangible) may reflect in part the preference of the seller to accept a lower but steadier amount of income.

By focussing in more detail on the notion of risk with Actions 8, 9 and 10, the ultimate goal of the BEPS Action Plan is to provide a tool for tax administrations so as not to be limited in the exercise of their powers by the label given to the transaction by the taxpayer. To this end, certain relevant literature refers to the labelling of a transaction as "fiscal classification".[73]74 By means of this definition, once the transaction has been outlined in its key factual features, a tax administration may disagree with the label that the taxpayer has given to a related-party transaction and perform a "fiscal classification adjustment", i.e. adopt a labelling other than that submitted by the taxpayer. According to the same literature, such a "fiscal classification" should not amount to a non-recognition or disregard of a transaction simply because the controlled transaction as actually structured does not fit the fiscal label argued by the MNE.

The cornerstone of any transfer pricing analysis is the accurate delineation of the actual transaction between the parties for which the transfer prices need to be established. The significance of such an approach, informally referred to as the identification of "the real deal", is now more clearly reflected in the overarching guidance in chapter I of the OECD Guidelines (reference is made in particular to the new section D.2. of chapter 1).

The objective of the new approach is rather straightforward: in order to find out what the transaction undertaken by the associated enterprises actually is, such a step has to conceptually come before trying to determine an appropriate price for this transaction. It does so by analysing first the contractual relations between the parties as well as their conduct; evidence based on conduct will supplement or replace the contractual arrangements should the contractual arrangements be incomplete and elements that are economically relevant to the transaction are missing, or are not supported by the conduct. This process does recharacterize the fundamental nature of the transaction, but require instead a clear identification and allocation of risks in order to achieve a transfer pricing outcome consistent with the value chain of the group.

Based on this framework, the mere contractual assumption of risk, if not backed up by the substantive test of assessing which entity has control over risk, is not enough to support the entitlement of the risk-related return. The identification of the new approach to risk allocation can be highlighted as follows:

The OECD has provided comprehensive guidance with respect to the risks under the Final Report on Actions 8, 9 and 10. In this Report, the OECD clarifies that the detailed guidance with respect to risks should not be interpreted as risks being more important in functional analyses compared to functions performed and assets used. It is the functional analyses that determine the significance of these three components. Moreover, according to the OECD, more detailed guidance on risks in comparison to functions performed and assets used is due to the difficulty in identification of risks in a transaction.

In the Final Report on Actions 8-10, the OECD has provided a framework for risk analysis in controlled transactions. The mentioned framework consists of the following six steps:

Step 1. Identification of economically significant risks in the transaction.

Step 2. Contractual assumption of the risks.

Under this step, one has to analyse how the associated enterprises allocate economically significant risks between themselves in the controlled transaction taking into account the terms of the contract.

73. *See* A. Bullen, *Arm's Length Transaction Structures* pp. 165-170 (IBFD Doctoral Series 2011).

Step 3. Functional analysis with respect to risks.

Under this step one has to perform a detailed functional analysis with respect to economically significant risks. More specifically, the Final Report on Actions 8-10 provides that in analysing risks, the following important factors are to be considered: who performs the control functions and also risk management functions with respect to economically significant risk; who bears the consequences of the downside risk outcome and who benefits from the upside risk outcome; and who has the financial capacity to assume the risk, etc.

Step 4. Interpretation of Steps 1 through 3.

Under this step one has to interpret the information obtained in steps 1 through 3. More specifically, the OECD provides a two-step approach in order to determine if the contractual allocation of risks between associated enterprises is consistent with the conduct of the parties to the transaction. Under this two-step approach, one should verify (i) if the parties follow the terms of the contract and (ii) if the party assuming the risk in accordance with (i) has control over the risk and financial capacity to assume the risk.

Step 5. Allocation of risks.

This step has to be considered only if the party assuming the risk does not have the control over that risk or does not have a financial capacity to assume that risk. Under this step, the OECD provides guidance on how to allocate economically significant risks if the control over the risk or financial capacity to bear the risk is lacking.

Step 6. Pricing of the controlled transaction.

Under this step, a controlled transaction is to be priced after accurate delineation. The OECD emphasizes taking into account the consequences of risk analysis as performed in accordance with the suggested framework.

The Final Report on Actions 8-10 provides definitions for risk management and control over risk notions. According to the Report, control over risk comprises only the first two parts of the risk management definition. More specifically, the party to the controlled transaction having control over risk shall have "(i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function."[74] The Report emphasizes that in order to be considered as having control over a risk, one does not have to perform risk mitigation functions. More specifically, these functions can be outsourced, although the Report states that the party outsourcing risk mitigation functions shall be able to assess the outsourced functions together with actually making the decisions. Consequently, in order for a party to the controlled transaction to be considered as having control over the risk, that party shall be capable of performing the functions in relation to the economically significant risks, as well as actually performing such functions.

In summary, according to the Final Report on Actions 8-10, mere contractual allocation of risks between associated enterprises is not decisive. The true allocation of economically significant risks in a controlled transaction should be determined through the framework provided in the Final Report. Moreover, according to the Report, if the contractual allocation of economically significant risks differ from the

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74. OECD. *Aligning Transfer Pricing Outcomes with the Value Creation* (Paris: OECD, 2015), at para. 1.65.

conduct of the parties delineated through the framework described above, the actual conduct takes precedence over the contractual allocation of the risks. Furthermore, in the Report, the OECD states that mere provision of the funding shall not mean that the enterprise providing the funding assumes any risk other than financial risk, if it does not perform relevant functions with respect to those risks. Consequently, the enterprise should be remunerated taking into account only the risks assumed (e.g. the financial risk) and not for other risks (e.g. economically significant risks associated with the economic activities for which there was a need for funding).

The result of applying this guidance to scenarios where capital-rich members of the group provide funding but perform few, or no, activities at all (as is the case with so-called cash boxes) is that where such an enterprise does not control the financial risk associated with its funding, it will not be allocated the profits associated with those financial risks and it will be entitled to no more than a risk-free return. The level of activities required to control the financial risks will vary depending, for example, on the risk attaching to the enterprise to which the funding is provided and the nature of the investment being funded. The return may be even lower than a risk-free return if, for example, the transaction is not commercially rational, as non-recognition rules may apply in such a case.

In this respect, it is important to note that the guidance on risk influenced the revised guidance on intangibles contained, in particular, in chapter VI, particularly because transactions involving intangibles involve extensive risks. Consistent with the principles set out above, legal ownership alone does not determine the right to the returns generated by the exploitation of the intangible. On the contrary, the assumption of economically significant risks, together with the performance of important functions and the contribution of assets, particularly those in relation with DEMPE functions,[75] will need to be compensated in line with their contributions to value.

2015 BEPS deliverable on Action 10, updates on Chapter VIII of 2010 OECD Guidelines

The 2015 BEPS Final Report on Actions 8-10 updates the entire chapter VII of the 2010 OECD Guidelines in order to make it consistent with the new instructions regarding section D of chapter I (functional analysis) and chapter VI (intangibles) of the OECD Guidelines. It is emphasized in the updated chapter VIII that the same analytical framework for delineating the actual transaction, including allocating risk, as well as the guidance for valuing and pricing intangibles, including hard-to-value intangibles, is applicable to CCAs as to other kinds of contractual arrangements. The contractual agreements of CCAs can only be accepted to the extent that they do not deviate from the actual conduct of the associated enterprises. For an entity to be a CCA participant, it must have exercised control over the specific risks it assumes under the CCA, as well as the financial capability to assume these risks. If the entity only provides funding without being involved in the actual activities under the CCA, the value of its contribution is only equivalent to a risk-adjusted return on its funding commitment, provided that it has control over the financial risk arising from its funding commitments. If, however, it does not have the capability to make decisions to take on, lay off or decline the risk-bearing opportunity presented by participating in the CCA, or if it does not have the capability to make decisions on whether and how to respond to the risks associated with the opportunity, it cannot qualify as a CCA participant and therefore cannot be entitled to any shared interest in the CCA.

Another important aspect in the updated Guidelines concerns how to calculate the value of each CCA participant's contributions. There are two categories of CCA contributions, i.e. contributions of pre-

75. The idea is that entities performing functions related to e.g. developing, enhancing, maintaining, protecting and exploiting of intangibles are entitled to a share of intangible returns.

existing value, for example, existing intangibles that provide a basis for further development under the CCA, and the current value, for example, the activities of R&D, operations and other services. As a principle, all the contributions should be calculated based on their value at the time they are contributed. However, it may sometimes be more administrable for taxpayers to pay current contributions at cost, particularly with regard to development CCAs (i.e. CCAs established for the joint development, production or obtaining of intangibles or tangible assets).If this approach is adopted, it is important to ensure that only the current contributions are calculated at cost, while the pre-existing contributions should recover the opportunity cost of the ex-ante commitment to contribute resources to the CCA.

That being said, the guidance in chapters I-III and chapter VI shall be used to evaluate the pre-existing contribution, especially those with regard to the evaluation of intangibles. The value of current contributions is not based on the potential value of the resulting further application of the technology, but on the value of the functions performed. To this end, the guidance laid down in chapters I-III, VI and VII shall be applied, and it should be noted that compensation based on a reimbursement of cost plus a modest markup will not reflect the arm's length price for the contribution of the research team in all cases.

As a result of the major changes triggered by the conclusions of the BEPS Actions 8, 9 and 10, chapter VIII of the OECD Guidelines has been subject to a major revamp, largely influenced by the impact of the new approach in delineating the actual transaction in chapters I and VI. To this end, a first new important conceptual distinction refers to the terms "benefits" deriving from being a participant to a CCA and "contributions" to a CCA. In particular, it is important to clarify that the benefits derived from a CCA are, by definition, those specified in a CCA. This has some important consequences in that with respect to funding participants in CCAs, it is possible to distinguish two different types of funders, namely:

(i) the funder who can control the risks associated with its funding (in which case the funder might be termed as "investor"); and

(ii) the funder who cannot control the risk associated with its funding (in which case the funder holds what is normally referred to as "dumb money").

It stems from the above that in a CCA context an "investor" (scenario under (i)) would be entitled to an appropriate risk-adjusted anticipated return and would experience some upside profits or downside losses associated with the actual return to the cost shared intangible.

Therefore, it is important to note that the new and revised guidance in section D of chapter I of the OECD Guidelines is relevant to the analysis of all transactions between associated enterprises and applies to identify all the economically relevant characteristics of the commercial or financial relations between the parties as expressed in the CCA.

The contractual terms of the CCA provide the starting point for delineating the transaction between the parties and how the responsibilities, risks and anticipated outcomes were intended to be allocated at the time of entering into the arrangements. However, as set out in that guidance, the evidence of the conduct of the parties may clarify or supplement aspects of the agreement. To this end, the new section D.1.2. of the OECD Guidelines is relevant to analyse the assumption of risks under the CCA.

From a conceptual standpoint, though, the common thread arising from the BEPS actions requires a thorough understanding of the way in which MNEs create value. In particular, this has been commonly identified in Action 10, where the OECD has expressed to "clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains”. [76] The BEPS Report therefore suggests it is increasingly relevant to focus on a thorough value chain analysis, which will factor in tasks and stages in production, rather than gross goods or services that are exported. In particular, most value is typically created in upstream activities such as product design, R&D and production of core components, or in downstream activities where marketing or branding takes place.

To this end, an example of a group structure triggering base erosion and profit shifting may be mirrored with the current example in the transfer pricing jargon referred to as “passive investment”.

> Example:
>
> Assume that Orange is the parent company of an MNE group involved in the production and sale of electronic consumer goods. In order to maintain and improve its market position, ongoing R&D activities are carried out by the group to improve existing products and develop new ones. The Orange group maintains two R&D centres, one operated by Orange in Country X and the other operated by Company S, a subsidiary of Orange, in Country Y.

In Year 1, Orange sells its patent rights and those related to other types of technology to a newly established subsidiary T, resident in Country Z. Company T establishes a manufacturing facility in Country Z and begins to supply products to members of the Orange group around the world.

At the same time of the transfer of the intangibles, Company T enters into a contract research agreement with Orange and into a separate one with Company S. Pursuant to the agreements, Company T contractually agrees to bear the financial risk associated with the possible failure of R&D projects. Company T has no technical personnel capable of conducting or supervising the research activities. Orange continues to develop and design the R&D programme, determine its own levels of staffing and establish its own level of R&D budgets.

With respect to this type of structure, the most common transfer pricing risk will be the one flagged by the tax administration of the country where company Orange is resident, as from a functional standpoint the key decisions relating to the allocation of the R&D budget and people staffing will be unchanged other than the sale of the rights over the intellectual property. Therefore, in this type of scenario it will be important to determine whether the merits of the arm’s length principle are still valid in terms of achieving a pricing solution (in this regard a proper valuation of the intellectual property transferred will be one of the most controversial topics to focus on) or rather, a non-recognition of the transaction based on paragraphs 1.64-1.69 would be applicable. [77]

As regards some specific consideration to the profit split method, it is worth highlighting that due to the work the OECD has been carrying out on Action 10 of the BEPS Action Plan, the profit split method is subject to further scrutiny and more elaborated guidance is expected to be finalized in the first half of 2017. The 2015 deliverable on Action 10 with regard to the transactional profit split method outlines the scope of further work on how to correctly apply the transactional profit split, especially in the context of global value chains. This report forms the basis for draft guidance developed by Working Party No.

76. *See* Action 10, p. 21 of the BEPS Action Plan.
77. On the instances where a recharacterization of a transaction is justifiable *see* A. Bullen, *Arm’s Length Transaction Structures: Recognizing and Restructuring Controlled Transactions in Transfer Pricing*, IBFD Doctoral Series Publications, 2010.

6 during 2016. A discussion draft of the guidance was released for public comments and a public consultation in July 2016.

It is noteworthy that the work on the application of the profit split method should take into account the changes to the transfer pricing guidance in pursuit of other BEPS actions, including changes in relation to the guidance on applying the arm's length principle in the section on performing a robust functional analysis and identifying and allocating risks in the section on synergies, and to the guidance on intangibles. In addition, it is noted in the 2015 Report on Action 1 concerning the digital economy that attention should be paid to the consequences of greater integration of business models as a result of the digitized economy and the potential role for profit splits to account for such integration.

The most important issue that Working Party No. 6 needs to concentrate on in this regard is to determine when the transactional profit split method is the most appropriate transfer pricing method, particularly in cases where the nature of the transaction itself, based on the functional analysis of the parties, suggests that a sharing of combined profits would not be expected at arm's length. In such situations, an inappropriate method using inexact comparables may be more reliable than an inappropriate use of the transactional profit split method. The mere absence of the reliable comparables is not sufficient to justify the application of the profit split method. Due regard should be given to whether or not the profit split method itself is appropriate.

The current OECD Guidelines provide two situations, in particular where the transactional profit split method is considered the most appropriate method to be used. The first one is where the business of the group is highly integrated, for which the one-sided method may not be appropriate. The 2015 Action 8-10 Final Report[78] points out that integration alone may be insufficient to warrant the use of such a method, considering that all MNEs are integrated to a greater or lesser degree. It is also noted that sequential integration of a global value chain, which involves parties performing different activities linked through transactions between them in a coherent value chain, shall be distinguished from parallel integration, which involves parties performing similar activities relating to the same revenues, costs, assets or risks, since the former situation may not warrant the use of the profit split method. The second scenario mentioned in the current OECD Guidelines where the profit split method should be used is the case where both parties to the transaction make unique and valuable contributions. The 2015 Action 10 Final Report points out that further work needs to be carried out to clarify the meaning of "unique and valuable contributions". Due regard should also be given to situations where independent enterprises make use of profit split models in comparable transactions.

Other items of future work mentioned in the 2015 Action 10 Final Report regarding the application of the profit split method include:

- How to determine whether a transactional profit split method could be the most appropriate method for dealing with scenarios with significant group synergies, and how such profit split methods could be applied.
- How to reliably determine the profit allocation factors (e.g. invested capital, costs, surveys of functional contributions, weighting of factors, equalized expected rates of return) in order to make the results consistent with the creation of value and hence consistent with the arm's length principle.

78. OECD *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10 Final Reports* , OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), International Organizations' Documentation IBFD.

- How to use the profit split method to confirm or vary the results based on other transfer pricing methods, such as TNMM, as well as how to convert the results under the profit split method into royalties.

An important clarification to be added in light of the implementation of the BEPS Action Plan relates to the circumstance that the BEPS Action Plan is focussing on the profit split method as a practical instrument to better guarantee an allocation of profits between countries based on the proper identification of allocation keys. The OECD has affirmed that the profit split is by no means the most appropriate methodology to deal with BEPS scenarios, particularly in those instances where no sharing of risks take place.

Another important aspect arising with the future application of the profit split method is its close link with the (conceptually prior) identification of global value chains to which the method would apply. In this respect, the OECD in areas other than taxation describes a global value chain as the "full range of firms' activities, from the conception of a product to its end use and beyond … It includes activities such as design, production, marketing, distribution and support to the final consumer." [79] It is also noted that global value chains are "very heterogeneous across industries, companies, products and services".

The above definition of global value chain, if transposed into the framework of a transfer pricing analysis, entails that a full range of functions of a firm's activity in relation to a product or a service has to be taken into account and accordingly there can be no assumption that a particular transfer pricing method is more appropriate in determining arm's length prices for transactions between associated enterprises within that global value chain. In particular, the fact that an MNE group is spreading its key value chain activities across a number of associated enterprises in different countries does not trigger that the use of transactional profit methods will be the only method in the hands of tax administrations in order to benchmark arm's length returns for the enterprises.

Example where the use of transactional profit split may be deemed appropriate

Three associated original equipment manufacturers (OEMs) active in the heavy industry sector enterprises are associated enterprises resident in the Asia region. Each of the OEMs manufactures finished goods and other components for both their local market and Asian region, respectively. They license in technology (namely, patent and other industrial know-how) from their EU parent with respect to which they pay a royalty. Otherwise, the Asian operations of the group are largely independent. The OEMs have a number of subsidiaries in Europe providing contract manufacturing services in relation to certain components. Sales and distribution takes place through other group subsidiaries and, in the OEM's respective jurisdictions, through a division of the OEM itself.

Based on a further analysis of the facts, the way in which the various OEM enterprises interact is highly integrated. The enterprises have a shared "Leadership Board", on which all the OEMs are involved and represented, taking decisions for the business as a whole (e.g. what new business models to be developed, which current models to retain, which marketing and plant investment to be made, etc.) Most notably, the OEMs buy and sell components and finished goods to each other, with an effective pooling of entrepreneurial functions and risks. It seems from the highly interconnected web of transactions that in the case at stake, the application of a method other than the profit split would be difficult, when it

79. *See* OECD, *Interconnected Economies: Benefiting from Global Value Chains* p. 14, OECD Publishing 2013, available at: http://dx.doi.org/10.1787/9789264189560-en.

comes – in particular – to the need of finding reliable comparables (due to the very high degree of interdependence between the functions, assets and risks of the associated enterprises).

6.5. 2015 BEPS deliverables – Action 14: dispute resolution mechanisms

The actions to counter BEPS must be complemented with actions to ensure the certainty and predictability needed to promote investment in today's environment. This action will ensure such certainty by developing solutions to address obstacles that prevent countries from solving treaty-related disputes. In this respect, in light of the extensive backlog of cases that countries are experiencing with respect to mutual agreement procedures (MAPs) as a result of adjustments to profits of associated enterprises. The effective use and management of MAPs has always assumed a pivotal role in the work of Working Party No. 1 of the OECD. Indeed, with the release of the OECD Manual on Effective Mutual Agreement Procedures (MEMAP) in 2007 and the introduction of the arbitration clause with the new paragraph 5 of article 25, the guidance on dispute resolution was updated. The United Nations also updated their guidance on the use of dispute resolution mechanisms with the 2011 update to the Commentary to the UN Model.

Notwithstanding the above, it is a fact that the current practice with regard to MAPs and APAs can be improved, which also follows from the increasing number of cases pending in the various countries.

To this end, the OECD has created a dedicated MAP Forum – within the OECD Forum on Tax Administration (FTA) – comprised of the competent authorities of both OECD and non-OECD economies. They have been assigned with the challenging task of finding speedier resolutions of cases that quite frequently can lead to double taxation. In this respect, it is worth noting that at the supranational level, i.e. primarily at the OECD and EU levels, the instrument of joint audits is gaining ground as an effective tool to prevent international tax disputes.

Removing obstacles that double taxation presents is key to the development of economic relations between jurisdictions. In this regard, jurisdictions enter into tax treaties with the aim of removing such obstacles and providing taxpayers with certainty on the tax treatment of their cross- border trade, investment and activities. Where doubts or difficulties arise in relation to the interpretation or application of the tax treaty, or where taxpayers enter into disputes with tax authorities on the tax treaty treatment of their activities, article 25 of the OECD Model provides a mechanism (the mutual agreement procedure, MAP), that allows the resolution of such difficulties or disputes.

The MAP, which is independent from the ordinary legal remedies available under domestic law, allows the competent authorities of the contracting parties to resolve differences or difficulties regarding the interpretation or application of the OECD Model on a mutually agreed basis. This mechanism seeks to ensure the proper application and interpretation of tax treaties so that taxpayers entitled to the benefits of the treaty are not subject to taxation by either of the contracting parties which is not in accordance with the terms of the treaty.

The Action 14 minimum standard aims to strengthen the effectiveness and efficiency of the MAP process. The minimum standard is constituted by specific measures that jurisdictions will take to ensure that they resolve treaty-related disputes in a timely, effective and efficient manner and is complemented by a set of best practices. The elements of the minimum standard set out in the 2015 Action 14 Report seek to achieve the following three general objectives in order to ensure that dispute resolution mechanisms are more effective:

- jurisdictions should ensure that treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner;
- jurisdictions should ensure that administrative processes promote the prevention and timely resolution of treaty-related disputes; and
- jurisdictions should ensure that taxpayers that meet the requirements of paragraph 1 of article 25 of the OECD Model can access the MAP.

At the OECD level, work on joint audits has been carried out by the FTA that resulted in the 2010 Joint Audit Report (the Report). The Report defines joint audit as follows:

> [T]wo or more countries joining together to form a single audit team to examine an issue(s)/ transaction(s) of one or more related taxable persons (both legal entities and individuals) with cross-border business activities … and in which the countries have a common or complementary interest ….[29]

Thus, if countries want to carry out a joint audit, it is first necessary to determine the legal framework in which they can cooperate. The basis for cooperation can be found in bilateral treaties, tax information exchange agreements and multilateral treaties which provide for varying degrees of mutual assistance.

In this regard, chapter III of the OECD Convention on Mutual Administrative Assistance in Tax Matters (the Convention) sets out the form of assistance that countries can pursue within the framework of the Convention. Section 1, dealing with exchange of information (EOI), stipulates with article 4 the general provision for exchange of information. Within this legal framework, specific articles that relate to EOI include:

- EOI on request (article 5);
- automatic EOI (article 6);
- spontaneous EOI (article 7);
- simultaneous tax examinations (article 8); and
- tax examinations abroad (article 9).

Based on the above list of types of EOI, it is worth noting that while many forms of assistance are listed and discussed in the Convention, there is not a dedicated article specifically addressing joint audits, nor does there need to be, as joint audits are a combination of the various forms of EOI. Notwithstanding this, tax administrations cannot impose simultaneous tax audits or tax examinations abroad on other countries, as these only occur when two or more countries agree.

At the EU level, Directive 2011/16 of 15 February 2011 on the administrative cooperation in tax matters follows the same line of reasoning as the OECD Convention in pushing tax administrations towards simultaneous and joint audits. The above-mentioned European legislative intervention, in repealing the former EU Directive 77/799 CEE, stipulates at paragraphs 1 and 2 of article 11 that – subject to the prior agreement between the countries involved – officials of the tax administrations requesting the

29. *See* sec. D, ch. VI 2010 OECD Guidelines.

information can be present in the premises of the country's tax officials and assume a proactive role in questioning the taxpayers, together with the examination of documents.

Currently, tax administrations are experiencing a dramatic increase in the number of disputes with taxpayers revolving around transfer pricing. It is no secret that in both OECD and non-OECD countries, the vast majority of audits of large business taxpayers focus on the selection of the most appropriate transfer pricing method, comparability issues, economics and the "arm's length" rationale of business restructurings involving the transfer of intangibles, etc. This means that dispute prevention measures (such as APAs) and dispute resolution tools (such as MAPs) are substantially gaining ground in their utilization and are fuelling the convergence toward this "enhanced relationship" between tax administrations and taxpayers in an effort to increase compliance. In this respect, international bodies such as the OECD have launched a thorough review of the so-called "horizontal monitoring" programmes aimed at fostering strict cooperation between large taxpayers and tax administrations. In particular, the FTA undertook a study, led by the United Kingdom, which was finalized in the publication of the 2012 report Dealing Effectively with the Challenges of Transfer Pricing. [80] This report deals with the practical operation of transfer pricing programmes by tax administrations. Technical analysis of how transfer prices should be computed in accordance with the arm's length principle is outside the scope of this report. Instead, the report focuses on the practical experiences of a number of FTA member countries and some non-member countries. It also reflects comments made to the study team by transfer pricing specialists working for major advisory firms and by tax managers working in business and industry. Drawing on this evidence, the report discusses ways in which the management of transfer pricing programmes can be optimized, so that transfer pricing audits and enquiries are conducted efficiently and in a timely manner for the benefit of MNEs and tax administrations alike. It is concerned with the practical steps tax administrations need to take to correctly identify transfer pricing cases that merit audit or enquiry and then to progress those cases to as early a conclusion as possible.

Reports like the one mentioned above are the outcome of increased and enhanced government cooperation, as never before have tax administrations been so keen to share information concerning taxpayer's and profitable industries' value drivers, carry out joint audit activities and assist other countries with document and information requests so as to participate in simultaneous tax audits. [81]

It is important to note that the OECD BEPS Action 14 introduced important changes with respect to international dispute resolution mechanisms, i.e. the MAP process and arbitration. In particular, the outcomes of the OECD BEPS Action 14 addressed many inefficiencies of these processes. An important development concerns the introduction of the mandatory arbitration mechanism. The analysis of the outcomes of the OECD BEPS Action 14 indicates that its implementation will significantly improve the functioning of the international dispute mechanisms. As already mentioned above in this section, the MLI includes the provisions with respect to both the MAP and arbitration. Therefore, once the MLI enters into force, many of the amendments suggested under the OECD BEPS Action 14 will be implemented without a need for further bilateral negotiations between the signatory countries.

80. The Report is available at www.oecd.org/site/ctpfta/49428070.pdf (consult the website for variations).
81. *See* OECD FTA Report on *The Role of Joint Audits and Simultaneous Tax Examinations*, released during the 2010 FTA Meeting in Istanbul.

6.6. 2015 BEPS Final Report – Action 15 Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

The MLI aims at implementing the outcomes of the OECD BEPS Project in more than 1,100 existing bilateral tax treaties. The MLI will result in saving its signatories from the burden of bilateral negotiations between the countries as well as increasing the certainty for taxpayers. It implements the following changes in the existing bilateral tax treaties:

- outcomes of the OECD BEPS Action 3 regarding hybrid mismatches. This section covers the amendments with respect to transparent and dual resident entities. It also includes a section on the application of the method for the elimination of double taxation;
- outcomes of the OECD BEPS Action 6 with respect to treaty abuse. This section includes provisions on (i) the purpose of the covered bilateral tax treaties, (ii) the prevention of treaty abuse, (iii) a simplified limitation of benefits provision, (iv) dividend transfer transactions, (v) anti-abuse rules for PEs situated in third-countries, and (vi) the application of the tax agreements to restrict a state's right to tax its own residents;
- outcomes of the OECD BEPS Action 7 with respect to the avoidance of the permanent establishment status. This section comprises the provision preventing the artificial avoidance of the PE status by means of commissionaire arrangements and similar strategies, through specific activity exemptions and by splitting up contracts; and
- outcomes of the OECD BEPS Action 14 regarding the MAP procedures and arbitration. These sections cover the provisions on the MAP, corresponding adjustments and mandatory binding arbitration.

In this regard, one should highlight that the signing ceremony of the MLI was held at the OECD in Paris on 7 June 2017. The MLI covers 70 jurisdictions.[82] It is important to note that the provisional MLI position of each signatory country identifies the tax treaties it intends to cover and indicates the options selected and the reservations made. The countries can amend their MLI positions until ratification. Even after ratification they have the right to opt with respect to the optional provisions or to withdraw the reservations. The modifications with respect to the covered bilateral tax agreements are expected to be entered in force starting from 2018. The entry in force depends on the ratification process in the jurisdictions signing the MLI.

6.7. The interpretation of the arm's length principle according to the European Commission

According to recent EU initiatives in the field of direct taxation, transfer pricing ruling appeared in the spotlight highlighting its pejorative elements.

Looking back at the evolution of the application of the notion of State aid to the field of direct taxation in general, and transfer pricing in particular, it should be noted that already in 1998 the European

82. The jurisdictions covered by the MLI as of 11 July 2017 are Andorra, Argentina, Armenia, Australia, Austria, Belgium, Bulgaria, Burkina Faso, Cameroon*, Canada, Chile, China (including Hong Kong), Colombia, Costa Rica, Croatia, Cyprus, Czech Republic, Denmark, Egypt, Fiji, Finland, France, Gabon, Georgia, Germany, Greece, Guernsey, Hungary, Iceland, India, Indonesia, Ireland, Isle of Man, Israel, Italy, Japan, Jersey, Korea, Kuwait, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Mauritius*, Mexico, Monaco, the Netherlands, New Zealand, Norway, Pakistan, Poland, Portugal, Romania, Russia, San Marino, Senegal, Serbia, Seychelles, Singapore, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and Uruguay.

    Countries with an asterisk have expressed the intention to sign the MLI during the signing ceremony.

Commission adopted a Notice on the application of State aid rules to measures relating to direct business taxation, which also covers discretionary administrative practices. More specifically, since 2001, the European Commission has conducted a series of investigations into Member States' fiscal schemes that appeared to benefit only certain companies. Since then, the European Commission has adopted a series of negative decisions, finding such schemes to selectively advantage multinational companies. These decisions have, inter alia, concerned national schemes that accept multinational corporations pricing their intra-group transactions in a manner that does not reflect the conditions that apply between independent companies at arm's length. According to the European Commission, the arm's length principle aims to ensure that all economic operators are treated in the same manner when determining their taxable base for corporate income tax purposes, regardless of whether they form part of an integrated corporate group or operate as standalone companies on the market.

In 2006, the European Court of Justice endorsed the arm's length principle for determining whether a fiscal measure prescribing a method for an integrated group company to determine its taxable profit gives rise to a selective advantage for the purposes of article 107(1) of the TFEU. Accordingly, a fiscal measure that endorses a method for determining an integrated group company's taxable profit in a manner that does not result in a reliable approximation of a market-based outcome in line with the arm's length principle, can confer a selective advantage upon its recipient. That would be the case where such fiscal measure results in a reduced taxable profit, and thus reduced corporate income tax liability. The European Commission does not call into question the granting of tax rulings by the tax administrations of the Member States. It recognizes the importance of advance rulings as a tool to provide legal certainty to taxpayers. Provided the tax administrations do not grant selective advantages to specific economic operators, tax rulings do not raise issues under EU State aid law. Since 2013, the European Commission's Directorate-General for Competition (DG Competition) has been carrying out an inquiry into tax ruling practices from the perspective of EU State aid rules. By the end of 2014, all Member States had been asked to provide information about their tax ruling practice and the legal framework underlying that practice, as well as a list of tax rulings issued in the years 2010- 2012 (and partly 2013).

On the basis of this information, the DG Competition requested specific tax rulings. Overall, the DG Competition has looked at more than 1,000 tax rulings. The inquiry has focussed, in particular, on tax rulings which endorse transfer pricing arrangements proposed by the taxpayer for determining the taxable basis of an integrated group company. Transfer prices refer to the prices charged for intra-group transactions concerning the sale of goods or services between associated group companies. The European Commission has also analysed “confirmatory rulings”, which confirm the application, or the non-application, of a certain legislative provision to a specific situation. The inquiry led, mid-2014, to the opening of three formal State aid investigations by the European Commission on tax rulings granted by Ireland (to Apple), Luxembourg (to Fiat) and the Netherlands (to Starbucks). Further investigations were opened by the European Commission later the same year and in 2015 on tax rulings granted by Luxembourg (to Amazon and to McDonald's) and by Belgium (the Excess Profit scheme).

As a result, in the European Commission's view a tax ruling (APA) confers on the beneficiary a selective advantage under article 107(1) of the Treaty on the Functioning of the European Union (TFEU) insofar as it leads to lowering the tax burden by deviating from the tax that the beneficiary would otherwise be obliged to pay under the general corporate tax system.

Interestingly enough, the legal analysis of the European Commission does not refer to the arm's length principle as elaborated by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines), but it seems that such principle assumes a new dimension in the field of the EC competition law. Oddly enough, while the European Commission seems to strongly support the use and respect of the arm's length principle to prevent a distortion of the EU internal market, in other fields, such as that of the CC(C)TB, it seems that the arm's length principle is put aside in favour of formulaic approaches.

The starting point of the European Commission's legal analysis is article 107 of the TFEU of which the arm's length principle "necessarily forms part" (*see* paragraph 264 of the European Commission's decision of 21 October 2015 on State aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks, hereinafter Starbucks).

Accordingly, the arm's length principle that the European Commission applied in its State aid inquiries and decisions seems to be diverging from the wording of article 9 of the OECD Model, which is a non-binding instrument. However, article 9 is considered a general principle of equal treatment in taxation falling within the scope of application of article 107(1) of the TFEU, which binds the Member States and from whose scope national tax rules are not excluded.

Despite the lack of reference to the OECD arm's length principle, in all recent decisions on tax rulings, the European Commission has made thorough reference to the OECD Guidelines.

The European Commission does so because it believes that "the OECD guidelines are an existing manual in the area of transfer pricing that are the result of expert discussions in the context of the OECD and elaborate on techniques aimed to address common challenges of the application of the arm's length principle to concrete situations."[83] The OECD Guidelines also capture the international consensus on transfer pricing and provide useful guidance to tax administrations and multinational enterprises on how to ensure that a transfer pricing methodology produces an outcome in line with market conditions.

It follows that whenever the application of the transfer pricing methodology endorsed in APA is compliant with OECD standards, i.e. it does not depart from the OECD Guidelines, the APA itself does not amount to State aid under article 107 of the TFEU, i.e. the APA beneficiary is not treated more favourably compared to non-integrated companies whose taxable profit is determined by the market.

According to the European Commission, the taxable basis accepted in the APA must be substantiated by reference to comparable transactions. In particular, if direct observations can be identified in respect of the related transactions, such observations should serve to determine the remuneration of the company engaging in comparable transactions (Starbucks, paragraph 368). In particular, in assessing the arm's length nature of commercial conditions applicable between related parties, the first step to be taken is to look for and analyse potential internal comparables, if any (Starbucks, paragraph 272).

Moreover, in the European Commission's view, the comparability analysis (inherent to the choice of transfer pricing method) should be determined on the basis of the functional analysis of the company for which the APA is requested (Starbucks, paragraph 379). In particular, the European Commission endorses the use of comparables database search to estimate arm's length returns, provided that selected comparables result in a reliable approximation of a market-based outcome. For instance, according to the European Commission, companies which do not have a sustainable business

83. *See* para. 66 Starbucks.

model cannot, in principle, constitute reliable comparators when establishing an appropriate level of remuneration (Commission decision of 30 August 2016 on State aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP) implemented by Ireland to Apple, hereinafter Apple, paragraph 352).

Moreover, according to the European Commission, the approximate nature of the arm's length principle cannot be invoked by the taxpayer to justify a transfer pricing analysis that is either methodologically inconsistent or based on an inadequate comparables selection (Commission decision of 21 October 2015 on State aid SA.38375 which Luxembourg granted to Fiat, hereinafter FTT, paragraph 230).

Finally, it is worth mentioning that the European Commission has also referred to industry average determinations (FFT, paragraph 311). However, such approach may be arguable since the OCED Guidelines explicitly affirm that in no event can unadjusted industry average returns themselves establish arm's length conditions (paragraph 1.35 of the OECD Guidelines).

According to the European Commission, in order to appropriately estimate the arm's length remuneration of functions, the taxpayer should carry out a comparison of the functions performed by each party with respect to the related transactions (Starbucks, paragraph 364). As regard the TNMM, the European Commission maintains that the analysis should take into account the complexity of the functions of all group companies involved in controlled transactions so as to identify t he entity to be regarded as the "least complex function" (i.e. the "tested party") (Starbucks, paragraph 273). In this regard, the European Commission, referring to the OECD Guidelines, agrees that the "tested party" is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found (i.e. it will most often be the one that has the least complex functional analysis). According to the European Commission, complexity is to be assessed in relative terms or, in other words, by comparison to the other parties involved in the transactions. Thus, for the purpose of choosing the tested party, reference should be made to the "least" complex function rather than, in absolute terms, to a function which would not be complex (Starbucks, paragraphs 366 and 367).

According to the European Commission, the OECD Guidelines set certain requirements for the choice of the appropriate transfer pricing method in order to comply with the arm's length principle (State aid SA.38944 (2014/C), Luxembourg, Alleged aid to Amazon by way of a tax ruling, hereinafter Amazon, paragraph 64). Within the framework of an APA procedure, taxpayers and tax authorities should always be able to justify the reasons behind the selection of the most appropriate method. This conclusion has been elaborated on by the European Commission in various recent decisions.

The European Commission has stated that the use of the most appropriate transfer pricing method does not rule out per se the existence of State aid. The choice of an appropriate transfer pricing method and of the parameters which support its application must still be tested against the "market-based outcome" standard. Accordingly, the European Commission has explicitly maintained that the choice of the method and the choice of parameters cannot be arbitrary (FFT, paragraph 242).

By contrast, the choice of a second-best method does not give rise per se to State aid. For example, where such method is chosen, but that method is used in combination with an overly conservative set of parameters, the remuneration arrived at might nevertheless result in a market-based outcome or in an overestimated tax burden, in which case a tax ruling accepting that second-best method would not give rise to an advantage for the purposes of article 107(1) of the TFEU (FFT, paragraph 243).

According to the European Commission, methodologies based on a two-sided approach, i.e. where the financials of both companies to the intra-group transaction are analysed, leave less room to deviate from a market outcome.[84] Thus, theoretically, they are less likely to give rise to State aid.

This being said, amongst the two-sided methodologies, the Commission's decisional practice, in line with the OECD Guidelines, set a preference for the CUP method. Where applicable, this method is considered the best way for approximating conditions close to normal competition (Amazon, paragraph 73 and FTT, paragraph 245). However, the European Commission also seems to accept the use of "transactional profit methods", such as the profit split method. Provided that such method is applied consistently in all jurisdictions involved, the profit split leads to an allocation of the full amount of profits between the companies participating to the intra-group transaction (IWP, paragraph 20).

Accordingly, the apparent preference of the European Commission vis-à-vis two-sided methods does not imply that one-sided methods may not be considered State aid compliant. In a number of decisions, the European Commission has also referred to the TNMM, which determines the remuneration of a tested party based on its activity or functions performed. As regards this methodology, the criticism of the European Commission originated from the fact that it was applied in a wrong manner only. For example, in the European Commission decision of 11 January 2016 on the excess profit exemption State aid scheme SA.37667 (2015/C) implemented by Belgium, the use of the TNMM was challenged since its application resulted in the automatic allocation of the remaining profit (i.e. the residual profit) to another group company in a foreign jurisdiction, regardless of any precise information about the activities carried on by such foreign group company.

The European Commission has taken the view that, in order to avoid the granting of an advantage, the point in the range closest to the most likely market outcome should be used for the purposes of pricing controlled transactions (Commission decision of 21 October 2015 on State aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks, hereinafter Starbucks, paragraph 396). With regard to the positioning in the range, the European Commission has also acknowledged that, according to paragraph 3.57 of the OECD Guidelines, the use of the central tendency of the sample minimizes the risk of error due to unknown or unquantifiable comparability defects (FFT, paragraph 295).

According to the European Commission, a profit level indicator is deemed to be appropriate insofar as it is consistent with the taxpayer's main functions (Starbucks, paragraph 400). Typically, and subject to the facts of the case, sales or distribution operating expenses might be an appropriate base for distribution activities when using the TNMM (Starbucks, paragraph 387). In case of profit generated and recorded through a margin on distributed products, the European Commission considers sales as a more adequate indicator of a profit generating reselling function (Starbucks, paragraph 388).

As regard cost-based indicators, the European Commission may challenge both the choice of the taxpayer to include or exclude certain costs from the cost base and the calculation of the markup applied (Apple, paragraph 149). As regards the markup, the European Commission affirms that it may not be reverse engineered so as to arrive at a target taxable income (State aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP), Ireland, Alleged aid to Apple, paragraph 62).

According to the European Commission, should an entity not derive any benefit from the use of an intellectual property licensed, no royalty should be due (Starbucks, paragraph 339). However, the

84. *See*, in this respect, reference to DG Competition – Internal Working Paper – Background to the High Level Forum on State Aid of 3 June 2016 (hereinafter IWP), para. 20.

European Commission maintains that the calculation of the amount of the royalty should always be commensurate to the user's output, sales or, in some rare circumstances, profits (Starbucks, paragraph 287). Thus, the European Commission would raise doubts regarding the arm's length level of a royalty payment disconnected from the economic value of any underlying IP such as when, for example, the royalty is merely calculated as a residual in the taxpayer's profit and loss account (Starbucks, paragraph 287).

According to the European Commission, the method accepted by the tax authorities should take into account future changes, if any, in the economic environment and/or in the remuneration levels required which may occur in the years following the ruling application. In the view of the European Commission, indeed, an agreement between a tax administration and a taxpayer that has no end date makes less accurate predictions as to future conditions on which that agreement is based, thereby casting doubt on the reliability of the method endorsed by the APA (Apple, 364). This applies a fortiori for open-ended rulings.

The European Commission acknowledges that section V.C of the OECD Guidelines lists the type of information that may be useful when determining transfer pricing for tax purposes in accordance with the arm's length principle (Amazon, paragraph 64). The APA request must be accompanied by a transfer pricing report to substantiate the choice of a transfer pricing method and the arm's length nature (IWP, paragraph 12).

7. Associated Enterprises[85]

7.1. General

This section discusses the scope and definition of associated enterprises and the first requirement each transfer pricing provision requires to be met in order to be legitimately applied. In the current environment of strict rules on the enforcement of transfer pricing, particularly concerning the requirement of providing adequate documentation as to the choice of a method and the ensuing prices or margins, it is crucial to determine whether an enterprise is deemed to be associated. Various countries have introduced very broad concepts of associated enterprises, which also cover forms of de facto control, going beyond association through majority shareholding and managerial relationships (de jure control).

The preface to the 1995 OECD Guidelines stated that "transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises". As a result, the definition of "associated enterprises" is central to determining the subjective scope of application of transfer pricing regimes around the world. The other, relevant requirement is that the associated enterprises must carry out transactions among themselves (i.e. so-called controlled transactions).

The function of article 9(1) is further explained in paragraph 2 of the Commentary on Article 9: the tax authorities of a contracting state may rewrite the accounts of an enterprise if – as a result of the special relations between the enterprises – the accounts do not show the true taxable profit arising in that state. No rewriting of the accounts is authorized if the transactions between the enterprises have taken place

85. **This topic has been the subject of a comparative survey in issues 4 to 6 of the *International Transfer Pricing Journal* vol. 6 (1999), concluded in an article by C. Rotondaro, *The Notion of "Associated Enterprises": Treaty Issues and Domestic Interpretations – An Overview*, 7 Intl. Transfer Pricing J. 1, p. 2 (2000), Journals IBFD. This topic was also dealt with by a panel chaired by the author at the 2003 IFA Congress in Sydney; *see IFA Yearbook 2003*, 49-50.**

“on normal open market commercial terms (on an arm’s length basis)”. Article 9(1) therefore confirms an authority that is usually included in a country’s domestic tax laws. However, such a provision is not self-supporting, in that it depends on the domestic law of the various treaty partners for its interpretation and clarification.

In particular, the mechanism of corresponding adjustments may be effective to the extent that the domestic notion of “associated enterprises” (or related parties) is met by both the contracting states applying the relevant treaty. In other words, the rule contained in article 9 can be effective to the extent that the concept of control as applicable under domestic law is consistent with the definition of associated enterprises provided under the applicable tax treaty.

The current text of article 9(1) reads as follows:

1. Where

(a) An enterprise of a contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other contracting State, or

(b) The same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State [...]

Therefore, the definition of associated enterprise in article 9(1) of the OECD Model covers the following situations (emphasis added):

- Enterprise A of Contracting State A “participates directly or indirectly in the *management, control or capital*” of Enterprise B of Contracting State B; and
- the same persons “participate directly or indirectly in the *management, control or capital* of” Enterprise A in Contracting State A and of Enterprise B in Contracting State B.

As can be easily observed, the term “associated enterprise” is given a very broad meaning, i.e. it encompasses a number of different situations. [86]

The status of being associated is triggered by either (1) participation in the capital or (2) the management or control of another enterprise. No definition is given as to what constitutes participation in management, control or capital. The Commentary on Article 9 only refers in paragraph 1 to “associated enterprises (*parent and subsidiary companies and companies under common control*)” (emphasis added), but does not further expand on the meaning and scope of the phrase “management, control or capital”.

Neither the 1995 OECD Guidelines nor the revised 2010 version discuss this matter, apart from a definition in the Glossary repeating article 9(1)(a) and (b).

The 1979 OECD Report states in paragraph 7 that it was not thought necessary to define “associated enterprises” or “under common control”, because a broad basis of common understanding was assumed. For an explanation of the term “MNE”, the report refers to the OECD Guidelines for Multinational Enterprises of 21 June 1976 covering international investment. [87]

86. *See* P. Baker, *Double Taxation Conventions and International Tax Law* (Sweet & Maxwell UK 3rd edition, December 2014.
87. “Companies and other entities whose ownership is private, State or mixed … and so linked that one or more of them may be able to exercise a significant influence over the activities of others and, in particular, to share knowledge and resources with the others.”

The first question that arises is why the particular order in the wording "management, control or capital" is chosen. After all, the most straightforward and common relationship in the business world seems to arise through a sole or majority participation in the capital (including voting rights) of one or more companies by one legal entity or individual. This encompasses the power to decide on the application of profits and reserves of the company or companies concerned and eventually on its (their) liquidation.

In this regard, a point of confusion is seen in the fact that "control" (apparently, the notion to be defined in article 9(1)) is presented by the wording of the provision as one of the forms which can be taken by the association relationship among enterprises. Control is presented as something other than "participation in the management" or "participation in the capital". As a result, with no further specifications found in either the text of article 9 or the OECD Model, the term "control" is an undefined one falling within the scope of article 3(2) of the OECD Model. For instance, a number of countries tend to give the notion of control a broad meaning in order to encompass all those circumstances where an entity can actually or even potentially influence the business decisions of its affiliate. [88]

Consider an example of the uncertainties arising due to the lack of definition of what "control" means in the context of article 9, particularly for the purposes of avoiding economic double taxation.

Assume that Company A, located in Country A, has been subjected by the local tax authorities to a primary transfer pricing adjustment relating to one or more transactions entered into with Company B, in Country B, the other treaty partner of Country A. Under the law of Country A, but not under the law of Country B, Company B is deemed to be an associated enterprise of Company A. Therefore, the country applying the treaty under article 3(2) is Country B. Hence, the notion of control provided for by article 9 would be construed with reference to the domestic provisions of Country B.

However, the domestic law of Country B does not deem Company A and Company B to be associated enterprises (e.g. the domestic law of Country B follows a strictly legalistic approach, in that companies are deemed to be associated if one entity controls at least 25% of the share capital or the voting rights of the other enterprise, and Company A does not meet those standards in the case at stake). As a consequence, the following outcomes will arise:

- country B is bound, under the treaty with Country A, to make a corresponding adjustment of the profits of the associated enterprise only if it considers the primary adjustment in Country A justified in principle and as concerns the amount, i.e. first and foremost the companies must be associated enterprises under the applicable treaty;
- no participation in either capital or management occurs between the two associated enterprises;
- the wording "participation in control" under article 9(1) must be construed under the domestic law of Country B;
- in this example, the two companies, deemed to be associated enterprise under the domestic law of Country A, cannot be deemed as such under the domestic law of Country B because their situation falls outside of the scope of the notion of control endorsed therein.

88. *See* for this line of reasoning the Italian Ministry of Finance Circular letter 32/9/2267 of 22 September 1980 (the Circular), where, in short, the Circular deems that the decisive factor in assessing the existence of a "control" relationship consists in the ability of one party to influence the business decisions of the other party. It can also result from de facto relationships among entrepreneurs, i.e. based only on factual circumstances. As a result, the Circular states that the notion of "control" relevant for transfer pricing purposes encompasses all cases of economic influence, both actual and potential. In this respect, a number of circumstances are listed by the Circular as relevant for purposes of judging the existence of a "control" relationship, the most relevant being the situation where an actual or potential influence is exercised over the entrepreneurial decisions of an entity within the group. For further details, *see* G. Cottani, 64 Bull. Intl. Taxn. 8/9 (2010), Journals IBFD.

As a result, Country B can legitimately claim not to be required by article 9 of the tax treaty with Country A to make the corresponding adjustment based on the circumstance that the transaction adjusted by Country A cannot be deemed a "controlled transaction" under article 9(1) of the applicable treaty as construed under the legislation of Country B.

Management comes only second as a relevant criterion. Management entails the right to make business decisions; it has an impact on the creation of profits (and losses) but cannot normally on its own decide regarding the application of profit and reserves, nor on liquidation. Both relationships can be classified as de jure relationships, vested in company law.

The reason why article 9(1)(b) refers to "persons" in the plural remains unclear. Currently, the notion of common control seems to cover one person holding or managing two or more companies.

Another narrowing element of article 9(1) is the restriction to "companies", which is clearly not the purpose of any transfer pricing regulation. Multinationals may set up unincorporated partnerships within the group. Also, the relationship between an individual sole or majority shareholder and the ("his") company concerned is assumed to be covered by article 9(1).

A third weakness of the article 9 definition is that relationships between parts of one enterprise located in different countries (head office PE and PEs among themselves) are neglected.

In addition to dealing with associated enterprises in article 9, the OECD Model contains two provisions referring to "special relationships".

Articles 11(6) and 12(4) of the OECD Model refer to excess interest and excess royalties paid because of the special relationship between the payer in the source country and the beneficial owner in the latter's country of residence. The articles indicate that the reduced level of 10% withholding tax on interest and the absence of source taxation on royalty payments do not apply to the excess amount. The respective commentaries (paragraphs 32 and 22) include the words "stipulated at arm's length".

Lastly, the commentaries to articles 11(6) and 12(4) refer in paragraphs 33 and 23, respectively, to "cases where interest is [or, respectively, royalties are] paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having common interest with him. *These examples, moreover, are similar or analogous to the cases contemplated by Article 9*" (emphasis added). On the other hand, the concept of special relationship also covers relationship by blood or marriage. Apparently, the latter type of relationship is not covered by article 9.

If the bracket definition cannot be considered a proper definition, it must be assumed that participation in "management, control or capital" is not defined in the OECD Model. This would trigger the rule of article 3(2) of the OECD Model, under which any term not defined in the convention will have the meaning as determined under the domestic tax law of the country applying the convention, unless the context requires otherwise.

In conclusion, it is therefore necessary to first analyse the meaning of associated enterprise under domestic tax law, and then to determine whether domestic meanings make sense in the context of tax treaties and the OECD Model.

7.2. Domestic definitions of associated enterprise

For an overview of domestic associated enterprises, reference can be made to sections 2.5. of the Country Chapters of IBFD's Transfer Pricing, Topical Analyses IBFD (accessed 6 Feb. 2017).

Country
Argentina
Australia
Austria
Belgium
Brazil
Bulgaria
Canada
Chile
China (People's Rep.)
Colombia
Costa Rica
Cyprus
Czech Republic
Denmark
Egypt
Finland
France
Germany
Ghana
Greece
Hungary
India
Indonesia
Ireland
Israel
Italy
Japan
Korea (Rep.)
Latvia
Luxembourg

Country
Malaysia
Malta
Mexico
Netherlands
New Zealand
Nigeria
Norway
Pakistan
Panama
Peru
Philippines
Poland
Portugal
Romania
Russia
Singapore
Slovak Republic
Slovenia
South Africa
Spain
Sweden
Switzerland
Taiwan
Thailand
Turkey
Ukraine
United Kingdom
United States
Uruguay
Venezuela
Vietnam

Other than Denmark, which applies a definition of associated enterprises restricted to shareholding relationships or voting rights, the Netherlands and the United Kingdom, which have instead adopted a definition similar to article 9(1), almost all counties having transfer pricing legislation combine shareholding (voting) and managerial relationships (so-called de jure control) with various specific categories of de facto control – including through family or other personal relationships, and – in several cases – a reversed burden of proof (Brazil and France).

Noteworthy examples of de facto control are France (exclusive manufacturing or distribution rights), Germany (one party is able to influence the terms of business relations with the other), Brazil (exclusive agents, distributors), Italy (exercise of potential influence in the decisions of another enterprise) and India (at least 90% dependency on another enterprise concerning supplies; influence by another enterprise on prices and conditions of goods sold by an enterprise).

Unavoidably, purely open-market situations will be covered by formulas covering de facto control – for instance the position of a relatively small independent producer of automobile parts that sells almost exclusively to one large carmaker abroad. Because of the absence of readily available other clientele, the large client is able to dictate prices and conditions in that situation, which may lead to a marginal result of the supplier. Although the dependency situation ("control") is the result of open-market forces, the tax authorities may adjust the prices because of a broad definition of associated enterprise in several countries.

A specific anti-tax avoidance approach is seen in Australia, Canada, India and the United States, and is aimed at reducing the tax burden of one – otherwise unrelated – party against the usually non-taxable benefits of the other:

- Australia: any connection between any two or more parties;
- Canada: non-related parties may deal with each other on a non-arm's length basis;
- India: prior agreement between parties; and
- United States: "actions of two or more taxpayers acting in concert or with a common goal or purpose".

In addition to common clauses on a controlling influence of one entity over another, or of one party over two entities through shareholding (voting) or management which can be classified as de jure control – both relationships generally being covered by company law – most countries, as indicated above, cover de facto control, which may be the result of contracts, mutual understandings or situations arising in practice.

As shown earlier, reliance on the domestic law of the treaty party concerned by means of article 3(2) of the OECD Model would result in a greatly differing application, as well as an authority to adjust far beyond the scope of associated enterprises, which is very likely intended by article 9 of the OECD Model. The bracket definition of paragraph 1 of the Commentary on Article 9 may not be taken as a definition, but at least as an indication of the context. Another clue as to the context is the absence of the authority to make adjustments in the case of "normal open market commercial terms", as paragraph 1 of the Commentary states.

It is therefore concluded that in the situation where a tax treaty with similar provisions as article 9(1) and (2) of the OECD Model applies, the article permits an adjustment only in cases where double taxation would arise as a result of the adjustment, generally only in shareholding (including voting rights and interests in partnerships) and managerial relationships. [89]

This does not set aside the power of tax authorities attributed in domestic tax laws to challenge cases of tax fraud and tax avoidance without any business justification.

The above clauses in Australian, Canadian, Indian and US tax laws probably cover such situations. The OECD Guidelines refer to a distinction between transfer pricing rules and rules on tax fraud and tax avoidance in paragraph 1.2: "The consideration of transfer pricing should not be confused with the consideration of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes.". The latter point was reinforced in the newly enacted chapter IX of the OECD Guidelines in July of 2010. Part IV of the chapter is quite clear in pushing away tendencies to use upfront transfer pricing provisions as dedicated anti-avoidance clauses. In this regard, the new paragraph 9.168 quite bluntly stipulates that:

> [P]aragraphs 1.64-1.69 explicitly limit the non-recognition of the actual transaction or arrangement to exceptional cases. This indicates that the non-recognition of a transaction is not the norm but the exception to the general principle that a tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them.

The bottom line of a discussion of the meaning of control should be – but is unfortunately usually not indicated in the tax laws of countries – that if the interests of the parties concerned clearly diverge, no transfer pricing adjustment should be made. In cases of de facto control, the tax authorities should bear the burden of proof with regard to a common interest.

Articles 11(6) and 12(4) of the OECD Model should be considered special rules concerning secondary adjustments: [90] the reduction of withholding tax does not apply to excess interest or excess royalties (excess is understood to mean an amount higher than an arm's length remuneration).

A more fundamental question is related to the identification of the exact nature of article 9 of the OECD Model with respect to other provisions of tax conventions. In particular, it is an acknowledged principle that tax treaties generally function by restricting taxing rights under domestic tax law. This is done by allocating taxing rights to separate income categories between the residence state and the source state. The source state can only tax income to which it is expressly accorded the taxing right under the distributive articles. In contrast, the residence state's taxing right is generally not restricted, so the residence state is entitled to levy tax on the worldwide income in accordance with its domestic law.

Based on this premise, the Commentary on Article 9 claims there is no consensus (at least among the OECD member countries) on the fundamental question as to whether article 9(1) is of a restrictive or illustrative nature.

89. A tax treaty provision which makes a specific exception to this interpretation is article 9(3) of the Australia–United States treaty; each country retains the right to tax an enterprise in accordance with its domestic law, provided that the calculation is consistent with the principles of that article.
90. *See* section 8.

8. The Mechanism of Corresponding Adjustments under Article 9(2) of the OECD Model

8.1. Adjustments

8.1.1. Generally

As explained above, article 9(1) of the OECD Model and the tax laws of a great number of countries provide for an adjustment of the profits of an associated enterprise if conditions in the commercial or financial relationships with another associated enterprise are not at arm's length. The term "adjustment" or "primary adjustment" is used in this context.

A number of key issues need to be highlighted when one discusses the mechanism of primary or corresponding adjustments.

First, transfer pricing rules normally apply to increase, rather than decrease, taxable profit. This means that the application of transfer pricing rules to decrease taxable profits, other than in the context of a corresponding adjustment or a MAP, may lead to less than single taxation.

In addition, countries normally introduce transfer pricing rules in order to protect their tax base. This means that such rules will normally apply where the conditions (including the pricing) of cross-border transactions between associated enterprises have the effect of reducing the taxable profit in the country concerned (in comparison to the profit that would have been recognized had arm's length conditions be applied). The rules will apply to increase the profit to an amount that reflects arm's length conditions (including the pricing of the transaction).

There will also be circumstances where a country will need to be able to decrease the profit identified for tax purposes by a taxpayer in its own country (so-called downward adjustment). This will occur in order to prevent double taxation by giving effect to a corresponding adjustment claim made under article 9(2) of the OECD Model or a MAP request under a tax treaty provision mirroring that of article 25 of the OECD Model. Downward adjustments are made only as a result of the application of a treaty in order to reduce double taxation. Unilateral downward adjustments to profits are likely to result in less than single taxation.

8.1.2. Country experiences

Most countries have included in their transfer pricing legislation a provision allowing either the taxpayer or the tax authorities to carry out only upward adjustments to profits of associated enterprises.

In most countries, the ability to make a downward adjustment in order to prevent double taxation is made only under the terms of an applicable treaty and the legislation that implements that treaty into domestic law. Thus, the rules implementing domestic transfer pricing provisions are normally separate from those that provide relief from double taxation under the terms of the treaty.

Some countries, such as Italy, authorize the possibility of effecting a downward adjustment in their domestic transfer pricing legislation by limiting this to the application of treaty provisions. For instance, article 110(7) of the Italian Income Tax Code allows a downward transfer pricing adjustment only to the extent that it is the outcome of discussions among competent authorities at a MAP level.

Example: A taxpayer, X, in Country A, sells goods for 100 to an associated enterprise, Y, in Country B. The arm's length price for that type of controlled transaction is 80. Should Country A have a domestic provision allowing a downward adjustment to the profits of X, the latter may be able to make use of its transfer pricing rules to reduce the taxable receipts in Country A to 80. In such a case, the taxpayer in Country A would be taxed on a receipt of 80 and taxpayer Y in Country B would receive a deduction against income of 100. The result would be less than single taxation, an outcome that bilateral tax treaties based on the wording of the OECD and UN Models all seek to avoid.

The following example may illustrate the effect of a transfer pricing adjustment: Group Company X in Country A manufactures and sells goods to an associated sales Company Y in Country B. Applying the cost-plus method for several years, X charges the manufacturing costs and a proportion of overhead expenses plus a profit markup of 10%. In a given year, 100,000 items are sold to Y at an average price of EUR 10, yielding an income of EUR 1 million to X (Stage 1 of Table 1).

After an audit of the accounts of X, the tax inspector in Country A decides to increase the price per item to EUR 15, which results in an adjusted income of EUR 1.5 million for X. He justifies the adjustment to an amount of EUR 500,000 by referring to open-market prices for similar goods, which were on average 50% higher than the prices charged by X in the year concerned. The inspector qualifies the open-market price as a comparable uncontrolled price (CUP), because in his opinion, other aspects of the X-Y transaction are comparable with transactions between unrelated parties.

Company X therefore has to pay additional tax on an amount of EUR 500,000.

From the perspective of the group to which X and Y belong, an amount of EUR 500,000 is taxed twice, yet the tax accounts of Company Y remain the same: only EUR 1 million has been deducted as an expense for tax purposes by Y in the year concerned (Stage 2 of Table 1).

8.2. Corresponding adjustments

As indicated above, article 9 of the OECD Model was supplemented in 1977 by a second paragraph, which allows for a corresponding (downward) adjustment of the profit of the related entity in the other state. The corresponding adjustment avoids economic double taxation or – in the relationship between a head office and a PE – juridical double taxation.

Article 9(2) provides for a solution in cases where economic double taxation arises: additional tax is levied because of the rewriting of accounts of one enterprise, while the accounts of the related enterprise in the other country remain the same. A corresponding adjustment in the other country (rewriting to the same amount of the books of the related enterprise) would remove the economic double taxation that would otherwise arise.

To this end, article 9(2) states that, where an enterprise of one state is taxed on profits on which an enterprise of the second state has already been charged to tax and, under conditions made or imposed between independent enterprises the profits should have accrued to the first enterprise, then the tax authorities of the second state “shall make an appropriate adjustment to the amount of tax charged thereon on these profits”. The drafting of article 9(2) is rather ambiguous for a provision of increasing practical importance. Indeed, based on the wording of the paragraph, it does not appear necessary that the enterprises be associated (within the meaning given in article 9(1)) or that a transfer pricing adjustment has been made in the first state, simply that the same profit has been counted twice.

Paragraph 5 of the Commentary on Article 9(2) settled the issue by making clear that the paragraph aimed at finding its application where transactions between associated enterprises had been recharacterized as envisaged by article 9(1).

Notably, while the wording of article 9(2) stipulates that "the other State shall" make an appropriate adjustment, paragraph 6 of the Commentary weakens this by providing that the second state needs to make an adjustment only if it "considers that the figure of the adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length.". The paragraph ends: "State B is therefore committed to making an adjustment of the profits of the affiliated company only if it considers that the adjustment made in State A is justified both in principle and as regards the amount."

An amendment to paragraph 6 in 1992 stressed that no adjustment should be made if profits are adjusted above the arm's length level. The rationale for this restriction is discussed in the Mutual Agreement Report (paragraph 70) of the OECD CFA. To this end, the Committee deemed "it unacceptable to commit State B to provide an automatic corresponding adjustment, whether or not it considered the adjustment made in State A justified in principle and amount, since this would be tantamount to requiring State B to give State A a blank cheque.".

Equally, the CFA, unlike the amendments made in 2008 with the introduction of the new paragraph 5 of article 25, rejected any introduction of compulsory arbitration or of any amendments to article 9(2). As a result, the taxpayer has no right to obtain a corresponding adjustment. This means that the taxpayer may solely initiate a competent authority procedure on the basis that under article 25(1) of the OECD Model, "the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention."

This should not lead to the conclusion that there is an obligation of results hanging over the heads of the states involved. The competent authorities must endeavour to find an agreement, but they are not bound to reach a solution.[91]

According to the Commentary on Article 9(2), a corresponding adjustment is mandatory only if State B agrees to the method applied and to the amount of the original adjustment made in State A. A general consensus on arm's length transfer pricing methods within the OECD is therefore very important.

Continuing the example from section 8.1.2., group Company Y may inform the tax authorities of Country B of the adjustment in the amount of EUR 500,000 made in Country A and request the application of article 9(2) of the applicable tax treaty between Countries A and B. In clear-cut cases, the tax authorities of Country B may agree to apply a corresponding adjustment (Stage 3 of Table 1).

In particular, in complicated cases with a high revenue impact for Country B, cases may have to be resolved through the MAP of article 25 of the OECD Model. In such cases, it may take several years before a conclusion is reached. The solution may be the application in Country B of a corresponding adjustment to the same amount as the primary adjustment in Country A, a reduced primary adjustment and a corresponding adjustment or the withdrawal of the primary adjustment.

The MLI includes the provisions with respect to the corresponding adjustments in the framework of the MAP procedure. In accordance with the provisions of the MLI, the contracting states would have a requirement to make a corresponding adjustment, where the profits included in the taxable profits of the other associated enterprise are consistent with the arm's length principle. In particular, the MLI states the following:

91. *See OECD Model Tax Convention on Income and on Capital: Commentary on Article 25* para. 71 ("under paragraph 2 of Article 25, the competent authorities must endeavour to resolve a case...").

> Where a Contracting Jurisdiction includes in the profits of an enterprise of that Contracting Jurisdiction — and taxes accordingly — profits on which an enterprise of the other Contracting Jurisdiction has been charged to tax in that other Contracting Jurisdiction and the profits so included are profits which would have accrued to the enterprise of the first-mentioned Contracting Jurisdiction if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other Contracting Jurisdiction shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Covered Tax Agreement and the competent authorities of the Contracting Jurisdictions shall if necessary consult each other.[92]

One of the options suggested in the MLI is to discuss the corresponding adjustments under MAP procedures. Where the contracting states choose this option, i.e. to make a corresponding adjustment within the framework of the MAP negotiations in case the primary transfer pricing adjustment is consistent with the arm's length principle, they can avoid including the above-mentioned provision in their existing bilateral tax treaties.

MAPs and other forms of transfer pricing dispute resolution and prevention mechanisms, including the EU Arbitration Convention and APAs, are discussed in greater detail in section 21.

8.3. Secondary adjustments

Article 9 does not cover the matter of so-called secondary adjustments, as this is probably looked upon as a domestic, rather than an international, tax problem.

A transfer pricing adjustment normally changes only the tax accounts concerned. An actual payment to cover the difference between the payment under the original transaction and the adjusted price of EUR 500,000 has not been made by group Company Y in the above example. A secondary adjustment accounts for the fact that Company Y has, in reality, not paid the difference.

Continental European countries such as Austria, Germany, the Netherlands and Switzerland find a solution under the concepts of constructive dividend and informal capital (in the case of a shareholding relationship). If the non-payment of the difference is an advantage to a parent company, the amount of the difference is treated as a constructive dividend. An advantage for a subsidiary is treated as an informal capital contribution.

In the case of two sister companies, the advantage is treated as a dividend paid by Company X to the parent company and as informal capital contributed by the parent company to sister Company Y.

Other solutions may be to treat the difference as a loan or to actually transfer the amount concerned to the other party, or leave the situation as it is, the latter under the motto: too complicated!

The term "secondary adjustment" also covers aspects such as levying dividend withholding tax and capital tax on the amount of the adjustment or the corresponding adjustment, as the case may be.

In the actual implementation of the arm's length principle in domestic tax laws, four categories can be distinguished:

92. *See* art. 17(1) MLI.

(1) Countries that have included an explicit or implicit reference to the arm's length principle, and to adjustments in case of deviations, in their tax laws. For example, Australia refers to considerations less than an arm's length consideration (section 136 AD of the Income Tax Assessment Act); the United Kingdom mentions "the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length" (section 770 of the Income and Corporation Tax Act 1988 – formerly section 485); Italy refers to "the normal value" (articles 110(7) and 9(3) of the *Testo Unico delle Imposte sui Redditi*); and Spain refers to "normal market value" (article 16 of the *Ley del Impuesto sobre Sociedades*).

(2) Countries that permit prices to be adjusted in the case of associated enterprises, without reference to the arm's length principle; for example, France (article 57 of the General Tax Code, "transferred income") and the United States (section 482 of the IRC, the Secretary "may distribute, apportion or allocate gross income, deductions or credits, or allowances between or among such organizations, trades or businesses").

(3) Brazil is a special case, having specific rules for the deductibility of the cost of imported goods (and rights) and the recognition of revenue arising from exports (articles 18-24 of Law 9.430 of 27 December 1996).

(4) Countries with a broad statutory basis that has been developed for transfer pricing purposes in case law. For example, Germany (apart from section 1 of the Foreign Tax Act): excessive payments to, or understated receipts from, shareholders constitute a constructive dividend that is not deductible (section 8(3) of the Corporate Tax Act); and, similarly, the Netherlands (apart from the new transfer pricing legislation adopted in 2001) and Switzerland.

8.4. Year-end adjustments

The issue of compensating adjustments (also referred to as "year-end adjustments") is increasingly gaining prominence as a topical issue within the transfer pricing governance of large multinational groups (MNEs). In the glossary of the OECD Guidelines the term "compensating adjustment" refers to an adjustment in which the taxpayer reports a transfer price for tax purposes that is – in the taxpayer's opinion – an arm's length price for a controlled transaction, although this price differs from the amount actually charged between associated enterprises. Such an adjustment would be made before the tax return is filed.

As pointed out by the Joint Transfer Pricing Forum (JTPF) in the Future Work Programme document, the above-mentioned adjustments are required when:

- "the preliminary results" of a company in a given tax period are not in line with budgeted results for that period;
- "the preliminary results" of a company are not in line with the predetermined arm's length range applicable to that company;
- "the actual results" of a company in a given tax period are not in line with budgeted results for that period; or
- "the actual results" of a company are not in line with the predetermined arm's length range applicable to that company.

The factors that generate such differences can have a different nature and can be fully legitimate; for example, changes in the surrounding economic environment, decreases in sales volume (or sale prices), increases in operating expenses and the presence of new transactions not previously taken into account.

As indicated by the JTPF in the Future Work Programme of 29 September 2010, in business practice, adjustments are usually made in the last quarter of the tax period or the quarter immediately following it, and they are implemented through:

- a lump-sum payment to bring the recipient company back into the "benchmarked margin range";
- a reallocation of costs that increases profitability; or
- the budgeting of new services (e.g. marketing supports payments) to reduce excessive margins.

Often, companies are not able to defend the adjustment made because of difficulties in classifying payments and in identifying third-party comparables in support of the price changes applied. For example, it is difficult to support an adjustment classified as:

- a royalty, as it would be necessary to identify the licensed intangible and explain the reasons why royalty payments were not recognized and formalized in a licence agreement at the beginning of the year; or
- a service fee, as it would be necessary to demonstrate which services were supplied to the related party, the related costs and the reasons why such services were not formalized in a service agreement at the beginning of the year.

When not stipulated by contract, these practices are not easily found in relations between independent parties. In order to comply with the spirit of transfer pricing regulations and the arm's length principle, compensating adjustments should follow the same logic applied in transactions between unrelated parties.

The OECD is attempting to regulate timing issues related to transfer pricing which arise in connection with the existence of two different approaches to the application of the arm's length principle, namely:

- determination of transfer prices on an ex ante basis, based on the information available when the transaction is carried out; and
- compliance with the arm's length principle on an ex post basis.

As outlined in the Draft on Timing Issues Relating to Transfer Pricing: Request for Comments of the Secretariat of Working Party No. 6 of the OECD Centre for Tax Policy and Administration on Certain Transfer Pricing Issues (Draft on Timing Issues) published on 6 June 2012,[93] the existence of the two above-mentioned approaches presents a series of problems, including the need for year-end adjustments.

On 29 October 2012, the OECD published The Comments Received with Respect to the Discussion Draft on Timing Issues Relating to Transfer Pricing,[94] which compiles the comments by private sector representatives to issues raised by the Draft on Timing Issues. The private sector representatives

93. *See* http://www.oecd.org/ctp/transfer-pricing/50519380.pdf.
94. *See* http://www.oecd.org/ctp/transfer-pricing/Timing_Issues_Comments.pdf.

highlighted the need for OECD operating guidelines regarding year-end adjustments, which guidelines would allow companies to operate in compliance with the arm's length principle and common rules.

Attention was focused on the concept of "hindsight". For example, an approach on an ex ante basis adopted by a taxpayer would inevitably differ from an approach on an ex post basis adopted by the tax authorities, who, for their transfer pricing analysis, are able to use more updated and reliable information than that initially used by the taxpayer, which could not have known and adopted it at the beginning of the tax period.

9. Comparability Analysis as the Cornerstone for Application of the Arm's Length Principle

Article 9(1) of the OECD Model is the authoritative statement of the arm's length principle. It reads as follows (emphasis added):

> *[A]nd in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises*, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of the enterprise and taxed accordingly.

In summary, article 9(1) seeks to assess and, if applicable, adjust the profits of an enterprise derived from transactions with associated enterprises (i.e. controlled transactions) by reference to the conditions which would have been obtained between independent enterprises in comparable transactions and circumstances (i.e. comparable uncontrolled transactions).

As a result, the comparability analysis can be defined as the identification and subsequent comparison of the conditions of controlled transactions with those of comparable uncontrolled transactions.

Accordingly, article 9(1) is the foundation of the comparability analysis, as it first introduces the need to determine whether a profit adjustment is authorized under the applicable tax treaty provision, and then introduces the need to determine the profits which would have accrued at arm's length, in order to determine the amount of the profit adjustment.

As expressly highlighted by the new paragraph 1.7 of the OECD Guidelines, it is important to put the issue of comparability into perspective in order to emphasize the need for a balanced approach. On the one hand, a comparability analysis needs to be reliable, while on the other hand, it does not need to trigger an excessive burden for taxpayers and tax administrations alike.

Ultimately, as some literature has suggested, [95] this two-step approach does not explicitly highlight that only conditions which impact the profits of the enterprise should be considered. This is true to the extent that it is considered that a third step, albeit implicit, is that the association must be the trigger of the non-arm's length conditions made or imposed.

In light of the above, the following conclusions may be drawn:

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95. *See* E. Kamphuis, *How to Deal with Affiliation in Interpreting the Arm's Length Principle: The* GE *Case Reviewed*, 17 Intl. Transfer Pricing J. 4 (2010), Journals IBFD.

- article 9(1) is the foundation for the comparability analysis, as it introduces the need for:
    - a comparison between conditions (including, but not limited to, prices) made or imposed between enterprises and those which would be made between independent enterprises, in order to determine whether a rewriting of the accounts, for purposes of calculating tax liabilities of associated enterprises is authorized under article 9 of the Model Convention; and
    - a determination of the profits which would have accrued at arm's length, in order to determine the quantum of any rewriting of the accounts; and
- an income tax treaty provision similar to article 9(1) of the OECD or UN Model may not expand, but may only restrict, the domestic right to levy tax to the extent that it adjusts the profits of enterprises beyond those allowable under the arm's length principle. That said, many countries have incorporated the arm's length principle of article 9(1) of the OECD Model in their domestic legislation and may refer to the Commentary on the OECD Model and/or the OECD Guidelines for its interpretation and application.

As will be discussed in more detail in connection with the discussion of the 2010 revision of the OECD Guidelines, the relevance of the concept of comparability analysis is highlighted in the crucial role it assumes in the selection of the most appropriate transfer pricing method in light of the circumstances of the case, as well as in applying the selected transfer pricing method to arrive at an arm's length price or financial indicator (or range of prices or financial indicators). It thus plays a central role in the overall application of the arm's length principle.

A practical difficulty in applying the arm's length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there is little or no direct evidence of what conditions would have been agreed by independent enterprises. The mere fact that a transaction may not be found between independent parties does not of itself mean that it is – or is not – arm's length. Similarly, the lack of comparables for a taxpayer's controlled transaction does not mean that such transaction is – or is not – arm's length, or that the arm's length principle is not applicable to that transaction.

In a number of instances, it will be possible to use "imperfect" comparables, e.g. comparables from different countries having comparable economic conditions or comparables from another industry sector, possibly adjusted to eliminate or reduce the differences between them and the controlled transaction. In other instances, where no comparables are found for a controlled transaction between associated enterprises, it may become necessary to use a transfer pricing method that does not solely rely on comparables, or to examine the economic substance of the controlled transaction to determine whether its conditions are those that might be expected to have been agreed between independent parties in similar circumstances – lacking evidence of what independent parties have actually done in similar circumstances, as is the case for the application of the profit split method.

Controlled and uncontrolled transactions are regarded as comparable if the economically relevant characteristics of the transactions being compared and the circumstances surrounding them are sufficiently similar to provide a reliable measure of an arm's length result or adjustments may be performed to take into account any such difference (*see further* below the reference to paragraph 1.33

of the 2010 OECD Guidelines). It is recognized that, in reality, two transactions are seldom completely alike and, in this imperfect world, an apple-to-apple comparison is not possible.

One must therefore use a practical approach in ascertaining the degree of comparability between controlled and uncontrolled transactions. To be comparable does not mean that the two transactions are necessarily identical, but that either none of the differences between them could materially affect the arm's length price or profit or, where such material differences exist, that reasonably accurate adjustments can be made to eliminate their effect. Thus, in determining a reasonable degree of comparability, adjustments may need to be made to account for certain material differences between the controlled and uncontrolled transactions. These adjustments (which are referred to as comparability adjustments) are to be made only if the effect of the material differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results.

The above-mentioned degree of comparability is typically determined on the basis of a number of attributes of the transactions or parties that could materially affect prices or profits and the adjustment that can be made to account for differences. These attributes, which are usually referred to as the five comparability factors, include:

- characteristics of the property or service transferred;
- functions performed by the parties, taking into account assets employed and risks assumed, in short termed "functional analysis" (or FAR, for functions, assets and risks);
- contractual terms;
- economic circumstances; and
- business strategies pursued.

As the degree of comparability increases, the number and extent of potential differences that could render the analysis inaccurate necessarily decreases. Also, in general, while adjustments can and must be made when evaluating these factors so as to increase comparability, the number, magnitude and reliability of such adjustments may affect the reliability of the overall comparability analysis.

As the OECD Guidelines have repeatedly stated (paragraph 1.33 of the 2010 OECD Guidelines) throughout their history, 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 (i.e. the price or the gross or net margins), or that reasonably accurate adjustments can be made to eliminate the effect of any such difference. Most notably, the fact that MNEs devise certain supply chain structures featuring a high level of integration leads to the conclusion that uncontrolled third party transactions may not exist. In this regard, the 2010 OECD Guidelines acknowledge such a different business reality by adding a very important section at the end of paragraph 1.11 of chapter I, by stating that "... entailed two consequences: (i) the activities of the MNEs became even more complex and integrated, leading to transactions that at times have no comparables available in the open market; (ii) the same MNEs started to explore new markets and triggered a process of de-localization towards low cost jurisdictions, leading to location savings aimed at inflating the net profits at a group level." If we try to transpose this into the jargon of the OECD Guidelines, two relevant changes occurred. Firstly, a very important addition to chapter I witnessed a first important change in the application of the OECD Guidelines, as the last sentence of paragraph 1.11 stipulates that "[...] The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length ...". In other words, the OECD Guidelines acknowledge that not having comparables should not lead to the conclusion that transactions between associated enterprises are not arm's length. However, the analysis has to be further completed with the application of two further concepts, that of (i) control over risk and (ii) financial capacity to assume the risk, that are used in the scenario in the absence of comparables. These concepts allow consistency with the arm's length principle of the risk allocation in a controlled transaction, in that the examination of which party has greater control over the risk can be a relevant factor to assist in the determination of whether a similar risk allocation would have been agreed between independent parties in comparable circumstances. In such situations, if risks are allocated to the party to the controlled transactions that has relatively less control over them, the tax administration may decide to challenge the arm's length nature of such risk allocation. On top of that, where risk is contractually assigned to a party (hereafter "the transferee") that does not have, at the time when the contract is entered into, the financial capacity to assume it, e.g. because it is anticipated that it will not have the capacity to bear the consequences of the risk should it materialize and that it also does not put in place a mechanism to cover it, doubts may arise as to whether the risk would be assigned to this party in an arm's length situation. In effect, in such a situation, the risk may have to be effectively borne by the transferor, the parent company, creditors or another party, depending on the facts and circumstances of the case, irrespective of the contractual terms that purportedly assigned it to the transferee. [96]

In this respect, an interesting development in the settlement of transfer pricing cases, absent any comparable, is the landmark decision in the *DSG* case in the United Kingdom (*DSG Retail Ltd & Others v. HMRC* TC 00001) dealing with captive insurance. This decision is particularly important, not only because it is a rare victory for the tax authorities, proving that it is not necessary to have extensive domestic transfer pricing legislation to make it effective, but also because it is based on a sophisticated analysis grounded on bargaining theory, concluding in favour of the application of the profit split method. For the sake of the current discussion, one of the features addressed is the attempt to tackle the complex issue of "integration" raised by the OECD Guidelines at paragraph 1.10, which states that, "[t]he separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses."

As regards the issue of delocalization of activities, location savings is a concept currently at the centre of a heated debate amongst literature and tax authorities that consider such a notion as an intangible for purposes of a transfer pricing analysis, and those that instead look at this as a comparability factor, particularly relevant when business restructuring transactions are taking place. In this respect, it must be pointed out that the notion of location savings has been introduced for the first time in the OECD Guidelines with the release of the new chapter IX concerning business restructuring transactions. To this end, location savings have been defined in paragraphs 9.148 and 9.149 of the new chapter as savings that can be derived by an MNE group that relocates some of its activities to a place where costs (such as labour costs, real estate costs, etc.) are lower than in the location where the activities were initially performed, account being taken of the possible costs involved in the relocation (such as termination costs for the existing operation, possibly higher infrastructure costs in the new location, possibly higher transportation costs if the new operation is more distant from the market, training costs of local employees, etc.). Where a business strategy aimed at deriving location savings is put forward as a business reason for restructuring, the discussion at paragraphs 1.59-1.63 is relevant. Where significant location savings are derived further to a business restructuring, the question arises of whether, and if so how, the location savings should be shared among the parties.

96. *See* chapter IX of the 2010 OECD Guidelines, paragraphs 9.22 to 9.32.

The UN TP Manual addresses the issue of location savings in even greater detail where, in paragraph 5.3.2.39 of chapter 5 regarding the comparability analysis, the concept of "location savings" may come into play during a transfer pricing analysis.

In particular, location savings are defined as "the net cost savings that an MNE realizes as a result of relocation of operations from a high cost jurisdiction to a low cost jurisdiction". Typically, the possibility to derive location savings may vary from one jurisdiction to another, depending, for example, on the following:

- labour costs;
- raw material costs;
- transportation costs;
- rent;
- training costs;
- subsidies;
- incentives including tax exemptions; and
- infrastructure costs.

It is quite possible that part of the cost savings may be offset at times by "dis-savings" on account of poor infrastructure in relation to the quality and reliability of the power supply, higher costs for transportation, quality control, etc. Accordingly, only the net location savings (i.e. savings minus dissavings) may give rise to an extra profit arising to an MNE due to the relocation of its business from a high cost to a low cost jurisdiction.

According to paragraph 5.3.2.0, the computation of location savings typically involves the quantification of the net cost savings derived from relocating to a low-cost country, as compared to the relevant high-cost country. In theory, the cost savings computation includes selection of a pre-transfer manufacturing or servicing base in the relevant high-cost country compared to the comparable manufacturing or services cost in the low-cost country, taking into account such things as total labour cost per unit of output (adjustment on account of difference in labour productivity), cost of raw material, costs of land and rent costs, tax benefits, etc. In certain cases, the cost savings can be partially offset by a higher cost of infrastructure, such as less reliable power, etc.

Cost savings (e.g. cheap labour)	−	Dis-savings (e.g. high transportation cost)	=	Net location savings

As will be stressed during the discussion regarding the application of the methods, the type and attributes of the comparables available in a given situation typically determine the most appropriate transfer pricing method. In general, closely comparable products (or services) are required if the CUP method is used for arm's length pricing; the resale price method, cost-plus method and transactional net margin method (TNMM), normally referred to as "one-sided" methods, as they focus on the identification of one tested party only, generally require a lesser degree of comparability of products or services and may be appropriate if functional comparables are available, i.e. where the functions performed, assets used and risks assumed by the parties to the controlled transaction are sufficiently comparable to the functions performed, assets used and risks assumed by the parties to the uncontrolled transaction so that the comparison makes economic sense. An example would be two comparable distributors of consumer goods, where the goods distributed may not be exactly the same, but the functional analysis of the two distributors would be comparable.

10. The 1995 OECD Transfer Pricing Guidelines

10.1. Introduction

In 1992, a Task Force of Working Party No. 6 of the CFA began working on an update and consolidation of the 1979 and 1984 Reports on Transfer Pricing. An update was necessary to reflect developments in international trade (e.g. global trading) and technological developments. The 1995 OECD Guidelines aimed in particular at bridging the differences which have arisen between the United States and other OECD countries since the publication of the US White Paper in 1988. A worldwide standard on this matter was felt to be urgently needed, in particular to avoid double taxation.

First, the Guidelines were presented as discussion drafts. Their final version was released in instalments, starting with chapters I to V in July 1995, covering the arm's length principle (chapter I), traditional methods (chapter II), other methods (chapter III), administrative approaches (chapter IV) and documentation (chapter V). The second batch was released in March 1996, covering intangible property (chapter VI) and services (chapter VII). A chapter on cost contribution arrangements (chapter VIII) was published in October 1997. Guidelines for concluding APAs under the MAP were issued in October 1999.

The Preface to the OECD Guidelines emphasized that the OECD was holding to the endorsement of the separate entity approach as the underlying concept supporting the arm's length principle. [97] The OECD Guidelines were intended to indicate ways for tax administrations and MNEs to find mutually acceptable solutions, thereby minimizing conflict among tax administrations and between tax administrations and MNEs. Tax administrations are encouraged to take the taxpayer's commercial judgement with respect to transfer prices into account in the case of tax audits.

The Guidelines were also intended to be used in MAPs and arbitration proceedings between OECD member countries. As noted above, article 9(2) of the OECD Model requires that a corresponding adjustment be made in order to avoid economic double taxation only if the country in question, Country B, agrees with the primary adjustment made by the tax administration of Country A. As a result, the Preface stated that Country A must prove that the primary adjustment is applied correctly both in principle and as regards the amount.

10.2. The arm's length principle in the 1995 OECD Guidelines

Chapter I dealt with the arm's length principle. Important considerations from the 1979 Report were restated, e.g. tax administrations should not automatically assume that associated enterprises manipulate their profits. Determining transfer prices – under the OECD Guidelines – is very difficult because in many cases it is not possible to make a comparison with an open-market situation.

Furthermore, chapter I stated that arm's length adjustments must be applied, irrespective of any contractual obligation of the parties or of any intention of the parties to avoid tax. Tax authorities were

97. *See* J. Owens, *Should the Arm's Length Principle Retire?*, 12 Intl. Transfer Pricing J. 3, p. 99 (2005), Journals IBFD.

warned by the Guidelines not to automatically assume that MNEs manipulate transfer prices. Again, the consideration of transfer prices should not be confused with tax fraud or tax avoidance, although transfer prices may be used for such purposes.

If transfer prices were not determined in accordance with the arm's length principle, the tax liabilities of associated enterprises and the tax revenues of the countries concerned will be distorted. Nevertheless, factors other than tax considerations can lead to distortions, e.g. conflicting legislation relating to customs valuation, anti-dumping and exchange and price controls. Furthermore, distortions may be caused by cash flow requirements within an MNE or – in the case of MNEs quoted on the stock exchange – by the pressure from shareholders to show high profits at the parent company level.

An important issue of the 1979 Report was developed in more detail. Associated enterprises within a multinational group normally have a considerable amount of autonomy and often negotiate with each other as if they were independent parties with the possibility of buying and selling in the open market if conditions are more favourable there. Managers of such group enterprises have an interest in establishing good profit records; prices which would reduce profits are counter to that interest. Also, from the perspective of good management, MNEs can be motivated to use arm's length prices so as to be able to judge the actual performance of their profit centres.

In the 1995 OECD Guidelines, the OECD provided the fundamental basis to the arm's length principle: the equal treatment of MNEs and independent enterprises. One could, however, ask whether the balance has not swung in the other direction. In particular, the US documentation and penalty regulations place a high burden on group members dealing with each other, compared with non-associated parties.

The singularity of certain transactions within MNEs is not connected with tax considerations, but with commercial circumstances that are different from those found in independent enterprises. An independent enterprise, for instance, is normally not willing to sell intangible assets for a fixed price if the profit potential of the intangibles cannot be adequately estimated and there is another way of making the intangibles profitable. The OECD Guidelines do not provide a solution for this, but merely state that in such cases it is very difficult to determine an arm's length price.

This non-conclusive paragraph seems to be a compromise between the US approach to the transfer (sale) of intangibles whereby, in some cases, the price must be adjusted periodically, adjusting the transfer price on the basis of more recent knowledge, and the approach of other countries which excludes the use of hindsight.

Chapter I contained an important remark which seems to be aimed at the rather mathematical US approach (interquartile range, etc.): "[T]ransfer pricing is not an exact science but does require the exercise of judgement on the part of both the tax administration and taxpayer.".

The global formulary apportionment approach – also referred to as unitary taxation – was rejected as a possible theoretical and practical alternative to the arm's length standard.

10.3. Comparability issues

The former paragraphs 1.19 to 1.35 of the OECD Guidelines listed five factors which determine comparability:

- characteristics of the property or service concerned;

- functional analysis (functions performed, risks assumed and assets used);
- contractual terms;
- economic circumstances (aspects of the market: geographic, level, position, competition, supply and demand, government regulation, costs of production, substitute goods); and
- business strategies (e.g. new product development, risk aversion, market penetration).

The 1995 OECD Guidelines stated that for comparability it is necessary that:

- there be no difference between the intra-group transaction and an open-market transaction which could materially affect the price (or margin); or
- reasonably accurate adjustments can be made in order to eliminate such differences.

Comparison of prices and conditions as well as the evaluation of the differences are, under the OECD Guidelines, an essential aspect of deciding on a potential transaction by non-related enterprises. Therefore, tax administrations should also take these differences into account when establishing comparability. However, it should be noted that out of the officially described transfer pricing methods, only one requires a full comparison of prices: the arm's length principle. All the other methods either compare gross margins (such as the cost-plus and the resale price method) or operating margins (such as the TNMM and, to a certain degree, the profit split method).

Against this background, recent evolution in the practical application of the arm's length principles has added further layers of complexity in the implementation of the comparability analysis.

The CUP method compares an intra-group transaction to a similar transaction entered into by non-related enterprises. This method is less reliable if not all the characteristics that significantly affect the price are comparable. The resale price and cost-plus methods compare the gross profit margins to establish the arm's length price. Other methods are based on the comparison of profits which could have been derived if the transacting parties had dealt solely with independent enterprises.

In all cases, adjustments must be made to account for differences that would significantly affect the price charged or the return required.

10.4. Arm's length range

In the wake of the US regulations, the Guidelines also discussed the arm's length range, which was not included in the 1979 Report. It was stated that in many cases the application of the most appropriate method or methods produces a range of results all of which are equally reliable. The differences in the range of results are caused by the fact that, in general, only an approximation of the conditions between non-related enterprises is possible, or by the fact that the prices used by such enterprises are not exactly the same.

If the price or the margin is within the arm's length range, no adjustment should be made by the tax administration. If the price or the margin falls outside the range, the taxpayer should have the opportunity to present additional evidence. If the taxpayer fails to do so, the tax administration should find the point within the range that best reflects the situation of the particular transaction. The adjustment will be based on this determination.

The US regulations are more complicated and less flexible than the Guidelines in this regard. Whereas under the regulations, adjustments are made to the median of the range, the OECD Guidelines first give the taxpayer an opportunity to explain why the taxpayer's result is outside the range and next, if the taxpayer fails to do so, the adjustment should be made to the point in the range which best reflects the arm's length principle.

10.5. The use of transfer pricing methods

The most important issue that the 1995 OECD Guidelines addressed related to the existence of a formal hierarchy between the traditional transfer pricing methods and the "other" transfer pricing methods. In particular, the CUP method was considered the most relevant one to be preferred over any other method. The reasoning behind this was quite simple. As the CUP method (as a "two-sided method") is the one requiring the strictest standards of comparability, it was the one to be preferred if the comparability elements were satisfied. This meant that:

- the CUP method had to be accorded preference over any other method; and
- traditional methods had to be preferred over transactional profit methods, such as the TNMM or the profit split method, the latter being considered methods of last resort to be applied only to the extent that it was apparent that there is a lack of comparable third-party data or the transactions between the related parties were either highly integrated or presented the use of unique intangibles.

Other significant considerations on the use of methods stemming from the 1995 OECD Guidelines include the following:

- no one method is suitable in every possible situation, and it is not possible to provide specific rules that will cover every case;
- the tax administration should refrain from making minor adjustments (but "minor" is a relative concept!);
- the application of more than one method was not required, as making it obligatory to perform analyses under more than one method would create a significant burden for taxpayers;
- evidence from other group enterprises engaged in controlled transactions may facilitate an understanding of the transaction under review; and
- any method can be accepted which is agreeable to the members of the multinational group and the tax administrations in the jurisdictions of all those countries.

The issue of applying more than one method arguably represented the greatest practical difference between the OECD Guidelines and the US regulations embodying the so-called best method rule. Under the latter, the method to be selected is to be the one which, under the facts and circumstances of the case, produces the "most reliable measure" of an arm's length result. The US regulations only implicitly prescribe trying more than one method. In particular, they state that "it may be relevant to consider whether the results of an analysis are consistent with the results of an analysis under another method". However, when the IRS applies a different method with a deviating result, the taxpayer can escape a penalty only if the taxpayer can certify with contemporaneous documentation that it has tried the other method as well, and if the taxpayer can justify its choice.

11. 2010 OECD Transfer Pricing Guidelines

11.1. General introduction

The OECD Council Recommendation on the Determination of Transfer Pricing between Associated Enterprises contains a mandate from the Council to the CFA to monitor the implementation of the 1995 Report as amended, in cooperation with tax authorities of member countries and with the participation of the business community, and to recommend to the Council to amend and update, if necessary, the 1995 Report as amended, in light of this monitoring.

Within the context of this mandate, Working Party No. 6 has undertaken a major project focused on two areas, intrinsically linked, which were considered of great priority, namely:

- comparability issues encountered when applying the transfer pricing methods authorized by the OECD Guidelines (whether traditional transaction methods or transactional profit methods); and
- the application of transactional profit methods (i.e. the transactional profit split method and the transactional net margin method.

From the outset of this project, the involvement of the business community and other interested non-governmental stakeholders has played a key role in the review and development of new guidance in these two areas.

The topic of comparability was the first to be addressed, with an open invitation for comments in April 2003. Considering the comments received and the experience acquired by countries since the adoption of the OECD Guidelines, Working Party No. 6 developed a series of draft issues notes, which addressed 12 key topics:

- putting a comparability analysis and search for comparables into perspective;
- timing issues in comparability;
- internal comparables;
- determination of available sources of information and the reliability thereof;
- uncontrolled transactions;
- examining the five comparability factors;
- selecting or rejecting third parties of third-party transactions – degree of objectivity of the list of external comparables;
- determination of and making comparability adjustments, where appropriate;
- multiple-year data;
- aggregation of transactions;
- definition of the arm’s length range, extreme results, methods to enhance reliability and loss-making comparables; and
- documenting a search for comparables.

Public comments were invited on these draft issues notes in May 2006.

The revision of the guidance on the application of transactional profit methods followed the same procedural pattern as the project on comparability. In February 2006, the OECD invited comments on the application of transactional profit methods. Subsequently, Working Party No. 6 developed a series of draft issues notes, built on the input received and experience acquired by countries in applying transactional profit methods, which included the following issues:

- status of transactional profit methods as last resort;
- use of more than one method;
- access to information needed to apply or review the application of a transactional profit method;
- application of transactional profit methods and unique contributions;
- application of the TNMM;
- standard of comparability;
- application of the TNMM and identification of the net profit margin indicator;
- application of transactional profit split method – determining the combined profit to be split;
- transactional profit split method – reliability of a residual analysis and a contribution analysis;
- application of a transactional profit split method: how to split the combined profit; and
- other methods.

To this end, with regard to the use of transactional profit methods in general, both the TNMM and the profit split method can overcome the limits embedded in the existence of comparable uncontrolled transactions, as when performing a comparability search, one objective limit of commercial databases is the lack of information regarding third-party financial information on gross margins.

In particular, the need arose to reconsider their status of "last resort", as endorsed in the 1995 version of the OECD Guidelines, since despite their last resort status, transactional profit methods (and particularly the TNMM) are more commonly used in practice for a number of reasons.

These draft issues notes were released for public comment in January 2008.

From that point on, Working Party No. 6 took forward simultaneously the two projects and held a consultation on both topics in November 2008 with 35 representatives from the business community and over 50 senior officials from the OECD countries and observers. On that occasion, participants put forward their concerns and recommendations but, overall, considered that the Working Party was moving in the right direction. In particular, the Business and Industry Advisory Committee of the OECD (BIAC) applauded the OECD efforts to develop up-to-date guidance on comparability and profit methods, and highlighted the importance of consistency of approaches by governments. On their side, countries found the direct dialogue with the business community very valuable in taking forward the project.

With the business comments in mind, Working Party No. 6 resumed its work towards a proposed revision of the relevant guidance from the OECD Guidelines. This has proven to be a challenging undertaking, as the detailed review of the relevant guidance found in chapters I and III has entailed not only the amendment of the existing guidance, but also the development and insertion of new guidance on certain aspects. In this exercise, Working Party No. 6 has sought to achieve a balance between a theoretically sound framework and workable guidance on application.

Therefore, the revision of chapters I-III of the OECD Guidelines reflects the outcome of this work by introducing the following changes:

- *hierarchy of transfer pricing methods:* The OECD proposes removing exceptionality the application of transactional profit methods and replacing it with a standard whereby the selected transfer pricing method should be the "most appropriate method to the circumstances of the case". In order to reflect this evolution, it is proposed to address all transfer pricing methods in a single chapter, chapter II (part II for traditional transaction methods, part III for transactional profit methods);
- *comparability analysis:* The general guidance on the comparability analysis that is currently found at chapter I of the OECD Guidelines was updated and completed with a new chapter III containing detailed proposed guidance on comparability analyses. A new annex to this chapter provides an example of a working capital adjustment; and
- *guidance on the application of transactional profit methods:* Additional proposed guidance on the application of transactional profit methods was developed and included in chapter II, new part III. Additionally, two annexes have been drafted illustrating (i) the different measures of profits when applying a transactional profit split method and (ii) the sensitivity of gross and net profit margin indicators.

From a general perspective, the vast majority of commentators welcomed the proposed revision, as it "adds more flexibility and more pragmatism to the wording of a significant number of paragraphs". Moreover, private sector representatives acknowledged that the revision "is a significant achievement, representing as it does a potential consensus between some very diverse tax authority perspectives" and "shows significant improvements as compared to the 1995 document".

Most notably, almost all business commentators point to the fact that the revision clarifies the application of the OECD Guidelines, thereby enhancing the efficacy of the arm's length principle for cross-border transactions and reducing controversies between taxpayers and tax authorities as to the proper arm's length price (or results) in specific cases.

The project, begun in 2003, was finalized on 22 July 2010 with the release of the revised chapters I-III. The OECD has been able to achieve significant progress towards consensus on many complex and potentially controversial issues in an effort to improve the certainty of the tax environment in which the OECD Guidelines apply.

The main features of the revision of the 2010 OECD Guidelines are discussed below.

11.2. Revised chapters I-III of the 2010 OECD Guidelines

The chart below outlines the major changes that occurred with the 2010 revision of chapters I-III of the OECD Guidelines.

1995 OECD Guidelines	**July 2010 Revision**
Chapter I: The arm's length principle and comparability	Chapter I: The arm's length principle and the fundamentals of comparability

1995 OECD Guidelines	July 2010 Revision	
Chapter II: Traditional transaction methods	Chapter II: Transfer pricing methods:	
	–	Part I: Selection of the method
	–	Part II: Traditional transaction methods
	–	Part III: Transactional profit methods
Chapter III: Other methods: transactional profit methods	Chapter III: Comparability analysis	

As is shown in the above chart, the 2010 OECD Guidelines left chapter I of the Guidelines substantially unchanged. Apart from the renumbering of some relevant paragraphs, such as those concerning the recharacterization of transactions (*see* the new paragraphs 1.65-1.67, as former paragraphs 1.36-1.37 in the 1995 OECD Guidelines), Working Party No. 6 asserted the prominence of the arm's length principle in applying transfer pricing rules. This entailed a strong rejection of alternative methods, such as formulary apportionment, which have not yet been proven as validly applicable.

The major changes are seen instead in the redrafting of chapters II and III. Chapter II has been divided into three different parts, concerning:

- the selection of the method (part I) – (paragraphs 2.1-2.11);
- the application of traditional transaction methods (part II) – (paragraphs 2.12-2.55); and
- a new part III dedicated to the transactional profit methods (paragraphs 2.56-2.149).

Chapter III is brand new and is dedicated to the performance of a comparability analysis.

Before discussing each of these innovations in depth, consider that:

- Part III of the new chapter has embedded only parts of the former chapter III of the 1995 OECD Guidelines, referred to previously as methods of "last resort"; and
- from a conceptual perspective, a major point of discussion within Working Party No. 6 has been where to put the chapter on comparability analysis.

As regards the chapter on comparability analysis, a number of countries thought that it would be more logical to have the chapter on comparability placed before the discussion on the selection of the most appropriate method, but for organizational reasons the chapter on comparability was placed after the chapter on methods.

However, in the author's opinion, it would read better according to the following logical framework:

- first, chapter I;
- then chapter IX on business restructurings, as the guidance provided therein expands on a number of important concepts, such as that on control of risks;
- then chapter III on comparability analysis; and
- finally, the chapter on the selection and application of the most appropriate method.

Each of these issues is discussed in detail below.

11.2.1. New chapter III on comparability analysis

The 2010 revision of the OECD Guidelines, confirmed by its 2017 update, also contains substantial new guidance on comparability analysis. The general guidance on comparability analysis previously described in chapter I of the 1995 Guidelines was updated and completed with a new chapter III, containing detailed proposed guidance on comparability analyses and guidance on the application of transactional profit methods.

The comparability analysis aims to address one major issue: how to deal with the difficulties in accessing information on "comparables" (data on transactions between independent parties used in the application of the arm's length principle). Available statistics and academic research on the availability of information on comparables corroborate the difficulties reported by many developing countries. Often, the information relevant to a jurisdiction can only be accessed through the purchase of a licence from database providers. However, even putting aside the financial cost of acquiring access to such databases, challenges for developing country tax administrations often remain, particularly in cases where little relevant information relating to a specific jurisdiction or even region exists. Where the information does exist, it may exhibit differences compared to the transactions under review. Typically, in such cases, transfer pricing practitioners need to consider using imperfect data, including data from foreign markets. However, the effectiveness of such approaches has not been studied sufficiently to enable definitive conclusions to be drawn about when they are reliable or how any adjustments to account for such differences should be applied.

Comparability analyses are an important element in the implementation of the arm's length principle, requiring a comparison of the conditions in transactions between associated parties ("controlled transactions") with the conditions in comparable transactions between independent parties ("comparable uncontrolled transactions" or "comparables"). It is important to emphasize that comparability analyses are not always primarily focused on the actual price of the transaction. In some instances, transfer pricing rules operate to consider whether a transaction has occurred at all or has occurred in a way that is substantively different from that which is described in contracts or documentation; in ways that are substantively different from those which would occur at arm's length or are not commercially rational. It is also important to stress that comparability analyses are not always based directly on prices found in the market. More often, a comparability analysis utilizes data on profit margins. In some cases, the analysis considers economic or commercial factors to measure the relative contributions of value by the parties in order to inform a profit split.

A fundamental feature underlying the working of the comparability analysis is to distinguish between "controlled transactions" and "uncontrolled transactions". The former refers to transactions between two enterprises that are associated#in most instances this means that they are members of the same group of companies. The latter refers to transactions between independent enterprises. Such transactions may involve the sale or transfer of goods (including agricultural commodities, mineral products or manufactured goods), or anything else of value, such as physical and financial assets, intangibles (including rights), services or rights to services. The conditions of a controlled transaction are established, or tested, by reference to the conditions observed in comparable uncontrolled transactions. In order to apply the arm's length principle to controlled transactions, it is necessary to thoroughly understand the commercial or financial relations between the associated enterprises and, specifically, the features of the controlled transaction(s) to be compared. The process of doing this is referred to below in this section as “accurately delineating” the controlled transaction. Once this is understood, it will then be necessary to start the process of selecting the most appropriate transfer pricing method and identifying one or more potential uncontrolled transactions that may be considered comparable. An uncontrolled transaction is comparable to a controlled transaction when there are no differences between them that could materially affect the pricing being examined; or when such differences exist, if reasonably accurate comparability adjustments are made in order to eliminate the effects of such differences. The OECD TP Guidelines and the UN TP Manual each set out a framework of five economically relevant characteristics or comparability factors to be kept in mind when considering whether a controlled transaction is comparable to an uncontrolled transaction. These are:

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

The following example illustrates the general objective of a comparability analysis.

Assume that Company A produces raw nuts in Country A and sells it in bulk to associated enterprises only. Raw nuts are a commodity product. Terms and conditions of the controlled transaction have been agreed upon (type and quality of sugar, quantity, commercial and contractual rights, and obligations, etc.), and a transfer price of USD 0.08 per pound of nuts has been determined by Company A in its transfer pricing analysis. To test whether the transfer price of USD 0.08 complies with the arm’s length principle, a comparability analysis needs to be performed: a broad-based analysis of Company A’s circumstances needs to be undertaken and the transaction needs to be accurately delineated. The accurate delineation of the transaction shows that Company A purchases nuts from local producers and processes it into raw nuts. Those nuts are then sold to the associated enterprise that packages, sells and distributes it to third-party wholesalers and retailers, under a well-known trademark. The accurate delineation concludes that, at arm’s length, the associated enterprise would have the right to a return from the exploitation of that trademark. The analysis also shows that Company A carries out the functions (as well as uses assets and assumes risks) that are typical of independent nuts processors, and that the associated enterprise conducts functions (as well as uses assets and assumes risks) that are typical of an independent enterprise that packages, distributes and sells nuts products. Additionally, in this case, a market price of the same type of nuts sold between independent parties under comparable conditions is available. That is, the market price is derived from the sale of comparable products between independent parties carrying out the same split of functions as those between Company A and its associated enterprises. Based on the accurate delineation of the transaction and the availability of information on comparable transactions, the taxpayer concluded that a CUP method is the most appropriate method. In general terms, comparable products (ideally, identical nuts) need to be identified from available sources of information, and their comparability tested based on the economically relevant characteristics of the controlled transaction, which would have to be replicated as closely as possible by the uncontrolled transactions for which market prices are available. Then, the most appropriate transfer pricing method is to be selected (in this case the CUP method). Having identified the reliable comparable transactions, and having determined their market prices, these are compared to the transfer price of USD 0.08 per pound to determine if the latter complies with the arm's length principle.

In particular, chapter II of the OECD Guidelines introduces the notion, specified in the new chapter III, of "reasonably reliable comparables", i.e. the most reliable comparables under the circumstances of the case, bearing in mind the limitations on the availability of information and that searches for comparables data can be burdensome. It states that there is no requirement for an exhaustive search of all possible sources of comparables/all methods. It describes the non-compulsory process that taxpayers and tax authorities alike should follow in performing a comparability analysis:

- the typical nine-step process for performing a comparability analysis contains proposed guidance on the aggregation of a taxpayer's separate and combined transactions;
- disclosure of information on the foreign associated enterprise;
- internal and external comparables;
- the use of foreign comparables;
- secret comparables;
- cases where information on potential comparables is missing;
- comparability adjustments;
- determination of the arm's length range and use of statistical tools;
- loss-making comparables;
- timing issues in comparability; and
- evaluation of transactions with significant valuation uncertainties.

The new chapter III contains detailed guidance on comparability analyses, thereby updating the current reference to comparability found in chapter I of the 1995 OECD Guidelines. The new chapter apparently takes a different approach to comparability vis-à-vis the widespread practice of utilizing standardized searches with rather generic samples characterized by broad screening criteria and/or using databases with smaller comparables bases.

The chapter reflects the desire of the OECD to curtail this undesired trend to approach the comparability analysis by establishing a detailed and thorough review of facts and circumstances. In this regard, paragraph 3.1 aims to clarify what comparability involves and how the search for comparables should be undertaken. By definition, a comparison implies examining two terms, namely:

- the controlled transaction under review; and
- the uncontrolled transactions that are regarded as potentially comparable; the search for comparables is only part of the comparability analysis.

This should be neither confused with nor separated from the comparability analysis. The search for information on potentially comparable uncontrolled transactions and the process of identifying comparables are dependent upon a prior analysis of the taxpayer's controlled transactions and of the relevant comparability factors.

Moreover, to bridge the gap between taxpayers and tax authorities, the OECD has suggested following a nine-step "typical process" as a matter of good practice, with a consistent and systematic platform to perform comparability analysis. A key caveat here is, as paragraph 3.5 of the proposal states (emphasis added):

> The process described below [typical process] is *not a compulsory one* as the reliability of the outcome is more important than process (i.e. going through the process does not provide any guarantee that the outcome will be arm's length, and not going through the process does not imply that the outcome will not be arm's length).

In principle, the OECD also states that the comparability analysis aims at finding the most reliable comparables. This does not entail a requirement for an exhaustive search of all possible sources of comparables in view of information limitations and the potentially burdensome nature of a comparables search. That said, however, the fact that reasonable efforts have been made in finding and selecting comparables cannot rule out the possibility that more reliable comparables data may ultimately be found and used in determining an arm's length outcome. This effectively means that taxpayers are at risk if the comparables search process is not sufficiently thorough.

Following the earlier 2008 Discussion Draft on comparability, requiring that analyses go beyond some vague categorization of one of the parties to the controlled transactions, followed by the use of lightly examined comparable companies, it was somewhat implicit that the OECD member countries were not happy with the industry-wide application of comparability analysis.

To this end, it comes as no surprise that the OECD focused on raising the bar on comparability standards.

In the 2008 Discussion Draft, the OECD introduced what initially was a 10-step analysis, which it defined as a "typical process". The typical process seems to aim at supplying taxpayers and tax authorities with a general road map of the steps that a typical comparability analysis should entail. The OECD took one step further to clarify that the steps involved are not mandatory, although they constitute a good practice (*see* the new paragraph 3.4, i.e. going through the process does not provide any guarantee that the outcome will be arm's length and not going through the process does not imply that the outcome will not be arm's length). The recommended nine steps are as follows:

- Step 1: determination of years to be covered;
- Step 2: broad-based analysis of the taxpayer's circumstances;
- Step 3: understanding the controlled transaction(s) under examination based, in particular, on a functional analysis in order to choose the tested party (where needed), the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method) and to identify the significant comparability factors that should be taken into account;
- Step 4: review of existing internal comparables, if any;
- Step 5: determination of available sources of information on external comparables, where such external comparables are needed, and of the reliability of the sources;

- Step 6: selection of the most appropriate transfer pricing method and, depending on the method, definition of the relevant financial indicator (e.g. definition of the relevant net profit indicator in the case of a TNMM);
- Step 7: identification of potential comparables, including defining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in Step 3 and in accordance with the comparability factors set forth at paragraphs 1.38-1.62;
- Step 8: determination of and making comparability adjustments, where appropriate; and
- Step 9: interpretation and use of data collected, and determination of the arm's length remuneration.

The previous Step 10, referring to the implementation of a support process, was deleted during the last Working Party No. 6 consultation on the project, as it was deemed to place a too high additional burden on the taxpayer.

The 2010 revision emphasizes that the above nine-step process "is not a linear one" and that some steps might need to be carried out more than once in order to reach the desired result. For example, in particular Steps 5 through 7 would have to be repeated until the most appropriate method is selected, especially because the examination of available sources of information may in some instances influence the selection of the transfer pricing method.

Arguably, the inclusion of such a common and – most importantly – suggested (non-mandatory) process is a significant improvement, although the business community has several times expressed its concern that the inclusion of such a road map might still theoretically carry a certain degree of risk that such process may turn into the only accepted practice, with any deviations or different approaches being frowned upon by some tax authorities. This might, at least in theory, prompt either taxpayers or tax authorities to be ready to defend why the nine-step analysis was not performed.

Interesting guidance has been developed by the United Nations as well in the May 2013 release of the UN TP Manual. Paragraph 5.2 explains in a very practical manner the steps to be undertaken in the course of a comparability analysis, mirroring the existing guidance in chapter III of the OECD Guidelines.

In conclusion, it is important to bear in mind the OECD's new guidance on the comparability analysis and the need to place this analysis in perspective. Significantly, any disagreement regarding the process should be resolved by the results of such analysis, and the comparability (including the functional) analysis should lead to the choice of a method (and of the relevant process), not vice versa.

To this end, the new chapter IX on the transfer pricing aspects of business restructurings has also affirmed a very important concept often leading to controversies between the tax administration and the taxpayers. In this regard, the newly introduced paragraph 9.46 stipulates that:

> [T]he most appropriate transfer pricing method should be consistent with the allocation of risk between the parties (provided such allocation of risk is arm's length) as the risk allocation is an important part of the functional analysis of the transaction. Thus, it is the low (or high) risk nature of a business that will dictate the selection of the most appropriate transfer pricing method, and not the contrary.

The new chapter III of the 2010 revision of the OECD Guidelines plays a pivotal role in guaranteeing a proper application of the arm's length principle. Within this revision process, the role of the functional analysis (in terms of functions, assets and risks) stands out.

In summary, the following may be noted.

In view of the fact that the application of the arm's length principle entails a comparative analysis of the conditions in similar unrelated transactions under sufficiently comparable facts and circumstances, guidance with regard to the core application of the arm's length principle has always been welcome but often lacking in most regulatory frameworks. Nonetheless, the new chapter regarding the comparability analysis is the chapter that clearly takes a different approach as compared to where part of the practice has shifted.

For a number of years, there has been an increasing reliance upon standardized searches with rather generic samples. These generic samples are often characterized by very broad screening criteria (e.g. merely relying upon four-digit industry classifications) and/or using databases with smaller comparables bases. Furthermore, the increased popularity of software that combines documentation and comparables search capabilities has contributed to the more generic approaches to comparables searches. This chapter takes one back to the basics, namely a thorough analysis of facts and circumstances.

The new chapter III makes a number of clear statements:

- By definition, a comparison implies examining two things: the controlled transaction under review and the uncontrolled transactions that are regarded as potentially comparable. The search for comparables is only part of the comparability analysis. It should be neither confused with nor separated from the comparability analysis. The search for information on potentially comparable uncontrolled transactions and the process of identifying comparables is dependent upon prior analysis of the taxpayer's controlled transaction and of the relevant comparability factors.
- In particular, as the comparability analysis is at the heart of the application of the arm's length principle, it requires a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. To this end, it is worth highlighting that there are two key aspects in such an analysis: the first is to identify the commercial and financial relations between the associated enterprises and the conditions attaching to those relations in order that the controlled transaction is accurately delineated. The second aspect is to compare the conditions of the controlled transaction with the conditions of comparable transactions between independent enterprises.
- With respect to the above two elements, it is important to stress that the first aspect (i.e. accurately delineating the transaction between associated enterprises) is distinct from the second aspect of considering the pricing of the controlled transaction under the arm's length principle. With respect to the latter, chapters II and III provide guidance on the second aspect of the analysis.
- A methodical, consistent approach should provide some continuity or linkage in the overall analytical process, thereby maintaining a constant relationship amongst the various steps: from the preliminary analysis of the conditions of the controlled transaction, to the selection of the transfer pricing method, through to the identification of potential comparables and ultimately a

conclusion about whether the controlled transactions being examined are consistent with the arm's length principle as described in paragraph 1 of article 9 of the OECD Model.

- In reviewing the controlled transaction and the choice of the tested party, the 2010 OECD Guidelines continue to state that the arm's length principle should be applied on a transaction-by-transaction basis. However, a portfolio approach is introduced under which certain transactions can be bundled if the portfolio approach is part of the company's business strategy.
- Furthermore, the term "tested party" is also introduced, which should be the party with the less complex functional analysis.
- Additionally, the 2010 OECD Guidelines have added section A.4 in chapter III. Several pages have been added to expand on the definition and importance of how to approach comparable uncontrolled transactions during the process of performing a comparability analysis. This addition provides taxpayers and tax administrations further guidance on the usefulness, as well as limitations, of both internal and external comparables, their sources (e.g. databases) and the appropriateness of domestic versus foreign comparables and secret comparables.

Particularly the latter two items regarding domestic comparables and secret comparables should provide taxpayers with a further level of comfort in terms of how to prepare their comparability analysis and what should be expected of tax authorities in their review of a taxpayer's transfer pricing position. The use of foreign-source or non-domestic comparables and their relative reliability should be assessed through an analysis of the five comparability factors, instead of default rejections of non-domestic comparables. The 2010 OECD Guidelines also caution tax administrations against the unfair use of information undisclosed to taxpayers – in other words, no (more) secret comparables.

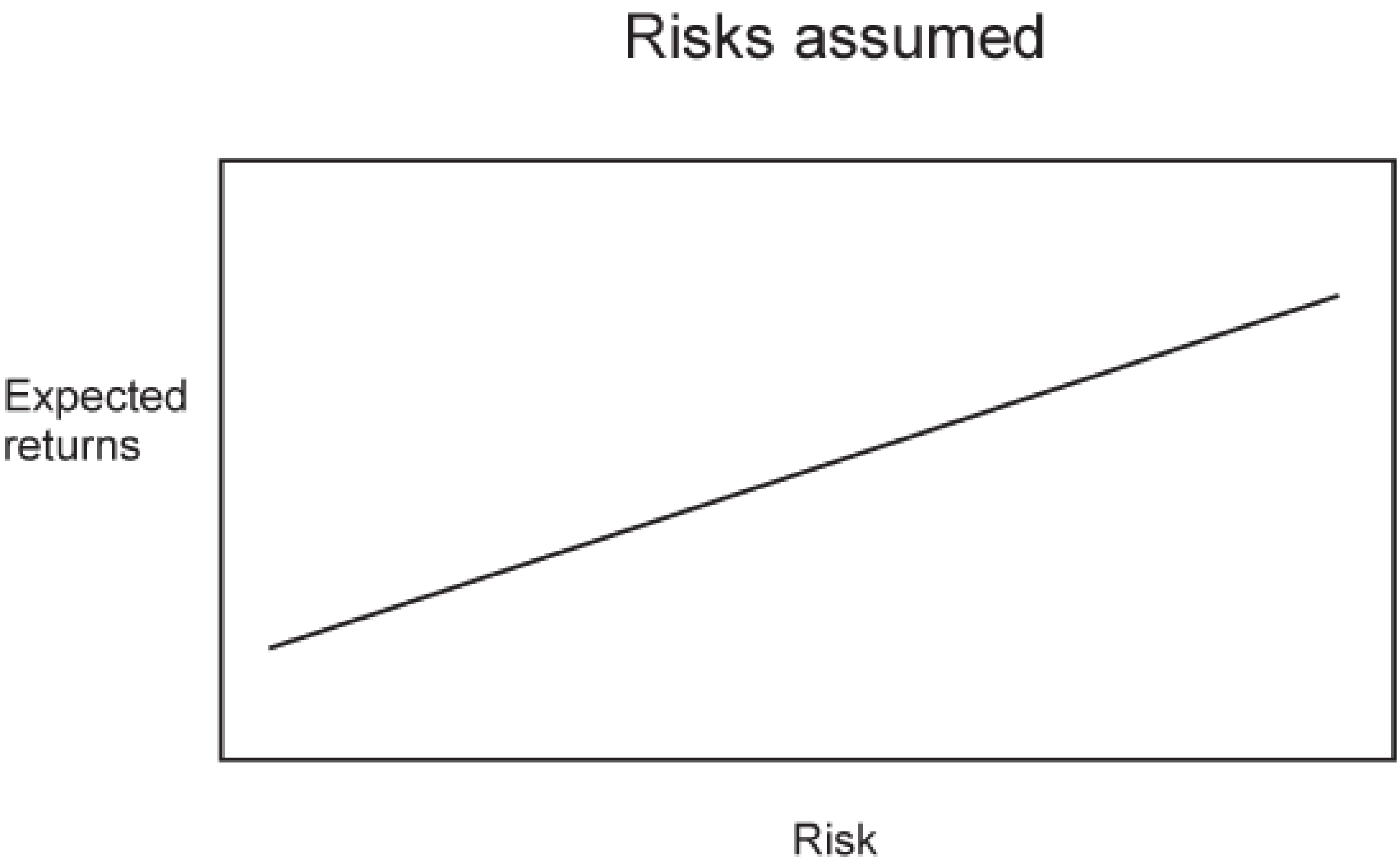
Furthermore, regarding compliance considerations, paragraph 3.81 does make it clear that there is no requirement for an exhaustive search for all possible relevant sources of information. In other words, taxpayers cannot be expected to consider multiple databases.

In addition to these helpful additions on comparability, the 2010 OECD Guidelines contain further clarification on the treatment of extreme results from potential comparables. Particularly, the text brings to light the discussion of whether loss-making comparables should be included in a comparables set. Although the 2010 OECD Guidelines state that loss-making comparables should not be rejected solely on the grounds that they suffer losses, the guidance provided cautions that further investigation and review should be conducted on loss-making comparables to determine if, in fact, they satisfy the comparability analysis in full.

Also, paragraph 3.63 clearly articulates that the topic of extreme results is a two-way street, and that high profits can be considered equally extreme as losses which entail that similar considerations should be applicable.

Lastly, the 2010 OECD Guidelines include as an annex an example regarding working capital adjustments in order to help guide taxpayers on improved comparability through the use of such adjustments. The annex provides a useful background introduction on working capital adjustments. This includes an explanation of why working capital adjustments might be considered to improve comparability, the process of calculating working capital adjustments and a practical example of how to calculate working capital adjustments.

As a further conclusive remark, some additional considerations should be developed on the central role that risks assume in the new OECD guidance. The starting point can be highlighted as follows:



This entails that under the new paragraph 1.45 of the OECD Guidelines (former paragraph 1.23), it is acknowledged that the functional and comparability analysis is incomplete unless the material risks assumed by each party have been considered, as the assumption or allocation of risks would influence the conditions of transactions between the associated enterprises.

Usually, on the open market, the assumption of increased risk would also be compensated by an increase in the expected return or expected loss, although the actual return may or may not increase, depending on the degree to which the risks are actually realized.

To this end, in determining the degree of comparability between controlled and uncontrolled transactions, it is necessary to compare the significant risks that could affect prices or profits. From a transfer pricing perspective, categories of risks that are generally identified include:

- market risks (including fluctuations in costs, demand, pricing and inventory levels);
- risk associated with R&D activities;
- financial risks (including currency and interest rate risks);
- product liability risks;

- credit and collection risks; and
- general business risks related to the ownership of property, plant and equipment.

As is the case with the analysis of contractual terms (the starting point of every transfer pricing analysis), the allocation of risks pursuant to a contractual arrangement is respected to the extent that it is consistent with the economic substance of the transaction. However, an allocation of risks among controlled taxpayers lacks economic substance if such allocation is made after the outcome is reasonably knowable. As a result, when analysing the economic substance of a transaction, it is necessary to examine further whether the conduct of the controlled taxpayer over time has been consistent with the purported risk allocation, and whether changes in the behavioural pattern have been matched by changes in the contractual arrangements.

The bottom line of the above reasoning is that, as in arm's length dealings, a party usually bears a greater proportion of business risks over which it may exert more control and an economic substance analysis should examine the extent to which a controlled taxpayer exercises managerial or operational control.

Consider a practical example that illustrates the above concepts.

IT Co is the wholly owned foreign distributor of USM, a US manufacturer of electronic devices. Under the contractual terms of the arrangement, IT Co must buy and take legal title over 100,000 widgets for each of the 5 years of the contract at a price of EUR 10 per device. The instruments will be sold under the IT Co trade name and IT Co must finance any marketing strategy to promote sales in the foreign market. IT Co has sufficient financial capacity to fund its obligations under the contract under any circumstance that could be reasonably expected to arise. IT Co will be deemed to bear the risk associated with such transaction.

Risk is not expressly listed as an OECD comparability factor, but rather it is addressed as a key part of the functional analysis.

As will be shown in the section dedicated to business restructurings, the newly included chapter IX includes an elaborate Part I on special considerations for risk (paragraphs 9.10-9.47). While chapter IX addresses the issue of risks in the context of business restructurings, it is quite obvious that the principles embedded therein are relevant for an overall understanding of the OECD Guidelines. In particular, chapter IX provides that the contractual allocation of risks will be recognized to the extent that:

- the conduct of the parties is consistent with the contractual allocation of risks;
- the conduct of the parties is consistent with a third party contractual allocation of risks;
- absent any third party comparable regarding the allocation of risk, the conclusion is not that the risk allocation is not arm's length. Rather, where no comparables are found to support a contractual allocation of risks between associated enterprises, it becomes necessary to determine whether that allocation of risk is one that might be expected to have been agreed between independent parties in similar circumstances; and
- two relevant, although not determinative, factors that can assist in this risk allocation determination are the examination of (1) which party(ies) has (have) more control over the risk and (2) which party(ies) have the financial capacity to bear the risks.

Ultimately, there is a major difference in the risk allocation process when one is dealing with two separate legal entities (reasoning in an article 9 context) as compared to one single legal entity and a PE (reasoning in an article 7 context). In the former scenario, the tax authorities and taxpayer must start their analysis by first looking at the contractual arrangements.

In the case of a PE, absent any legally binding arrangement, the functions performed, or better, the identification of the SPFs relevant to the assumption and/or management of risks will be the decisive element for attributing profits to the PE and applying the most appropriate transfer pricing method by analogy.

11.2.2. The notion of the "most appropriate method": Resemblance of or distance from the US best method rule

The major breakthrough of the 2010 update of the OECD Guidelines, and confirmed by the 2017 update of the OECD Guidelines, has been the introduction of a new concept, that of the "most appropriate method". Pursuant to the new paragraphs 2.2 and 2.3 of part I of chapter II, the selection of the most appropriate method aims at finding the most appropriate method to the circumstances of the case. Before analysing the relevance and meaning of the four criteria leading to the identification of the "most appropriate method to the circumstances of the case", the following considerations should be borne in mind in order to guarantee a proper reading of the 2010 OECD Guidelines.

First, the most appropriate method rule of paragraph 2.2 of the OECD Guidelines does not resemble the best method rule under the US regulations. The reason is straightforward: pursuant to the last sentence of paragraph 2.2 of the 2010 revised Guidelines, it is stipulated that "no one method is suitable in every possible situation, nor is it necessary to prove that a particular method is not suitable under the circumstances."

In practical terms, this entails that unlike under the US Regulations, the taxpayer will not be required under the 2010 OECD Guidelines to prove (and submit documentation corresponding thereto) that all the other methods were not appropriate, i.e. to the extent a proper comparability analysis (including a functional analysis) has been performed, the taxpayer will not be subject to any additional documentation burden.

From a comparative perspective, the US regulations are grounded on the premise that the single best method will be chosen under the best method rule, but there are exceptions. The US regulations provide that in deciding between two methods where neither is clearly the best method, the results of an analysis under a third method may be considered (*see* section 1.482-1c(2)(iii) of the Treas. Reg.). Under this procedure, one method is selected as best, and except for instances where a hybrid method is agreed to in competent authority negotiations, more than one method may be required to construct an arm's length range.

Furthermore, as paragraph 2.49 no longer deals with the choice of method, one should also read the 2010 Guidelines as mandating the selection of the most appropriate method for services, as well. However, a difference on this particular issue still exists between the US regulations and the OECD Guidelines on choosing a method for services. Indeed, the US regulations include a cost safe harbour (the services cost method). Under the US regulations, the services cost method is deemed to be the best method if (i) the services are "covered services", i.e. listed by the IRS in a Revenue Procedure regarding low-margin services, (ii) the services are not an "excluded activity", (iii) the taxpayer reasonably concludes in its business judgement that the covered services do not significantly contribute to key competitive advantages, core capabilities or fundamental risks of success or failure in one or more trades or businesses of the service provider, the service recipient or both and (iv) the taxpayer's books and records include an election of the services cost method and contain the required cost information (*see* US Treas. Reg. 1.482-9(b)(2)).

On the other end of the spectrum, the OECD Guidelines consider an arm's length price as the norm and provide for accepting cost as the basis only in exceptional circumstances at the discretion of the tax administration, such as where a cost-benefit analysis indicates that the additional revenue from an arm's length price does not justify the effort. However, as the services cost method under the US regulations is elective, the divergence should not lead to any practical detriment.

In addition, a point of uncertainty arising from the 2010 Revision of chapters I-III of the OECD Guidelines relates to whether the hierarchy in selecting the transfer pricing methods as established in 1995 has been removed. The answer is negative, i.e. a hierarchy amongst the methods still exists, but it has been softened, in that, pursuant to the wording of the new paragraph 2.3 of chapter II:

> Where taking account of the criteria described at paragraph 2.2, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method. Moreover, where, taking account of the criteria described at paragraph 2.2, the CUP and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred.

As a result, the new softened hierarchy emerging from the 2010 revision of the OECD Guidelines can be summarized as follows:

Selection of the most appropriate method to the circumstances of the case:		
If CUP and another method can be applied in an equally reliable manner	⇒ CUP	
If not:		
Where one party to the transaction performs benchmarkable functions (e.g. manufacturing, distribution, services) with no valuable, unique intangible asset / risk	⇒ One-sided method ⇒ Choice of the tested party (seller / purchaser)	
The tested party is the seller (e.g. contract manufacturing or provision of services)	⇒ Cost-plus ⇒ Cost-based TNMM ⇒ Asset-based TNMM	⇒ If cost-plus and TNMM can be applied in an equally reliable manner: cost-plus
The tested party is the buyer (e.g. marketing / distribution)	⇒ Resale price ⇒ Sales-based TNMM	⇒ If resale price and TNMM can be applied in an equally reliable manner: resale price
Where each of the parties to the transaction contributes valuable unique intangibles / risks	⇒ Two-sided method ⇒ Profit split	

11.2.3. The four criteria and the relevance of the functional analysis

The process leading to the selection of the most appropriate method to the circumstances of the case should take into account the following four factors:

- the respective strengths and weaknesses of each of the OECD recognized methods;
- the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis;
- the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods, to the extent that they are consistent with the arm's length principle; and

- the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them.

In light of this list, several points should be considered.

First, the listing of the criteria is not casual, but represents an attempt to follow a clear logical framework. This entails that in the process of selecting the most appropriate method, a taxpayer should begin by performing a so-called helicopter view, i.e. attempting to understand at the outset what would be the pros and cons of applying a method to the controlled transaction the price of which needs to be set or tested.

Second, a thorough functional analysis will need to be performed so as to accurately determine the nature of the controlled transaction. Arguably, this is the most important part of the analysis leading to a selection of the most appropriate method, as it will determine the selection of the "tested party" (the definition of which is provided by paragraph 3.18 of the new chapter III, whereby:

> [T]he tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found, i.e. it will most often be the one that has the less complex functional analysis.

In the author's view, this is one of the major conceptual messages arising from the 2010 update of the OECD Guidelines, as taxpayers and tax administrations should perform their transfer pricing study by looking first at identifying the key entrepreneurial risks, functions and assets of the controlled transactions, and only after this action has been completed will the selection of the most reliable comparables begin.

In other words, the OECD acknowledges that certain types of related party transactions may not have third-party comparables, but this should not lead to the improper assumption that the most appropriate method cannot be found. Such a conclusion has been implicitly confirmed by the addition of a very important (and at times overlooked) provision at paragraph 1.11 of chapter I of the OECD Guidelines, which states that "the mere fact that a transaction may not be found between independent enterprises does not of itself mean that it is not arm's length".

The second criterion also explains the enhanced role that the transactional profit methods have achieved as a result of the 2010 update. To this end, the TNMM and profit split method can overcome the shortcomings of the lack of comparable third-party data in achieving an arm's length result.

Lastly, the third and fourth criteria confirm that the quality of uncontrolled transactions is far more important than producing comparables that do not produce consistency with the five comparability factors as arising in the controlled transactions. Therefore, if reliable adjustments can be performed on the comparable that can substantiate the functional analysis, the selection process of the most appropriate method will be accepted (otherwise it will have to take into consideration the existence of comparability defects).

11.3. Transfer pricing methods

11.3.1. Comparable uncontrolled price method

Chapter II, part II of the 2010 OECD Guidelines described the three traditional transfer pricing methods, namely the CUP method, the resale price method and the cost-plus method.

The CUP method compares the price charged for property or services in a controlled transaction to the price agreed in a comparable transaction between non-related enterprises in comparable circumstances. Differences between the two prices may indicate that the first price is not at arm's length and that it must be replaced by the second price. The Guidelines stated that, where it is possible to locate a comparable uncontrolled transaction, the CUP method is the most direct and reliable way to apply the arm's length principle. The CUP method is preferable over all other methods in such cases as it is the one that requires a strict fulfilment of the five comparability standards. As such, it requires neither the identification of a tested party nor the use (at least in the vast majority of cases) of commercial databases.

11.3.2. Resale price method

The resale price method under the OECD Guidelines is basically similar to the resale price method under the 1979 Report. The resale price obtained by an associated reseller from an independent buyer is reduced by an appropriate gross margin (the resale price margin), which represents the cost of goods sold and an appropriate profit in light of the functions performed. What is left can be regarded as an arm's length price for the transfer of the property between the associated enterprises concerned. It is commonly used to remunerate the activities of a low-value adding distributor by comparing the gross margin obtained by an associated enterprise with that of an independent enterprise performing the same or similar function. As a one-sided method, the resale price (normally referred to as "resale minus" in the US Treasury Regulations wording) requires the identification of a tested party and stresses functional over product comparability.

Aspects of comparability are dealt with extensively by the Guidelines. The 2010 version of the OECD Guidelines stipulated that, in applying this method, differences in products are less significant for comparison than differences in functions performed, assets used, risks assumed and economic circumstances. The resale price method may even be more reliable than the CUP method if all aspects except the product itself are comparable in all characteristics.

The resale price margin can normally easily be determined where reseller B does not add substantially to the value of the product purchased from A. Where the product, purchased from A, is further processed or incorporated into another product, or where B contributes substantially to the creation or maintenance of intangible property associated with the product, e.g. a trademark, the resale price method is difficult to use.

11.3.3. Cost-plus method

The cost-plus method of the 2010 OECD Guidelines is also similar to the method endorsed in the 1979 Report. This method is useful in the case of low-value adding service providers or toll or contract manufacturers of a sale of semi-finished products, of joint-facility agreements, long-term buy-and-supply contracts or the provision of services within the multinational group or no-adding-value service activities. The markup can be derived from the profit markup that the same supplier earns in comparable transactions with non-related parties. In addition, the profit earned by an independent enterprise in a comparable transaction may serve as a guide. Like the resale price method, the aspects of comparability are more extensively examined than in the 1979 Report. In addition, the nature of the costs to be taken into consideration is examined in great detail.

11.3.4. Use of transactional profit methods

Transactional profit methods, as stated above, include the TNMM (which analyses net profit in relation to an appropriate base, such as costs, sales or assets) and the profit split method (which refers to the (total) profit from the controlled transactions and splits that profit among the contractual parties on an arm's length basis).

In the 1995 version of the Guidelines, the OECD acknowledged that difficulties in obtaining data or relevant information should not automatically lead to the application of transactional profit methods. As a matter of fact, until a few years ago, some countries allowed the application of transactional profit methods only for purposes of testing whether the taxpayer adhered to the arm's length principle; however, most countries followed the OECD approach in requiring the application of the transactional profit methods, provided that these methods produce reliable results. For instance, the Dutch tax authorities are inclined to use the TNMM to identify audit targets. [98]

In addition, if a taxpayer can demonstrate why a transactional profit method is more suitable than a traditional transaction method, the transactional profit method should be acceptable to the tax authorities.

The other (profit) methods are internationally accepted and represent a very important instrument in practice to determine the appropriate transfer price. In the United States, for instance, several investigations have been made regarding the extent to which the different transfer pricing methods have been applied in practice. Furthermore, the 1995 OECD Guidelines mentioned as a problem in the application of methods which compare net margins (operating margin), the circumstance that these can be influenced by factors which have little or no influence on the gross margin or on prices. For example, poor management and cost control generally influence the operating profit in particular. For this reason, the 1995 OECD Guidelines classified the TNMM as a method which may only be used if the traditional transaction methods are not applicable.

The 2010 update of the Guidelines has greatly expanded the guidance on both the TNMM and the profit split method so as to take into account the fact that, in practice, their use is more the norm than the exception. In particular, due to the fact that:

- a vast majority of intercompany transactions are highly interrelated and entail the transfer or license of intangibles;
- information on gross markup on costs or gross margins is hardly available in databases; and
- from a financial statement perspective, the use of the TNMM and profit split method focuses on comparing the level of operating expenses, often providing useful information on the functional profile of the company.

98. *See* D. Oosterhoff & J.P. Donga, *Practical Application of Transactional Profit Methods*, 8 Intl. Tax Planning J. 1, p. 2 (2001). The authors review the application of transactional profit methods from the perspective of the Dutch tax authorities. They conclude that next to the profit split method, the residual profit split method is also accepted by the tax authorities concerned.

All of the above led to reconsideration of the transactional profit methods in the 2010 update of the OECD Guidelines.

From a general perspective, a thorough analysis of the strengths and weaknesses of each method has been carried out. In particular, paragraph 2.59 states clearly that a TNMM is unlikely to be reliable if each party to a transaction makes valuable, unique contributions (e.g. by means of deploying intangible property or carrying out highly integrated activities).

On the other hand, the TNMM seems effective in providing reliable results where a party to transactions makes contributions that are not unique (e.g. uses non-unique intangibles or non-unique business processes), whereas the other party does not add any value or perform any significant function in the transaction between associated enterprises. Another practical strength of the TNMM is that, as with any one-sided method (such as the cost-plus or resale price method), it is necessary to examine a financial indicator for only one of the associated enterprises (the tested party).

In the author's experience, the above provides a spark in adopting the TNMM even over a profit split. The latter method, in fact, although applicable to absent comparables, unavoidably requires the availability of information from both of the associated enterprises. However, the country where the headquarters of a company is located often does not provide any such financial information, rendering the application of the profit split method practically impossible.

In particular, as regards the features concerning the use of the TNMM, there have been discussions within academic circles regarding how to identify instances where a net profit indicator is weighted to sales, costs or assets.

As regards sales, a net profit indicator divided by sales is frequently used to determine the arm's length price of purchases from an associated enterprise for resale to independent customers. In such cases, the sales figure in the denominator should be the resales of items purchased in the controlled transaction under review.

As concerns costs, cost-based indicators (normally referred to as "total" or "net" cost plus) should be used only in those circumstances where costs are a relevant indicator of the value of the functions performed, assets used and risks assumed by the tested party.

Lastly, as regards assets, returns on assets or returns on capital employed may be an appropriate base in cases where the assets utilized are a better indicator of the value added by the tested party, e.g. in asset-intensive manufacturing industries (e.g. chemicals) or in capital-intensive financial activities.

As regards the new guidance on other possible net profit level indicators, the new paragraphs 2.100 to 2.102 refer to so-called Berry ratios. This ratio is named after Professor Charles Berry, the expert hired by the IRS in the 1979 DuPont transfer pricing case who proposed measuring gross profit against operating expenses. The underlying assumption of the Berry ratio is that there is a positive relationship between the level of operating expenses and the gross profit. In other words, the more operating expenses a pure distributor incurs, the higher the level of gross profit that should be achieved.

The markup imposed on the operating expenses represents the only value added by the distributor's function, excluding the cost of goods sold, which reflects the true basis for remuneration.

In the DuPont case, Professor Berry demonstrated that the margin for the Swiss distribution function was too high because of its low costs and its low risk profile compared to other independent distributors.

Independent distributors typically face a higher burden because they have no parent company that could assume a substantial portion of the risks. If the parent company assumes most of the distributor's risk, that distributor can no longer be paid at the same level as other independent companies which cannot share the risk with the parent company. Professor Berry pointed out that the only true way to measure the profitability of such a limited distributor is to calculate its remuneration based on the gross profit level to reflect its reduced functions performed, and refer this remuneration to the operating expenses incurred. As the spending can merely represent the value added by the distributor, the arm's length remuneration should not be higher than the markup earned on operating expenses.

In the 2010 update, the OECD concluded that in order for a Berry ratio to be appropriate to test the remuneration of a controlled transaction (e.g. consisting of the distribution of products), it is necessary that:

- the value of the functions performed in the controlled transaction (taking into account assets used and risks assumed) be proportional to operating expenses;
- the value of the functions performed in the controlled transaction be not materially affected by the value of the products distributed, i.e. it is not proportional to sales; and
- the taxpayer does not perform, in the controlled transactions, any other significant function (e.g. manufacturing function) that should be remunerated using another method or financial indicator.

There are a number of approaches for estimating the division of profits, based on either projected or actual profits, as may be appropriate, to which independent enterprises would have agreed, two of which are discussed below. These approaches are respectively referred to as (i) the contribution analysis and the (ii) residual analysis, and they are not necessarily exhaustive or mutually exclusive.

Contribution analysis

Under a contribution analysis, the combined profits, which are the total profits from the controlled transactions under examination, would be divided between the associated enterprises based upon a reasonable approximation of the division of profits that independent enterprises would have expected to realize from engaging in comparable transactions. This division can be supported by comparables data where available. In the absence thereof, it is often based on the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions, taking account of their assets used and risks assumed. In cases where the relative value of the contributions can be measured directly, it may not be necessary to estimate the actual market value of each participant's contributions.

In practice it can be difficult to determine the relative value of the contribution that each of the associated enterprises makes to the controlled transactions and the approach will often depend on the facts and circumstances of each case. The determination might be made by comparing the nature and degree of each party's contribution of differing types (e.g. provision of services, development expenses incurred and capital invested) and assigning a percentage based upon the relative comparison and external market data.

Contribution analysis

A residual analysis divides the combined profits from the controlled transactions under examination in two stages. In the first stage, each participant is allocated an arm's length remuneration for its non-unique contributions in relation to the controlled transactions in which it is engaged. Ordinarily this initial remuneration would be determined by applying one of the traditional transaction methods or a transactional net margin method, by reference to the remuneration of comparable transactions between independent enterprises. Thus, it would generally not account for the return that would be generated by any unique and valuable contribution by the participants. In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances, following the guidance as described at paragraphs 2.132-2.145 for splitting the combined profits.

An alternative approach to how to apply a residual analysis could seek to replicate the outcome of bargaining between independent enterprises in a free market. In this context, in the first stage, the initial remuneration provided to each participant would correspond to the lowest price an independent seller reasonably would accept in the circumstances and the highest price that the buyer would be reasonably willing to pay. Any discrepancy between these two figures could result in the residual profit over which independent enterprises would bargain. In the second stage, the residual analysis could therefore divide this pool of profit based on an analysis of any factors relevant to the associated enterprises that would indicate how independent enterprises might have split the difference between the seller's minimum price and the buyer's maximum price.

An example illustrating the application of the residual profit split is found in Annex II to chapter II of the OECD Guidelines.

As regards the features of applying the profit split method, the new paragraph 2.109 clarified that the main strength of the method lies in the opportunity offered for highly integrated operations for which a one-sided method would not be appropriate. For instance, a transactional profit split method may be found to be the most appropriate in cases where both parties to a transaction make unique and valuable contributions (e.g. contribute unique intangibles) to the transaction, as in such a case independent parties might wish to share the profits of the transaction in proportion to their respective contributions.

Another upside of the increasing utilization of the profit split method is its use in instances where there is no direct evidence of how independent parties would have split the profits in comparable transactions. In such situations, the allocation of profits may then be based on the division of functions (taking account of assets used and risks assumed) between the associated enterprises themselves.

However, the major downside of the profit split method relates to the difficulties arising in is application. As shown by the new paragraph 2.114, the profit split method seems to appear readily accessible to both taxpayers and tax administrations, as it tends to rely less on information about independent enterprises. However, associated enterprises and tax administrations alike may have difficulty accessing information from foreign affiliates.

In addition, the computation of combined revenue and costs for all the associated enterprises participating in the controlled transaction would entail stating books and records on a common basis and making adjustments in accounting practices and currencies – at times a very difficult task to achieve.

On top of the above amendments regarding the TNMM and the profit split method, two new annexes have been included in the 2010 Update of the OECD Guidelines, namely:

- Annex I to chapter II, concerning the sensitivity of gross and net profit Indicators; and
- Annex II to chapter II, which includes an example illustrating the application of the residual profit split method.

11.3.5. Profit split method

This method may be applied where transactions are strongly interrelated and unique valuable contributions (e.g. those associated with the creation, development, maintenance and enhancement of the intangibles) are involved in the transaction. There are two typologies of profit split method: the so-called "contribution profit split" and the "residual" profit split analysis. The application of the two methodologies is further considered below in the section devoted to the 2010 update of the OECD Guidelines.

First, the consolidated profit to be split must be identified. Then the profit is split between the related enterprises on an economically valid basis that approximates a division of profits in an arm's length situation.

The combined profit may be the total profit from the transactions or a residual profit which remains after the division of profits that can be easily divided between the parties. The division should take place on the basis of a functional analysis, which comprises assets used and risks assumed. If available, external data of profit split percentages between independent enterprises with comparable functions can also play a part, especially in assessing the value of the contributions of the related enterprises.

The Guidelines stated that this method, being a "two-sided" one (as both parties to the transactions need to undergo the thorough analysis of the five comparability factors), is useful, absent valid comparables. One of the advantages of this method is that both parties to a transaction receive a reasonable remuneration for the functions performed because the contributions of both are evaluated. A weakness of the method is that comparables are usually not available.

However, due to the even more highly integrated nature of the activities carried out by associated enterprises and the scarcity of third-party comparables data used, the need to develop more nuanced guidance arose and was felt at the OECD level. To this end, the discussion draft titled BEPS Action 10: Revised Guidance on Profit Splits (the Profit Split Discussion Draft) deals with the clarification and strengthening of the guidance on the transactional profit split method (PSM) and sets out the text of the proposed revised guidance on the application of this method. As a background, the structure of the Profit Split Discussion Draft has been revised as compared to the 2016 Discussion Draft, including the following main contents: (i) general introductory statements; (ii) selection of the PSM as the most appropriate method; (iii) guidance on application of the PSM; (iv) guidance on determining the profit to be split; and (v) guidance on how the profit should be split. In the Annex, ten examples have been provided.

The Profit Split Discussion Draft reiterates several positions from the 2016 Discussion Draft, specifically the view that the reference to profits applies equally to losses when applying the PSM, as well as emphasizing that the lack of comparables by itself is not a reason to apply the PSM. The Profit Split Discussion Draft provides considerations when the PSM is likely to be the most appropriate method. These considerations include the strengths and weaknesses of the method, the nature of the transaction and the availability of reliable information. With respect to the nature of the transaction, the Profit Split Discussion Draft expands guidance on when the PSM may be the most appropriate method. As compared to the 2016 Discussion Draft, there is additional guidance on the application of the PSM in situations where both parties to a transaction share the assumption of economically significant risks or separately assume closely related risks. It is mentioned that in such cases, a split of actual profits, rather than anticipated profits, would be more appropriate since actual profits will reflect the materialization of the risks of each party. In addition, and similar to the 2016 Discussion Draft, guidance for applying the PSM is provided for cases where both parties may make unique and valuable contributions to the transaction, and/or parties are both part of a highly integrated business operation. The Profit Split Discussion Draft continues by providing guidance for applying the PSM. This guidance includes general considerations, among others on the approaches to the splitting of profits (e.g. contribution analysis or residual analysis) and on determining the relevant profits to be split. With respect to determining the relevant profits, it is clearly indicated when the splitting of actual profits is appropriate and when anticipated profits should be used, as well as the different measures of profits that may be used. It is mentioned that generally the relevant profits to be split are operating profits, but a different measure of profits such as gross profits may also be appropriate in some cases. The splitting of the profits should be done on the basis of the relative contributions to the creation of those profits. The profit splitting factors should reflect these contributions. The Profit Split Discussion Draft refers to a MNE group's Master File as a potential useful source of information to determine such splitting factors (e.g. the sections on important drivers of business profit, principal contributions to value creation, and key group intangibles).

From a practical standpoint, the application of the PSM requires the following considerations. First, one of the key features of the PSM is that, unlike one-sided methods, it is typically applied without an external benchmark other than the combined profitability of the parties. Applying the method therefore requires a well-defined rationale for splitting the combined profits at arm's length as well as the ability to distinguish what the parties can be held responsible for in terms of relative contributions or other bases for determining the profit split. Doing so, companies will generally benefit from an analytical framework that relies at least in part on a value chain analysis. In this respect, the same concepts of value creation touched upon in paragraph 1.51 of the OECD Guidelines and embedded in the analysis of intangibles in chapter 6 (sections 6.10, 6.49, 6.78 and 6.133) are fully relevant here. While the analysis of value creation is not a substitute for determining profit split factors, it does provide important contextual information that helps best decide whether the method is appropriate in a case, and to provide insights on how it may be best be applied to the circumstances of a case. The Discussion Draft also points out in paragraph 28 that "a lack of comparables alone is insufficient to warrant the use of a transactional profit split." Further, in cases where relying on comparables is appropriate, but data on comparable benchmarks are scarce, the OECD encourages taxpayers (in paragraph 14 of the Discussion Draft) to rely on uncontrolled comparables even if they are imperfect rather than having recourse to the PSM. In this regard, increased access to economic and financial data facilitates the application of adjustments in transfer pricing.

Moreover, the selection of anticipated or actual profit when applying the profit split method is crucial. Notably, paragraph 44 of the Discussion Draft reads:

> the splitting of actual profits […] would therefore only be appropriate where the accurate delineation of the transaction shows that the parties either share the assumption of the same economically significant risks associated with the business opportunity or separately assume closely related, economically significant risks associated with the business opportunity and consequently should share in the resulting profits or losses.

In relation to this, the analysis of whether or not parties actually share economically significant risks should be conducted in light of the revised chapter I of the OECD Guidelines, in the context of accurately delineated transactions. In this respect, the steps highlighted in paragraph 1.60 of the OECD Guidelines should be relevant. The categorization of risks provided in paragraph 1.72 of the OECD Guidelines is particularly helpful as a starting point of the analysis. In this context, difficulties may arise in relation to risks affecting all businesses undertaking an activity. In the context of a discussion of the control over risks, the OECD Guidelines in paragraph 1.67 indicate that "[s]ome risks cannot be influenced, and are a general condition of commercial activity affecting all businesses undertaking that activity. For example, risks associated with general economic conditions or commodity price cycles are typically beyond the scope of an MNE group to influence." The Discussion Draft is silent on these risks. An analysis in line with the guidance contained in chapter I, including particularly an analysis of the roles of the related parties, their contribution to value creation, and the delineation of the transaction would provide information as to which entity or entities effectively assume such risks in the context of the application of the profit split method.

As a side note, it is worth keeping in mind that the OECD Guidelines, whether they look at anticipated or at actual profits, tend to deal with transfer pricing from a testing point of view; they give little or no guidance as to the process of setting prices. The Discussion Draft considers that risk assumption by both parties and sharing of risks are the key required conditions for applying the profit split method. When the relevant (non-routine) risks are shared with respect to ongoing operations, a split of actual profits is indicated, since the parties assume the risks that affect the actual outcome. In contrast, when the relevant risks are shared with respect to future operations and the relevant transaction involves a transfer of ownership rights to future cash flows (such as an IP license transaction, certain financial products, or a buy-in in a restructuring), the split of anticipated profit will be preferable. When anticipated profits are split, the price of a transaction is set by reference to the share of profits that the parties expect to generate from that transaction; but such parties may not share contemporaneously the risks related to that transaction, unlike in the situation when the actual profits are split.

As described above, profit splits are appropriate in situations where there is a fundamental sharing of economically significant risks between the parties, either on a prospective, anticipated basis or in terms of actual profit results. At arm's length, parties entering into such arrangements can be assumed to share profits in proportion to their relative contributions to the joint generation of profits based on information known or reasonably foreseeable at the time the transactions were entered into and in view of the associated risks undertaken by the parties. In many situations, each party's relative investment in long-lived assets, including intangible assets like technology and some marketing intangibles as well as tangible physical and/or financial assets, represents both the contribution to the generation of the relevant profits being shared and the investment at risk. Residual analyses refine this paradigm by distinguishing between relatively "routine" contributions of assets that can be valued at arm's length based on external market benchmarks and "non-routine" assets that constitute the more fundamental contributions to the residual profits that are at risk and that are shared between the parties that contribute such non-routine assets. As described further below, however, not all situations appropriate for application of the profit split method are amenable to using costs or capital employed as profit-splitting factors, as other profit split factors may be more reliable. The Discussion Draft rightly highlights that a prescriptive list of criteria or allocation keys in the OECD Guidelines is undesirable, and that the appropriate approach should be tailored to the underlying value chain analysis and risks. Following general principles adopted in the OECD Guidelines for determining the most appropriate transfer pricing method, capital- or cost-based factors should be defined taking the following considerations into account:

- capitalized costs are generally preferable to ordinary period costs when the underlying assets have different durations, including different gestation lags;
- discount factors may be appropriate in situations involving longer-lived investments with significant durations between expenditures and value realization; and
- risk weighting may also be appropriate where cost contributions have differing risks of success or failure or where there are intercountry differences in the cost of capital . Relative costs should be measured consistently in terms of currency and relevant purchasing power parity (additional details on this are provided below), including location savings if appropriate. Consistent accounting of profits and capitalized costs may be appropriate if there are material differences between available financial or managerial accounting statements and the economically relevant measures of profit and capital.

Relevant markets for which the profits to be split are established, should be defined based on the underlying market, competitive situation and value chain analysis, together with corresponding allocations of internal accounting data. While profit splits are akin to joint ventures and are informed in part by the same principles that inform joint venture profit allocations, they are not joint ventures in fact but instead apply joint venture principles in determining the allocation of profits based on the facts and circumstances. The most appropriate profit split factor in one set of circumstances may not be appropriate under different circumstances, depending upon the underlying profit drivers and the relative contributions and risk capacities of the parties.

For example, high levels of combined profit may be split appropriately based on the relative contributions of intangible investments, whereas losses attributable to unforeseen external events would appropriately be allocated to all invested capital. Such differences can be mitigated in part by consistent application of profit split factors over the lifetime of the arrangement, including loss years and the overall business cycle, but they cannot be presumed to apply uniformly in all situations. In situations where significant value contributions are provided by human capital, employee compensation can be an appropriate profit split factor.

Financial services and other services industries may be particularly amenable to using compensation as a profit split factor, as well as other industries or business segments where human capital is a major contributor to value based on the underlying value chain analysis. Certain attributes of compensation data make it especially suitable for its use for this purpose: since compensation of employees can generally be characterized as arm's length, except for situations involving owner-managers, it can be considered as an arm's length indicator of relative non-routine, entrepreneurial value. Headcount, on the other hand, is typically less indicative of entrepreneurial value in and of itself, and may therefore be less reliable for this purpose. Given that compensation policies differ by industry and by firm, use of compensation as a profit split factor should be evaluated for each specific case.

For example, variable compensation for management may be a better indicator of relative contribution to value creation than total compensation, since variable compensation may be more closely tied to the entrepreneurial value provided by individual employees, although the degree to which variable compensation approximates the value contribution can vary depending on the industry or firm. In addition, annual compensation may not properly reflect relative contributions with respect to longer-term risk taking or in situations where there are other contributors to value such as legacy intangibles that do not rely on human capital.

Compensation-based factors should be defined taking the following considerations into account:

- labour cost differences between countries should be evaluated and adjusted based on consistent measures reflecting cost of living, inflation, and purchasing power parity;
- consistent accounting of compensation data should take into account differences in regulations related to employment, benefits, and taxes; and
- relevant employees for which compensation data are used should be defined based on the underlying value chain analysis and value drivers, and, depending on the circumstances, may be limited to senior management of a business unit or certain categories of employees who provide non-routine, entrepreneurial contributions.

11.3.6. Transactional net margin method (TNMM)

This method examines the net profit margin in relation to the costs, sales or assets which a taxpayer realizes from a transaction or aggregated transactions with a related party.

The TNMM replaced the US comparable profit method included in the original draft Guidelines. The word “transactional” has been inserted in the definition, and the words “net profit margin” have replaced “the level of profits”, apparently for political reasons. In practice, the above inclusions reflect technical considerations rather than political ones. First, irrespective of the selection of a traditional method or profit method, all of them must be transactional, i.e. all of them apply on a transaction-by-transaction basis. The focus on net profit margin reflects the financial indicator of EBIT (earnings before interest and taxes). Several OECD member countries, in particular Germany, remained fiercely opposed to the use of profit methods, probably having in mind the CPI method and comparable profit method of the 1992 proposed US regulations and 1993 temporary regulations, respectively, under which taxable income could even be based on statistical data from the industrial sector concerned.

The comparable profit method of the final US regulations of 1994 was based on the level of net operating profits of uncontrolled taxpayers engaged in similar transactions under similar circumstances. The TNMM is related to specific transactions; the comparable profit method may be “company-wide”.

The net margin of the TNMM should be established by reference to the net (operating) margin that the same enterprise earns in comparable transactions with non-related enterprises. Where this is not possible, the net margin of an independent enterprise may serve as a starting point. It goes without saying that a functional analysis of both the related enterprise and the non-related enterprise is required to determine the degree of comparability.

Similar to the comparable profit method (PLI, *see* above), a ratio must be selected for the purpose of comparison. Depending on the character of the entity concerned, a return-on-sales ratio or a return-on-assets ratio can be selected.

Transactional net margin method

Sales income	100
Direct + indirect production costs	80
Gross profit	20
Operating expenses	10
Net margin	10

- return on sales 100: 10 = 10%
- return on sales to independent retailers: 18%, 14%, 12%, 9%, 6%
- 10% is within arm's length range

The greatest weakness of the method, under the 1995 OECD Guidelines, was that the net margin can be influenced by factors that have only a minor or indirect effect on gross margin or price, for instance relatively high costs caused by start-ups, inefficiencies, poor management and a less motivated work force. Furthermore, the one-sided nature of the method can lead to a situation where a member of a multinational group is left with an implausibly low or high profit level. As will be shown shortly, this weakness has been confirmed also in the new part III of chapter II of the 2010 OECD Guidelines. The major upside, however, was (and remains) the fact that the effect of functional difference is softened by looking at a net rather than gross profit margin indicator, as operating expenses and selling, general and administrative expenses (SG&A) are taken into account in the computation of the profit margin to be part of the comparability analysis.

11.3.7. The so-called "sixth method"

An interesting emerging trend as regards the application of the most appropriate method is that of the application by a number of tax administrations of emerging economies (with a focus in the Latin America region)[99] of the so-called "sixth method". Such an approach targets the use by taxpayers of offshore trading entities (usually located in low- or no-tax jurisdictions and it is adopted by tax administrations to prevent and tackle identified schemes leading to the erosion of taxable base in specific export transactions involving commodities. It comes as no surprise that the OECD is subjecting to further scrutiny such an approach, both in terms of (i) effectiveness in targeting BEPS structures and (ii) compliance with the arm's length principle.

In particular, the sixth method is aimed at large commodity-exporting companies which, when operating in Latin American markets, may allocate part of their profits to a different jurisdiction, directing the transactions through economically related traders.

In this respect, it is worth noting that most Latin American economies (e.g. those of Argentina,[100] Ecuador, Guatemala, Honduras, Peru and Uruguay) have a strong economic dependence on the prices of various exported commodities (e.g. oil, grains and minerals).

On the basis of the above, transfer pricing-oriented base erosion in commodity products can trigger harmful consequences to Latin American economies due to the relative importance of these industries in Latin American economies. Indeed, from the perspective of Latin American countries, the sixth method is seen as an attractive measure to mobilize revenue while addressing tax avoidance schemes in a more "user friendly" manner if compared with the application of the other recognized OECD methods.

For the above-mentioned reasons, one of the key findings the OECD will have to achieve will relate to determining the potential merits of the sixth method in terms of consistency with the OECD standards

99. Such an approach is generally referred to as the sixth method because the other five existing methods for transfer pricing purposes are the OECD-recognized transfer pricing methods: CUP; RPM; cost-plus; TNMM and PSM. For the widespread use of the sixth method, *see* C. Goldemberg, *Transfer Pricing in Argentina* , 59 Bull. Intl. Taxn. 8/9, p. 390 (2005), Journals IBFD.
100. Argentina the so-called sixth method in its Income Tax Law in 2003.

for transfer pricing purposes (although most of the Latin American countries that have introduced the sixth method are not OECD members).[101]

In general technical terms, the sixth method may be described as a modified CUP method, whereby the price of the transaction is determined without taking entirely into account the facts and circumstances of the specific transaction. More notably, the sixth method applies mandatorily to one or more of the following types of transactions:

- exports and imports of commodities between associated enterprises through a foreign intermediary that is not the final recipient of the goods; and/or
- exports and imports of goods between related parties for which a publicly quoted price in a transparent market is available (i.e. all commodities, regardless of the existence of a foreign intermediary); and
- in addition, in some countries, the tax authorities may decide to apply the sixth method to the importation or exportation of any other goods when it is justified by the nature and the features of the international transaction and when it has been verified that the general conditions for the application of the sixth method are also met.

It should be observed that the sixth method generally determines the transfer price by reference to the publicly quoted price in a transparent market on the date the goods are loaded for shipment (as opposed to the date agreed upon by the parties in the contractual arrangements). Moreover, the possibility to perform comparability adjustments tend to be limited to certain items, e.g. freight and insurance clauses, unlike under the OECD recognized transfer pricing methods, for which comparability adjustments are required for all the relevant comparability factors in order to eliminate differences between the controlled transaction under examination and the comparable that could materially affect the condition being examined, i.e. the price or margin according to paragraph 1.33 of the OECD Guidelines.

The sixth method provides for a let-out clause when certain conditions are met and can be reliably proven, e.g. with respect to the existence of substance of the foreign intermediary or by registering the relevant contracts with the respective tax authorities. In such cases, depending upon each country, the transfer price would generally be the publicly quoted price in a transparent market on the date the contract was signed or the price agreed by the parties in the contract, rather than the date on which the goods are loaded for shipment.

Lastly, it should be noted that some countries (e.g. Argentina) introduced the sixth method as an anti-abuse clause. To this end, neither the fact that this method might entail the risk of possible double taxation nor its potential non-arm's length outcome have hampered the implementation of this method in the Latin American region. However, even those advocating for the application of the sixth method acknowledge that it will not always be the most appropriate one to apply in transactions involving a foreign intermediary with actual substance. Countries generally acknowledge that in the latter circumstance one of the five OECD transfer pricing methods should apply instead.

101. The sixth method has been adopted in the legislation of the following countries: Uruguay (2007), Ecuador (2008), Honduras (2011), Brazil (2012), Guatemala (2012) and Peru, in addition to Argentina. Moreover, Paraguay seems to apply a similar approach for exports and imports under its general tax system, despite not having enacted a formal transfer pricing legislation.

11.4. The use of database searches

Paragraphs 3.30 to 3.34 of the new chapter III discuss the use of databases as a source of information on potential external comparables. To this end, the OECD's discussion of databases in chapter III sends a very important message regarding the lack of a preference between internal and external comparables under the new OECD guidance. In particular, a comparable must properly satisfy the five comparability factors in order to be considered reliable, irrespective of whether it is an internal one (i.e. arising from a transaction between the tested party and an uncontrolled third party) or an external one (i.e. a comparable uncontrolled transaction).

As regards the use of commercial databases, it is acknowledged that they can be a practical and sometimes effective way of identifying external comparables and may provide the most reliable source of information, even though a number of limitations exist.

First, because commercial databases rely on publicly available information, they are not available in all the countries taken into account. In the author's opinion, the most notable limitation in using databases comes from the circumstance where there is a time lag in the information utilized and the financial information to be found therein relates to companies, whereas the arm's length principle compares transactions. The use of databases is also one of the major reasons why the traditional methods are difficult to apply in practice, as information on gross profit margins and gross markup on costs are scarce.

Having said that, commercial databases commonly used in practice include:

- Amadeus (pan-European);
- Osiris, Onesource, Compustat Global, Thomson Worldscope and Mergent Global (worldwide);
- Aida (Italy);
- Diane (France);
- Fame (United Kingdom);
- Reach (Netherlands); and
- SABI (Spain and Portugal). [102]

Commercial databases are not necessarily designed for transfer pricing purposes. They typically contain information from public disclosures, for instance, audited company accounts required by corporate, market, financial services, or other regulators, and may cover a large number of sectors and companies. There are different types of databases. Some contain only financial markets data, others contain data on particular transactions, and still others contain company accounts or other financial information. Some databases collate information from specific geographic areas. The amount of available details also varies by database, company, and geographic area. In many cases, since the database relies on disclosures required by certain regulatory bodies, the extent of disclosures in a database is determined by the relevant disclosure requirements. This tends to limit the amount of data directly drawn from developing countries.

102. *See* descriptions in W.F. Finan, I. The & T. Toutcheva, *Appendix to Practical Issues in Preparing EU Transfer Pricing Documentation*, Tax Management Transfer Pricing 11 (12 Oct. 2005).

As has been noted above, most commercial databases collate information produced for purposes other than transfer pricing. This can mean that the information collected does not always address the issues relevant for a transfer pricing analysis. With respect to commercial databases, many developing countries report two core challenges: access and limited data coverage. First, they highlight difficulties, including costs involved, in relation to accessing commercial databases. Second, even where they can be accessed, the databases often contain limited information on local economic operators that may potentially serve as comparables. A combined review of several private databases commonly relied upon by practitioners does suggest a scarcity of domestic information that can be used for comparability analysis in many countries. To approximate practical requirements, only local companies that are independent and for which revenue and net margin information is available have been counted.

Around 5 million of about 8,885,000 global records for which revenue and net margin information is available, meet the basic independence requirement. For more than 164 countries, fewer than 1,000 local observations were available that met the stipulated minimum requirement in 2013. While ongoing efforts of commercial providers to increase coverage are improving the situation, it will regularly be necessary to look for alternative, non-domestic information sources in many countries. At first glance, this review confirms that for many countries, and in particular emerging and developing economies, there may not be easy access to local comparables. It is noteworthy that this list of countries with very limited domestic information available in public databases includes many that have introduced comprehensive transfer pricing regulations. In these countries, the scope for the application of any transfer pricing method is severely constrained if it has to be based on local comparables. Moreover, the depiction also reveals inconsistency in amount of data available in various OECD economies.

A number of factors affect the variation on the availability of information. The obvious starting point is the relation between the size of a country's economy and the number of companies in that country. Other structural factors may include the dominance of markets by a few large MNEs or other corporations, important levels of state ownership in selected sectors, and the importance of smaller, sometimes informal, economic operators in many developing countries. In addition to these structural factors, there is, however, a range of regulatory and administrative choices that affect information availability. Besides limited information being captured in commonly used databases, tax administrations of developing economies frequently report that they face challenges in accessing these databases. Notably, in a survey of tax officials participating in the Global Transfer Pricing Forum 2016, almost half of the representatives from non-OECD countries indicated that their administration did not have access to a commercial database. The challenge of obtaining access to existing information largely relates to budgetary constraints faced by tax administrations in purchasing commercial databases. These constraints could be addressed through a range of initiatives:

- at the outset, countries should consider exploring the possibility of discounted rates with the commercial database providers. The use of a specific database by the tax administration likely has a non-negligible signalling effect on the private sector and tax advisory service providers. Consequently, commercial data providers have an interest in strategic partnerships with revenue services;
- countries may also consider the acquisition and use of databases, perhaps through regional organizations;

- some countries, such as Romania, have addressed budgetary constraints by using funds from APA application fees to buy database access; while other countries, such as Kenya, used actual or projected transfer pricing collections as a basis to obtain budgetary approval; and
- other countries have obtained donor support to obtain funds to purchase access to commercial databases. Reportedly, some countries' tax administrations have sought to deal with the lack of access to databases by increasing their requirements of taxpayers, for example, by requiring taxpayers to include screenshots in their transfer pricing documentation files as part of the documentation of the benchmarking study.

In addition to the general databases described above, specialized databases and publications are available for mineral, agricultural, and energy products, both from specialist trade publications (which may include additional analysis and commentary) and data directly from commodities or futures exchanges.

These publications typically provide information on market conditions and prices, trading terms and industry developments (such as long-term and short-term demand and supply forecasts, including, for example, the maintenance operations or other conditions impacting output of major mines). These publications can be useful for revenue authorities to understand market dynamics and the context for transactions, as well as finding transactions that are potentially comparable to the transaction under review.

In some cases, publications may also provide information on average premiums or discounts which may apply for a particular commodity sold at a place other than that indicated in standardized contracts. A non-exhaustive list of data sources for each mineral product case study is available in the supplementary report into mineral product pricing. Quoted prices from commodities or futures exchanges may also be a useful source of information in some cases. However, as with any potential source of information, its reliability as a comparator to the tested transaction needs to be considered. Exchange quoted prices for commodities generally reflect derivatives transactions which may deviate from market prices for the physical transfer of the commodity in a particular market. Furthermore, the particular conditions of the tested transaction may differ from the standardized contracts traded on the exchange. The depth, transparency and liquidity of the market should also be taken into account. Nevertheless, such information can provide useful indications as to market prices and the process of price discovery undertaken by independent industry players.

A critical part of market price determination is the flow of information on market conditions to market participants. This includes information about current and future demand and supply conditions, as well as information on the trading activities of competing firms. This information # in particular information on the terms used in the last incremental sale of a unit of the commodity # helps prices gravitate toward one consistent market price. In some markets, much of the information on individual transactions is not available to parties outside the trade and is closely guarded by market participants. For example, a supplier who has extracted a relatively high price for a commodity may not wish his competitors to know that, since this may risk those prices being undercut in future. Alternatively, there may be only a limited number of buyers or sellers, such as in markets for many rare earth minerals.

To assist market price discovery, numerous publications have arisen for particular mineral and other commodity products, publishing information on market conditions and recent transactions. These publications are based on observations of transactions and/or continuous contact with key market participants and traders, who may report transactions but not necessarily identify the parties to the transaction. Because sales terms can vary widely, some data publishers adjust raw trade data before publication. This could mean the publisher:

- excludes sales at terms that are notably inconsistent with other transactions around that time;
- fills in elements of a transaction that have not been disclosed by market participants (for example, the publisher may know a particular quantity of a specified form of iron ore has been sold and where it is going, but not the full commercial terms of the transaction);
- adjusts or "normalizes" observed prices in transactions back to a standard product specification, where those transactions do not occur under common contract terms (for example, where iron ore is shipped to an uncommon destination port); and
- provides an assessment of the price in the absence of sufficient trades. That is, the publishers may publish their own estimate of what the product would have traded at on that day, had a transaction occurred. Adjustments to the raw data ultimately reflect the publisher's opinion. Their appropriateness, therefore, depends on the ability of publishers to access detailed information on transactions, as well as their experience and skill to choose which pieces of information are most relevant to market participants. Many publishers provide information about the methodologies used to make adjustments, increasing transparency around the process. Some market participants (and, indeed, revenue authorities) urge that the data, therefore, be used with care, as they may not reflect purely factual information. Revenue authorities will need to give consideration as to how, for example, judicial processes may view a data source. For instance, it may be relevant to consider how widely the source is used by market participants themselves. In the absence of other information, such as in instances where a taxpayer refuses (or is unable) to provide information about actual contract terms, it may be reasonable to use data publications or exchange quoted prices as a starting point to ascertain what terms were used in similar transactions around the same time. It may also be appropriate to use prices disclosed in such publications, or quoted on a public exchange, as the basis upon which to determine arm's length prices, particularly where such a publication or data source is widely used by independent market participants themselves.

11.4.1. The notion of the arm's length range and the use of statistical tools

Arm's length range

As a final conclusion of the comparability screening process, the final comparable set determines the so-called arm's length range, which is normally determined by means of statistical tools such as the interquartile range (which is defined further below).

In general terms, usually a transfer pricing model will produce a range of possible results. This entails that if the results of the tested party fall within an acceptable range of arm's length prices, then no adjustment should be made. If the results of the tested party fall outside an acceptable range, tax administrations and taxpayers need to agree how to revise the tax computation so that the arm's length price replaces the actual transfer price.

A transfer pricing report usually produces a list of companies proposed as comparables. The results are often summarized as an interquartile range. An interquartile range discards the results of the bottom quarter and top quarter of the results. The median is the mid-point of the interquartile range. The median will generally produce a different result to the average of the range being considered. In a case where all the comparables being used are more or less equally valid, and there is no reason why the tested company is any better performance-wise than those comparable companies, then there is probably nothing wrong with using the interquartile range.

No guidance is provided by the OECD Guidelines stating that an interquartile range must be used, although paragraph 3.57 of the 2010 Guidelines stipulates that the use of an interquartile range may enhance the reliability of a range in which non-quantifiable comparability defects remain as a result of the limitations in available information on the comparables used.

A potential problem with using the interquartile range is the discarding of more accurate comparables which fall within the full range but outside the interquartile range. This problem arises when some of the companies in the reported list are less reliable comparables than others. It is therefore important to carry out as robust a comparability analysis as is reasonably possible in arriving at the arm's length range from which the interquartile range is derived.

From a practical standpoint, factors to take into account when trying to narrow the range will have to consider the comparable companies put forward very carefully. This involves looking at the available information about the comparable companies, including what they say about themselves on their websites. In particular, it is important to think about the following points:

- Should any of the companies obviously be excluded? Are there any other companies which should be included? This may involve a search of commercial databases.
- Is there a subset of comparables within the larger range? For example, consider a company carrying out contract R&D in the field of computer software. The transfer pricing report may contain 16 comparable companies carrying out contract R&D in the computer field (ranging from hardware, operating systems, communications, switching and software), but that there are only three companies involved in just software R&D. Why not use just those three companies as a starting point? These companies should in theory be more comparable to the tested party.

Decide where, within a range of results, to set the transfer price.

The OECD Guidelines say that if the results of the tested party fall within the arm's length range of results (or the interquartile range where this is used to enhance the reliability), then no adjustment should be made. If they fall outside that range, then the tax authority will need to determine where in the range the transfer price should be set (*see* paragraphs 3.60 to 3.62 of the Guidelines).

The reliability of the comparability analysis should be taken into account in deciding where, in a range, the transfer price should be set. If all points in the range are considered highly reliable, it could be argued that any point in the range satisfies the arm's length principle. However, if unidentifiable or unquantifiable comparability defects remain (e.g. due to limitations in information available on the comparable transactions), the use of measures such as the median, mean or weighted average and so on may be useful in deciding where to set the transfer price.

In all cases, selecting the appropriate measure increases the likelihood that the adjusted price falls within the true arm's length range. Case teams should always look at a tested party in the round to consider what its results would be if it was independent. It might be that a well-run company, efficient and competitive, would profit more than one where the opposite was true. On other occasions, these factors might not materially affect profit in a commercial world. A company which is inefficient might still have a product that is profitable.

An "arm's length range" may be identified if more than one reliable arm's length result becomes available. The arm's length range may be derived from applying a single method, selected under the best-method rule, but also from different methods if this is appropriate under the best-method rule.

An arm's length range is derived from uncontrolled transactions of similar comparability and reliability. Equal degrees of comparability may be achieved by making appropriate adjustments for all material differences; further, it should be likely that no unidentified material differences exist. All uncontrolled comparables of such quality must be included in the arm's length range.

If these conditions are not met, the arm's length range is derived from the results of all comparables that achieve a similar level of comparability and reliability. If possible, the reliability of the analysis must be enhanced by applying statistical data to produce the "interquartile range". This is the band of results between the 25th and 75th percentile of the results derived from the uncontrolled comparables.

The approach of tax administrations vary considerably as to the use and determination of the arm's length range. The vast majority of the OECD countries and tax administrations do not provide an exact definition of the arm's length range. The only country which intervened recently on the topic is India.

Indeed, the Indian Finance Minister, in his speech while introducing the Finance Bill 2014, proposed the introduction of the concepts of "range" and "multiple-year data", with the objective of reducing transfer pricing litigation in India. In this speech, the Finance Minister stated as follows:

> In particular, the Central Board of Direct Taxes ("CBDT") has announced draft rules that contain detailed provisions on the application of the range concept and the use of multiple-year data. Through this Notification, the CBDT has proposed to make the draft rules effective from 1 April 2014, i.e. applicable for assessment year 2015/16. The CBDT invited comments and suggestions from professionals, stakeholders and the general public on the proposed rules by 31 May 2015. However, to date, the final notification for the Rules has not been issued.

The proposed conditions/steps for the use of the range, as proposed by the CBDT are as follows:

- The range is applicable only when the cost-plus method, resale price method or TNMM is used to determine the arm's length price.
- It is necessary to use financial data of at least nine comparable companies. Furthermore, such companies must have data for at least two out of the three relevant financial periods (i.e. current financial year and previous 2 financial years).
- The weighted average is to be computed for these nine companies. This is to be computed by aggregating the numerator and denominator of all the years of every comparable company.
- A total of nine weighted averages will represent nine data points. Thus, points falling between the 40th and 60th percentile will constitute the range.

It is proposed that if the transfer price falls outside the above-prescribed range, a transfer pricing adjustment will be made considering the median of the range to be the arm's length price (i.e. 50th percentile of the series). Needless to say, no transfer pricing adjustment will be made if the transfer price falls within the prescribed range.

The current provisions on the use of the arithmetic mean will continue to apply in cases where the arm's length price is determined by using the CUP method, profit split method or the so-called other method, or where there are less than nine comparable companies that have been identified for the purpose of benchmarking the international transaction.

Use of multiple-year data

Current transfer pricing provisions specify that the data to be used in analysing a comparable company are to be the past data relating to the financial year in which the transaction took place. However, if data influence the determination of the transfer prices of the transaction, data of two previous years are allowed for comparison.

Rule 10B(4) of the Rules states as follows:

The data to be used in analysing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction or the specified domestic transaction has been entered into.

Provided that data relating to a period not being more than 2 years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared.

Accordingly, existing provisions do not generally permit the use of multiple-year data of comparable companies. Jurisprudence on this subject has also decided and accepted the use of only financial data of comparable companies which relate to the financial year in which the taxpayer entered into the international transaction.

The above-mentioned draft rules have proposed the use of multiple-year data. The conditions in the draft rules are as follows:

- multiple-year data may be used only when the method for determining the arm's length price is a profit-based method, i.e. cost-plus method, resale price method or TNMM;
- the multiple-year data must include 3 years, i.e. the current year in which the transaction took place and the 2 previous years;
- when data from 3 years are not available, the use of data from any 2 years out of the 3 years is permitted if:
    - the data of the current year are not available in databases at the time of filing the return of income;
    - a comparable fails to qualify for a quantitative filter in any 1 year; or
    - a comparable has commenced operations in the last 2 years or closed down operations during the current year; and
- current year data may be used by the income tax department and/or the taxpayer if the same become available subsequently, at the time of assessment.

Continued use of arithmetic mean

In cases where the range concept does not apply, the arithmetic mean concept will continue to be used in the same manner as it applied earlier, along with the benefit of the tolerance range. Furthermore, in cases where multiple-year data are to be used, the same would apply in both cases, whether the arm's length price is computed based on a range or the arithmetic mean, as the use of multiple-year data is dependent on the application of a profit-based method.

Range vs arithmetic mean

The arithmetic mean and range are statistical measures, used to analyse dispersion variability in a distribution, which – from a transfer pricing perspective – would mean the margin of comparable companies. Dispersion and central tendency are the often-characterized properties of distributions. They are used to derive a central or typical value that can represent the distribution/population. The authors have enumerated certain points of distinction that will further an understanding of the concepts, as in Table 1:

Table 1: Range vs arithmetic mean

Arithmetic mean	**Range**
Meaning/concept	
It is the average of a set of numerical values, as calculated by adding them together and dividing by the total number of terms in the set (i.e. simple average).	It is a measure of central tendency which divides the data set based upon its dispersion from the median. The interquartile range is a measure that indicates the extent to which the central 50% of values within the data set are dispersed. It is based upon, and related to, the median.
Properties/advantages	
It is often used to report central tendencies; it is not a robust statistic, meaning that it is greatly influenced by outliers (values that are significantly larger or smaller than most of the values). Notably, for skewed distributions, such as the distribution of income for which a few people's incomes are substantially greater than most people's, the arithmetic mean may not accord with one's notion of "middle", and robust statistics (such as the median) may be a better description of central tendency.	Compared with the arithmetic mean, one advantage of the range is that it indicates the spread or concentration for the middle of the distribution, ignoring the extremes of the distribution. This is worthwhile for statistical analysis when the extremes are of less interest and more consideration of the middle part of the distribution is required. That is, in the case of the interquartile range, the difference between the 75th and 25th percentiles provides a good indication of the range of the values for the middle, or more typical cases, of the distribution.
Limitations	
- It is highly affected by extreme values. - It cannot average the ratios and percentages properly. - It is not an appropriate average for highly skewed distributions.	One of its defects as a measure of variation is that it is based on only two specific percentiles and does not take other values of the variable into account. This occurs because the range is a

Arithmetic mean	Range
- Sometimes, the mean does not coincide with any of the values in the set.	positional measure, indicating only the difference between two other positional measures.

Example 2

Consider the following example of a set with the following nine data points, where the 3-year weighted average margin of the comparable companies is shown in percentages:

Serial no.	**1**	**2**	**3**	**4**	**5**
Margin (%)	10	15	16	-4	5
Serial no.	6	7	8	9	
Margin (%)	25	30	6	13	

This set in ascending order is as follows:

4, 5, 6, 10, 13, 15, 16, 25, 30

The arithmetic mean or the simple average of the above distribution is 12.89%, whereas the range of the same set of distributions comes to 10% to 15% (i.e. 40th and 60th percentile, specifically the fourth and sixth term of the series arranged in ascending order).

Thus, when benchmarking the sale of products or services to its associated enterprises, if the taxpayer has earned 9.75%, the taxpayer's transfer price would fall outside the range given above; however, if the taxpayer would have opted for the arithmetic mean, the taxpayer would have been at arm's length, considering the +/-3% allowable under the proviso to section 92C(2) (i.e. 9.5%).

Example 4

This example tweaks one data point, such that serial number 6 is changed from 25 to 40. The 3-year weighted average margin of comparable companies is shown in percentages.

Serial no.	**1**	**2**	**3**	**4**	**5**
Margin (%)	10	15	16	-4	5
Serial no.	6	7	8	9	
Margin (%)	40	30	6	13	

The above set in ascending order is as follows:

4, 5, 6, 10, 13, 15, 16, 30, 40

The arithmetic mean or simple average of the above distributions is 14.56%, whereas the range of the same set of distribution continues to be 10% to 15% (i.e. 40th and 60th percentile, specifically the fourth and sixth term of the series arranged in ascending order).

Thus, when benchmarking the sale of products or services to its associated enterprises, if the taxpayer has earned 10.50%, the transfer price of the taxpayer will fall within the range given above and it will be deemed to be at arm's length; however, if the taxpayer would have opted for the arithmetic mean, the taxpayer would have been subject to an adjustment, even after considering +/-3% allowable under the proviso to section 92C(2) (i.e. 11.12%).

Thus, there is a wide deviation between the results derived from the arithmetic mean and the range of the 40th to 60th percentile.

However, it is evident from the above examples that the arithmetic mean deviated from 12.89% to 14.56% when a smaller data point (i.e. 25) was replaced with a higher data point (i.e. 40), whereas the range remained static at 10% to 15% under both scenarios. This illustrates that the arithmetic mean reacted to the extreme values, whereas the range remained indifferent. As a result, compared with the arithmetic mean, one advantage of the range is that it indicates the spread or concentration from the middle of the distribution, ignoring the extremes of the distribution.

11.5. A logical framework to follow in performing a comparability analysis

Based on the author's experience, there are a number of suggestions that any taxpayer or tax authority may follow to help in performing a comparability analysis.

In an article 9 OECD Model/UN Model scenario, the starting point of every transfer pricing study is the analysis of the contractual arrangements.

However, considering the developments undertaken at the OECD level, it must be noted that this represents a clear move towards a more economic approach to tax issues, which would require an important balancing act in terms of respecting the legal environment within which intra-group transactions take place.

Furthermore, the increasing practical use of transactional profit methods has led to the following considerations:

- there is tendency in practice to adopt profit level indicators (PLIs) that relate net profit from the primary value-added functions (at the numerator) to a relevant base or scaling factor that is not impacted by the transfer price itself (as the denominator). This entails that net profit is generally referred to with the financial level indicator of EBIT, i.e. operating profit before interest, taxes and extraordinary items; and
- regarding the use of databases to find external comparables, the following elements should be factored in:
  - in analysing the criteria used in selecting comparable companies from commercial databases, one must always bear in mind that the database is only the first of several

possible steps in carrying out a comparables search. This means that the results obtained from such an initial search may be further refined by carrying out a primary, quantitative and qualitative screening. As regards the primary screening, this phase is generally applied with regard to the following: industry codes, geographic region, independence, year of incorporation and financials. The quantitative screening often involves screening the financial information of the potential comparable companies to determine whether they report sufficient data and report sufficient operating profit data. As concerns the qualitative screening, this phase of the search process usually comprises a review of the business descriptions, a qualitative database review and review of the company's homepage and the Internet;

- the primary reference is the functional analysis of the tested party as prepared or verified by the auditor. This means that whenever there is sufficient information, one should attempt to make adjustments that reasonably approximate the value of material differences between the tested party and the comparables;
- one of the most important textual filters will always be the detailed reading of potential comparables' public filings to ensure that the companies selected on the basis of quantitative screens from the database are functionally comparable to the tested party. Annual and 10k reports, for example, may also provide more details than the database regarding the classification of costs between operating expenses and cost of goods sold (COGS), nature of R&D spending, etc.;
- lastly, the use of commercial databases is not compulsory, as there is no database that will provide the correct answer for every case. In principle, and as a matter of good practice, normally at least 3 years (or 5, depending on the product life cycle under analysis) need to be considered in performing a comparability analysis, with the objective of avoiding small, director-owned companies, companies part of the same groups and consistent loss makers, but also with the aim of comparing entities with similar turnover levels; and
- the practical limitations of databases are apparent when one compares entities performing services embedding intangibles, and where major accounting differences exist.

2017 OECD Guidelines

On 10 July 2017, the OECD released a new edition of the OECD Guidelines. The 2017 OECD Guidelines is a consolidation of the amendments resulting from the OECD BEPS Project. In addition to the outcomes of the OECD BEPS Project, it also includes a revised guidance on safe harbours.

The chart below summarizes the changes implemented in the 2017 OECD Guidelines as compared to the 2010 OECD Guidelines.

2010 OECD Guidelines	**2017 OECD Guidelines**
Chapter I: Arm's Length Principle	Chapter I: section D is substantially amended
Chapter II: Transfer Pricing Methods	Chapter II: additional guidance on commodity transactions and revised guidance on transactional profit split method

2010 OECD Guidelines	2017 OECD Guidelines
Chapter IV: Administrative Approaches to Avoiding and Resolving Transfer Pricing Disputes	Chapter IV: section C.4.1 on the Denial of Access to Mutual Agreement Procedure in Transfer Pricing Cases was added
Chapter V: Documentation	Chapter V: substantially amended as per the outcomes of the OECD BEPS Action 13
Chapter VI: Special Considerations for Intangibles	Chapter VI: substantially amended as per the outcomes of the OECD BEPS Actions 8-10
Chapter VII: Special Considerations for Intra-Group Services	Chapter VII: substantially amended as per the outcomes of the OECD BEPS Actions 8-10
Chapter VIII: Cost Contribution Arrangements	Chapter VIII: substantially amended as per the outcomes of the OECD BEPS Actions 8-10
Chapter IX: Transfer Pricing Aspects of Business Restructuring	Chapter IX: amended in order to be in conformity with the changes made to the other chapters

The OECD BEPS Actions 8-10 and 13 were entirely focussed on transfer pricing issues. Due to the implementation of the outcomes of those Actions, the 2017 OECD Guidelines substantially differ from the 2010 OECD Guidelines. The paragraphs below provide a more detailed description of the changes made to each particular chapter under consideration.

Chapter I: amendments made to chapter I regard the application of the arm's length principle in general. More precisely, section D of chapter I of the 2010 OECD Guidelines was removed and replaced by a new section D incorporating the outcomes of the OECD BEPS Project. The current section D provides a detailed guidance as to the delineation of the controlled transactions under consideration. It emphasizes the importance to identify risks with specificity and provides a special framework to do so. Section D also includes an updated definition of risk management and control over risk concepts. The 2017 OECD Guidelines also introduced amendments to the comparability factors. In particular, those amendments are related to location savings, assembled workforce and group synergies.

Chapter II: guidance was added with respect to the application of the transfer pricing methods to the commodity transactions. The section on the transactional profit split method was entirely reviewed. However, the guidance provided on the application of the transactional profit split method is not final and might be further amended taking into account the work carried out by Working Party No. 6.

Chapter IV: a section was added regarding the access of the transfer pricing cases to the mutual agreement procedure. This section implements the outcomes of the OECD BEPS Action 14. In particular, it reiterates the minimum standards agreed during the negotiations on Action 14 that can be of relevance from a transfer pricing perspective.

Chapter V: the chapter was entirely re-drafted taking into account the outcomes of the OECD BEPS Action 13. As a consequence, the new chapter V introduces a three-tier documentation approach in accordance to which the MNE groups shall prepare a Local File, a Master File and, where certain predetermined conditions are met, also a country-by-country report.

Chapter VI: the chapter was entirely re-drafted taking into account the outcomes of the OECD BEPS Actions 8-10. In accordance to the amendments made to chapter VI, only legal ownership of the intangible property does not give the legal owner the right to receive all the income deriving from the intangible under consideration. In order for the associated enterprise to be eligible to get the income from the IP it legally owns, it has to carry out the DEMPE (i.e. development, enhancement, maintenance, protection and exploitation) functions. More precisely, the legal owner of the intangible would be attributed the income depending on the functions it carries out. For example, where the legal owner of the intangible property provides only financing and does not carry out any other relevant function, it would be eligible to get only a risk-adjusted return. Income derived from the IP other than the risk-adjusted income will be allocated to the other associated enterprise (or enterprises) carrying out the relevant functions. The new chapter also provides guidance on the use of valuation techniques.

Chapter VII: the new chapter introduces a simplified approach for the low-value adding services. It provides a general definition of low-value adding services. New chapter VI further provides lists of services that may or may not qualify as low-value adding services. New guidance recommends introducing a simplified approach to price the services meeting the requirements of low-value adding services, in order to lighten the compliance burden for taxpayers. Wherever the recommended simplified approach is implemented, taxpayers will not be required to perform a benchmarking analysis. They can simply apply 5% markup to the costs incurred in relation to the provision of the low-value adding services.

Chapter VIII: the chapter on cost contribution arrangements (CCAs) was substantially amended taking into account the outcomes of the OECD BEPS Actions 8-10. Changes introduced in chapter VI (on intangibles) are also applicable to CCAs. The analysis of CCAs is based on the actual conduct of the associated enterprises and not on the contractual terms, where those contractual terms do not reflect economic reality. As per the new guidance, an associated enterprise is considered to be a participant of the CCA only if there is a reasonable expectation that it will benefit from the objectives of the CCA activity. In addition, the mentioned associated enterprise shall exercise control over the risks assumed and it shall have the financial capacity to assume those risks. In accordance with the amendments made to chapter VII, the contributions to the CCA cannot be made at cost, due to the fact that the valuation at cost might lead to a non-arm's length result.

Chapter IX: conforming amendments were made to chapter IX in order to make it consistent with the other chapters of the OECD Guidelines updated in accordance to the outcomes of the OECD BEPS Project.

12. Administrative approaches

Chapter IV dealt with the administrative approaches that may minimize and resolve transfer pricing disputes, both in the relationship between taxpayers and tax administrations, as well as between different tax administrations. This chapter replaced the 1984 Report on corresponding adjustments and MAPs ("Three taxation issues"), which had a more limited scope.

The risk of double taxation, where there is a different interpretation and application of the arm's length principle, may be resolved by administrative procedures as set out in this chapter.

The chapter also called for an understanding of the problems of the taxpayer. This meant taking into account that transfer pricing is not an exact science, and there should not be unrealistic expectations as regards precision. Tax administrations should take the commercial judgement of the taxpayer and business realities as a basis.

With regard to the burden of proof, the 1995 OECD Guidelines distinguished three situations, although all are based on the assumption that this notion of burden of proof is a matter of domestic law, strictly linked also with the documentation requirement obligations:

- the tax administration bears the burden of proof;
- the burden of proof falls on the taxpayer if the taxpayer did not produce appropriate documentation or if the taxpayer filed a false return, etc.; and
- the burden of proof is on the taxpayer to prove that the adjustment made by the tax authorities was wrong. This is the case in the United States and in, for example, France (in the case of transactions involving tax havens).

These differences may cause problems which are hard to resolve through MAPs. The starting point of the 1995 OECD Guidelines in such a procedure was that the state performing the primary adjustment bears the burden of proof that the adjustment is justified, both in principle and as regards the amount.

12.1. Advance pricing arrangements (APAs)

An APA is an agreement between a taxpayer and the tax administration for a fixed number of years that specifies the criteria for determining transfer prices for future transactions between related enterprises. In the process of concluding an APA, applicable methods, the degree of comparability with open-market situations, appropriate corrections to comparables and assumptions as to future events may play a role.

As a unilateral APA may have consequences for related enterprises in other countries, the OECD Guidelines stress the importance of bilateral or multilateral APAs. If domestic legislation does not provide for agreements between the tax administration and taxpayers, APAs can be concluded under the MAP of applicable tax treaties.

According to the OECD Guidelines, APAs differ from private rulings in that APAs deal with factual issues, whereas rulings are concerned with explaining the law based on facts presented by the taxpayer. In the case of rulings, the facts may not be questioned by the tax administration, whereas under an APA the facts are subject to investigation. APAs usually cover several or all of a taxpayer’s transactions for a given period of time, whereas a ruling generally covers only one particular transaction.

The related enterprises are expected to provide the tax administrations with the transfer pricing method that they consider most appropriate in a given situation, supported by data relating to the industry, markets and countries concerned. In particular, data on comparability and a functional analysis are desirable.

An APA is valid for the agreed period. According to the OECD Guidelines, the APA should include a provision for revising or cancelling the APA for future years when (internal or external) circumstances change significantly.

APAs provide certainty with regard to the tax treatment of transfer prices for a specified period of time and reduce the risk of double taxation or non-taxation.

Unilateral APAs carry the risk that the tax administrations of other countries will disagree with the APA's conclusions. They may also effect an over-allocation of profit to the country where the APA has been concluded.

In 1999, an annex to the 1995 Guidelines was published with detailed guidance on the use of the MAP for bilateral (and multilateral) APAs.

APAs have been made possible by a great number of countries since 1995. By means of example, since the introduction in the United States in 1991 of the APA programme, 549 unilateral and bilateral APAs and eight multilateral APAs were concluded through the end of 2004. [103] Similar astonishing results have also been reached in countries like Australia, Italy, the Netherlands and Japan where the APA process is instrumental in achieving cooperative tax compliance between large taxpayers and tax administrations, as well as in smoothening the risk management process.

12.2. Safe harbours

On 16 May 2013, the OECD Council approved the revision of section E on safe harbours in chapter IV of the OECD Guidelines (*see* OECD-2, News 1 October 2012). New guidance on safe harbours provides opportunities for countries to relieve some compliance burdens and to provide greater certainty for cases involving smaller taxpayers or less complex transactions. With that, it provides a basis for countries, especially developing countries, to design a transfer pricing compliance environment that makes optimal use of the limited resources available.

As part of its project to improve the administrative aspects of transfer pricing, the OECD reviewed the guidance on safe harbours in chapter IV of the OECD Guidelines.

The previous guidance in the OECD Guidelines had a somewhat negative tone regarding transfer pricing safe harbours. This negative tone did not accurately reflect the practice of OECD member countries, a number of which have adopted transfer pricing safe harbour provisions. Also, the previous guidance was largely silent with regard to the possibility of a bilateral agreement establishing a safe harbour, even though some countries have favourable experience with such bilateral agreements.

The OECD developed in 2012 a draft proposed revision of the guidance which recognizes that properly designed safe harbours can help to relieve some compliance burdens and provide taxpayers with greater certainty. It encourages, under the right circumstances, the use of bilateral or multilateral safe harbours as they may provide a significant relief from compliance burdens without creating problems of double taxation or double non-taxation. To facilitate negotiations between tax administrations, it provides sample memoranda of understanding (MoUs) for competent authorities to establish bilateral safe harbours for certain classes of transfer pricing cases.

An interim discussion draft which contained the draft proposed revision of the guidance and the associated sample MoUs was released for public consultation in June 2012. Comments received were generally favourable to the proposed revision, and they were further discussed at a public consultation in November 2012. The draft was subsequently revised following this consultation and further discussions within the OECD.

Accordingly, safe harbours, as currently being conceived, focus either (i) on the type of taxpayers benefiting from the regime (e.g. taxpayers whose turnover or profitability does not exceed certain

103. *See* the Annual Reports concerning Advance Pricing Agreements, published by the IRS.

predetermined thresholds) or (ii) certain types of low-value transactions. The OECD approach towards simplifying, rather than twisting, the application of transfer pricing rules is confirmed by the recent introduction of safe harbours legislation in India.

In this respect, India provides an interesting example with respect to the use of safe harbour provisions, [104] after Mexico at the beginning of the 2000s introduced, in a similar vein, the *maquiladora* industry. [105]

The Finance Act 2009 introduced safe harbour provisions in the Income Tax Act 1961 (ITA 1961) with a view to simplifying compliance procedures, as well as providing certainty that the price of controlled transactions will not be reviewed by the tax authorities, thereby reducing transfer pricing disputes. The term "safe harbour" is defined to mean circumstances in which the income tax authorities will accept the transfer price declared by the taxpayer. At the time of writing this chapter, discussions were ongoing regarding safe harbour provisions, but no rules had yet been issued. On 14 August 2013, the Central Board of Direct Taxes issued Draft Safe Harbour Rules (the Draft Rules) in India after extensive deliberations, as regards various financial parameters for the prescribed sectors/activities performed by eligible taxpayers and based on the recommendations of the Rangachary committee. These Draft Rules would be applicable for 2 assessment years, 2013/14 and 2014/15, for the prescribed sectors and activities.

The Draft Rules cover international transactions (related-party transactions) involving the following activities and sectors: software development services (information technology), information technology enabled services, knowledge process outsourcing services, contract research and development (R&D) related to software development and related to generic drugs, financial transactions (outbound loans and corporate guarantees) and automotive ancillary manufacturing.

The other important initiative related to transfer pricing was the one launched by the Global Forum on Transfer Pricing concerning the development of a Draft Handbook on Transfer Pricing and Risk Assessment. The new Handbook, published on 30 April 2013 and produced by the Steering Committee of the OECD Global Forum on Transfer Pricing, is a detailed, practical resource that countries can follow in developing their own risk assessment approaches. This Handbook supplements useful materials already available with respect to transfer pricing risk assessment. Individual country tax administrations have published information on their risk assessment practices. In January 2012, the OECD Forum on Tax Administration published a report entitled, Dealing Effectively with the Challenges of Transfer Pricing. One chapter of that report addresses transfer pricing risk assessment.

Effective risk identification and assessment are critical if tax administrations are to select the right transfer pricing cases for audit. Risk assessment before commencing an audit enables decisions about which cases should be audited, and once the risk is appropriately identified and assessed, it enables the actual audit to be more focused, shorter and more effective.

In addition, it may waste taxpayer and tax administration resources to devote enforcement resources to cases where an adjustment could not ultimately be sustained in a MAP. Risk assessment can help avoid needless debates among tax administrations. For these reasons, many countries have recently focused significant attention on the measures they use to identify and assess transfer pricing risk, and to select cases for audit.

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104. *See*, for further details, V.T. Patel, *India – Draft Safe Harbour Rules Issued under Transfer Pricing Regulations* , 20 Int. Transfer Pricing J. 6 (2013),
105. *See* M.E. Tron & M.A. Martinez-Borja, *Maquiladoras: US and Mexican Implications* , 8 Intl. Transfer Pricing J. 3, p. 80 (2001).

As a result, the Draft Handbook assembled recent country procedures, methods and practices in order to provide a resource to tax administrations designing their own risk assessment approaches.

13. Documentation

13.1. Documentation requirements (BEPS Action 13 excluded from this section)

13.1.1. Introduction

A rapidly increasing number of countries (mid-2006, over 30) require specific transfer pricing documentation, ranging from more general information on the composition of a group and a description of intra-group transactions to detailed explanations of comparables used under a transfer pricing method.

The spread of specific transfer pricing documentation requirements to countries is to a great extent an automatic process, generated by regular meetings of high-level tax officials under the auspices of the OECD, including its outreach programme for non-member countries, and of CIAT, in particular in Latin America.

Moreover, the impact of the EU Transfer Pricing Documentation Code of Conduct will very likely be that European countries without specific transfer pricing documentation requirements will become aware of their backlog. In one country, a court decision has resulted in the adoption of legal provisions concerning transfer pricing documentation. In 2001, the German Supreme Tax Court held that the German tax authorities cannot require a taxpayer to prepare special documentation to support its transfer pricing system, as such a requirement is not present in the (old) German tax law. [106]

Seen from the perspective of tax authorities, information on how group members in their country arrive at transfer prices charged for transactions with related entities is necessary for assessing whether the arm's length principle is correctly applied.

The preparation of transfer pricing documentation is commonly perceived by multinational taxpayers as burdensome, time-consuming and expensive, in particular because, to a great extent, such information is not necessary for managerial or commercial purposes, nor for reporting reasons other than tax. [107] However, even where there is no legal requirement to keep documentation on the process of selecting a method and the comparables used, it may be useful and efficient to collect and store such information under a group-wide policy and system. In doing so, problems during transfer pricing audits, which are usually carried out many years after a transaction has occurred, can be avoided.

Because of differences in domestic requirements and differences in the transfer pricing rules themselves – even among OECD member countries – one centralized standard set of documentation is, unfortunately, not possible. The latter source of discrepancies may be illustrated with the following example:

Applying the best-method rule, a US company must select the comparable profit method for its transactions with a Canadian sister company because of reliable information on the operating profit of non-related businesses in the sector concerned. Adhering to the OECD Guidelines, the Canadian

106. *See* H-K. Kroppen & A. Eigelshoven, *Landmark Federal Tax Court Decision: No Transfer Pricing Documentation Requirements under Tax Law* , 8 Intl. Transfer Pricing J. 6 (2001), Journals IBFD.

107. At a Deloitte-IBFD Conference in Guadalajara, Mexico in December 2005, the tax manager of a large US MNE explained that over the last 20 years the documentation burden of the group had increased from ten documents on global transfer pricing, via 600-1,000 documents covering separate documentation for each legal entity within the group, to far over 2,000 documents for each entity and each separate flow within that entity in 2005.

transfer pricing rules do not support the use of the comparable profit method, so for Canadian tax purposes the resale price or cost-plus method would have to be used here, and its selection would have to be supported with appropriate documentation. The US documentation on the method selection process and comparables is therefore of little use for Canadian purposes, and vice versa.

The domestic transfer pricing documentation requirements are discussed in the various country chapters that are part of this work.

This chapter discusses the OECD framework for documentation, the so-called PATA package and the solution presented by the EU Joint Transfer Pricing Forum on documentation.

13.1.2. OECD Guidelines on documentation: The former chapter V

The former chapter V, i.e. the one in force before the publication of the Action 13 Report, provides general guidance for tax administrations to be taken into account in developing rules and procedures on transfer pricing documentation. It also provides guidance to taxpayers as to which documentation would be useful in supporting the arm's length character of their controlled transactions. The chapter combines a number of principles and general exhortations to tax authorities and taxpayers in paragraphs 5.3 to 5.15, with an enumeration of information that may be useful in paragraphs 5.16 to 5.27.

The following principles are stated:

- the OECD Guidelines are not intended to impose a greater burden on the taxpayer than that imposed by domestic rules;
- the determination of transfer prices by taxpayers should be based upon information reasonably available at the time of determination;
- prudent business management principles also cover the preparation or collection of documentation of efforts to comply with the arm's length principle;
- there is no contemporaneous obligation at the time of determining prices or filing the tax return to produce such documentation;
- the document storage process should be subject to taxpayer discretion;
- tax administrations should balance the need for documentation against the burden for taxpayers to obtain documentation;
- the taxpayer should only prepare/obtain documents which are:
  - indispensable for a reasonable assessment of transfer prices;
  - obtainable without disproportionally high cost; and
  - the minimum needed to make a reasonable assessment;
- tax administrations should not require taxpayers to produce documents that are not in actual possession and cannot be obtained through normal enquiry;
- information about foreign associated enterprises is essential, but subsidiaries or minority shareholders may have difficulties obtaining this;
- there should be no public disclosure of trade secrets, etc., except when obliged in court; and

- tax administrations should limit the amount of documentation at the stage of filing the return. It should be sufficient to enable tax administrations to select cases for further examination.

As "information that could be relevant" without serving as "a minimum compliance requirement", the following categories of information are specified:

- outline of the business;
- structure of the organization;
- ownership linkages within the MNE;
- amount of sales and operating results from the last few years before the transaction;
- level and kind of taxpayer's transactions with associated enterprises;
- associated enterprises involved in the transactions concerned;
- functions performed and risks assumed;
- information on competitors with similar transactions;
- nature and terms of transactions, economic conditions and property involved;
- how the product or services flow among associated enterprises;
- changes in trading conditions;
- description of similar transactions with unrelated parties;
- information on "whether independent enterprises under comparable circumstances would have entered into a similarly structured transaction";
- information on pricing, pricing policies, business strategies and special circumstances;
- regarding the transfer pricing method used, an explanation of the selection, application and consistency with the arm's length principle;
- set-off transactions;
- management strategy;
- general commercial and industry conditions;
- financial information, e.g. explaining profits and losses;
- reports on cost of manufacturing, R&D and general and administrative expenses; and
- documents on the negotiation process.

The above general principles may have played a role for countries which have adopted transfer pricing documentation requirements since 1995.

The impact of the enumeration of "information that could be relevant", however, may have been contrary to the OECD intention of not being a minimum requirement. The PATA package and the EU Joint Transfer Pricing Forum's proposal – both adopted by countries that are also OECD member countries – are clearly not less comprehensive.

An important consideration concerns the protection of confidential information. Paragraph 5.13 states that tax administrations should take great care to ensure that there is no public disclosure of trade secrets, scientific secrets or other confidential data. Such information should be requested only if the authorities can undertake that the information will remain hidden to outside parties.

13.1.3. Transfer Pricing documentation requirements under 2017 OECD Guidelines

The transfer pricing documentation requirements have been significantly changed as a result of the OECD BEPS Project. As a result of the OECD BEPS Action 13, MNE groups shall comply with a three-tiered transfer pricing documentation requirement. In accordance with the outcomes of Action 13, the MNE groups shall prepare and submit (i) a Master File containing standardized information relevant for all MNE group members; (ii) a Local File containing information on the material controlled transactions of the relevant associated enterprise; and (ii) a country-by-country report containing information on the global allocation of the MNE group's income and taxes paid.

Master File

The purpose of the Master File is to provide a general overview of the MNE group's business. In particular, it shall provide the information on global business operations, transfer pricing policies applied and its global allocation of income. The information to be included in the Master File can be split into the following categories:

- an organizational chart of the MNE group;
- description of the MNE group's business or businesses:
  - important profit drivers;
  - a description of the supply chain for the largest 5 products and of services amounting to more than 5% of the turnover of the MNE group;
  - a brief description of important service agreements;
  - a description of the main geographic markets;
  - a brief functional analysis with the emphasis on the contributions to the value creation; and
  - a description of important business restructurings;
- information on the intangibles owned by the MNE group:
  - a general description of overall IP strategy;
  - a list of important intangibles and their legal owners;
  - a list important agreements relating to the intangibles as well as CCAs;
  - a description of the group's transfer pricing policy in relation to the IP; and
  - a general description of the transfers of interest in intangibles;
- description of the MNE group's intercompany financial activities:
  - a general description of how the MNE group is financed (including third-party arrangements);
  - identification of the members with central financing functions (if any); and

    - a description of the MNE group's transfer pricing policy regarding the financing arrangements;
- the MNE group's financial and tax position:
    - a consolidated financial statement for the fiscal year under consideration wherever available; and
    - a list and brief description of existing APAs wherever available.

Local File

The transfer pricing Local File provides more detailed information regarding the intercompany transactions entered into by the local MNE group member under consideration. The Local File shall cover the intercompany transactions entered into by the local entity that are material in the context of the local country's tax system. The Local File shall contain the information as described below:

- local entity:
    - local organizational chart;
    - management structure;
    - information on the individuals to which the local management reports;
    - a detailed description of the business and the business strategy pursued by the local entity;
    - information on whether a local entity was involved in the business restructurings or in the transfers of interest in the intangibles; and
    - key competitors;
- controlled transactions:
    - a description of material intercompany transactions;
    - amount involved in the material intercompany transactions broken down by tax jurisdiction of the foreign payor or recipient,
    - associated enterprises involved in the intercompany transactions shall be identified;
    - copies of material intercompany agreements;
    - detailed comparability and functional analysis for each category of intercompany transactions;
    - identification of the most appropriate transfer pricing method for each category of the intercompany transactions;
    - identification of the tested party for each category of intercompany transactions (where relevant);
    - a summary of the important assumptions used in the application of the most appropriate transfer pricing method;
    - explanation of why a multi-year analysis is applied;

  - a list and a description of the comparable uncontrolled transactions (including the search strategy);
  - a description of the comparability adjustments (wherever relevant);
  - reasons why the intercompany transactions under consideration are consistent with the arm's length principle;
  - description of the financial information used in the application of the selected transfer pricing method; and
  - a copy of existing APAs or other rulings (wherever applicable);
- financial information:
  - annual financial accounts for the fiscal year concerned;
  - information allowing to tie up the financial data used in the application of the transfer pricing method to the annual account; and
  - summary schedules of financials for the selected comparables.

Country-by-country report

The country-by-country (CbC) report provides an aggregate tax jurisdiction with information on the global allocation of the income, the taxes paid, and certain indicators of the location of economic activity among tax jurisdictions in which the MNE group operates. The CbC report shall include information regarding:

- tax jurisdictions;
- revenues divided into related and unrelated party revenues;
- profit (or loss) before income tax;
- income tax paid and income tax accrued;
- stated capital;
- accumulated earnings;
- number of employees;
- tangible assets other than cash and cash equivalents;
- jurisdictions of tax residence and jurisdictions of incorporation or organization wherever different from the jurisdiction of tax residence; and
- main business activities.

The OECD recommends imposing the CbC reporting requirement on MNE groups with a consolidated group turnover amounting to EUR 750 million or more. As per the OECD recommendations, MNE groups shall be required to submit the first CbC report for the fiscal year starting on 1 January 2016. Updated transfer pricing guidelines include a model legislation for imposing the CbC reporting requirement on the MNE groups.

Information contained in the CbC report shall be used for risk assessment purposes and it cannot be a substitute for a detailed transfer pricing analysis carried out with respect to individual material intercompany transactions. Tax administrations shall not use the information contained in the CbC report to make transfer pricing adjustments on a global formulary apportionment basis. However, the jurisdiction can use the information provided therein as a basis for further enquiry.

13.1.4. The PATA Documentation Package

The PATA is an intergovernmental tax organization, the member countries of which are the United States, Australia, Canada and Japan. The PATA member countries discuss tax-administrative issues of joint concern, including cross-border tax avoidance, tax evasion and other international tax matters.

In 2003, PATA issued an agreement among its members concerning documentation. The PATA Documentation Package will allow taxpayers to prepare one set of uniform transfer pricing documentation that will meet the requirements of all four of the PATA member countries. This is intended to eliminate the need for taxpayers to prepare separate documentation for each PATA member country. Compliance with the requirements of the new PATA Documentation Package is voluntary, but the agreement states that MNEs will be deemed to satisfy each PATA member country's transfer pricing documentation requirements if they comply with the principles contained in the package, and will not be subject to tax penalties in the four jurisdictions covered by the agreement if they do so.

According to the PATA, an MNE must follow three "operative principles" to avoid transfer pricing penalties regarding a transaction; namely, the MNE must (1) make reasonable efforts, as determined by the tax administration of each PATA member country, to establish transfer prices in accordance with the arm's length principle, (2) maintain contemporaneous documentation of its efforts to comply with the arm's length principle and (3) produce the documentation in a timely manner when requested to do so by the tax administration of a PATA member country. The PATA agreement sets out the conditions under which each of the three operative principles will be deemed to have been satisfied. This includes the provision of 48 mandatory documents listed.

The Package states that it is in line with the general principles of chapter V of the OECD Guidelines. The mandatory production of 48 documents, however, is in conflict with the OECD principles of prudent business management concerning the collection of documentation (paragraph 5.4), as it leaves no flexibility to the taxpayer.

The Package also explicitly states that it is meant to reduce the administrative burden. It seems, however, far more complex and detailed than the documentation rules of the four members, including the United States. [108]

Under the Package, the confidentiality of information is protected by the domestic laws concerned and the applicable tax treaty.

13.1.5. EU Code of Conduct on transfer pricing documentation

13.1.5.1. EU Joint Transfer Pricing Forum

The OECD Guidelines on documentation have not resulted in a common approach to this issue among its member countries and, consequently, not in EU Member States. Different documentation rules

108. For extensive commentaries, *see* P. Anderson, *PATA Transfer Pricing Documentation Package* , 9 Asia-Pac. Tax Bull. 3 (2003), Journals IBFD; J. Hobster et al., *Practical Implications of the PATA Documentation Package* , 10 Intl. Transfer Pricing J. 3 (2003), Journals IBFD.

hamper the functioning of the EU internal market and cause additional compliance and operational costs for groups active in the European Union, as well as for tax authorities.

This was one of the reasons why the European Commission set up the EU Joint Transfer Pricing Forum in 2002. The Forum consists of experts from all Member States and ten experts from business. The Forum works on the basis of consensus and aims at non-legislative improvements to practical transfer pricing problems, focusing on improvements of dispute resolution and on documentation requirements, including the scope for reducing the compliance burden for small and medium-sized enterprises.

In the May 2005 Report on its activities regarding documentation requirements, [109] the Forum presented an EU-wide common approach, called "EU TPD", which combines one set of documentation containing common standardized information relevant for all EU group members (the "master file") and – where required – sets of standardized documentation containing country-specific information. The documentation set for a specific EU Member State would consist of the Master File plus the standardized specific documentation for that country. The Report expects that standardized and, to a certain extent, centralized, documentation could reduce taxpayers' compliance costs by fulfilling the documentation requirements in all EU Member States in a similar way.

Documentation-related penalties would be avoided by taxpayers acting in good faith and complying with the EU TPD in a timely manner. However, tax authorities remain entitled to request additional information, in particular during tax audits.

The Forum proposes to implement its proposal through "soft law", not via a directive, leaving freedom for Member States to decide on the domestic legal vehicle used.

13.1.5.2. The Master File

The Master File should contain the following items:

- a general description of business and corporate strategy, including changes in business strategy compared to the previous tax year;
- a general description of the group's organizational, legal and operational structure (including organization chart, list of group members and a description of participations of the parent company);
- a general identification of associated enterprises engaged in controlled transactions involving enterprises in the European Union;
- a general description of flows of controlled transactions involving enterprises in the European Union (invoice and amount flows);
- a general description of functions performed and risks assumed, as well as a description of changes in respect of functions and risks compared to the previous tax year (e.g. a change from full-fledged distributor to commissionaire);
- ownership of intangibles (e.g. patents, trademarks, brand names, know-how) and royalties paid or received;
- the group's intercompany transfer pricing policy or a description of the group's transfer pricing system that explains the arm's length nature;

109. Doc.: JTPF/020/REV4/2004/EN of 27 May 2005.

- a list of any cost contribution agreements, APAs and transfer pricing rulings, to the extent that group members in the European Union are affected; and
- an undertaking by the taxpayer to provide supplementary information upon request and within a reasonable timeframe under the national rules.

13.1.5.3. The local country file

The EU TPD country file should contain:

- a detailed description of the taxpayer's business and business strategy, including changes in the business strategy compared to the previous tax year;
- a description and explanation of country-specific controlled transactions;
- a comparability analysis, i.e.:
  - characteristics of property and services;
  - functional analysis (functions performed, assets used, risks assumed);
  - contractual terms;
  - economic circumstances; and
  - specific business strategies;
- an explanation of the selection and application of the transfer pricing method(s);
- relevant information on internal and/or external comparables, if available; and
- a description of the implementation and application of the group's intercompany transfer pricing policy.

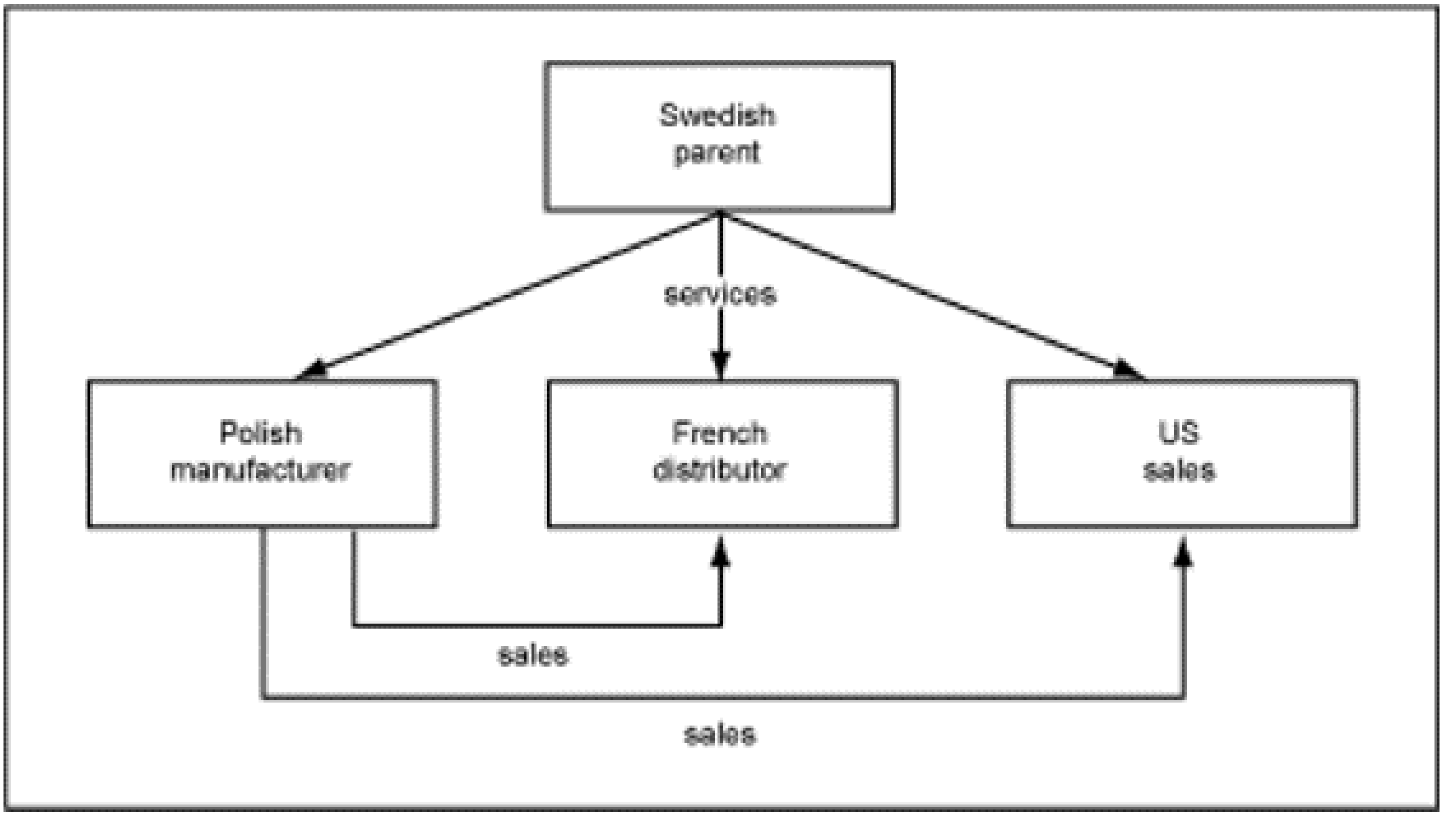
13.1.5.4. Timing, application, confidentiality

The Forum recommends that the EU TPD be required to be submitted to the tax administration only at the beginning of a tax audit or upon specific request, not at the time of filing the tax return. At that stage, only a brief questionnaire or risk assessment form would have to be submitted, if required.

An MNE opting for the EU TPD should apply it to all group members. Depending on the organizational structure, more than one Master File is allowed and specific group members may be exempted from EU TPD.

The Forum did not see a specific need to develop special rules for small and medium-sized enterprises. It only refers to the "reasonableness" test, which allows a lower compliance standard for different types and sizes of business.

The Report does not provide a specific solution for the protection of confidential information in the EU TPD. It should be realized that the Master File of a specific MNE will have to be furnished to all interested tax authorities in the European Union, revealing information on flows of transactions of the MNE concerned not only within the European Union, but also with third countries.



In the above example, the French tax authorities will, via the Master File, also be informed about services performed by the Swedish parent to the US subsidiary, as well as sales by the Polish subsidiary to the US subsidiary.

Because of the magnitude and detail of information concerning flows of transactions and other matters of MNEs in Europe becoming available to a great number of officials in EU Member States, it will be necessary to monitor the process. Monitoring should become a task within the field of activities of the Forum.

14. Intangibles

14.1. Introduction

The topic of intangibles has developed since the issuance of the OECD Transfer Report in 1979 and nowadays is at the core of all the transfer pricing issues revolving around the BEPS Project.

From a historical standpoint, a distinction was made in the 1979 Report between transfer of technology (patents and know-how) and the use of trademarks (*see* paragraphs 76 to 138).

In the subsequent chapter VI, the current version of the OECD Guidelines focuses on commercial intangibles (literary and artistic property rights not being relevant in this context), dividing these into trade intangibles usually developed through R&D, which are related to the production of goods (also called manufacturing intangibles) and the provision of services, and marketing intangibles, which are related to the commercial exploitation of products and services. Such a theoretical distinction has been put into question by the ongoing project on the revision of chapter VI, where – rather than focusing on legal or accounting "labellings" – the thrust of related-party transactions involving intangibles should focus more on the identification of the important functions justifying an "intangible related return".

Another development with regard to intangibles has been the introduction of the commensurate with income concept (CWI) in the United States via an amendment to section 482 of the IRC in 1986 (*see* above). This provision was negatively received by other OECD member countries primarily from a conceptual standpoint, due to the information asymmetry between taxpayers and tax administrations. More in detail, the CWI in its application can require – in certain cases – to take ex post results into account even though the arm's length principle is an ex ante concept. Specifically, it can be appropriate to take ex post results into account in two situations:

- the fact that the actual results differ materially from the price paid may be evidence of non-arm's length pricing; accordingly, further investigation and analysis of the price may be appropriate in such a case; and
- in some cases, such as where (i) comparables are not available; (ii) the taxpayer did not develop income projections and (iii) the tax administration cannot build its own projections, it could be difficult – if not impossible – to reliably determine the appropriate ex ante arm's length price; hence, actual results may provide the only feasible indication of the ex-ante arm's length price and therefore actual income may be used as the basis for determining the arm's length price and associated transfer pricing adjustments.

The current version of the OECD Guidelines reflects a reaction to the CWI by stating that "hindsight" should be avoided. To this end, former paragraphs 6.32 to 6.35 of the OECD Guidelines (as in force before the publication of the Final Intangibles Report in October 2015 within the context of Action 8) acknowledge that when tax administrations evaluate the pricing of a controlled transaction involving intangible property where valuation is highly uncertain at the outset, the arrangements that would have been made in comparable circumstances by independent enterprises should be followed. This entails that if independent enterprises would have fixed the pricing based upon a particular projection, the same approach should be used by the tax administration in evaluating the pricing.

Intangible property is often referred to as the most complicated area of transfer pricing. Contributing to this complexity are, in particular, the absence of an internationally adopted definition of intangible property based on clear characteristics; ownership issues; and – lacking comparables for valuable intangibles – problems in establishing an arm's length remuneration for the use or transfer of an intangible.

Chapter VI (Special Considerations for Intangible Property) of the OECD Guidelines has not been able to bridge differences in approach, in particular between the United States and European countries. Differences appear on issues such as ownership of intangibles, the application of transfer pricing methods for intangibles and the so-called commensurate-with-income clause, particularly relevant in countries like the United States, which firstly introduced dedicated legislation and, recently, in Germany with provisions which consider the value of the hypothetical transfer package.

The problems were dramatically illustrated by the *Glaxo* case in the United States, culminating in a USD 3.4 billion settlement between Glaxo Smith Kline and the IRS in September 2006. In this case, the IRS asserted that extraordinary marketing efforts by the Glaxo subsidiary in the United States had substantially contributed to the value of the intangibles but had not been adequately compensated by the UK parent. A MAP between the US and UK competent authorities has not been successful. [110]

Increasingly, the issue of intangibles is becoming relevant for developing, high-growth economies, such as China and India.

Apart from the country surveys below, valuable information on intangible property is included in the 2007 IFA Cahiers, vol. 92a, *Transfer pricing and intangibles*, with a General Report by Toshio Miyatake.

14.2. Definitions and characteristics of intangible property

14.2.1. Definitions and categories

The Convention of the World Intellectual Property Organization (WIPO) lists the following categories of intellectual property: [111]

(1) literary, artistic and scientific works;

(2) performances of performing artists, phonograms and broadcasts;

(3) inventions in all fields;

(4) scientific discoveries;

(5) industrial designs;

(6) trademarks, service marks and commercial names, and designations; and

(7) all other rights resulting from intellectual activity in the industrial, scientific, literary or artistic fields.

Categories (3) to (6) are typical for international business, creating transfer pricing issues; categories (1) and (2) are relevant only to the extent that international trade is involved, e.g. in the audio/video business.

Paragraph 6.2 of chapter VI of the OECD Guidelines describes intangible property as including rights to use industrial assets such as patents, trademarks, trade names, designs or models; literary and artistic property rights; and intellectual property such as know-how and trade secrets. The OECD Guidelines state that the focus is on intangible property associated with commercial activities, including marketing activities. Such intangibles may have considerable value, even where not included in a company's balance sheet.

The OECD Guidelines divide commercial intangibles into marketing intangibles and other intangibles, the latter category being referred to as "trade intangibles". Trade intangibles are often created through R&D activities (paragraph 6.3). [112]

The US regulations (section 1.482-4(b)) specify six categories of intangible assets, stating that an intangible must have substantial value independent of the services of any individual:

- patents, inventions, formulas, processes, designs, patterns and know-how;

110. For an analysis of the *Glaxo* case, *see* A. Musselli, Glaxo *Transfer Pricing Case* , 14 Intl. Transfer Pricing J. 3 (2007), Journals IBFD.
111. The term "intellectual property" is sometimes used as a synonym for intangible property, and sometimes as a subcategory of the broader concept of intangible property.
112. In transfer pricing literature, the term "manufacturing intangibles" is sometimes used as a synonym for trade intangibles.

- copyrights and literary, musical or artistic compositions;
- trademarks, trade names and brand names;
- franchises, licences and contracts;
- methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists and technical data; and
- "other similar items", as an open-ended last category.

Deloris R. Wright's distinction of intangibles between two main categories – manufacturing intangibles and marketing intangibles – is useful in practice. Manufacturing intangibles are developed by an R&D department or by a manufacturing activity. Examples include patents, trade secrets and unpatented technical know-how. Marketing intangibles are developed by the marketing and/or sales personnel of a company. Examples include trademarks, trade names and distribution networks. Not all intangibles fit into these categories, e.g. trademarks which derive their value from R&D/manufacturing efforts rather than from marketing activities. Another example of such a "hybrid" intangible is corporate reputation. [113]

A fourth category of intangibles includes those which cannot be classified, e.g. a method of doing business. In the *Hospital Corporation of America* case, [114] HCA had transferred a method of managing hospitals to an affiliate. The court classified this as a valuable intangible.

In this context, it is notable that the Australian Tax Authority (ATO) derives three categories of intangibles from the OECD Guidelines, namely:

- internal or manufacturing trade intangibles;
- external or marketing intangibles; and
- human capital competencies [115] (although for the latter as a separate category, no explicit source can be found in the Guidelines).

Only in a limited number of countries do the tax laws or regulations include a definition or enumeration of intangible property (*see* United States above). In other countries, such as Canada and Denmark, [116] the meaning is derived from intellectual property or commercial law and jurisprudence. Again, other countries may, for tax purposes, stretch the concept of intangible beyond the boundaries of other areas of law.

Lacking definitions for transfer pricing purposes, many (member) countries rely on the examples of intangibles in the OECD Guidelines. These examples, unfortunately, do not constitute a workable definition, nor do they specify the essential characteristics of intangible property.

Accounting rules, such as IFRS/IAS, define an intangible asset as an "identifiable non-monetary asset without physical substance". It is identifiable if it is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability, or when it arises from contractual or other legal rights. [117] Under the French

113. D.R. Wright, *Intangibles and Transfer Pricing*, 1 Intl. Transfer Pricing J. 2, p. 95 (IBFD 1994).
114. 81 TC 520 (1983).
115. TR 98/11, paragraph 5.39.
116. IFA Cahiers 92a, at 139, 216.
117. IAS 38, paragraphs 8 and 12 (2006); *see* IFA Cahiers 92a, at 589.

accounting standards, an intangible asset must be identifiable, separable and capable of generating future economic benefits. [118]

14.2.2. Essential characteristics for classification as an intangible

In the absence of a clear OECD definition specifying the essential characteristics for classification as an intangible, relevant elements may be derived from a comparison of domestic legislation, circulars and case law, as well as from accounting standards.

A bottom line is given by the US Supreme Court in the *Merck* case: [119] an "organizational structure, without more, is not included in the concept of an enforceable property right that would support an arm's length licence agreement".

Miyatake [120] distinguishes three essential characteristics of intangibles:

- intangible property derives its value not from its physical attributes but from its intellectual content;
- intangible property is any non-tangible property that can be exploited; and
- an intangible must be directly observable and commercially transferable.

The condition that it must be commercially transferable and therefore subject to valuation is essential from an arm's length perspective. Additional characteristics are therefore:

- being capable of legal protection (as a patented or registered intangible or – more generally – as property) and transfer;
- being in existence at an identifiable time; and
- being capable of producing future economic benefits. [121]

14.2.3. Questions as to the scope of intangibles

"Residual" profit higher than average earnings. The question arises as to whether this can be attributable to "undefined" intangibles. Commonly, this is not regarded as an intangible. [122] If the business is sold, the extra profit capacity ("goodwill") will result in a higher price.

A related matter is the *transfer of profit potential/business opportunities through a relocation of functions, assets, risks, opportunities and services.* Tax authorities may seek to tax an alleged transfer of profit potential to other group members, in particular in cases where a full-fledged manufacturer is converted into a contract manufacturer or a full-fledged distributor is converted into an agent. [123]

Status of efficient corporate management systems as an intangible. Applying the above criteria, the answer depends on whether the intangible is directly observable, commercially transferable and subject to legal protection. The US court ruling in the *HCA* case [124] (*see* above) should normally not be taken as a guideline, as managing hospitals constituted the core business of HCA.

118. IFA Cahiers 92a, at 255.
119. 24 Cl.Ct. 73, 91-2 USTC.
120. General Report, IFA Cahiers 92a, at 22, 23.
121. IFA Cahiers 92a, at 611.
122. Id. at 141, 435.
123. Id. at 282.
124. 81 TC 520 (1983).

14.3. Ownership of intangible property

14.3.1. General

According to the OECD's position until the recent 2015 overhaul of chapter VI by means of Action 8 of the BEPS Project, the ownership of an intangible is a relevant factor for determining which related party should receive the return of the intangible. Secondly, an arm's length remuneration depends, at least partly, on the functions and risks of the owner of the intangible.

Ownership of marketing intangibles in particular is currently one of the most-discussed issues in transfer pricing. The focus is on ownership of and remuneration for intangibles (allegedly) developed by distributors when selling branded products of foreign related companies. One criterion for establishing whether an intangible exists looks to whether there is a level of marketing expenditure higher than that of unrelated distributors. Tax authorities may react to this by reducing the transfer price, giving the distributor a higher operating profit, by imputing a service fee arrangement with an appropriate markup or – based on a different approach in certain countries – by disallowing the deduction of the additional marketing expenditure (and treating it as a dividend). Such actions may be based on an approach of the arm's length principle developed in the United States, which postulates that each entity must earn a return "commensurate" with the functions exercised, risks borne and assets held by that entity. [125]

Previously, three categories of ownership may be distinguished: legal ownership, economic ownership and ownership by agreement. In many cases, legal and economic ownership remain with the same party. Legal ownership is ownership that is legally protected from infringement under intellectual property law. Economic ownership depends on economic reality and used to be characterized as the possibility for an associated enterprise to share in the premium/residual profit arising from the exploitation of the intangible for commercial purposes by performing activities related to the development, maintenance and enhancement of the intangibles' commercial value. On the other hand, exploitation rights may have arisen because of creation of the intangible and considerable investment in it. Ownership by agreement may cover the (partial) transfer of rights, e.g. through a license agreement.

The 2007 IFA General Report [126] on the transfer pricing aspects of intangible property concluded from country analyses that economic ownership is more important than legal ownership. If an intangible is not legally protected, economic ownership prevails (i.e. the party that bears the greatest share of development costs); if legal ownership (or ownership by agreement) is inconsistent with economic substance, the latter prevails. Ownership by agreement may override legal ownership.

The IFA General Report [127] noted that only one member of a group will normally be considered to be the owner of an intangible. If another member of the group assists the owner of an intangible in developing it or enhancing its value, the situation is resolved by requiring the owner to pay an arm's length compensation to the assisting group member. The report further states that intangibles may be owned by more than one party, e.g. in the case of cost sharing.

Having said that, it must be pointed out that the notion of economic ownership is slowly fading away, as far as the current project leading to the revision of chapter VI of the OECD Guidelines is concerned. Instead, the OECD is focusing more on the concept of intangible related return in order to avoid confusion with a term the exact boundaries of which are not yet clearly defined.

125. *See* M.M. Levey et al., *The Quest for Marketing Intangibles*, 1 Intertax, p. 4 (2006).
126. IFA Cahiers 92a, at 25.
127. Id.

Yet marketing intangibles has been a difficult issue in transfer pricing for some time, particularly for some countries, like India, that rely heavily on the concept (and implicitly on that of economic ownership). Such a fact is reflected in the specific attention to this issue in chapter VI of the OECD Guidelines and specifically in paragraphs 6.36-6.39 on marketing activities performed by businesses that do not themselves own the relevant brands or trademarks.

The issue of marketing intangibles has been taken up thoroughly by the transfer pricing officers of the Indian Revenue.

While the matter has been dealt with by the tax authorities on numerous occasions, two recent cases relevant in this area are *CIT v. Adidas India Marketing (P) Ltd.*, 195 Taxman 256 (Delhi), and *Maruti Suzuki India Ltd v. ACIT*, 2010-TII-01-HC-DEL-TP.

In the *Maruti-Suzuki* case, the Delhi High Court has ruled on the transfer pricing aspects of marketing intangibles for a licensing arrangement between the Indian company and its associated enterprise. The taxpayer, an Indian joint-venture company of Suzuki, entered into a licence agreement with Suzuki, under the terms of which Suzuki agreed to provide technical collaboration and licences necessary for the manufacture, sale and after-sale service of Suzuki products and parts. Suzuki also granted the exclusive right to use its trademarks. The taxpayer was required to pay a royalty for the use of the intangible property.

In an appeal to the High Court by the taxpayer, the court held that in the case of associated enterprises, payment of royalties should satisfy the arm's length test. The test is to determine what a comparable entity placed in the position of the taxpayer would have done. The High Court also held that use of a trademark belonging to a foreign associated enterprise, by itself, would not entail a payment from the foreign associated enterprise to the domestic entity so long as the benefit of such brand name accrues to the Indian enterprise alone. With regard to the advertising, marketing and promotional expenditure, the High Court held that if such expenses incurred by the Indian affiliate using the trademark were more than what a similarly situated and comparable enterprise would have incurred, the owner of the intangible needs to suitably compensate the licensed user for the advantage obtained by it in the form of brand building and increased awareness of the intangible. Reference can be made to the chapter on India in IBFD's Transfer Pricing and Dispute Resolution.

One well-known case that considered this issue for the first time from a substantive standpoint is the *DHL* case in the United States.

United States – *DHL Corporation and Subsidiaries v. Commissioner of Internal Revenue*, 11 April 2002

The IRS assessed a transfer pricing adjustment to DHL for transfer of the trademark rights in the DHL name and logo to DHL International (DHLI), incorporated in Hong Kong, and Middlestown N.V. (MNV), incorporated in the Netherlands Antilles. DHL and DHLI/MNV valued the trademark at USD 20 million. The USD 20 million valuation was based on a comfort letter provided by an independent expert. The IRS valued the trademark at USD 100 million. The IRS sought to make additional transfer pricing adjustments related to the royalty-free use of the trademark by DHLI and MNV, and the IRS sought further to impose penalties under IRC § 6662 for gross and substantial transfer pricing misstatements in the tax returns filed by DHL. In a lower court opinion by the Tax Court dated 30 December 1998 and reported at 76 T.C.M. (CCH) 1122 and 74 T.C. Memo (RIA) 98,461, the Tax Court agreed with the IRS position and valued the trademark at USD 100 million and made other transfer pricing adjustments between the parties. The Tax Court awarded back taxes and transfer pricing penalties to the IRS. The Tax Court opinion did not address treaty aspects of the case.

The Court of Appeals agreed with the Tax Court that USD 100 million was the correct valuation for the trademark, but held that only the USD 50 million amount attributable to the US rights could be allocated to DHL. The Court of Appeals held that the remaining USD 50 million attributable to the foreign rights could not be allocated to DHL since DHLI and MNV were entitled to these rights without payment under the developer-assister rules of the 1968 US Transfer Pricing Regulations (Treasury Regulation § 1.482-2(d)(1)(ii)(a)).

OECD Guidelines

The difficulty identified in the OECD Guidelines is that a distributor may not be able to earn a sufficient return to justify a high level of marketing expenditure. Paragraph 6.38 suggests that an abnormally high level of such expenditure might warrant an additional return – perhaps through a reduction in the price paid for the goods distributed or a reduction in any royalty rate. Perhaps, once the final discussion draft on intangibles is published, these will provide more clarification.

14.3.2. Current guidance of the OECD Guidelines: Chapter VI

At the time of drafting chapter VI of the OECD Guidelines (1994/95), ownership of intangible property was a secondary issue, implicitly discussed only in the context of marketing activities by enterprises not owning trademarks or trade names (paragraphs 6.36 to 6.39). The issue arises as to whether the marketer should be compensated as a provider of promotional services or whether the marketer should share in an additional return attributable to the marketing intangibles.

The example is given of a distributor with a long-term contract for sole distribution rights for the trademark product. In such a case, the distributor's share in the benefits should be determined on the basis of what an independent distributor would obtain in comparable circumstances. Where a distributor bears extraordinary marketing expenses beyond those of independent distributors, an additional return from the owner of the intangible – e.g. through a decrease of the purchase price of the product or a reduction in the royalty rate – may be appropriate, under the Guidelines.

14.3.3. US regulations

The US regulations, as amended by the Temporary Regulations of 31 July 2006, deal with ownership of intangibles in section 1.482-4 T(f)(3):

> The legal owner of an intangible pursuant to the intellectual property law of the relevant jurisdiction, or the holder of rights constituting an intangible pursuant to contractual terms (such as the terms of a license) or other legal provision, will be considered the sole owner of the respective intangible for purposes of this section unless such ownership is inconsistent with the economic substance of the underlying transactions [...]. If no owner of the respective intangible is identified under the intellectual property law of the relevant jurisdiction, or pursuant to contractual terms [...] or other legal provision, then the controlled taxpayer who has control of the intangible [...] will be considered the sole owner of the intangible for purposes of this section.

Consider the following example as an illustration. A legal owner of a trademark resident for tax purposes in Europe licenses it to a US subsidiary. The licensor is the legal owner of the trademark; the licensee is the owner of the licence, not the co-owner of the trademark. If the US subsidiary develops a consumer list not covered by the contract, the US subsidiary should be deemed as the sole owner of this intangible because it controls it.

If a controlled taxpayer develops or enhances the value of an intangible owned by another controlled taxpayer, an arm's length consideration should be paid. Such compensation may be combined with other transactions under a contract or be paid separately.

The former version of the Regulations distinguished in section 1.482-4(f)(3) between legally protected intangibles and intangibles not legally protected. In the latter case, the developer of the intangible would be considered the owner.

The first purpose of the new provision is to stress that the ownership of a licence to use an intangible is an intangible itself that deserves a portion of the income attributable to the intangible. In this manner it may be avoided that all income earned through an intangible is allocated to the owner, leaving the other party which might have contributed to the development of the intangible with a low, stable return. [128]

The provision "codifies" the position taken by the IRS in the *Glaxo* case, such that in situations where a US subsidiary has a long-term distribution contract with a licence to use an intangible, efforts going beyond the limited contractual rights should be rewarded with a portion of the return to the intangibles. [129]

14.4. Determining an arm's length price for intangible property

14.4.1. OECD Guidelines

The OECD Guidelines deal with the issue of determining an arm's length price for intangible property in paragraphs 6.20 to 6.27. Various factors of comparability (or rather, valuation) are discussed, including:

- expected benefits (which are probably the most important factor);
- limitation of the geographic area;
- export restrictions;
- exclusive or non-exclusive character;
- capital investment;
- start-up expenses and development work required in the market;
- possibility of sublicensing;
- the licensee's distribution network; and
- whether the licensee has the right to participate in further developments of the property.

128. S. Allen, R. Tomar & D.B. Wright, *Sec. 482 Service Regulations: Implications for Multinationals* , 13 Intl. Transfer Pricing J. 6, p. 279 (2006), Journals IBFD.
129. For a history of IRS attempts to tackle "standard" profits of related US distributors of foreign branded products, *see* M.M. Levey et al., *The Quest for Marketing Intangibles*, Intertax 1, pp. 2-4 (2006).

Under the OECD Guidelines, for patents, the nature (process or product); the degree and duration of protection; the period during which the economic value of a patent is maintained; and the value that the production process contributes are particularly important.

For marketing intangibles (trademarks), consumer acceptability, geographic significance, market shares and sales volume should be considered.

Concerning transfer pricing methods for intangibles, the Guidelines refer to the (internal) CUP where the same owner has transferred or licensed a comparable intangible under comparable circumstances to an independent party. A CUP or resale price method may be used in cases of sales of goods incorporating intangibles.

The profit split method may be appropriate in cases where both parties to a transaction contribute valuable intangibles for which no comparables exist.

14.4.2. US regulations

Their application being dependent on the best method rule, the US regulations in section 1.482-4(a) specify three transfer pricing methods: the comparable uncontrolled transaction (CUT) method, comparable profit method and profit split method. Other "unspecified" methods are also allowed.

The CUT method requires a high degree of comparability of the intangible concerned:

- the intangible must be used in connection with similar products or processes within the same general industry or market; and
- the intangible must have a similar profit potential; this comparability factor is explained in several examples.

In addition, a list of circumstances of the transactions must be considered from the perspective of comparability. These are to a great extent similar to the comparability aspects listed by the OECD Guidelines.

Exact CUTs are rare because of the problem of evaluating the profit potential of unrelated-party transactions. Inexact CUTs usually rely on interquartile arm's length royalty ranges, supplemented by transfer pricing analyses under other methods.

The comparable profit method may be used for routine intangibles in cases where the transferee is the tested party. Data on operating profits of similar businesses are publicly available. Under a rule of thumb based on analyses of licensing activities between unrelated parties, at least 50% of the income attributable to the licensed intangible should be retained by the licensee. [130] However, the German "thumb" is shorter (or longer, depending on one's perspective!), in that the German tax authorities apply an upper limit of 33% in such cases. [131]

The profit split method, in particular its residual version, can be applied where both parties to a transaction contribute (non-routine) intangibles which are difficult to value. The new temporary regulations in section 1.482-6T describe the functioning of a profit split. In the first stage, income from routine contributions to the joint operating profit of the two related parties is calculated. This can be derived from similar contributions by unrelated parties. Second, the residual profit from non-routine

130. Id. at 644.
131. Id. at 289.

contributions must be allocated. Lacking materials for comparison, this calculation must be based on the capitalized development costs of both parties.

14.4.3. Periodic adjustments/uncertain valuation

US tax law and regulations require an adjustment of the remuneration for intangible property in certain situations. The basic provision for this was added to section 482 in 1986 as a reaction to aggressive tax planning, in particular by US pharmaceutical multinationals, and the ensuing *Eli Lilly* case. [132] The provision states, "In the case of any transfer (or license) of intangible property … the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible". This provision was meant by Congress to prevent taxpayers from transferring intangibles for low royalty rates at an early stage of development, i.e. before the profit potential could be demonstrated. The other reason was the concern over "super royalties", such that the remuneration for unique, highly valuable intangibles should not be determined by industry average royalty rates. [133]

The introduction of this clause was fiercely objected to by other OECD countries and multinationals. The main criticism was that the provision is contrary to the arm's length principle, as retroactive price corrections were unusual among unrelated parties. Moreover, its application largely depends on hindsight (considering results made afterwards for pricing the earlier transfer or use of an intangible).

The practical application of the commensurate-with-income clause is covered by section 1.482.4(f) of the US transfer pricing regulations. Where arrangements concerning intangible property cover more than 1 year, the commensurate-with-income provision requires taxpayers to check whether the remuneration agreed still matches ("is commensurate with") the income generated by the associated party through the intangible concerned. If it was determined in a given year that the remuneration charged was arm's length, the IRS may nevertheless make an adjustment in a subsequent year if the amount is no longer commensurate with the income.

No adjustment under this clause need be made if the remuneration was based on an exact CUT (same intangible). An arm's length inexact CUT is also accepted as an exception under strict conditions, e.g. the CUT does not include a change clause; no substantial changes in function have occurred subsequently (except when required by unforeseen events); and the actual profits or cost savings remain within a range between 80% and 120% of the profits/cost savings anticipated. If other transfer pricing methods are used, an exception to periodic adjustment applies if the latter two conditions are met and the original remuneration agreed was arm's length and actually paid. If the 80/120 test and other conditions are satisfied during the first 5 consecutive years after the transfer, it is no longer necessary for a periodic adjustment to be made. Also, in the case of a profit decrease as a result of "extraordinary events" beyond the control of the taxpayer which could not be anticipated, an exception to periodic adjustment applies (unless functions were changed).

Other countries generally reject the application of a commensurate-with-income provision. The OECD Guidelines warn against the use of hindsight when tax authorities consider data from years after the transaction concerned (paragraph 1.51). Several arm's length approaches to the problem of uncertain valuation at the time of the transaction are given in paragraphs 6.28 to 6.35, in all cases referring to what unrelated parties would do in a similar situation. Independent parties, under the Guidelines, would try to determine anticipated profits in a reasonable way. One could add that a sound business manager-

132. 62 AFTR 2d 88-5569.
133. IFA Cahiers 92a, at 648.

licensee would do this anyway. Other solutions may be to adopt a short-term agreement; to include a step-up royalty in proportion to increasing sales; or the option of renegotiations, in order to share the risk of lower-than-expected sales due to unexpected developments.

The OECD Guidelines state that arrangements that would have been made by unrelated parties in comparable circumstances and projections that they would have made for their pricing should be used when evaluating controlled pricing. This should be done on the basis of information reasonably available at the time of the transaction.

The approach of the OECD Guidelines is therefore considerably different from the almost “automatic” adjustment mechanism applied if profits are outside the 80/120 range in the United States.

Double taxation may arise as a result of the isolated US position in this regard. A retroactive adjustment of a royalty may be made in the United States, but the associated enterprise in the other country may normally only deduct (and continue to deduct) the royalty agreed upon in the contract between the related parties. A MAP may not provide a solution because of principal differences in approach.

14.5. Transfer of intangibles

14.5.1. General

Transfer pricing rules generally do not include provisions defining the cases in which a transfer of an intangible to a related party occurs. Applying the arm’s length principle, the point of comparison should be – for instance – whether a licence to use a patent or trade name is commonly given by the owner to an independent manufacturer/distributor in a similar situation.

Transfers of intangibles or of the use of intangibles commonly take place via a sale of the intangible or via a license agreement. Under a license agreement, ordinarily royalties are paid based on output or sales of the licensee, but seldom based on profits.

As the OECD Guidelines state in paragraphs 6.17 and 6.18, compensation for the use of an intangible may (also) be included in the price of goods. The transfer or use of different types of intangibles (e.g. patents, trade names and know-how, including technical assistance) may be bundled in one contract. The contract may also provide for the use by the licensor of improvements made by the licensee to products or processes. The Guidelines stress that unbundling may be necessary for an arm’s length test and, in specific countries, for withholding tax purposes.

A transfer of an intangible may occur without any agreement or formal contract, and without payment. For instance, if technical staff of one group company visit another group company, know-how may be exchanged on an informal basis. If, subsequently, one of the companies apparently benefits from improved products or processes, a transfer of a valuable intangible may be traceable.

14.5.2. Transfer of manufacturing intangibles

It is generally agreed that in the case of contract manufacturers, no transfer of manufacturing intangibles takes place. A contract manufacturer uses technology owned by the (sole) customer, produces according to instructions and specifications of the customer and does not bear product warranty or product obsolescence risks. Contract manufacturing may be classified as the provision of a production service.

In the case of a full-fledged group manufacturing company, the usual manufacturing risks (as compared to an independent full-fledged manufacturer) are borne. Where patents and know-how developed by a related party are used for the manufacturing, further development may be agreed on and an arm's length royalty should be paid.

14.5.3. Transfer of marketing intangibles

In open-market situations, a manufacturer of a branded product that appoints an unrelated distributor abroad to develop the market and sell the product will usually not charge a license fee for the trademark concerned. It is not assumed that an intangible was transferred; instead, a price will be agreed at a level that enables the distributor to develop the market adequately. The arm's length principle requires a similar treatment of a related distributor.

The combination of manufacturing, marketing and sales in one company would make a difference. Both manufacturing and marketing intangibles are transferred to such a full-fledged manufacturer and marketer, giving rise to royalty payments. Whether the trade name and mark have been promoted already in the country concerned affects the local value of the intangibles and the amount of the royalty. If the value of the trade name/mark must be developed entirely by the company in the new market, the licensor would be entitled to only a limited royalty for the use of the intangible property. The royalty rate should not increase proportionally with the value of the trade name/mark if the increased value is due to the marketing activities of the licensee. [134]

14.5.4. Transfer of personnel with valuable specific knowledge and experience

Under one approach, if the related company to which the employee is transferred pays full compensation, no additional payment for the transfer of know-how as a normal consequence of the daily activities must be made. [135] This is based on the assumption that a transfer of staff between unrelated parties does not go with royalty payments (in the absence of so-called handcuff provisions in employment contracts).

The German Administrative Principles require an examination as to whether the assignment of the employee includes the purpose/permission of transferring specific know-how for which unrelated parties would have established a specific compensation. [136] The German Administrative Principle also suggests distinguishing between professional know-how of the employee and know-how owned by the sending company. In the latter case, the transfer may be considered a transfer of an intangible, provided that the intangible is sufficiently valuable and identifiable. [137]

The first sentence of section 1.482-4(b) of the US regulations supports this distinction: "an intangible must have substantial value *independent of the services of any individual*". (emphasis added)

14.6. Factors relevant for comparability

The current version of chapter VI of the OECD Guidelines indicates numerous factors that should be taken into account when carrying out a comparability analysis for transactions involving the transfer of intangible property, including:

- expected benefits from the intangible;
- limitations of use in a geographic sense;

134. D.B. Wright, *Intangibles and Transfer pricing*, 1 Intl. Transfer Pricing J. 2, p. 91 (IBFD 1994).
135. Id.
136. IFA Cahiers 92a, at 287.
137. Id. at 617.

- exclusive or non-exclusive character;
- capital investment (e.g. new plant, special machinery);
- start-up expenses/development work in the market;
- whether sub-licensing is allowed;
- the nature of the patent, if any (e.g. degree and duration of legal protection);
- the period during which a patent will maintain its economic value; and
- the contribution of the patented process to the final product (if a patent covers only one component, it would be inappropriate to calculate the royalty by reference to the selling price of the complete product).

However, current section A of the July 2013 Intangibles Revised Discussion Draft shifts the attention towards the possibility of introducing amendments to chapters I-III of the OECD Guidelines in order to take into account some peculiar comparability factors that can play a major role when analysing a transaction involving intangible property. For illustration purposes, it is important to mention, inter alia (e.g. assembled workforce and MNE group synergies), the increasing role of location savings. This has been the subject of hot debates among tax administrations around the world (*see*, in this respect, the clear view of the Chinese SAT in looking at location savings as an intangible in itself from a substantive standpoint), particularly its exact identification.

At the OECD level, the OECD Guidelines (paragraphs 1.55 and 1.57) indicate that features of the geographic market in which business operations occur can affect comparability and arm's length prices. Difficult issues can arise in evaluating differences between geographic markets and in determining appropriate comparability adjustments. Such issues may arise in connection with the consideration of cost savings attributable to operating in a particular market. Such savings are sometimes referred to as location savings. In other situations, comparability issues can arise in connection with the consideration of local market advantages or disadvantages that may not be directly related to location savings.

At the UN level, chapter V on comparability addresses the issue of location savings by defining, at paragraph 5.3.2.39, location savings as the net cost savings that an MNE realizes as a result of relocation of operations from a high-cost jurisdiction to a low-cost jurisdiction. Typically, the possibility to derive location savings may vary from one jurisdiction to another, depending, for example, on the following:

- labour costs;
- raw material costs;
- transportation costs;
- rent;
- training costs;
- subsidies;
- incentives including tax exemptions; and
- infrastructure costs.

It is quite possible that part of the cost savings may be offset at times by “dissavings” on account of the poor quality and reliability of the power supply, higher costs for transportation, quality control, etc. Accordingly, only the net location savings (i.e. savings minus dissavings) may give rise to an extra profit arising to an MNE due to the relocation of its business from a high-cost to a low-cost jurisdiction.

This entails that the computation of location savings typically involves the quantification of the net cost savings derived from relocating in a low-cost country, as compared to the relevant high-cost country. In theory, the cost savings computation includes a selection of a pre-transfer manufacturing or servicing base in the relevant high-cost country compared to the comparable manufacturing or services cost in the low-cost country, taking into account such things as total labour cost per unit of output (adjustment on account of difference in labour productivity), cost of raw material, costs of land and rent costs, tax benefits, etc. In certain cases, the cost savings can be partially offset by a higher cost of infrastructure, such as less reliable power supplies, etc.

14.7. Methods

In the case of a sale or licensing of intangible property, the CUP method may be used if the same owner has transferred comparable intangibles under comparable circumstances to independent parties. In practice, the use of the CUP method can be limited to the amount of comparable internal transactions that can be reflected in contracts providing third-party licensing arrangements. However, such an instance rarely occurs in practice, although certain commercial databases can provide a useful starting point for addressing royalty valuation issues (e.g. Royalty Stat and KT Mine). If such information is available, the amount of consideration charged in comparable transactions between independent enterprises in the same industry can be taken as a guide.

The resale price method may be used in the case of sub-licensing by the associated enterprise to third parties.

In cases involving highly valuable intangibles, comparables might not be found. In particular, where both parties own valuable intangibles or unique assets, the profit split method may be used.

Costs may be an aid to determine comparability on the relative value of contributions of each party, but it is stressed that there is no necessary link between costs of an intangible and value. Intangibles may be the result of long-lasting and expensive R&D.

The treatment of intangibles is discussed in greater detail below (*see* section 15.).

15. Specific Issues Concerning Intangible Property

15.1. The 2010 OECD project on the transfer pricing of intangibles

15.1.1. General

In November 2010, the CFA decided to begin a new project on the transfer pricing aspects of intangibles. As has been seen so far, the topic is covered in the 1995 guidance of chapter VI of the OECD Guidelines and is in need of updating to address all the transfer pricing issues encountered in today’s business transactions and transfer pricing practices. In particular, the call for review is a direct consequence of the revision of the OECD Guidelines completed by the OECD in 2010.

This new project has commenced because many of the issues addressed in the 2010 revision of the OECD Guidelines are relevant to intangible transactions, identified as a key area of concern, due to insufficient international guidance about the treatment of intangibles for transfer pricing purposes, in particular with respect to their definition, identification and valuation.

This lack of clarity leads to many complex and monetarily-significant transfer pricing disputes and to risks of double or less-than-single taxation. The OECD felt that it is necessary to develop clearer and consensus-based international guidance on the transfer pricing aspects of intangibles in order to limit uncertainty and derived risks of double or non-taxation, as well as linked disputes between taxpayers and tax authorities.

The expected outcome of this work should be an update of chapter VI of the OECD Guidelines. This work will be carried out by Working Party No. 6, which was set up for this purpose and expects, as a first deliverable, to release a discussion draft by the end of 2013.

15.1.2. Key issues behind the OECD project

As mentioned, a major circumstance that propelled the OECD to undertake this project is the 2010 update of the OECD Guidelines. In particular, the study on intangibles became necessary in the context of the issues arising from the analysis of business restructuring transactions in the new chapter IX, representing an extension and clarification of the recent work that the OECD did with the revision of chapters I-III of the OECD Guidelines.

Part II, (C) of chapter IX, discussing the reallocation of profit potential as a result of a business restructuring, introduced the concept of “something of value”. Paragraph 9.65 of the OECD Guidelines states (emphasis added):

> An independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction in its profit potential or expected future profits. The arm’s length principle does not require compensation for a mere decrease in the expectation of an entity’s future profits. When applying the arm’s length principle to business restructurings, the question is whether there is a transfer of something of value (rights or other assets) … that … would be compensated between independent parties in comparable circumstances.

The key issue then, in order to comply with the arm’s length principle set forth by the OECD Guidelines, is for the relevant local tax law to identify a “taxable object” (property or service) triggered by a “taxable event” (transmission of value involving that “taxable object”) to be subject to taxation.

Intangibles and, in particular, all the value drivers of an enterprise (manifestations of organization, knowledge and experience – in jargon also called “soft intangibles”) may not be considered as property or services under domestic law so as to be regarded as “taxable object” of “taxable events” when somehow transmitted to benefit others within a corporate group who would assume responsibility and risk in relation thereto.

Accordingly, when “intangibles” – and “soft intangibles” – lack legal status and, therefore, status as taxable objects, in order to capture as taxable events the transmission of economic value they manifest, it will be important in an international setting for countries to adhere to the system of definition and consequently of valuation.

In this regard, the OECD would offer more consistent guidance in order to avoid the impairment of the utility of the arm's length principle by attempting to answer the following questions:

- Is a new definition of intangibles needed for transfer pricing purposes?
- What are the key features needed to identify an intangible transfer?
- What are the valuation methods applied for intangibles?

To the extent that the project develops, this section will be updated accordingly.

15.2. BEPS Action 8: Final Report on the Transfer Pricing Aspects of Intangibles

From a general standpoint the October 2015 Report should be commended as it arguably takes a different, more pragmatic approach with previous OECD reports, as any statement of principle is substantiated by examples. [138]

In particular, from a definitional standpoint, a first important result has been achieved as regards the identification of intangibles. [139] In this respect, paragraph 6.6. outlines the important concept according to which, "rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction." However, paragraph 6.6. outlines the term "intangibles" to address something (i) that is neither a physical nor a financial asset, (ii) that is capable of being owned or controlled for use in commercial activities and (iii) whose use or transfer would be compensated had it occurred in a transaction between independent enterprises in comparable circumstances.

Within this line of reasoning, for instance, intangibles (e.g. patents) that are important to consider in the context of a transfer pricing analysis are not always accounted for in the balance sheet of the associated enterprises transacting with each other. For example, costs associated with developing intangibles internally through expenditures such as R&D or advertising, marketing and promotional expenses, these are – depending on the domestic accounting principles applicable – generally expensed rather than capitalized for accounting purposes. As a result, the intangibles resulting from such expenditures, despite not always being reflected on the balance sheet, nevertheless they will have to be factored in in a comparability analysis as they may be used to generate significant economic value.

Moreover, the availability and existence of legal, contractual or other forms of intellectual property protection, although potentially affecting the value of an asset and the return that should be attributed to it, should not be considered a necessary requirement for an asset to be labelled as an intangible for transfer pricing purposes. Therefore, separate transferability is not a necessary condition for an item to be labelled as an intangible.

Against the same token, the OECD addressed the controversial notion of whether the terms "goodwill" and "ongoing concern" should be treated as an intangible for transfer pricing purposes. In this respect, paragraph 6.29 stipulates that accounting and business valuation measures of goodwill and ongoing concern do not in principle correspond with the arm's length value of the transferred goodwill or ongoing concern. However, in the absence of a single precise and acceptable definition of what is goodwill,

138. The report presents a total of 29 examples.
139. *See* section A, paragraphs from 6.5 to 6.31 of the new chapter VI of the OECD Guidelines.

depending on the facts and circumstances, accounting valuations and the information underlying such valuation may provide a useful starting point in conducting a transfer pricing analysis.

According to the new guidance suggested under the Final Report on Actions 8-10, only legal ownership of intangibles does not allow its owner to obtain the revenues from this intangible property. According to the OECD, revenues from intangible property should go to the enterprise that performs important functions in relation to the development, enhancement, maintenance, protection and exploitation of the intangible property. Consequently, in order to be eligible to the revenues from the intangible property one has to perform actual functions and only having legal ownership would no longer be sufficient.

Moreover, the OECD recognizes that provision of funding is important. No one can make any investments without appropriate amount of funds at the right time. Where an associated enterprise provides funds it assumes financial risk in relation to those funds, providing that it has control over those financial risks. In such a case, the above-mentioned Final Report provides that an enterprise providing funds for investment and at the same time having control over the financial risks in relation to those funds is eligible to risk-adjusted financial returns. Furthermore, in certain cases, the fund provider is not even able to control the financial risks associated with the funding it had provided, e.g. the enterprise sometimes does not even check the creditworthiness of the borrower, etc. In such cases, the Final report on BEPS Actions 8-10 allows the fund provider to obtain only risk-free financial return, which can be very low.

As already mentioned, if the fund provider is not able to control the financial risks, the remuneration it can obtain may be as low as the risk-free financial return. However, one may question if the remuneration can be lower than that. According to the mentioned Final Report, the remuneration can be lower and the fund provider may receive nothing if the transaction is considered to be artificial and the non-recognition provisions apply.

The OECD emphasizes that in certain cases there are no reliable comparables and, also, it is very difficult to make financial projections or assumptions in order to value intangibles. Therefore, tax administrations have problems with this type of intangible property, which is why the OECD has proposed a special approach to deal with such cases. Consequently, the Final Report on Actions 8-10 provides tax administrations with the possibility to make an adjustment to controlled transactions involving hard-to-value intangibles based on ex post outcomes when certain circumstances are met. According to the OECD, such an approach does not involve hindsight, but it is more a kind of a commensurate-with-income approach. The necessity for such a provision is due to the information asymmetries between taxpayer and tax administration.

Paragraph 6.189 of the Final Report on Actions 8-10 defines the term “hard-to-value intangible” (hereinafter HTVI). The paragraph states the following:

The term hard-to-value intangibles (HTVI) covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist, and (ii) at the time the transactions was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.[140]

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140. OECD. *Aligning Transfer Pricing Outcomes with Value Creation* (OECD 2015), at para. 6.189.

Furthermore, the Final Report provides the list of features that HTVI can have. These features include: transfer of partially developed intangibles; transfer of intangibles not to be exploited until several years are passed since its transfer; transfer of an intangible that represents an integral part of the HTVI; transfer of an intangible that is to be used in an innovative way; transfer of the HTVI for a lump-sum payment; and an intangible is exploited in relation to or is developed in a CCA or similar arrangements.

As mentioned earlier, under this new guidance the tax administration is allowed to make adjustments based on ex post outcomes in certain circumstances. However, the same report provides exemptions from such an approach. These exemptions are discussed in paragraph 6.193 of the Final Report on BEPS Actions 8-10. There are four exemptions from this rule. More specifically, tax administrations are not allowed to make adjustments based on the mentioned approach if:

1. the taxpayer provides detailed information on how it arrived to the price of HTVI and in case a significant difference occurs, it provides reliable evidence that this difference is due to unforeseeable events;
2. a bilateral or multilateral APA covers the HTVI transfer;
3. the significant difference does not change the compensation for the HTVI by more than 20% of the existing compensation; and
4. the HTVI generated independent-party revenues for 5 years and the difference between the projections and actual revenues was not more than 20%.

On 23 May 2017, the OECD published a discussion draft which provides guidance on the implementation of the approach to pricing transfers of hard-to-value intangibles described in chapter VI of the OECD Guidelines.

16. Intra-Group Services

16.1. Introduction

Chapter VII of the OECD Guidelines discusses services provided by one member of a multinational group to other members and the arm's length consideration for such services. Cost contribution methods for services provided within a group are discussed in chapter VIII in a broader context, including CCAs involving intangibles.

The extent of intra-group services varies considerably among MNEs, depending on the structure of the group. In a highly decentralized group, the parent may limit its intra-group activity to monitoring its investments in its subsidiaries in its capacity as a shareholder. In contrast, in an integrated group, the management of the parent may make all important decisions concerning the affairs of the subsidiaries and may carry out all marketing, training and treasury functions.

A group member may acquire services from independent service providers or from associated service providers, or perform the services for itself. Intra-group services may include management, coordination and control functions for the whole group, typical intra-group services such as central auditing, financing advice and training of staff, and services which are typically available externally from independent parties, such as legal and accounting services.

16.2. Characterization of activities as an intra-group service

Whether an activity performed by a group member for one or more other group members can be recognized as an intra-group service under the arm's length principle depends on whether the activity provides the respective group member(s) with economic or commercial value to enhance its commercial position. The yardstick is whether an independent enterprise in comparable circumstances would have been willing to pay for the activity concerned (or to perform it in-house for itself). If not, such activity should not be considered as an intra-group service under the arm's length principle.

The analysis becomes complex where an associated enterprise undertakes activities relating to more than one group member or to the group as a whole. The activity may be performed even if specific group members do not need the activity and would not be willing to pay for it if they were independent. Such an activity would not justify a charge to the recipient companies.

16.3. Types of services

Members of MNEs may acquire services from specialized independent service providers or from other group members, or may perform the services in-house. As the OECD Guidelines state in paragraph 7.3, certain services are typically available from outside sources, such as legal services, while others are ordinarily provided within MNEs, such as financing advice.

From a managerial perspective, there is much merit in concentrating frequently needed services in a group service centre, either as a separate entity or as a department of a parent company. Reasons for concentrating services include economies of scale, synergy, efficient use of resources, and a high degree of specialization. Developing own expertise, coordination and control and avoiding duplication are important managerial considerations, as well. The location of a centre depends to a great extent on the availability of experts, which includes the necessity of having good facilities and a pleasant environment for expatriates, and appropriate communication and travel facilities. A favourable corporate tax regime may not be the most important reason.

Centralized activities – a concept broader than services (*see* below) – may include the following:

- coordination and control;
- administrative services;
- technical and IT services;
- management of know-how/administration of licences;
- purchasing and procurement;
- leasing;
- distribution;
- engineering;
- human resources services, including recruitment and training;
- financial services, e.g. debt factoring;
- legal and tax services (advice, compliance);
- managerial services;

- research and development;
- contract manufacturing (*see* OECD Guidelines paragraph 7.40); and
- contract research (*see* OECD Guidelines paragraph 7.41).

The latter two categories should be distinguished from full-fledged manufacturing and full-fledged sales. These activities typically combine entrepreneurial and other risks with the use and/or development of intangibles.

Because of the emphasis on the development of valuable intangibles, research and development, unless structured as low-risk contract research, is a centralized activity going beyond the scope of services.

The OECD Guidelines point to intra-group service arrangements, which also cover the transfer of goods and intangibles (paragraph 7.3). The provision of technical services may go with the transfer of valuable knowledge to the associated client. In such a case, segregation of the elements of the transaction may be required (paragraph 1.43).

Terminology in the services area is sometimes confusing. The term "management fees" may be used for payments for an array of different services but should be restricted to typical managerial services for the sake of clarity and to avoid withholding tax on typical management fees.

16.4. Benefit test

The OECD Guidelines classify an activity by a group member as a (chargeable) service if the activity provides another group member with "economic or commercial value to enhance its commercial position". This benefit test is coupled with an arm's length test: would an independent party in comparable circumstances have been willing to pay for the activity concerned (or have performed the activity in-house for itself)?

As to the benefit test, both the OECD Guidelines and the US regulations seem to focus on the receiver of a service, requiring a specific benefit for which an unrelated party would be willing to pay. Such requirements may not be feasible, however, in common practice in MNEs, where different types of activities are carried out for the benefit of the group as a whole and a specific actual benefit for individual group members may be difficult to determine. [141]

The explanation to the provisions of the new US services regulations gives as a solution the application of shared services arrangements (cost contribution arrangements, in OECD terminology), which may be used for routine services qualifying for the services cost method. Such a shared services arrangement may "include activities that provide benefits on only an occasional or intermittent basis" (section 1.482-9T(b)). The explanation, moreover, states that the benefit test focuses on the recipient of the service, but the application of the best-method rule may require analysis of the recipient, the renderer or both. Looking at the full picture may be particularly appropriate in a situation where the renderer is located in a high-cost jurisdiction and the recipient is located in a low-cost jurisdiction, where the same service could have been obtained at much lower cost. [142]

141. *See* OECD 1984 Report, Part III F.
142. *See* S. Allen, R. Tomar & D.R. Wright, *Section 482 Service Regulations: Implications for Multinationals* , 13 Intl. Transfer Pricing J. 6, p. 279 (2006), Journals IBFD.

16.5. Shareholder activities

A typical example of non-chargeable activities is shareholder activities. Shareholder activities comprise costs of activities relating to the legal structure of the parent itself and to reporting requirements of the parent. Also, costs of raising funds for the acquisition of participations are shareholders costs.

The scope of shareholder activities is a classical point of discussion between MNEs and tax administrations, and – in MAPs – between tax administrations. Countries with predominantly inbound investment may prefer a broad concept of shareholder activities, meaning that charges by foreign parents to subsidiaries in the country concerned remain more limited than under a narrow concept. Countries where many parent companies tend to be located will favour a narrow concept, which would allow more room for charges to foreign subsidiaries (e.g. the "sole effect" criterion in the United States; *see* below).

The OECD Guidelines explain in paragraph 7.9 that the term "stewardship activity" is to be distinguished from shareholder activity. In the 1979 Report, the term was used in a broad sense, covering shareholder and other central activities or services to group members. The 1984 Report on the allocation of central costs avoids the term "stewardship activities" because of its ambiguity. The term is sometimes used for categories of costs which cannot be charged to group members. [143]

The OECD Guidelines cite the following examples of shareholder activities from the 1984 Report in paragraph 7.10:

- costs of activities relating to the legal structure of the parent itself, such as meetings of its shareholders, issuing of shares in the parent and costs of the supervisory board;
- costs relating to reporting requirements of the parent, including consolidation of reports; and
- costs of raising funds for the acquisition of participations.

According to the OECD Guidelines, category (d) of the 1984 Report ("cost of managerial and control (monitoring) activities related to the management and protection of the investment as such in participations") falls under the "independent party test", which considers whether an independent party would have been willing to incur such costs. The relevance of this test in this case is not clear, however. In the author's opinion, the arm's length principle is not applicable to the acceptability of costs borne by the spending entity for its own purposes.

Section 1-482-9 T(l)(3)(iv) of the (new) US regulations deals with shareholder activities. An activity is not considered a benefit if the *sole* effect of that activity is either to protect the renderer's capital investment in the recipient or to facilitate compliance of the renderer with its own reporting and legal requirements, or both. The scope of shareholder activity is narrow because of the wording "sole effect" (the proposed regulations referred to "primary effect") so, consequently, charges must be made to subsidiaries even if there is only a limited benefit of the activity concerned.

The examples given in the US regulations illustrate the limited scope. For instance, Example 7 refers to compliance with accounting rules of a publicly held parent company in the United States. Reports are prepared by subsidiaries to be incorporated in the reports of the parent. The preparation of the report by the parent is a shareholder activity, as the subsidiaries do not derive a benefit therefrom. In Example

143. *See* N. Mehta, *Formulating an Intra-Group Management Fee Policy*, 12 Intl. Transfer Pricing J. 5, p. 253 (2005), Journals IBFD (excellent article in which the author equates duplicative services with stewardship services).

8, a subsidiary uses the analysis made by the parent for its own reporting requirements. Because the analysis by the parent also benefits the subsidiary, it is not classified as a shareholder activity. Part of the costs involved must be charged to the subsidiary on the basis of section 1.482-9T(k) (*see* below).

The US sole-effect criterion for shareholder activities will result in uncertainty for taxpayers, as well as in conflicts with other tax administrations because, in practice, a collateral benefit for other group members may arise in many cases from activities carried out by a parent company. Charging (or not) then depends on two other criteria – the "indirect or remote benefit" test and the "duplicative services" test. The primary-effect criterion would have prevented such unnecessary discussions.

16.6. Common audit issues

Intra-group services are a major target of tax audits.[144] Depending on the origin of a service, tax authorities may wish to check whether a charge had to be made, whether a charge was allowed or whether a charge was sufficient from an arm's length perspective. For multinational taxpayers, the issues in this context are, in particular, to avoid non-deductibility of service costs, to avoid withholding tax (in particular on management fees, e.g. in Canada and India) and to prepare adequate documentation.

Essential guidance on the treatment of intra-group services can be found in chapter VII of the 1995 OECD Guidelines and the predecessor thereto – the 1984 OECD Report, Three Taxation Issues, Part III, The Allocation of Central Costs. [145]

The transfer pricing regulations and communications by tax authorities of a number of countries deal with services in varying detail.[146] The 1994 US transfer pricing regulations, as amended by the Final and temporary regulations on treatment of services under section 482 of 31 July 2006, through many examples provide insight with regard to the revised approach of the IRS to services. The new US approach may have an impact on the treatment of intra-group services in other countries.

16.7. Charging or not charging?

Both the OECD Guidelines and the US services regulations discuss categories of activities and benefits for which no charges should be made; namely, shareholder activities, duplicative services, incidental benefits and affiliation benefits. The OECD Guidelines and the new US regulations classify these categories as generally not resulting in a benefit for the other party.

16.7.1. Duplicative services

No charge should be made in cases where an activity of a group member merely duplicates a service that another group member is performing for itself or which is rendered by a third party for it. A seemingly duplicative activity may, however, be useful for the party aimed at, under the OECD Guidelines, for example, in the case of a second legal opinion.

In cases of reorganization, duplication of activities may arise, justifying a temporary exception to the principle of not charging. Section 1.482-9T(l)(3)(iii) of the US regulations makes an exception where the duplicative activity itself provides an additional benefit to the recipient. Example 6 in the paragraph mentioned illustrates the situation: Company X has expert in-house legal staff. (Group) Company Y negotiates a complicated joint venture with a third party, for which it obtains outside legal advice. Before

144. *See* Ernst & Young, *Transfer Pricing Surveys* (published annually).
145. Drafted by the author for Working Party No. 6, OECD CFA.
146. *See* the country chapter of this publication.

the deal is made, the legal department of X reviews the documents and concurs with the external counsel's opinion. Although the activities are duplicative, there is an additional benefit for Y in that its commercial risk is reduced because of the check by the internal legal department.

In practice, it may often occur that tax authorities do not accept a charge, pointing to the duplicative character of an activity and using the argument that an independent party would not have ordered or carried out the same activity twice.

Counter arguments could be risk reduction in complicated matters and the benefit of intra-group expertise at relatively low cost (if charged on a cost-only basis, which is commonly appropriate in cost contribution arrangements).

16.7.2. Incidental benefits

Incidental benefits arise from activities meant for other group members. As an independent enterprise would not be willing to pay for such benefits, under paragraph 7.12 of the OECD Guidelines no charges should be made.

Just as the OECD Guidelines, the US regulations in section 1.482-9T(l)(3)(ii) focus on the recipient, stating that a recipient would not be prepared to pay an uncontrolled party to perform an activity yielding only an indirect or remote benefit.

16.7.3. Affiliation benefit

No intra-group service can be recognized in the event of merely being a member of a larger concern without any specific activity being performed for that member. The OECD Guidelines give the example of a higher credit rating than that which would arise when being unaffiliated. Only when this is due to a guarantee given by another group member or as a result of a group's reputation deriving from public relations campaigns, the benefit is more than incidental. The US term “passive association” is illustrative. The US regulations give an example in which US Company A takes over a small company, B, in another country. After the takeover, Company B obtains a much larger and more complex project than ever before in its country of residence. Company A was not involved, but its reputation was decisive in Company B's obtaining the contract. In the absence of any specific activity, the benefit results from passive association (section 1.482-9T(l)(3)(v)).

16.8. Charging methods

16.8.1. General

The OECD Guidelines distinguish between direct charging, indirect charging (paragraphs 7.20 to 7.27) and CCAs (chapter VIII) as systems for the allocation of central activities and remuneration for services rendered to other group members. In almost all cases, CCAs employ indirect charging, but probably because of their more formal character and their application to both the development of intangibles and the provision of services, they are treated as a special category in the Guidelines and usually also in domestic transfer pricing regulations.

16.8.2. Direct charging

Direct charging, i.e. charging for specific services rendered to other group members, has traditionally been favoured by tax authorities, as it allows a relatively easy check of the arm's length character. The OECD Guidelines state that MNEs should be able to adopt direct charging arrangements where similar services are also rendered to unrelated parties. It is not phrased, however, as being mandatory, as the Guidelines use the term “encouraged”. Only where the services concerned form a main business activity of the enterprise concerned and are rendered also to third parties would indirect charging not be permitted (paragraph 7.23).

Where similar services are also rendered to unrelated parties, the third-party charge may be – or may become after necessary modifications – an internal CUP.

The OECD Guidelines also point to comparable services, such as accounting, legal and IT, available in the open market which may provide external CUPs. It is, however, very questionable whether per-hour charges of a big-four advisory firm could be used as a CUP for internal tax or financial advice in an MNE. Liabilities, market position and cost base are differences for which adjustments are very difficult to make.

In the absence of (internal) CUP, the cost-plus method is the most appropriate method under the OECD Guidelines and the transfer pricing regulations of almost all countries, and it is also the most common method in practice. Under the cost-plus method, an arm’s length markup must be established.

In section 1.482-9T, the US services regulations specify six methods to which the best-method rule is applicable. The most striking feature is the introduction of a cost-only method, namely the services cost method, which may be used for specified (routine) services and low-margin services. “Low margin” means that the median of an arm’s length interquartile range is 7% or less. The services cost method is not allowed for manufacturing, production, extraction of natural resources, construction, sales activities, R&D, engineering, financial transactions or insurance.

The comparable uncontrolled service price method, the gross services margin method, the cost of services-plus method, comparable profit method and profit split are the other methods specified. A very high degree of comparability is required for application of the comparable uncontrolled service price method. The gross services margin method may be used particularly for agency services. According to the US regulations, the (residual) profit split method is ordinarily used where two or more related entities provide non-routine services.

16.8.3. Indirect-charging

According to the OECD Guidelines, indirect charging methods are allowable if sufficient regard is given to the value of the services to the recipient and to the extent to which comparable services are provided between independent enterprises. An exception is made for services rendered also to unrelated parties which form a main business activity of the renderer.

Under the OECD Guidelines, indirect charging is unavoidable in two cases:

- where the value of the services to the related entities cannot be quantified except on an estimated basis, e.g. in cases of central sales promotion; and
- where separate recording and analysis of service activities for each recipient would involve a disproportionate administrative burden.

An allocation method must be applied which makes sense for the activity concerned. The number of staff, in the case of payroll services, and the quantity of goods sold, in the case of central sales promotion activities, are given as examples of appropriate allocation keys.

The *Dow Sverige* case [147] illustrates indirect charging. Dow Europe, a Swiss subsidiary of the Dow Chemical Group, acts as a group service centre, rendering marketing, production, administrative, human resources and management services to group members, including Dow Sverige AB. Dow Europe applies an indirect charging method with different allocation keys for each category of services: net sales for marketing services; production results for production services; accounts receivable for administrative services; and number of personnel for human resources services. A 10% markup is applied to the costs. Arguing that expenses were disproportionate to the benefit obtained, the Swedish tax authorities allowed a deduction of only 75% of the expenses. The markup was disallowed on the grounds that Dow Europe was merely a cost centre without any risk.

After decisions of lower courts in favour of the tax authorities, the Swedish Supreme Court ruled that the burden of proof as to the arm's length character of the charges was to be borne by the tax authorities, and the Supreme Court reversed the lower courts' decisions without detailed reasoning. The Supreme Court held that the transfer pricing policy adopted by the group was reasonable; the Court concluded that the allocated costs were proportionate and the 10% markup acceptable. Apparently, the correct application of allocation keys to the different categories of services has implicitly resolved the benefit question in this case.

The allocation method used must lead to a result that is consistent with what comparable independent enterprises would have been prepared to accept. This test seems rather theoretical, as information on acceptability by independent enterprises in such cases is probably very difficult to obtain (except where non-related parties participate in the activity and the allocation system concerned on the same conditions).

Unlike the OECD Guidelines, the US services regulations do not express a preference for direct charging. Cost sharing for services (shared services arrangement) is presented as a specific application of the services cost method (cost only), not as secondary to direct charging.

16.9. Costs to be included in charges

The OECD Guidelines discuss the cost base of the cost-plus method from the perspective of comparison of transactions, referring to the necessity of adjusting the cost base of a controlled transaction if the proportion of overhead costs to direct costs is higher than in the transaction to which it is compared.

The US regulations (section 1.482-9T(j)) clearly indicate which costs must be included: "total service costs", meaning all costs in cash or in-kind (including stock-based compensation) that are directly identified with, or reasonably allocated to, the services concerned. Total services costs do not include interest expense or foreign domestic income taxes.

For a reasonable allocation of indirect costs, such as overhead expenses, costs of supporting departments and other general or administrative costs, consideration must be given to all bases and factors, e.g. assets, sales, compensation, space utilized and time spent (section 1.482-9T(k) of the Treas. Reg.).

147. *See* A. Berglund, *Supreme Court Decision on Intra-Group Service Fees* , 13 Intl. Transfer Pricing J. 5, p. 271 (2006), Journals IBFD.

16.10. Profit element in the charge or not?

Should a service charge be such that it results in a profit for the provider? An independent enterprise would normally seek to charge for services in such a way as to generate a profit, rather than providing the services merely at cost. In certain circumstances, an independent enterprise, however, may not realize a profit from the performance of services alone (e.g. the costs of the supplier may exceed the market price, but the service complements the range of otherwise profitable activities of the supplier).

When the associated enterprise acts merely as an agent or intermediary in the provision of services, the markup should relate to the cost of the agency function itself rather than to the cost of the service. For example, an associated enterprise that rents advertisement space on behalf of group members may pass on these costs to the group members without a markup, but apply a markup only to the costs incurred as an intermediary.

For practical reasons, tax administrations and MNEs may agree that all relevant costs are charged rather than trying to find arm's length prices for the services concerned. Tax administrations, however, may not agree to charging costs only if the provision of the service is a principal activity of the associated enterprise, where the profit element is relatively significant or where direct charging is possible.

If, in the absence of a CUP, a cost-based method must be applied, the question arises as to whether a markup should be added.

The 1984 OECD Report states that normally an appropriate profit element should be included, except where the service is usually performed between unrelated parties on a cost price base. In particular, where the provision of the services concerned is a major activity of the enterprise, or the enterprise is particularly capable of providing valuable services to related recipients, a profit element would be mandatory. The 1984 Report, however, makes an important exception to this rule. It states that, where a group service centre renders services to group members only, the function of such a centre may in essence be to reduce the costs of the group rather than making a profit for itself. In such a case, direct or indirect charging of costs only should be acceptable.

This approach comes close to the services cost method of the new US services regulations: routine services may (or rather, must) be charged on a cost-only basis, whether directly or indirectly.

The OECD Guidelines are not straightforward on this topic. In paragraph 7.33, reference is made to independent service providers which normally aim at a profit, rather than providing services at cost. However, business strategies may justify waiving the making of a profit from the performance of service activities alone. Business strategies include innovation, new product development and risk aversion (*see* OECD Guidelines, chapter I, subchapter 5): "Therefore, it need not always be the case that an arm's length price will result in a profit for an associated enterprise that is performing an intra-group service" (paragraph 7.33).

Paragraph 7.37 of the OECD Guidelines seems to point to low-profit services when stating that additional tax revenue may not justify the burden of searching for arm's length prices: "In most cases, charging all relevant costs rather than an arm's length price may provide a satisfactory result for MNEs and tax administrations". The Guidelines state that such a conclusion is unlikely to be made by tax authorities where it concerns a (profitable) principal activity of the associated enterprise or where direct charging is possible. The US services cost method seems a modern, specific interpretation of this rather vague consideration of the OECD Guidelines.

16.11. Practical approach regarding intra-group services: Documentation requirements

As indicated above, intra-group services are a major transfer pricing audit target of tax authorities worldwide. In the country where the central activities are organized, the tax administration may check, for example, whether charges have been made; whether the charges have been sufficient (at arm's length); whether there have been valid reasons not to include a profit element; and whether costs have been covered through the key applied.

In the country of the recipient, the tax authorities may, for example, prefer direct charging; seek to verify the benefit; classify activities as shareholder or duplicative activities; find the charges too high; and refuse a profit element.

Where service-type activities are carried out by group members that may benefit group members in other countries, it is necessary to prepare adequate documentation, for both renderers and recipients of a service. Apart from general information on the group as such, information included in the "master-file" service-related documentation may be structured as follows: [148]

- identification of all relevant intra-group service relationships, covering parent-subsidiary services and sister company services (including service centres); general charging policy; and contracts; and
- documentation of the relations between a foreign service provider and a domestic service recipient or vice versa; functions and risks; specific services rendered (whether also rendered to third parties); method applied, cost included; comparables; and analysis of benefits.

In summary, except where a major part of the services is also provided to third parties, indirect methods may generally be acceptable to tax authorities. Shareholder costs should be classified with care, and the non-duplicative character of services should be evidenced.

In the absence of (internal) comparables which could produce a CUP, the cost-plus method would almost always be appropriate. Charging on a cost base only may be acceptable for routine services to which otherwise a low markup would apply.

For indirect charging and particularly CCAs, a profit markup is generally not required, although the facts and circumstances of the case may require achieving a different outcome.

16.12. Low value adding services

The issue of balancing the administrative burden of searching for arm's length prices for low-profit intra-group services and the limited additional tax revenue thereto is brought up again in the 2015 BEPS Report of Actions 8-10 on Low Value-adding Intra-group Services. The report adds a section D to chapter VII of the OECD Guidelines, which provides an elective and simplified approach with regard to qualifying low-value-adding intra-group services. This approach recognizes that the arm's length price for low-value-adding intra-group services is closely related to costs, allocating the costs of providing each category of such services to those group companies which benefit from using those services, and then applying the same markup to all categories of services. The simplified approach is advantageous in the sense that it will reduce the compliance effort of meeting the benefits test and in demonstrating arm's length charges, provide greater certainty for MNE groups and provide tax administrations with targeted documentation enabling efficient review of compliance risks. Countries that do not opt for this

148. *See* N. Mehta, *Formulating an Intra-Group Management Fee Policy* , 12 Intl. Transfer Pricing J. 5, p. 268 (2005), Journals IBFD.

simplified approach will continue to use the guidelines laid down in sections A-C of chapter VII of the OECD Guidelines to decide the arm's length prices of intra-group services.

Low-value-adding intra-group services are defined by the nature of the transactions, which:

- are of a supportive nature;
- are not part of the core business of the MNE group;
- do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and
- do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.

The report also presents a list of services that could not fall into the scope of the low-value-adding intra-group services, including, for example, R&D services, manufacturing and production services, sales, marketing and distribution services, financial transactions and so on. In addition, a list of potential low-value-adding services is also provided, which includes, for instance, the accounting and auditing service, human resource activities and legal service. It is important to note that services listed as potential low-value-adding services may not necessarily qualify as such in all cases. A case-by-case analysis should be conducted to determine whether they constitute part of the core business of the group or whether they are of a supportive nature.

Under the simplified approach, tax administrations should generally refrain from reviewing and challenging the benefits test with regard to qualifying low-value-adding services, provided that the relevant documentation requirements are satisfied. All direct and indirect expenses incurred by one or more group members in providing each category of low-value-adding intra-group services will be pooled together and allocated to different service recipients based on certain allocation keys. A fixed markup of 5% will then be applied to the allocated expenses, which does not need to be justified by a benchmark study. In order to help countries, especially developing countries, to better prevent base erosion, the Report provides an option to set a threshold for the application of the simplified approach. If the threshold is exceeded, the tax administrations will not be obliged to adopt the simplified approach and may require a full functional analysis and comparability analysis, including the application of the benefits test to specific service charges.

17. Cost Contribution Arrangements

17.1. General

Chapter VIII of the OECD Guidelines, released in September 1997, discusses CCAs, [149] commonly called "cost sharing". Paragraph 8.3 defines a CCA as a framework among business enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights, and to determine the nature and extent of the interest of each participant therein. Each participant's proportionate share of the overall contributions "will be" consistent with the participant's proportionate share of the overall expected benefits from the CCA.

149. For a detailed analysis of chapter VIII, *see* H. Becker, *Commentary on Chapter VIII of the OECD Transfer Pricing Guidelines*, 5 Intl. Transfer Pricing J. 2, p. 78 (IBFD 1998).

The OECD Guidelines allow a CCA for many purposes, in particular in the R&D area, but also for services and for developing or acquiring tangible property (paragraphs 8.6 and 8.7).

A CCA is a contract, rather than necessarily a distinct legal entity or a PE, under the OECD Guidelines (paragraph 8.3). The US rules are more straightforward: a qualified cost-sharing arrangement is not treated as a partnership. Foreign participation in a US qualified cost-sharing arrangement is not treated as being engaged in a trade or business within the United States.

Similar to R&D expenditure or costs of service activities carried out by an enterprise for itself, contributions to a CCA are, in principle, to be treated as business expenses, not as royalties (paragraph 8.23). The results of R&D under a CCA should not be treated as an asset.

A CCA participant is entitled to exploit its share in the results of a CUP as an effective owner for its own purposes, without paying a price for the transfer or paying a royalty (paragraph 8.3). One of the participants may act as the legal owner of the rights developed. However, all participants are economic co-owners (paragraph 8.6).

The US regulations dealt with cost sharing only with regard to the development of intangibles, but the services regulations of 31 July 2006 introduced the concept of "shared services arrangement" (section 1.482-9T(b)(5)). Section 1.482-7 covers "qualified cost-sharing arrangements" applicable to intangibles development. Final regulations were issued on 19 December 1995, but these were amended shortly thereafter (13 May 1996). Provisions on stock-based compensation related to intangibles development under a cost-sharing arrangement were added to section 1.482-7 in 2003. The IRS proposed substantial changes to section 1.482-7 in August 2005. Because of harsh criticism, these proposals have not been adopted so far. [150]

17.2. Conditions

The OECD Guidelines recognize the existence of CCAs among independent parties that wish to share risks or achieve savings. Independent enterprises would expect a share in the overall benefit proportionate to their contributions (paragraph 8.9). Only if there is a reasonable expectation of a benefit would an independent party be interested in participating in a CCA. This does not mean that all activities must, in fact, be successful, but independent parties would not continue their participation if the activity were not to produce a positive result within the anticipated period of time (paragraph 8.11). Losses may continue for several years in cases where high-tech products are developed. Also, basic research which may not lead to the development of successful products, but which is necessary for long-term business reasons, may be carried out in the form of a CCA.

Participation in a CCA is therefore limited to associated parties that reasonably expect to gain a benefit by directly or indirectly exploiting or using the results of a CCA. A similar condition applies under section 1.482-7(c)(1) of the US regulations.

The OECD Guidelines and the US regulations allow participation of both associated and non-associated parties in a CCA. Exploitation of the results may be direct or indirect. Participants may use the results of the CCA for their own business activities or allow, e.g. a subsidiary company to use the results for its own purposes.

150. T.A. Reichert & D.R. Wright, *Proposed Cost Sharing Regulations: A Departure from Arm's Length?* , 13 Intl. Transfer Pricing J. 1,(2006), Journals IBFD.

The US cost-sharing regulations of December 1995 required participants to use the developed intangibles in the active conduct of their own trade or business. The amendment of May 1996 allows a qualified participant to transfer or license the intangibles developed to others.

17.3. Amount of contribution

To satisfy the arm's length principle, contributions under CCAs must be consistent with what an independent enterprise would have agreed to contribute under comparable circumstances (paragraph 8.8 of the OECD Guidelines). This means that contributions should be in proportion to anticipated and/ or received benefits.

There are two main aspects in this regard:

- *Estimating the share of benefit expected to be obtained by each participant, and allocating contributions in the same proportion* (paragraph 8.19). Common techniques are:
  - on a direct basis: to estimate the additional income generated, e.g. projected sales of a new product or income from licensing a new process (paragraph 8.21), or estimate costs saved by each participant as a result of the CCA;
  - to use prices charged for similar assets or services (a quasi-CUP, probably difficult in practice); and
  - to use an indirect method, an allocation key, e.g. based on sales; units used, produced or sold; gross or operating profit; number of personnel; or capital invested. The appropriateness of an allocation key depends on the nature of the CCA activity and the relationship between the key and the benefit. Sales is an appropriate key if all participants are expected to have a similar increase in net profits. A condition to this is that all participants operate at the same market level, e.g. manufacturing or distribution. Units used, produced or sold may be an appropriate key if the participants exploit the intangible concerned in the use, production or sale of similar products under similar economic conditions. Gross or operating profit (from the activities in which the intangible concerned is exploited) is an appropriate key if the activity could not be carried out without using the intangible.

  Paragraph 8.20 stresses that a CCA should provide for possible adjustments to reflect changes in relevant circumstances with an impact on shares in the benefit. When actual results differ considerably from projections, tax authorities may adjust a participant's contribution (paragraph 8.27).
- *Valuation of the contribution* (if not in cash). The problem arises when contributions are made in-kind, such as the use of assets by, or administrative assistance to, a CCA. Paragraph 8.15 refers to a case-by-case approach, leaving open the possibility to use costs or market prices for measuring the value of such contributions. Costs may be appropriate where services are contributed; replacement costs where tangible property is made available; and market prices if valuable know-how is contributed.

Government subsidies and grants for R&D activities may have an impact on participants' contributions. The OECD Guidelines remain inconclusive on this matter (paragraph 8.17) because of disagreement between those member countries which take the position that all participants, whether domestic or foreign, may benefit from a subsidy, and others which restrict the advantage to participants residing in the country of the subsidy granter. [151]

Balancing payments may be necessary to correct contributions if the proportionate share of the overall contributions of one or more participants is not consistent with its/their share in the overall expected benefits. Such payments increase the costs of the payer and reduce the costs of the receiver (paragraphs 8.18 and 8.25).

The comparison of the share of expected benefit and the share of costs of participants is an essential element under the US regulations, as well. A "reasonably anticipated" participant's benefit under the US regulations may be measured on a direct basis by reference to additional income generated or costs saved. Indirect bases allowed include units used, produced or sold; sales; operating profits; or any other reliable basis (section 1.482-7(f)(3)).

Costs of intangibles development include operating expenses other than depreciation and amortization plus charges for the use of tangible property provided. The individual contribution shares of participants are a proportion of the above costs, plus balancing payments received, minus balancing payments made. Intangible property provided is accounted for separately through arm's length buy-in payments.

A 20% safe harbour is available to cope with difficulties in anticipating benefits. If the difference between projected and realized benefits from the arrangement is 20% or less, the projections are not considered unreliable by the IRS.

17.4. Markup on costs shared?

The question as to whether a markup on contributions would be appropriate is not explicitly answered in the Guidelines. [152] The reference to what independent enterprises would have agreed in a similar situation may answer the question, as generally cost sharing between independent enterprises, such as in the oil and gas exploration and exploitation sector, takes place on a cost-only basis.

The US shared services arrangement (section 1.482-9T(b)(5), as a special application of the services cost method (which is based on costs only), is clear in this regard: no profit markup. The cost-sharing arrangement for intangibles under the US regulations is based on sharing only costs, as well.

The German Administrative Principles prohibit a markup because of the absence of entrepreneurial risks in cost-sharing (pooling) activities. Cost sharing is, in fact, equated to incurring costs within one enterprise. An exception is made for cases where a pool member carries out a substantial part of its economic activity for the pool.

It could be argued, however, that in cases where related and unrelated parties are participating in a CCA and all parties pay the same cost-based contributions, the contributions must be qualified as at arm's length.

The OECD Guidelines refer to activities rendered by a non-participant – which may be an entity associated with one or more CCA participants – to the joint participants in a CCA (contract research or manufacturing). In such a case, an arm's length charge would be appropriate under the OECD Guidelines (paragraph 8.12). Again, it could be argued that if these activities are charged at cost to both associated and non-associated CCA participants, these charges are at arm's length.

151. *See* Becker, *Commentary on Chapter VIII of the OECD Transfer Pricing Guidelines*, 5 Intl. Transfer Pricing J. 2, p. 72 (IBFD 1998).
152. Buy-in arrangements and the valuation of contributions at market value are matters different from the markup of contributions.

17.5. CCA entry, withdrawal and termination

New participants may obtain an interest in the results of prior CCA activity, such as intangible property. In such a case, the existing partners transfer part of their interest to the new participant. This requires valuing the existing knowledge base and charging an arm's length compensation for the share in the anticipated benefits (buy-in payment; paragraphs 8.31 to 8.33).

The OECD Guidelines recognize arrangements under which no access is given to existing results of a CCA to a newcomer and situations where CCAs have not (yet) created any added value. In these cases, no buy-in fee would be required.

In practice, new participants often contribute valuable know-how, which may balance the access to research results already obtained under a CCA. The OECD Guidelines require valuing both the contributed and acquired intangibles, and a buy-in or balancing payment, as the case may be, is required. Independent parties joining a CCA usually contribute their knowledge without paying additional compensation. [153] Valuing of intangibles is often waived because of the complexity involved in such a task. It is unlikely, however, that tax authorities would accept this practical solution where associated parties join a CCA.

Similar issues arise when a participant leaves a CCA. The arm's length principle requires compensation if there is a transfer of property rights by the leaving participant to the others at the time of withdrawal (paragraphs 8.34 to 8.38).

Upon termination of a CCA, each participant should (have) receive(d) an interest in the results consistent with its contributions during the existence of the CCA (paragraph 8.39). If that is the case, no additional compensation is required. Some provisions of the CCA may remain applicable after its termination, e.g. concerning intangibles that may only be exploited jointly.

17.6. Documenting a CCA

The OECD Guidelines refer to prudent business management in this context (paragraph 8.41). Not assuming such prudence, the transfer pricing regulations of many countries require detailed documentation of relevant aspects of a CCA as mentioned above.

The OECD Guidelines (paragraph 8.42) list the following information to be documented:

- participants;
- other associated enterprises that may be involved in the CCA activity or that may use the results;
- scope of activities and projects;
- duration;
- how the benefit is measured;
- focus and value of contributions, as well as how accounting principles are applied in this regard;
- allocation of responsibilities and tasks;
- buy-in and buy-out, as well as termination;

153. *See* H. Becker, *Commentary on Chapter VIII of the OECD Transfer Pricing Guidelines*, 5 Intl. Transfer Pricing J. 2, p. 62 (IBFD 1998).

- balancing payments, as well as adjustment of the arrangement if economic circumstances change;
- subsequent changes in the arrangement and consequences thereof;
- comparison of benefit projections and actual results; and
- annual cost of the CCA activity; the form and value of contributions during the CCA term; a description of the method of determining value; and accounting principles applied.

The US regulations require a document with similar information as specified in the OECD Guidelines. If such a document is not prepared at the time of the formation (and revision), an arrangement is not treated as a "qualified cost-sharing arrangement".

Cost Contribution Arrangements under 2017 OECD Guidelines

Chapter VIII of the 2010 OECD Guidelines was significantly amended taking into account the outcomes of the OECD BEPS Project. The issues in relation to the CCAs were addressed within the framework of the OECD BEPS Action 8. The new guidance on the CCAs resulting from the work on the OECD BEPS Action 8 replaced the existing chapter VIII.

New chapter VIII introduces a framework to follow in order to analyse the CCA. In particular:

- the guidance provided in chapter I, section D also applies to CCAs. Therefore, the same analytical approach applies for delineating the actual controlled transaction, including allocating risk;
- the same valuation and pricing mechanisms are applicable to the CCAs as to the intangibles set out in chapter VI of the OECD Guidelines;
- the analysis of the CCAs shall be based on the economic reality, where it differs from the contractual arrangements;
- an associated enterprise can be considered as a participant of the CCA where a reasonable expectation exists that it will receive a benefit from the objectives of the CCA in the future. In addition, the associated enterprise shall exercise the control over the risks assumed under the CCA and shall have the financial capacity to assume those risks; and
- the contributions to the CCA shall not be valued at cost, due to the fact that a valuation at cost might lead to a non-arm's length situation, especially where the contributions are intangible property.

The new guidance on the CCAs ensures their appropriate analysis and an outcome consistent with the value creation.

18. Intercompany financial transactions

Intercompany financial transactions have been under closer scrutiny by tax authorities in recent years. An overview of transfer pricing and intra-group financing and the financial market can be found in the introductory chapter of IBFD's Transfer Pricing and Intra-Group Financing database. It should also be noted that intercompany financial transactions have also been considered in the 2015 deliverable of Action 4 of the BEPS Action Plan. Due to the fact that money is very mobile and fungible, multinational groups may achieve favourable tax results by adjusting the amount of debt in a group entity, which will increase the risk of base erosion and profit shifting. Such risk may arise in situations where group companies place higher levels of third-party debt in high-tax jurisdictions, use intra-group loans to generate interest deduction in excess of the group's actual third-party interest expenses or where they borrow loans to fund tax-exempt income. In order to address these issues, Action 4 of the BEPS Project suggests an approach on the basis of a combination of the fixed ratio method and group ratio method, with some other specific optional rules including the *de minimis* monetary threshold to remove low-risk entities, the carry-forward or carry-back of the disallowed interest or unused interest, the targeted rules to support general interest limitation and address specific risks. The Action 4 Report also particularly addresses the intra-group financial issues with regard to banking and insurance industry. The core of the Action 4 Report is the fixed ratio and group ratio method, the mechanism of which can be summarized as below:

- Fixed ratio rule: An entity should be able to deduct interest expense, including that paid to third parties, related parties and group entities, up to a specified proportion of EBITDA, ensuring that a portion of an entity's profit remains subject to tax in a country. The proportion of EBITDA is determined by the government irrespective of the actual leverage of an entity or its group. It is recommended by the report that countries set their benchmark fixed ratio within a "corridor" of 10% to 30%, subject to a review by the year 2020. Countries can adjust the range of rate taking into account factors such as the interest rate and size of the entity, as well as whether the carry-forward of unused interest expenses is permitted and whether other targeted rules are in place.
- Group ratio rule: Considering the fact that certain sectors may be differently leveraged, or that even without a sector bias, some groups are simply more highly leveraged, the isolated application of the fixed ratio rule itself may result in situations where groups having a net third-party interest/EBITDA ratio above the benchmark fixed ratio are unable to deduct all of their net third-party interest expense. Therefore, it is recommended that countries complement the fixed ratio rule with the group ratio rule. Under the group ratio rule, a group ratio will firstly be calculated, which equals the net third-party interest expense divided by the group's EBITDA. Then, the group ratio will be applied to the EBITDA of the specific entity in question. If the result is higher than what is calculated under the fixed ratio method, the entity shall be allowed to deduct interest expenses up to the former amount. Countries can also choose to allow an uplift of net third-party interest expense of up to 10%.

It is important to note that Action 4 is only setting a limit to the deduction of interest expenses of group companies, but does not deal with transfer pricing aspects of calculating the amount of intra-group interest and payments economically equivalent to interest. It has been stated in the 2015 BEPS Actions 8-10 Report on Aligning Transfer Pricing Outcomes with Value Creation that if the associated enterprise providing funding does not exercise control over the financial risks associated with the funding, then it is only entitled to no more than a risk-free return. A discussion draft was published with regard to BEPS issues related to interest in banking and insurance sectors in July 2016, focusing on:

- the risks posed by banking and insurance groups to be addressed under Action 4,
- approaches to address risks posed by banks and insurance companies, and
- approaches to address risks posed by entities in a group with a bank or insurance company.

19. The new chapter IX on the transfer pricing aspects of business restructurings

19.1. Background and origin of the project

Transfer pricing issues related to business restructuring were the other major project completed in July 2010 by Working Party No. 6 that led to the introduction of a new chapter IX in the 2010 OECD Guidelines.

Pressured by competition as well as the need to improve efficiency and reduce costs, MNEs increasingly reorganize their structures to provide more centralized management of manufacturing, sales, distribution, research and other service functions. Also, smaller domestic enterprises doing business with parties in other countries may set up subsidiary companies elsewhere to further develop functions originally carried out by the parent.

Business restructurings by MNEs have been a widespread phenomenon in recent years. They involve the cross-border redeployment of functions, assets and/or risks between associated enterprises, with consequent effects on the profit and loss potential in each country. Restructurings may involve cross-border transfers of valuable intangibles, and they have typically consisted of the conversion of full-fledged distributors into limited-risk distributors or commissionaires for a related party that may operate as a principal; the conversion of full-fledged manufacturers into contract manufacturers or toll manufacturers for a related party that may operate as a principal; and the rationalization and/or specialization of operations.

The Discussion Draft on Transfer Pricing Aspects of Business Restructurings (issued on 19 September 2008) is the outcome of more than 3 years of hard work by the OECD, in which a proactive dialogue with the business community played a crucial role.

In January 2005, in recognition of the widespread phenomenon of business restructurings by MNEs and the tax issues raised thereby, the OECD Centre for Tax Policy and Administration organized a roundtable on business restructurings (the January 2005 CTPA Roundtable), which was attended by senior officials from OECD member countries, as well as from China, South Africa and Singapore, and by a panel of private sector representatives.

Government and private sector participants addressed a broad range of issues, including administrative approaches taken in examinations, as well as treaty, transfer pricing and VAT issues. The January 2005 CTPA Roundtable acknowledged that these restructurings raise difficult transfer pricing and treaty issues for which OECD guidance under both the OECD Guidelines and the OECD Model is needed. These issues involve primarily the application of transfer pricing rules upon and/or after the conversion; the determination of the existence of, and attribution of profits to, permanent establishments; and the recognition or non-recognition of transactions. In the absence of a common understanding on how these issues should be treated, they may lead to significant uncertainty for taxpayers and governments, as well as possible double taxation or double non-taxation.

Recognizing the need for work to be done in this area, the CFA decided to start a project to develop guidance on these transfer pricing and treaty issues. In 2005, the Committee created a Joint Working Group of delegates from Working Party No. 1 (responsible for the OECD Model) and Working Party No. 6 (responsible for the OECD Guidelines) to initiate the work on these issues. At the end of 2007, having taken stock of the progress made to that point, the CFA referred the work on the transfer pricing aspects of business restructurings to Working Party No. 6 and the work on the PE threshold aspects to Working Party No. 1.

The Discussion Draft that was released on 19 September 2008 resulted from the work done on the transfer pricing issues by the Joint Working Group and Working Party No. 6.

The Discussion Draft comprises four Issues Notes:

- Issues Note 1: Special consideration for risks;
- Issues Note 2: Arm's length compensation for the restructuring itself;
- Issues Note 3: Remuneration of post-restructuring controlled transactions; and
- Issues Note 4: Recognition of the actual transactions undertaken.

The deadline for public comments was 19 February 2009. More than 35 contributions were received from the public, demonstrating the awareness and importance of this project within the business community and the significance of the issues addressed.

In March 2009, a Special Session of Working Party No. 6 on business restructurings held a first discussion of the comments received and identified the topics that would most benefit from a public consultation to be held on 9-10 June 2009 with the organizations that submitted comments.

After the public consultation took place, Working Party No. 6 was able to finalize the project in July 2010. This ultimately led to the inclusion of a new chapter IX in the Transfer Pricing Guidelines.

19.2. Key aspects of business restructurings

The most common types of restructuring carried on by MNEs involve:

- as concerns production activities, the conversion of domestic full-fledged manufacturers into contract or toll manufacturers;
- as regards distribution activities, the adoption of limited-risk distribution or commissionaire structures; and
- as regards the management of valuable intellectual property, the transfer of either trade or marketing intangibles to principal companies located abroad.

A common thread in these three scenarios is that the conversions may involve the stripping away of functions, assets and/or risks from one or more of the MNE's profit generating entities, with the subsequent redeployment of the stripped components in one or more principal entities. As a result, the stripped entity ends up performing limited routine functions, holding minimal assets and bearing low risks, and it has a lower profit/loss potential attached to it. The latter element, to be construed as "expected future profits", is relevant in the valuation phase of determining an arm's length compensation for a transfer of intangibles or of an ongoing concern, or in the determination of an arm's length indemnification for the termination or substantial renegotiation of existing arrangements.

However, from the perspective of developing countries, another form of reorganization that gained momentum in recent years due to adverse economic and financial conditions is referred to as "reverse restructuring". The term entails a cross-border redeployment of functions, assets and risks directed towards high-tax jurisdictions. In other words, this type of rearrangement may be triggered when there are losses to be used at the group level and the stripped entity is resident in a country where group taxation is not available.

Under internationally accepted tax principles, taxpayers are generally free to arrange their business operations as they see fit. This holds true, in particular, in the context of cross-border business restructurings, as disregarding or recharacterizing an arrangement as entered into by an entity that is part of a multinational group should be the exception to the general rule of respecting the structuring as adopted by the taxpayer.

Accordingly, although a country may not have specific transfer pricing provisions dealing with cross-border restructurings, transactions entered into with the sole purpose of obtaining an undue tax saving could be eventually challenged either by the application of a general anti-avoidance rule (if present in the tax system of the jurisdiction concerned) or by the application of a deemed general written anti-abuse rule (so-called abuse of law theory). As a result, should either a general anti-avoidance rule or the abuse of law doctrine be applicable, the transaction as entered into by the taxpayer will be disregarded and there would not be room to apply any transfer pricing provision in order to set or test the arm's length conditions of the restructuring (i.e. the transaction is erased or treated as null and void.)

Should the restructuring not be regarded as arm's length, the application of paragraphs 1.64-1.69 of the OECD Guidelines will be allowed so as to challenge those structures.

19.3. Common tax consequences arising from business restructurings

Arrangements involving the cross-border redeployment of functions, assets and risks must respect the arm's length principle. This holds true both with respect to "exit scenarios" (i.e. when something of value is transferred abroad from a developing country) and "entry scenarios" (i.e. when functions, assets and risks flow into the developing country). To this end, the following four situations are envisaged:

- as concerns the transfer of functions and risks, the key question is whether such event may trigger taxation at normal value of any built-in gains embedded in the assets transferred, or whether a comparable charge may be envisaged in the entry scenario;
- as regards cross-border restructurings involving the transfer of intangible assets, the most controversial points focus on (1) the legal identification of the intangible asset vis-à-vis its economic exploitation, (2) how to value the intangible property and (3) how to assess whether the terms and conditions of the intangible transfer are arm's length;
- the cross-border transfer of a going concern is arguably the most controversial scenario to be addressed. From a tax perspective, generally the legal characterization of what is meant by "going concern" may, in principle, influence the tax and transfer pricing consequences of that legal characterization, although an arm's length substance-over-form approach is increasingly gaining ground in the view of tax authorities. Valuation issues – particularly those surrounding the identification of goodwill – play a prominent role in the analysis, as well; and
- relevant tax consequences to be taken into account are also those arising from the termination or substantial renegotiation of existing arrangements. The approach likely to be followed here is a two-pronged one. First, an analysis of the underlying contractual arrangements is required so as to identify whether an indemnification clause was expressly included. Next, there is a determination of whether a third party would have claimed an indemnification – irrespective of the provision of any contractual clause – in the event of an abrupt termination due to a restructuring.

19.4. Transfer of functions and risks arising from business restructurings

As regards the transfer of risks or functions within the context of business restructurings, two approaches may be followed, namely, a legalistic one or a substantive one. Under a legalistic approach, an arm's length compensation will be due only to the extent that the transfer of risks and functions is embedded in (1) a legally identifiable transfer of assets, (2) a disposal of a going concern (or a branch of business) or (3) the provision of services.

Under a substantive approach, the major consequence stemming from reasoning purely in arm's length terms is that an intra-group transfer of functions and risks may potentially lead to taxation where it can be proven that independent third parties would have agreed to compensation if something of value were transferred, irrespective of its legal characterization.

19.5. Transfer of intangibles arising from business restructurings

Arguably, the transfer of intangible assets is emerging as one of the most controversial areas in the context of cross-border business restructurings. Generally, according to a number of developing countries, legal title should be the driver for identifying the existence of intellectual property within a business, as the notion of economic ownership has not been directly addressed by domestic provisions.

Notably, chapter VI of the OECD Guidelines refers to two methodologies (one "technical", the other "juridical") to determine an arm's length compensation upon the transfer of an intangible. As regards the technical evaluation of the intellectual property, it is necessary to identify its technical features, its uniqueness and the expected results arising from its exploitation; as concerns the legal evaluation, an analysis of the contractual terms underlying the licensing of a patent or trademark is required for the purposes of a comparability analysis.

Nevertheless, an increasing trend has been witnessed by tax authorities assessing that a transfer of intangible property took place irrespective of its legal identification in a cross-border restructuring. This led to the argument that the notion of economic ownership of intellectual property is slowly gaining ground as regards the transfer pricing implications of a restructuring.

Absent any specific guidance, it seems that in order to determine whether a conversion of the activities of a company entails the transfer of an intangible, it is necessary to perform a thorough functional and comparability analysis (before and after the restructuring) so as to understand whether a transfer of "something of value" took place. This would mean that the tax authorities should be keen to place more reliance on the actual conduct and true terms of the restructuring rather than limiting themselves to examining only the contractual conditions.

Lately, there have been a number of instances where the tax authorities have interpreted the notion of intangible property broadly, i.e. without limiting it to the assets accounted for in the balance sheet of the stripped company. Such an approach holds true when know-how, customer lists, assignment of employees and goodwill are transferred so as to justify an arm's length compensation.

19.6. Transfer of going concern

In a manner similar to what has been argued concerning the transfer of intangible property, the analysis of a transfer of a going concern in a cross-border context should depart from the legal characterization to be the main driver of the analysis over a purely economic approach. As a result, traditionally the key elements to be taken into account to determine whether the assets of an enterprise could qualify as a going concern are the "organization" and the "attitude" instrumental to carry on a business.

Based on these grounds, the key question to be addressed in the context of a cross-border business restructuring is whether the transfer of a going concern or a branch of business actually took place. If the answer is affirmative, it will be necessary to investigate what is the value of the entire bundle of assets transferred, including goodwill.

As concerns the first question, the transfer of a going concern entails that the key elements of a business are passed on to the transferee. In particular, it seems that if the transferor retains essential features (assets, contracts, people) to run the business without discontinuing it, no transfer of a business takes place.

In the experience of a number of countries, a decisive aspect not to be overlooked with these types of transactions is the treatment of goodwill, something *other than* the profit potential attached to the assets to be transferred. In this regard, it is not always the case that domestic statutory legal or tax provisions provide a relevant definition of what is meant by goodwill. On the contrary, a definition may be inferred from general accounting definitions.

In this regard, goodwill refers to the inherent capacity of a business for generating profits in an amount greater than the value of the assets forming part of the business if considered separately. For accounting purposes, goodwill can be accounted for in the balance sheet as an intangible only if it is acquired against the payment of consideration in the course of an acquisition. For tax purposes, acquired goodwill may be capitalized and amortized in line with its economic lifetime.

Based on this premise, it seems that the majority view among tax authorities is that goodwill exists and assumes relevance only if considered together with the business as a whole and not on a stand-alone basis. Therefore, compensation for the transfer of goodwill should be paid only to the extent that a transfer of a going concern (or a branch of business) has been identified.

Nevertheless, the tax authorities may approach the goodwill issue in the context of the transfer of a going concern by taking a substance-over-form approach. This means that at arm's length, the provider of a package of interrelated assets and services would not settle for a separate valuation of each transaction if an aggregated valuation of the transactions would yield a higher value. As a result, the focus should be on the full valuation of the controlled transactions actually undertaken, rather than on the identification of purportedly legally separate transactions.

19.7. Termination or substantial renegotiation of existing arrangements

In the case of a contract termination or substantial renegotiation, an indemnity payment may be due under the arm's length principle. Depending on the applicable commercial law of the country concerned, an indemnity payment generally must be acknowledged if a party withdraws from a contract in an unjustified and unforeseeable manner. If so, the party claiming the damage will be entitled to receive an indemnification the amount of which will include the future expected profitability that would have arisen from the activity to be performed.

If a contract includes a termination clause and the terms and conditions set out in the agreement are followed upon termination, the termination itself – in principle – would not trigger any exit taxation, provided that the terms and conditions are arm's length. However, the answer may vary depending to the actual facts and economic circumstances of the case.

There is a wide variety of elements that may be taken into account in determining whether a termination clause entailing compensation should be applied. Key elements include the nature and terms of the contractual arrangements, the dependence of one party on another and whether investments have been made.

From a transfer pricing perspective, another relevant factor relates to the opportunities that the terminated party will be granted to obtain alternative business opportunities. This appears to be specifically relevant in the context of a cross-border business restructuring, as it is frequent in practice that in a group context, the terminated party will enter into a different agreement with another affiliate within the group.

19.8. Operational considerations

As regards business restructurings, the main challenge emerging in recent years has concerned not the traditional conflict between residence and source countries, but rather the conflict between high-tax jurisdictions where actual activities take place and low-tax jurisdictions characterized by the centralization of the management of entrepreneurial risks and intangibles.

Two main issues that should always be factored in when dealing with business restructurings are (1) the lack of comparables data and (2) the transfer pricing analysis of location savings. As regards the lack of comparables data, the practical application of the arm's length principle requires a good study of comparable uncontrolled transactions. It is a fact that in some business restructurings it may be likely that comparables will be found, but in the vast majority of cases the outcome of a comparables search will be negative, as MNEs implement structures that are unique to their own internal supply chain model.

The above should not lead to the conclusion that the arm's length principle is not suitable to test the appropriateness of a business restructuring. This holds true even when no comparables are found to exist to that related-party transaction, as MNEs may implement transactions that independent parties would not enter into.

As regards the transfer pricing analysis of location savings, such savings may be derived by an MNE group that relocates some of its activities to a place where costs (such as labour costs, infrastructure costs or real estate costs) are lower as compared to the location where the activities were initially performed, taking into account the possible costs involved in the relocation, such as termination costs for the existing operation, as well as different and possibly higher infrastructure costs for the new operation.

From a tax and transfer pricing perspective, where significant location savings are achieved as a consequence of a restructuring, the question that arises should be whether and – if so – how location savings should be shared among the related parties. The response will necessarily be based on a comparability analysis and, absent any comparables, what would have been agreed between independent parties based on the functions performed, assets used, risks assumed and the relative bargaining powers of the related parties involved in the business restructuring.

19.9. Example

Company A develops and manufactures luxury consumer goods. It bears the warranty risk and operates an after-sale service centre. It is located in a European country with an average corporate tax rate. Associated Companies B, C and D, located in different affluent European countries with above-average corporate tax rates, add features specific for their domestic markets, package according to local tastes; have extensive marketing and sales functions, and sell to domestic retailers. A cost-plus-20%

arrangement is applied by A because CUPs are not available and the resale price method is too complicated to apply because of the functions and risks of B, C and D.

In view of future expansion into other countries, the group intends to enhance the marketing and sales functions by concentrating these in a strategically located European country. In addition, efficiency will be improved by removing duplicative activities of B, C and D. To that end, a new group company, Company E, is established that is responsible for product development, market research, marketing strategy and implementation thereof, and packaging, distribution and sales into the existing (and future) markets.

At the same time, Companies B, C and D are stripped of their original functions and risks. Instead, a commissionaire agreement is concluded between E on the one hand, and B, C and D on the other, whereby E will act as principal and B, C and D will act as commissionaires (so-called undisclosed agents) for E. In addition, the development function, product warranty and after-sale function of A are transferred to E.

As a result, the remuneration for A is reduced to cost-plus 8% and B, C and D receive only an arm's length commissionaire remuneration, rather than their previous (substantial) margin.

In addition to efficiency gains, the new structure – assuming that the cost-plus and commissionaire arrangements are arm's length – may in principle be tax efficient, as follows:

- Company A has less taxable income;
- only a commissionaire remuneration is taxable now with Companies B, C and D; and
- substantial income is earned by Company E in a low-tax jurisdiction.

The following paragraphs explain which transfer pricing issues the restructuring itself may generate and which countermeasures have been (or are being) developed and introduced.

19.9.1. Transfer pricing issues

Consider first the recognition issue. May a tax administration completely disregard a restructuring in some circumstances?

Although specific judicial criteria vary from country to country, the doctrine of abuse of law, whether or not in conjunction with statutory general anti-avoidance provisions, allows tax administrations to disregard an arrangement created by taxpayers if the predominant motive is tax avoidance. This doctrine is typically applied by means of three tests. The motive test requires tax avoidance to be the exclusive or primary motive for entering into the transaction. The artificiality test ascertains whether the transaction has a real meaning or economic value for the parties concerned. The legitimacy test concerns the objective of the tax law: the legal solution chosen does not have the tax consequences that are stipulated in the law. [154]

In practice, the recognition issue might not often arise, as business reasons may play a decisive role in restructurings. Moreover, courts seem to be reluctant to accept the position taken by tax administrations that the taxpayer should have conducted its affairs differently. In both the *Bausch & Lomb* and *Sundstrand* cases, the US Tax Court rejected the IRS argument that the companies

154. *See* G.S. Cooper (ed.), *Tax Avoidance and the Rule of Law* (IBFD Publications BV 1997).

concerned should not have constructed production facilities in Ireland and Singapore, respectively (which was supposed to create considerable tax savings), but rather in the United States:

> The decision of where to construct that facility was the petitioner's (i.e. the taxpayer) to make, however, not the respondent's (i.e. the IRS). The respondent may not substitute its business judgment for the petitioner's under the guise of a Section 482 allocation.[155]

The OECD Guidelines discuss the matter of recognition in paragraphs 1.64 and 1.65: "In other than exceptional cases, the tax administration should not disregard the actual transaction or substitute other transactions for them". In two exceptional cases, however, it may be appropriate and legitimate to disregard a structure adopted by a taxpayer and recharacterize it:

- where the economic substance of a transaction differs from its form; and
- where a totality of arrangements made in relation to a transaction differs from those which would have been adopted by independent enterprises behaving in a commercially rational manner, and the actual structure impedes the tax administration from determining an appropriate transfer price.

As an application of the arm's length principle, the latter test may be the most relevant. Its successful application by tax authorities, however, largely depends on the mere possibility to compare a controlled situation with the vague notion of how an independent enterprise would have behaved in a similar situation under similar circumstances.

Another crucial issue is whether taxable gains are realized upon the conversion of functions and risks and/or transfer of assets. This matter ranges from a change in functions and risks which may not go with a real value transfer, via the transfer of e.g. marketing intangibles developed by a full-fledged distributor upon conversion into a commissionaire to a new entity, to a complete transfer of profit-making potential (sometimes classified as "goodwill"), through to an associated entity or entities as a result of a restructuring.

The principle deriving from the OECD Guidelines is clear: any transfer of a commercial value to a related party should be treated in the same manner as a transfer to an independent party. In a different context (business strategies; paragraph 1.35), the Guidelines state as follows: "(would) a party operating at arm's length … have been prepared to sacrifice profitability…".

If a taxable gain can be identified, the problem of valuation arises. Where a transfer of individual intangibles can be identified, the traditional techniques for valuing intangibles should be used, based on comparable uncontrolled transactions, on development costs of the intangible, or on income generated by the intangible. Another approach is based on the profit level of the entity concerned prior to the restructuring, compared with the expected profit level after the restructuring took place. This approach assumes that the old profit level would be sustainable over the years covered in the calculation.[156]

Still another issue concerns which entity should benefit from the location savings (the advantage of low costs) originating from the restructuring. The arm's length principle requires a comparison with

155. 92 T.C. 525, 584 (1989) and 96 T.C. 226, 357 (1991).
156. *See* T. Hopkins, *Business Restructuring – "Conversion" Issues and a Framework for Analysis*, TPI Transfer Pricing 23 (August 2007).

independent parties. Among such parties, the strongest bargaining power will determine the power to set the price. Elements of bargaining power are market and manufacturing know-how; access to the market; and having alternatives such as production facilities and distribution channels.[157]

Regarding whether the transferring entity is compensated for contract termination, if in a similar case an unrelated party would have a well-founded claim and exercise such a claim in practice, the arm's length principle would demand compensation.

The deductibility of business restructuring expenses is another issue that arises in this context. Restructuring costs for the function-transferring entity may specifically include severance payments for staff redundancies. Tax authorities may be reluctant to accept such deductions, referring to the absence of a benefit for the transferring entity. Where a receiving entity benefits from the costs concerned, tax authorities may insist on allocating the cost to the latter party.

A clue can be found in the treatment of services in the OECD Guidelines. Paragraph 7.6 refers to a test as to whether an activity enhances the commercial position of the group members concerned. In addition, the arm's length test requires that an independent party would have been willing to pay for the activity. It may be assumed that an independent party would be willing to pay for an initiative that actually improves its profitability. [158]

There is also an issue as to whether the restructured entity with an agent function could be classified as a PE of the company that has taken over functions of the former entity. At the meeting of 26 and 27 January 2005 (*see* above), the PE issue was raised as well. If the entity's business activities are restricted to transactions on behalf of the related party and it has the "authority" to conclude contracts in the name of the related party (principal) as well as if its activities are sufficient to qualify as a PE, the entity could in principle be an agency PE.

The civil law issue was raised that a commissionaire – as opposed to an agent – acts and concludes contracts in its own name. However, the commissionaire does not take legal title to the goods and acts at the risk of the principal. Government representatives commented that, in substance, a commissionaire's activities may be binding upon a principal's participation in the host country.

On the crucial question of the amount of profit to be allocated to such a PE, reference was made to the OECD reports on this matter. In brief: should – in addition to an arm's length commissionaire remuneration – profit be allocated to the agency PE based on the allocation rules developed in the OECD Report on attribution of Profits to Permanent Establishments of July 2008, as revised in July 2010.

19.10. The PE argument

The above-mentioned German decree deals with the issue of whether – in the event of a restructuring of a full-fledged distributor into a commissionaire – the commissionaire constitutes a PE. Interesting in this respect is the *Zimmer* case. In *Zimmer*, [159] the Paris Administrative Court concluded that a French company, Zimmer SAS, which was acting as a commissionaire on behalf of its principal, Zimmer Ltd, a UK company, constituted a (dependent agent) PE in France of Zimmer Ltd. The court reasoned that Zimmer SAS indeed acted in its own name as a commissionaire, but this was irrelevant concerning

157. *See* S.N. Allen et al., *Location Savings – A US Perspective* , 11 Intl. Transfer Pricing J. 4, p. 158 (2004), Journals IBFD.
158. *See* D. Oosterhoff, *Business Restructuring Expenses – Tax Challenges and Opportunities*, TPI Transfer Pricing 371 (October 2007).
159. Paris Administrative Court, 2 February 2007, 05PA02361, BF 05/2007.

its capacity to bind its principal, Zimmer Ltd. The matter of how much profit should be allocated to this PE remained undecided.

Other cases of interest are *Boston Scientific International BV v. Italian Revenue Agency* and the *Roche Vitamins* case.

From a historical standpoint, the arm's length principle was already explicitly made applicable to the relationship between a PE in a host country and parts of the enterprise (the head office or other PEs) in other countries in the first draft tax convention covering the allocation of profits – the 1933 League of Nations Draft Convention. Article 3 dealing with PEs of this draft convention is even more explicit than article 5 on associated enterprises. The latter refers to "conditions different from those which would have been made by independent enterprises".

However, this explicit reference to the arm's length principle does not appear in either article 7(2) (Permanent Establishment) or article 9 (Associated Enterprises) of the OECD Model. Article 7(2) of the OECD Model refers to the attribution of profit a PE "might be expected to make if it were a distinct and separate enterprise … dealing wholly independently with the enterprise of which it is a permanent establishment.". The Commentary on Article 7(2) and (3), however, allows member countries to apply the fiction of treatment as a separate enterprise for the calculation of the taxable profit of a PE differently from the transfer pricing rules generally applicable to associated companies.

The main examples of permitted different treatment are as follows:

- paragraph 12.1 states that internal agreements within one enterprise cannot qualify as legally binding contracts. In other words, the fiction of separate enterprise does not cover the treatment of agreements between the fictitious separate enterprises concerned;
- paragraph 15 allows postponement of the realization of profit or loss where goods or assets are transferred between the fictitious separate enterprises. Only when goods or assets are sold to a party outside the enterprise concerned is a profit or loss realized under this rule, which deviates from the arm's length principle;
- paragraph 17.4 allows an exception to the deduction of royalty payments and the application of CCAs; and
- paragraph 18 finds the charging of interest incompatible with the true legal nature of a PE (except for bank branches). A problem related to this issue concerns the allocation of capital to a PE.

The above possibilities to deviate from general transfer pricing rules in the case of profit attribution to PEs may result in discrimination under article 24(3) of the OECD Model and may constitute infringements of the freedom of establishment or the free movement of capital under EU law.[160]

The Commentary to the OECD Model in many cases represents a compromise between different approaches among member countries. The above exceptions to the arm's length principle reflect a concern among various member countries on tax planning opportunities that utilize PEs.

160. For a report on an interesting discussion of these topics, *see IFA Yearbook 2006*, 40-43.

Differences in domestic treatment allowed by the OECD Model create the risk of double taxation, however. For this reason, the matter has been on the agenda of the CFA since the early days of the OECD Model and its predecessor, the 1963 Draft Convention.[161]

Discussion drafts were released in February 2001. Part I deals with general principles; Part II discusses bank branches. Part III on global trading appeared in March 2003, together with a revised version of Part II. Revised versions of Parts I, II and III were released in August 2004. Part IV, discussing PEs of insurance companies, was released in June 2005.

The results of consultations and a consensus reached among member countries were included in a document covering Parts I, II and III, published on 21 December 2006. This document served as the basis for the 2008 finalization of the Report on the Attribution of Profits to Permanent Establishment and the authorized OECD approach endorsed therein. The Report is composed of four parts, (i) one relating to general principles, (ii) one relating to the attribution of profits to PEs of banks, (iii) one relating to PEs of enterprises carrying on global trading of financial instruments and (iv) the last relating to the attribution of profits of PEs of insurance companies.

Below, only a brief reference to the main findings of the Report will be described, as it is beyond the scope of this Introduction to provide an extensive analysis of the Report.

The Report distinguishes between two different approaches of member countries: the functionally separate entity approach and the relevant business activity approach.

The relevant business activity approach, which was rejected in the 2008 OECD Report, limits the profits to be attributed to a PE. Profits are attributable to a PE only when realized by the enterprise as a whole in transactions with other enterprises; the attributed profits may not exceed the profits that the whole enterprise earns from the relevant business activity. For instance, the head office produces goods at a loss as a result of considerable R&D expenditure. The PE distributes the goods. A comparison with independent distributors would usually result in the attribution of profit to the PE. Under the relevant business activity approach, a profit may be attributed only as soon as the production line as a whole becomes profitable.

Variations between countries in the application of the relevant business activity approach exist, e.g. evaluation per year or per number of years, or reference to gross profits or to income and expenses.

The functionally separate entity approach, better known now as the authorized OECD approach, applies the separate entity approach consistently. A taxable profit (or loss, as the case may be) is realized when an asset or trading stock of a PE is transferred to another part of the same enterprise. For instance, the PE manufactures goods and another PE is the distributor. This entails that under the authorized OECD approach, a PE may be in a profitable position where the rest of the enterprise of which it is a part is in a loss position; the opposite is also true.

Because of its consistency with the arm's length principle and its easier administrability, the functionally separate entity approach has become the authorized OECD approach and consists of two steps.

As a first step to allocate profits to a PE, the Report requires a functional analysis covering five aspects:

161. *See* e.g. the report on transfer pricing in the banking sector, *Three Taxation Issues* (1984) and the 1994 Report on *The Attribution of Income to Permanent Establishments*.

- determining activities of the PE on the basis of “people functions” performed; inter alia, it is important to extract what the SPFs are, i.e. the functions relevant to the assumption and/or management of risks and the functions relevant to the economic ownership of assets;
- assets of the PE are determined on the basis of economic ownership through SPFs;
- the PE assumes risks that are inherent to SPFs of the PE’s personnel;
- the attribution of “free capital” to the PE, i.e. the amount of funding that does not give rise to a tax-deductible amount in the nature of interest; and
- the recognition of dealings of the PE with other parts of the enterprise.

The second step involves the application of the OECD Guidelines by analogy, a comparability analysis and the selection of the most appropriate transfer pricing method.

Some further considerations are needed, in particular with respect to the wording adopted by the OECD PE Report. It is not the case that the Report refers to the notion of “analogy”, as the starting point for purposes of attributing profits to a PE is conceptually different than for a separate legal entity, i.e. the PE is neither legally nor economically a separate part of the rest of the enterprise. This means that it is not possible to talk about “intercompany transactions”, but rather of “internal dealings”, when discussing the application of the arm’s length principle and the application of the OECD Guidelines.

Furthermore, the pivotal role in implementing the arm’s length principle revolves around the notion of SPFs, which in Step 1 of the AOA serves the role of a proxy of the arm’s length principle, the latter coming into play only in Step 2 of the AOA in performing the comparability analysis necessary for the selection of the most appropriate transfer pricing method.

The attribution of free capital to a PE necessary to support its functions, assets and risks, delimits the deduction of interest by the PE and is currently the source of major controversy between tax authorities and taxpayers as countries (other than the United Kingdom, Germany and the United States) have not released domestic guidance on the topic. If the amount of free capital stated in the PE accounts is less than the outcome of one of the authorized capital attribution approaches of the Report, the amount of interest expense claimed will be reduced in proportion.

In the absence of consensus on one single method, the Report specifies four acceptable methods for calculating the free capital of a PE:

- the capital allocation approach, based on the value of assets and risks of the PE in proportion to the value of assets and risks of the enterprise as a whole;
- the economic capital allocation approach, based on the economic risk borne by the PE;
- the thin capitalization approach, under which the PE must have the same amount of free capital as an independent enterprise with similar activities under similar conditions in the host country of the PE; and
- the quasi-thin capitalization or regulatory minimum capital approach, under which at least the same amount of free capital must be attributed as an independent enterprise under the regulations of the host country of the PE. This is deemed to be a safe harbour approach and not an arm’s length one, as it refers to the regulatory requirements of the domestic bodies in place.

Where the home country of the enterprise and host country of the PE apply different methods for the calculation of free capital, resulting in taxation of interest in the former and non-deductibility in the latter, the Report suggests the mechanism of corresponding adjustments in the new paragraph 3 of article 7 of the 2010 OECD Model to avoid recourse to the procedure.

As already discussed, the OECD introduced an anti-fragmentation rule to deal with cases where MNEs split their activities in order to fall under the exceptions of article 5(4) of the OECD Model. Moreover, a preparatory and auxiliary limitation was expressly introduced on all exceptions mentioned in article 5(4) of the OECD Model. (Fragmentation in particular may give rise to several transfer pricing challenges, as a particular feature – relevant in a functional analysis – is that an MNE has the capability to spread evenly highly integrated functions across several group companies to achieve efficiencies of scale and specialization in the knowledge that the fragmented activities are under common control for the long term and coordinated by management functions. However, there may be several linkages between the fragmented activities which would, let alone "pure" transfer pricing considerations, trigger the existence of either a fixed place of business PE or agency PE. For example, the separation into different legal entities of logistics, warehousing and marketing and sales functions may require considerable coordination in order for the separate activities to function properly. Risk may be managed by contributions from all the parties involved. Accordingly, when conducting a functional and risk analysis to identify the commercial or financial relations in the fragmented activities, it will be important to determine how those fragmented activities relate to one another in terms of determining any potential liability from a transfer pricing standpoint.

20. Practical Transfer Pricing Issues

The introduction of the earlier 1995 OECD Guidelines (including their revision in 2010) and of domestic transfer pricing regulations in many countries before (e.g. the United States in 1994) and thereafter, in particular dealing with documentation, has led many MNEs and their advisers to develop transfer pricing protocols and standardized transfer pricing reports.

A transfer pricing report focuses on the selection of the most appropriate transfer pricing method with the need of carrying out a thorough comparability (including functional) analysis. Such an exercise should be distinguished from more general documentation, including a description of the activities and the legal and organizational structure of the group concerned and the flows of transactions among group members. A transfer pricing report typically covers:

- an economic analysis of the industry sector in which the taxpayer is operating;
- a functional analysis;
- an analysis of transactions concerned (intra-group and with non-related parties);
- an explanation of the selection of the most appropriate method used;
- the comparables used and, if applicable, not used for the selection;
- the underlying rationale (including financial evidence) for the selection of the tested party and the profit level indicators chosen, in case of a one-sided method; and
- a list of supporting documents.

(1) With the help of functional and risk assessment checklists, questionnaires and interviews to senior management and operational staff of the company, a *functional analysis* should reveal which group entity involved in the transactions concerned creates the value and competitive advantage (by using valuable trade and/or marketing intangibles) for the group as a whole (therefore justifying the entitlement to the residual profit) and which group entity involved carries out routine functions (the tested party, or "least complex entity" according to common transfer pricing jargon as endorsed by paragraph 3.18 of the OECD Guidelines). The analysis may also reveal that important functions and risks are spread over the related parties involved. Information in this regard can be derived from organizational charts, income reports, balance sheets, 10-K reports (United States), analyst reports, strategic plans, budgets and projections, progress reports, audit reports and also personnel involved. Tax returns and customs declarations are also relevant.

(2) An *analysis of the transaction(s) concerned* should include:

- characteristics of the product or service;
- contractual terms of the transaction;
- whether transactions in similar goods are carried out with non-related parties; and
- whether offers are made to, or quotes are received from, third parties involving similar goods or services.

(3) An *economic analysis* should specifically focus on characteristics of the market(s) concerned: geographic market, level and size of business, development of the market, market share, penetration, competition, publicized price lists of similar products (e.g. commodities), published details of similar transactions and alternatives available.

(4) Analyses (1), (2) and (3) provide material for a *preliminary choice of method*, generally:

- CUP method, in particular in the case of similar transactions involving similar goods with non-related parties, as well (internal CUP);
- resale price method, in particular in cases where the reseller is the least complex entity;
- cost-plus method, in particular in cases where the manufacturer is the least complex entity and in the case of services where an internal CUP cannot be established;
- profit split method if both parties contribute valuable intangibles for which no comparables exist; and
- TNMM in other cases and, particularly, as a method to check the result of other methods.

(5) The OECD Guidelines and the regulations of a large number of countries require the corroboration of the method, initially selected after analyses (1), (2) and (3), with reasonably reliable *comparables*. Useful materials may have been found during these phases already. The analyses carried out provide material for the comparability criteria to be applied under the method selected, e.g. for the resale margin (gross margin/discount) realized in exercising the functions specified and risks borne in selling (roughly) comparable products to unrelated retailers in a specific market.

Next, a search for comparable distributors selling to unrelated parties in the country concerned should be made in publicly available databases, using standard industry codes, if available. As mentioned earlier, databases may have rigid formats and be unable to cope with business developments, and the trade descriptions may be inaccurate or incomplete. The information necessary for comparisons may be too limited (query: is a contract manufacturer sufficiently distinguished from a full-fledged manufacturer?).

A first broad result must be narrowed down more precisely on the basis of the comparability criteria developed, e.g. leaving out distributors selling products that are too different. The transfer pricing report should specify the reason for removing certain search results.

The final result of the search may be that ten companies meet the criteria. The result may, however, require adjustments of the resale margin. The costs included may not be fully comparable, e.g. the company concerned does not charge its customers for transportation costs, whereas the companies compared normally do so. If necessary, the adjusted ten margins form an arm's length range, which may have to be reduced (in particular in the United States) to the interquartile range if the comparison is still not completely reliable.

If the taxpayer's margin remains safely within the arm's length range (or within the interquartile range, as the case may be), further benchmarking may not be necessary. If outside the range, even after a careful recheck of data and periods, it may be useful to apply the TNMM as a check or as last-resort transfer pricing method, which may produce an acceptable result. Eventually, sound business reasons, acceptable from an arm's length perspective, may justify a result outside the arm's length range, e.g. accepting a lower margin for the time being in order to develop a market.

(6) As indicated, the TNMM or comparable profit method could be used for *benchmarking*. For this purpose, databases could be used as described above under the resale price method.

(7) *See* above for *documentation* requirements included in the OECD Guidelines, the Pacific Association of Tax Administrators (PATA) Documentation Package and the EU Joint Transfer Pricing Forum's EU-wide approach (the so-called EU TPD). The analyses and data described above are essential elements of the "transfer pricing report".

In terms of transfer pricing applications, two tools commonly used to increase the level of comparability of potential comparables with the tested party or comparable transactions are (i) adjustments and (ii) screens. Suppose there are differences in key economic characteristics between the tested party and potential comparables that would materially impact upon the transfer price. Adjustments work directly to eliminate the effect of such differences, while screens are employed to ensure a broad level of comparability. In particular, an "adjustment" is the change in income (or, in the case of CUP, the change in price) derived by valuing the difference in a particular economic feature between a potential comparable and a target. For example, assume one is applying as a profit level indicator (PLI) a total cost plus and that a comparable Y differs from the tested party in that Y performs an additional processing activity that costs USD 100 for each unit of production. Assume also that one knows (e.g. from other database searches) that a dollar more of that specific processing activity generates five cents of operating profit. This entails that, in calculating the markup in the total cost plus of Y, one would adjust its net profit downward by (USD 100 x 5% x number of units) and subtract (USD 100 x number of units) from its total cost base. Such an adjustment would eliminate the material difference between Y and the tested party, allowing one to compute an arm's length markup rate for the tested party.

On the other side of the coin, unless there are CUPs or internal comparables to benchmark the tested party's transaction, it often becomes necessary to look at large databases of public corporations in order to find potential comparables. Since one can rarely adjust for all material differences in these external comparables, screens are then applied to the entire database in order to find companies whose economic key features are broadly similar to the target.

The first screen usually looks for potential comparables in industry sectors similar to that of the tested party. This screening is done using either NACE or SIC codes. NACE (*Nomenclature des Activités Économiques dans la Communauté Européenne*) is a European industry standard classification system similar in function to SIC (Standard Industry Classification) and NAICS (North American Industry Classification System) for classifying business activities in the database. One chooses NACE or SIC codes based on functional similarity to the tested party including, in particular, industry sectors dealing with similar products to the tested party.

Next, one applies "quantitative" screens that are based on the range of a certain financial ratio. For instance, if the target had a ratio of operating expenses (OPEX) on sales of, say, 25%, 20% 30% is a screen that might be employed to identify all companies in the database with a similar profile. Furthermore, the so-called "textual screens" include or exclude companies based on written descriptions of their operations and markets. For example, after a set of potential comparables is derived based on quantitative screens, brief summaries found in e.g. Orbis, Amadeus, etc. can be used (together with information retrieved from the company's Internet website, if available) to eliminate those that are obviously unlike the target. Within this area, it is worth noting that more detailed companies' descriptions may be available in reports filed with the NY Securities Exchange Commission Website, such as the 10K Report. These should be read to decide whether or not the company should remain in the set of potential comparables. As a result, from a transfer pricing standpoint, screens have to be performed before adjustments.[162]

In any case, what is important to note is that it may be unnecessary to use a commercial database if reliable information is available from other sources, e.g. internal comparables. Where they are used, commercial databases should be used in an objective manner and genuine attempts should be made to use the databases to identify reliable comparable information.

21. Dispute Prevention Measures and Dispute Resolution Mechanisms

21.1. Introduction

According to a survey involving a large number of multinationals, [163] the main dispute areas arising as a result of transfer pricing audits concern:

- administrative and managerial services and shareholder costs;
- intercompany financing;
- sales of finished goods;
- intangible property and royalty rates;
- technical services;
- cost sharing (trade intangibles);
- commission for sales; and

162. *See* J. Reyneveld, E. Gommers & H. Lund, *Pan-European Comparables Search: Enhancing Comparability using Diagnostic Ratios* , 14 Intl. Transfer Pricing J. 4, pp. 219-227 (IBFD, 2007).
163. *Ernst & Young Transfer Pricing Global Survey 2003*.

- sale of raw materials.

In addition, business and changes in the functional and risk profile of an entity within a group (normally referred to as “business restructuring” according to the definition provided for by part I of chapter IX of the OECD Guidelines) are subject to scrutiny by tax administrations in several countries, both in OECD and non-OECD economies.

A transfer pricing dispute usually is the result of an adjustment of prices, contributions or remuneration charged or not charged, by the tax administration of one country on the profits of an enterprise that is part of a multinational group.

If an administrative appeal against an adjustment is not successful, the taxpayer is left with the option of litigation and/or requesting the tax authorities concerned to enter into a mutual agreement procedure with the other tax authorities involved. Litigation is generally an extremely expensive, lengthy and – by its very nature – uncertain option, illustrated particularly by US court cases such as *Sundstrand* and *Bausch & Lomb*.

One aspect of litigation is that the taxpayer’s relationship with the fiscal authorities in the country concerned usually becomes hostile for many years. This aspect is largely absent in the other options; namely, the MAP, the MAP and advisory commission procedure under the EU Arbitration Convention and APAs, the latter being a means of avoiding future transfer pricing problems.

Further reference can be made to IBFD’s publications on Transfer Pricing and Dispute Resolution.

21.2. The mutual agreement procedure (MAP)

Article 25(1) of the OECD Model and similar articles in tax treaties provide for the so-called specific case agreement. If actions of one or both of the contracting states result or will result in taxation not in accordance with provisions of the applicable treaty, the taxpayer may present its case to the competent authority of its country of residence.

It is commonly understood that unrelieved economic or juridical double taxation is covered by the notion of taxation not in accordance with an applicable tax treaty. The case may be presented “irrespective of remedies provided by domestic laws”, which means that the taxpayer may also commence litigation.

Paragraph 23 of the Commentary to article 25(1) states that the competent authority concerned should not wait until the final court decision, but should inform the taxpayer whether it considers the case to be eligible for the MAP. Even after a final court decision, the taxpayer may present the case for a MAP.

According to article 25(1), the case must be presented within 3 years from the first notification of a transfer pricing adjustment or intended adjustment.

According to the Commentary, the article entails a duty for the competent authorities to negotiate and to use their best endeavours, but there is no duty to achieve a result. The implementation of a mutual agreement reached should not be hindered by domestic time limits, under the article.

If a MAP has been concluded prior to a final court decision on the matter, a request by the taxpayer to defer acceptance of the agreement until the court has delivered its judgement should be granted. On the other hand, the competent authorities may make the implementation of the mutual agreement subject to acceptance by the taxpayer and withdrawal of the lawsuit concerning the point settled in the agreement.

The Commentary on Article 25 discusses two stages of the procedure. The first stage begins with the presentation of the case by the taxpayer to the competent authority of the taxpayer's country of residence. The competent authority considers whether the request can be accepted.

The second stage begins with approaching the competent authority of the other state by the competent authority to which the taxpayer has applied. This stage concerns the dealings between the two countries, with the country of the original request acting as a defender of the claim, under paragraph 25 of the Commentary.

Already in 1984, the OECD CFA made an inventory of problems connected with the MAP, [164] namely:

- no solution of the problem concerned can be guaranteed (thus, article 25 refers to "endeavour");
- the taxpayer is not involved in the negotiation process;
- there is a risk that the two competent authorities will set off the matter concerned against other previous or current cases; and
- the duration of the procedure.

At that time, the CFA did not consider arbitration as a solution for transfer pricing disputes.

Problems relating to the MAP were discussed again in the 1995 OECD Guidelines, in particular the aspects of time limits under domestic law, the duration of procedures, taxpayer participation and accrual of interest.

In July 2004, another study on the functioning of the MAP was published by the OECD.

Virtually all problems concerning the MAP that have been addressed by the CFA have been reconsidered by the EU Joint Transfer Pricing Forum. Solutions are included in the Code of Conduct for the effective implementation of the Arbitration Convention adopted on 7 December 2004.[165]

Apart from procedural complications and the reluctance to surrender tax receipts by the country requested to make a corresponding adjustment, the main reason for difficulties in reaching a solution between the countries concerned are differences in transfer pricing legislation and regulations. Also, among OECD member countries' domestic rules and practices concerning the order and selection of methods, the use and availability of comparables and secret comparables and the approach and expertise of tax authorities vary considerably.

It is likely that the OECD will launch a peer review process of the functioning of dispute resolution mechanisms in the near future, as it is expected that taxpayers will increase the use of such instruments. In this respect, the OECD is trying to enforce the widespread use of the best practices contained in the Manual on Effective Mutual Agreement Procedures (MEMAP), published in 2007, which contains a number of important principles dealing with the timing of the filing and the interaction with domestic law and unilateral tax settlement mechanisms. [166] The MEMAP was intended as a guide to increase awareness of the MAP process and how it should function.

The following points are important elements to consider in understanding the status of the Manual and its interaction with other OECD guidance:

164. *Three Taxation Issues: Transfer Pricing, Corresponding Adjustment and the Mutual Agreement Procedure* (OECD 1984).
165. EU Council Document Fisc. 173, 12695/2/04, REV2 of 31 March 2005.
166. *See* the *OECD Manual on Effective Mutual Agreement Procedures*, available at www.oecd.org/ctp/38061910.pdf.

- the Manual does not, and is not intended to, modify, restrict or expand any rights or obligations contained in the provisions of any tax convention;
- information contained in the Manual complements and should not be considered as a substitute for the criteria, procedures and guidance contained in the OECD Model and in the OECD Guidelines; and
- "best practice" is a term used in the MEMAP to describe what is generally thought to be the most appropriate manner to deal with a MAP process or procedural issues. This entails that although taxpayers and tax administrations should ideally strive towards implementing these best practices, it is recognized that it may not always be possible to apply a best practice as described in the Manual or there may be situations where their application may not be appropriate.

With respect to the latter term, an interesting element of contradiction may be found in the best practice No. 19 (Avoid blocking MAP access via audit settlements or unilateral APAs) and the current guidance that some countries, like Italy, have adopted in the recent past via the issuance of secondary legislation.

Italy clarified with its Circular Letter 21/E of 5 June 2012 that as regards the activation of a MAP pursuant to article 25(1) of the OECD Model, the access to unilateral tax settlement and the resulting resolution by means of an agreement between the taxpayer and the tax authorities renders any resolution regarding the same case agreed between the tax authorities of the two states involved ineffective.

In other words, should the tax authorities and the taxpayer reach an agreement with regard to a case of alleged double taxation, this understanding may not be modified and is consolidated while the MAP is still in progress and independently of the result of the MAP. This is also the case if the domestic agreement reached under a deflationary process does not have the effect of eliminating the original double taxation entirely, in which case the only possible remedy is the substantially unilateral discretion of the foreign authorities to conform their position in order to eliminate the double taxation.

Other relevant domestic guidance regarding the use of MAPs may be found, for instance, in the Netherlands and Spain, the tax administrations of which have all released secondary legislation on the topic. [167]

Consider the following example:

Company X, resident in the United States, applies the cost-plus method for sales to its sister, Company Y, in Canada. Because of comparables available concerning (higher) operating profits of similar businesses in the United States, the IRS applies the comparable profit method and adjusts the profit of Company X. Following the OECD Guidelines, the comparable profit method is not recognized in Canada. If Canada considers that the cost-plus method is correctly applied in this case (based on reasonable comparables), the Canadian competent authority may refuse to apply a corresponding adjustment.

On a bilateral level, attempts are made to improve the functioning of the MAP under the applicable tax treaty. The memorandum of understanding between Canada and the United States of 3 June 2005 serves as an example. Because of problems in reaching a solution, particularly in transfer pricing cases, the principles were adopted that the resolution of cases of double taxation contrary to the treaty should

167. *See*, for the Netherlands, reference to the Decree of 29 September 2008, IFZ 2008/248M; for Spain, Royal Decree 1794/2008 of 3 November 2008, published on 18 November 2008 by the Spanish Ministry of Economy and Finance.

be possible in all cases and that domestic administrative policies, practices and procedures should not delay or impede a MAP. Both countries being (founding) members of the OECD, it was surprising that the parties felt it necessary to state that the OECD Guidelines concerning MAPs will be followed.

It was indicated that a further memorandum of understanding will be prepared on the procedure to determine facts, how to resolve specific problems, procedural obstacles and notification requirements.

21.2.1. MAPs and BEPS Action 14

Improving the effectiveness of the MAP process is included in Action 14 of the BEPS Action Plan. The Action Plan provides in relevant part as follows:

> The Actions to counter BEPS must be complemented with actions that ensure certainty and predictability for business. Work to improve the effectiveness of MAPs will be an important complement to the work on BEPS issues….

On the basis of the above, in light of the comprehensive and holistic nature of the BEPS Action Plan, it is necessary to also consider that an effective MAP able to provide timely resolution of disputes regarding the application of novel rules will be essential to prevent overkill and to maintain a healthy business climate for compliant taxpayers.

The OECD finalized the work on BEPS Action 14 and published the Final Report in October 2015. As stated by the OECD, the purpose of BEPS Action 14 is to increase the effectiveness and efficiency of the MAP process. The Final Report introduces the minimal standards that are supplemented by the peer review mechanism and the list of best practices.

According to the Final Report on Action 14, the minimum standards are supposed to achieve the following objectives:

- ensure that treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner;
- ensure the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes; and
- ensure that taxpayers can access the MAP when eligible.[168]

The elements of the minimum standards are set so as to meet the above-mentioned objectives. The elements to achieve the first objective mentioned above are the following:

- Countries are obliged to include paragraphs 1 through 3 of article 25 of the OECD Model in their tax treaties; moreover, countries are required to ensure that taxpayers can access the MAP in order to solve their transfer pricing issues and, also, to implement the agreements reached under the MAP.
- Countries need to ensure that taxpayers have access to the MAP even if the opinions of the taxpayer and tax administration differ on whether the requirements of the tax treaty anti-abuse

168. OECD, *Making Dispute Resolution Mechanisms More Effective* (OECD 2015), at p. 9.

clauses are met or whether anti-abuse clauses under the domestic legislation conflict with the tax treaty provisions.

- Countries have to resolve the MAP cases within 24 months on average.
- Countries are encouraged to become members of the Forum on Tax Administration MAP Forum and work together in order to improve the effectiveness and efficiency of the MAP.
- Countries should provide complete MAP statistics in a timely manner.
- Countries agree to be reviewed by their peers on their compliance with the minimum standards adopted under BEPS Action 14.
- Countries should ensure transparency with regards to MAP arbitration.

The elements to achieve the second objective of the minimum standard are the following:

- Countries are required to publish clear and easily accessible rules, guidance and procedures for accessing and using the MAP.
- Countries are obliged to publish their MAP profiles.
- Countries have to ensure that MAP staff have the authority to solve MAP cases and that tax administration staff introducing an adjustment cannot influence the decision of the MAP staff. Moreover, policy considerations should not impact the decisions of the MAP staff.
- Countries should not assess the performance of competent authority functions and MAP staff based on the indicators such as sustained adjustments or retained tax revenues.
- Resources provided to the MAP function should be adequate.
- Country MAP guidance should clarify that audit settlements do not prevent taxpayers having access to the MAP. If there is a dispute settlement mechanism in the country legislation that limits taxpayer's access to the MAP in case the taxpayer applied for such a dispute settlement mechanism, this country should inform other treaty partners regarding the mentioned mechanism and address the effects of such a mechanism in the public MAP guidance.
- If countries have bilateral APA programmes, they should provide for a roll-back when certain requirements are met.

The elements to achieve the third objective of the minimum standards are the following:

- Countries should ensure that competent authorities of both countries are aware of the MAP requests and have the opportunity to give their views on the acceptance or rejection of the request. For this purpose, BEPS Action 14 provides two different possibilities to do so.
- Countries should indicate the information and documentation required to request for MAP assistance. Moreover, countries cannot reject an application on MAP assistance based on the argument of insufficient information when the taxpayer provided all the information and the documentation indicated by that country.
- Countries should ensure that the agreements reached are implemented notwithstanding the time limits under their domestic legislation by adding the appropriate sentence in their tax treaties (article 25(2) of the OECD Model). If such an addition is impossible, countries should limit the period during which they can make an adjustment.

In order to ensure compliance with the minimum standards, BEPS Action 14 introduces a peer reviewing mechanism. Under the peer review process, the jurisdiction's legal framework, as well as MAP guidance and the practical implementation of the minimum standards, will be evaluated. This review will identify the existing strength and deficiencies and provide recommendations.

In October 2016, the OECD issued a package of Peer Review Documents, consisting of the following four documents:

- the *Terms of Reference* which translate the Action 14 minimum standard into 21 elements complemented by 12 best practices;
- the *Assessment Methodology* which establishes detailed procedures and guidelines for a two-stage approach to the peer review and monitoring process;
- the *MAP Statistics Reporting Framework* which reflects a collaborative approach for the resolution of MAP cases through the adoption of a common timeline for both competent authorities to resolve MAP cases; and
- the *Guidance on Specific Information and Documentation Required to be Submitted with a Request for MAP Assistance*, in light of the minimum standard which requires member countries to publish MAP guidance that identifies the specific information and documentation a taxpayer is required to submit with a request for a MAP, and which prohibits member countries from limiting taxpayers access to the MAP procedure based on the argument that insufficient information was provided if the taxpayer has provided the required information.

Furthermore, the OECD has released an assessment schedule for stage 1 of the peer reviews, which involves 61 jurisdictions and will come to an end in April 2019, with the first batch of reviews scheduled to be launched by December 2016.

As already stated above, the minimum standards are complemented by a list of best practices. However, one should mention that not all OECD member countries have committed to implement these best practices, therefore, they do not form the part of the minimum standard.

One of the important steps forward is that even though there is no agreement among OECD countries to adopt mandatory binding arbitration in their treaties, more than 20 countries have agreed to do so. According to the Final Report on BEPS Action 14, these countries are involved in more than 90% of outstanding MAP cases. Moreover, the mandatory binding arbitration provision is included in the multilateral instrument (Part IV, Arbitration).

21.3. EU Arbitration Convention

21.3.1. Introduction

The Arbitration Convention of 1990 was proposed by the EEC Commission in November 1976 as a directive. However, several Member States did not agree to the instrument of a directive, fearing a surrender of tax sovereignty to the Court of Justice of the European Union. [169]

169. D. Schelpe, *The Arbitration Convention: Its Origin, Its Opportunities and Its Weaknesses*, EC Tax Review 3, p. 71 (1995).

Eventually, a revised proposal was adopted by the EC Council on 23 July 1990 in the form of a Convention based on article 220 of the EEC Treaty (currently article 293 of the EC Treaty), [170] which did not leave any jurisdiction or powers to the ECJ or to the European Commission.

The Arbitration Convention entered into force on 1 January 1995 after the last ratification by a Member State, namely Portugal in 1994. The initial duration was for 5 years. A Prolongation Protocol, signed in May 1999, entered into force on 1 November 2004, providing for automatic extension of the Convention after each 5-year period if no objections are raised by the contracting states at least 6 months before the end of such period.

Austria, Finland and Sweden acceded to the Convention in December 1995. This Accession Convention took effect after its last ratification, namely by Greece in 2005.

Another lengthy ratification process took place with the ten new Member States of 2004 and the two of 2007.

There has been uncertainty about the force of the Convention during the period between 1 January 2000 and 1 November 2004. Article 3(2) of the Protocol provides for retroactive effect during this period, but the contracting states have had different opinions as to requests for the MAP under the Convention received within that period of time.

Only Germany, Greece, Ireland, Luxembourg, the Netherlands, Spain and the United Kingdom declared that they would apply the Convention in the latter situation (provided that the other country involved agreed; if not, a MAP under the applicable bilateral tax treaty would be initiated instead). [171]

21.3.2. Scope of application

The Convention applies to existing taxes on income (article 2(1)) and future identical or similar taxes (article 2(3)). The list of existing taxes in article 2(2) is not meant to be exhaustive. Penalties are not covered. [172]

The Preamble states that the Convention is intended for eliminating double taxation arising from adjustments of profits of associated enterprises. Article 1(1) restricts the scope to transfer pricing adjustments:

> [W]here for the purposes of taxation, profits which are included in the profits of an enterprise of a Contracting State are also included or are also likely to be included in the profits of an enterprise of another Contracting State on the grounds that the principles set out in Article 4 … have not been observed.

The term “enterprise” does not exclude any legal form. A PE of an enterprise of a contracting state will be deemed an enterprise itself in its situs state.

170. Article 293 reads: “Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals … the abolition of double taxation within the Community.”
171. COM(2004) 297 final of 23 April 2004, 27.
172. L. Hinnekens, *The European Tax Arbitration Convention and its Legal Framework II*, British Tax Review 3, p; 276 (1996).

There is no requirement in the Convention that the transfer pricing adjustment result in higher or double taxation, as it is applicable also in loss-making situations (article 1(3)) and where loss carry-over is available.

A term not defined in the Convention will have the meaning under the applicable tax treaty (article 3(2)), unless the context otherwise requires.

Article 4(1) is a copy of article 9(1) of the OECD Model. Article 4(2), dealing with PEs, has been derived from article 7(2).

It should be noted that the Convention has not taken over the text of article 9(2) of the OECD Model. An obligation to provide for a corresponding adjustment in the country of the associated enterprise – if that country agrees to the initial adjustment in the first state – is therefore formally not included, although it is the heart of the matter! [173]

Because article 9(1) of the OECD Model is copied, uncertainties remain as to the meaning of "associated enterprises", in particular on the scope of "control".

Articles 1(2) and 4(2) confirm that the arm's length principle fully applies to PEs. A PE is treated as an associated enterprise located in the country where the PE is located.

A significant exception to the applicability of the Convention is given in article 8(1). Where a final ruling in a legal or administrative proceeding concerning the actions that have led to the profit adjustment results in a serious penalty, the competent authority of that country may deny access to the Convention.

Where domestic proceedings that may result in a serious penalty are conducted simultaneously with proceedings under the Convention, the competent authorities may stay the Convention proceedings until the end of the domestic procedure (article 8(2)).

Lacking a definition of "serious penalty" in the Convention, each contracting state has added an individual declaration to the Convention. Serious penalties range from fines in Greece for not submitting declarations, to administrative penalties for serious tax infringements and criminal penalties for tax offences in Spain.

21.3.3. Phase 1 of the proceedings: The MAP

Article 5 requires a contracting state to inform the taxpayer concerned of an intended transfer pricing adjustment. The enterprise concerned may then inform its associated enterprise in the other contracting state. Next, the latter enterprise has the opportunity to inform the competent authority of its own state. If the taxpayers involved and the other state agree to the adjustment, no MAP is necessary on the assumption that the latter state will make a corresponding adjustment. Lacking a provision similar to article 9(2) of the OECD Model, the legal basis of such a corresponding adjustment is the applicable bilateral or multilateral (Nordic countries) tax treaty with that provision.

Such an immediate acceptance by State B of an initial adjustment made by State A being exceptional, the Convention begins with regulating the MAP in article 6. Article 6 gives a time limit of 3 years after the first notification of the adjustment to present the case to the competent authority concerned. If the competent authority accepts the case as being well founded (article 6(2)) and it cannot resolve the matter itself, the competent authority will commence the actual MAP with the other competent authority.

173. Id. at 295.

The competent authorities must endeavour to resolve the case by eliminating the double taxation that has arisen.

In the absence of procedural rules in the Convention, the Code of Conduct prepared by the EU Joint Transfer Pricing Forum and adopted by the EU Council [174] tries to improve the functioning of MAPs under the Convention and also under article 25(1) of the OECD Model included in tax treaties between EU Member States.

Part 3 of the Code deals in detail with the MAP under the Arbitration Convention. The Code recommends a quick resolution of cases, i.e. within 2 years after first submission to a competent authority. Face-to-face meetings of competent authorities and a presentation of the case by the enterprise to its competent authority are also recommended. The MAP should not impose excessive compliance costs on the enterprise requesting it.

A common working language is advised, and the contracting states undertake to keep the taxpayer informed of important developments during the procedure.

There is agreement as to three ways to react to the taxpayer's requests:

- if the competent authority has doubts about the double taxation having arisen or to arise, the enterprise must be invited to explain further;
- if the competent authority can arrive at a satisfactory solution on its own, it should inform the enterprise accordingly and resolve the matter as quickly as possible; and
- the competent authority should inform the enterprise that it will endeavour to resolve the case by mutual agreement with the competent authority of any other contracting states concerned.

In the third case, the competent authority must commence the MAP by informing the other competent authority and attaching specified information. At the same time, the enterprise must be informed. The Code of Conduct further discusses the exchange of position papers and the content thereof.

According to article 7(1) of the Convention, an agreement between the competent authorities must be reached within 2 years from the date on which the case was first submitted to one of the competent authorities. A MAP must be implemented irrespective of time limits in the laws of the contracting states concerned (article 6(2)).

The relation with domestic remedies is covered in article 6(1): the availability of a domestic procedure does not exclude access to the MAP under the Convention. However, article 7(1) provides that the 2-year limit for reaching a mutual agreement starts after the judgement of the final court of appeal is given. This means that a MAP begins after the recourse to domestic judicial procedures has been fully depleted or after an appeal has formally been withdrawn (article 7(3), *see* below).

Because of the usually very long time taken by judicial procedures, taxpayers may prefer to rely on procedures under the Arbitration Convention only.

21.3.4. Phase 2: The advisory commission proceedings

This phase represents the added value of the Arbitration Convention. There are two aspects to it:

174. *Code of Conduct for the Effective Implementation of the Arbitration Convention*, 31 March 2005, 2695/2/04 Rev 2 Fisc 173.

- different from the past, where MAPs under treaties between EC Member States usually lasted more than 2 years, the competent authorities – since the entry into force of the Convention in 1995 – seem to try to avoid Phase 2 of the Convention by reaching agreements within 2 years; and
- if no agreement has been reached within 2 years after the case was first submitted, the advisory commission procedure provides the certainty of a solution within a reasonable period of time thereafter (article 7(1)).

However, if the domestic laws of a contracting state do not permit its competent authorities to derogate from judicial decisions, the competent authorities must set up an advisory commission only if the time for an appeal has expired or the taxpayer has withdrawn an appeal before the court's decision (article 7(3)).

An advisory commission consists of at least five members: an independent chairman, elected by its members; an even number of other independent persons appearing on the lists of five "independent persons of standing" for each EU Member State; and one or more representatives of each competent authority involved (article 9). The opinion of the advisory commission must be delivered within 6 months from the date the case was referred to it (article 11(1)).

An opinion of the European Commission must be based on article 4 of the Convention. Given the broad wording of article 4 and the different interpretations and applications of the arm's length principle within the European Union, the approaches of advisory commissions and the results of procedures may vary widely. One commission may accept the legitimacy of the original adjustment without further inquiry but may question its amount; another may want to check whether all material and formal requirements have been met by the assessing officers. The issue of whether secret comparables may be provided to and used by a commission as the basis for an opinion may also have an impact on the result.

The European Commission adopts its opinion by simple majority (article 11(2)). The role of the taxpayer under the advisory commission procedure is more pertinent than under a MAP (article 10(1) and (2)): the associated enterprises may provide any information, evidence and documents to the European Commission which they deem useful and have the right to be heard by the commission. On the other hand, they must appear or produce information if so requested by the commission.

The competent authorities do not have an obligation to provide information to the European Commission if it is at variance with or not obtainable under domestic law or normal administrative practice. Similarly, business secrets or information that would impact public policy do not have to be disclosed, under article 10(1).

The JTPF has also developed various rules for the advisory commission procedure, included in the above Code of Conduct. Matters are dealt with such as secretariat, costs of the procedure, fees of commission members, which state must take the initiative to set up the advisory commission and what the opinion should include. The 6-month time limit for the European Commission has also been clarified. It starts on the date that the chairman confirms that its members have received all relevant information.[175]

In paragraph 5 of the Code of Conduct, it is recommended that the Member States take all necessary measures to ensure that the suspension of tax collection during cross-border procedures can be obtained under the same conditions as in domestic appeals/litigation.

175. Code of Conduct, article 4.3.a.

21.3.5. Phase 3: Implementation of the advisory commission's advice

Article 12 provides that the competent authorities either adopt the opinion of the advisory commission and act in accordance with it or, "acting by common consent", take a decision which will eliminate the double taxation. Either action must take place within 6 months from the date on which the advisory commission has delivered its opinion.

Article 14 explains in which cases double taxation of profits is eliminated:

- where only one state includes the profits in the computation of taxable profits, which (probably) means that the original adjustment is withdrawn by that state; and
- if the tax chargeable on these profits in one state is reduced by an amount equal to the tax chargeable in the other, then this means that the other state makes a corresponding adjustment to the amount of the primary adjustment or the state of the primary adjustment reduces the amount and the other state applies an adjustment corresponding to that amount.

21.3.6. Practical experience

The first case resolved under the advisory commission procedure of the Arbitration Convention appeared to be the *Electrolux* case between France and Italy. Lacking an official publication of the case, some information concerning procedural matters can be derived from discussions at the EU JTPF meetings. These discussions have contributed to the development of procedural rules by the JTPF.

The case began with a MAP in 1997. As not all matters were resolved during the 2-year MAP phase, the advisory commission procedure was due to commence before 1 January 2000. In the course of 2000, the French competent authority approached its Italian counterpart in order to initiate the advisory commission procedure. A preparatory meeting was held in March 2001. Procedural and practical matters (such as arranging meetings, translations and secretariat) were settled on an ad hoc basis. However, it turned out to be difficult to set up the advisory commission itself and to find a chair. This took 18 months. [176]

It is noteworthy that the JTPF report indicates that the advisory commission has requested information on whether MAPs with other countries in similar cases of the group had been initiated or agreed on. This raised the question as to whether the advisory commission should have access to correspondence with competent authorities not involved in the pending case.

The first meeting of the advisory commission took place in November 2003, 3 years after expiration of the 2-year time limit for the MAP. Reasons for this delay were the long time it took for the competent authorities to produce the requested documents and the time needed by the members of the advisory commission to study these papers.

The advisory commission took the date of its first meeting as the starting date of the 6-month deadline of article 11(1). Although the taxpayer was invited, he declined to be present.

The advisory commission adopted its opinion by simple majority and delivered it on 19 May 2003, i.e. before the end of the 6-month period. As the competent authorities apparently did not agree on an alternative solution, the opinion became binding 6 months later.

176. Draft summary record of the third EU JTPF meeting of 2 April 2003, section IV.

From a general perspective, the first case has been extremely useful, revealing many procedural weaknesses and gaps which have to a great extent been addressed in a practical way by the JTPF. [177]

21.3.7. Arbitration Convention: Concluding remarks

Although the Arbitration Convention has had a long gestation period and a difficult start with its first "arbitration" case, it has already been successful in reducing the time generally needed for MAPs within the European Union to less than 2 years.

The useful work of the EU JTPF on procedural and practical aspects that has resulted in a Code of Conduct of the EU Council will make future procedures much easier. After all, the European Commission plays a role under the Convention: via the Code of Conduct, the Council has instructed the European Commission to monitor the implementation of the Code of Conduct on the basis of biannual reports by the Member States and to propose improvements where necessary.

21.4. Advance pricing arrangements

21.4.1. Introduction

Paragraph 4.124 of the OECD Guidelines defines an APA as:

> [A]n arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumption as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time.

The OECD Guidelines deal with APAs in chapter IV, Part F (paragraphs 4.124 to 4.166) and in an Annex of October 1999 covering Guidelines for Conducting Advance Pricing Arrangements under the Mutual Agreement Procedure (MAP APAs).

A distinction should be made between unilateral APAs, which are agreements between a taxpayer and the tax authorities of its country of residence, and bilateral and multilateral APAs. The latter consist of agreements between the tax authorities concerned, based on an article in the applicable tax treaty or treaties concerned (MAP APA) equivalent to article 25 of the OECD Model, and agreements between the associated taxpayers concerned and the competent authorities of the countries involved.

In the wake of the introduction of APAs in the United States in 1991, many countries have adopted APA regulations or, in the absence of regulations, are prepared to conclude MAP APAs. As at November 2011, domestic APA regulations are in force in 42 countries.

Different rules and procedures are, of course, time consuming and burdensome for European businesses. Moreover, differences in approach may prevent bilateral APAs from being concluded. In the framework of its agenda concerning dispute avoidance and supplementary dispute resolution, the EU JFTP has dealt with APAs as well. The Forum has developed a common approach to APAs for EU Member States in the form of a "Best Practice". [178]

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177. *See also* summary record of the fourth EU JTPF meeting of 19 June 2003, section IV.
178. DOC: JTPF/001/REV3/2006/EW of 28 July 2006.

21.4.2. Coverage

APAs may generally cover one specific future transaction, groups of transactions or all transfer pricing matters of the taxpayer(s) concerned.

An interesting feature of APAs is the rollback effect. In certain countries, it may be agreed between the taxpayer(s) and the tax authorities involved that open issues of past years are also resolved by the APA. Such an APA may be concluded after a transfer pricing audit.

21.4.3. Pros and cons of an advance pricing arrangement [179]

Determining whether obtaining an APA has advantages for the taxpayer concerned involves a careful risk assessment analysis and an estimate of costs and pressures on the organization concerned.

No APA would be necessary in the ideal situation, where one is able to establish adequately documented transfer prices on the basis of reliable comparables (with results that nicely remain within an arm's length range), where there is a low audit risk and where the countries involved apply the OECD Guidelines consistently. Another situation is also straightforward: where taxpayers have set up aggressive tax planning schemes, systematically moving risky, sophisticated functions to low-tax countries or countries with special tax regimes, tax authorities may refuse to enter into APA negotiations. The choice for an APA therefore mainly depends on two considerations:

- complexity of transfer pricing issues, combined with the risk of transfer pricing audits in the jurisdiction concerned; and
- whether cooperation with the tax authorities is preferable to confrontation because of aggressive tax planning.

Complexity of transfer pricing issues usually stems from the existence of high-value trade or marketing intangibles and from highly integrated cross-border business. For these reasons, APAs are particularly common in the semiconductor, automotive and pharmaceutical industries, as well as in the securities and commodities trade. [180] Other areas for which APAs are advisable concern multilateral CCAs and the allocation of profits and free capital to PEs.

The OECD Guidelines describe upside (certainty, reduction of cost and time compared with audits and litigation, reduction of double taxation in the case of bilateral and multilateral APAs) and disadvantages in paragraphs 4.143 to 4.159. In particular, disadvantages of unilateral APAs are noted; namely, no increased level of certainty and no reduced risk of double taxation. For this reason, the OECD, the EU JTPF and also the IRS strongly recommend bilateral and multilateral APAs.

21.4.4. Process

The APA process is usually divided into four phases:

- pre-filing;
- formal application;
- evaluation and (under a MAP APA) negotiation; and

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179. For an analysis, *see* M. Markham, *APAs in Australia, Canada and the United States: Current Developments and Future Directions*, Intertax 8/9, pp. 401-404 (2006).

180. The APA Reports of the IRS, published annually in March since 2000, provide ample information on APAs per business sector.

- agreement (between competent authorities and with the taxpayer).

Monitoring, withdrawal, revocation, cancellation and revision of an APA are related issues. The phases are described in the OECD Guidelines (Annex, paragraphs 29 to 69), the EU JTPF Report (paragraphs 62 to 93) and in IRS Revenue Procedure 2006/09, published 9 January 2006.

Probably concerned about the long time frame for obtaining a bilateral or multilateral APA in the United States, [181] the JTPF has drafted a time frame for APAs: the pre-filing stage and the formal application stage may take 3 months. Nine months may be used for evaluation and production of position papers. In month 13, the competent authorities review each other's position papers. In month 17, the negotiations are to be finalized and the taxpayer must be consulted on the result. In month 18, the APA must formally be agreed between the competent authorities and the taxpayer must be informed of the agreement (*see* Appendix C).

21.4.5. Pre-filing stage

This stage allows for informal discussions between the taxpayer and the tax authorities as to the feasibility of an APA and the documentation needed for a formal application. For a pre-filing meeting, basic information on activities and transactions covered, methods to be applied, countries involved and desired duration of the APA should be provided. In some countries, including the United States, an anonymous approach by the taxpayer is accepted.

The tax administration should give a clear indication whether a formal proposal is likely to be accepted.

Under a MAP APA, the JTPF Report (at 68) recommends involvement of the other tax administrations from the outset, unless the taxpayer wishes to test the water first with its "own" tax authorities.

21.4.6. Formal application

A formal application must be made to the tax authorities of the country involved. If a MAP APA is requested, the application should be sent to all jurisdictions involved (JTPF Report, at 71).

Rules for the content of the formal application are included in the APA regulations of various countries. The EU JTPF Best Practice document lists the necessary information in Appendix A and requires a functional analysis (Appendix B). The main elements are:

- transactions covered;
- group companies/PEs involved;
- countries involved;
- organizational structure of the MNE;
- financial information;
- supply chain;
- functional analysis;
- industry analysis;
- choice of transfer pricing method;

181. Recent annual IRS APA reports refer to an average completion time of over 4 years.

- analysis of selected comparables;
- determination of the arm's length range;
- comparison of transactions concerned with selected comparables;
- critical assumptions/effect of divergence;
- market conditions;
- tax years to be covered; and
- demonstrations of compliance with applicable laws, treaty provisions and OECD Guidelines.

Concerning comparables, search criteria should be explained, as well as the selection between accepted and rejected data. In addition, adjustments to account for material differences between controlled and uncontrolled transactions should be noted.

Critical assumptions are an essential part of any APA. These are assumptions about operational and economic conditions that will affect future transactions. Critical assumptions cover, for instance, a particular way of doing business, the market share and conditions, the sales volume, the end selling price, foreign exchange rates and the functions and risks of the companies involved. It is advisable to set parameters for an acceptable level of divergence concerning certain assumptions in advance. If actual conditions diverge beyond an agreed level, the APA may have to be revised or cancelled.

Taxpayers should inform the tax administrations involved if critical assumptions cease to be met. The next step for the parties involved should be to check why the assumption has not been met and whether the APA methodology is still appropriate (*see* JTPF Report, at 99).

21.4.7. Evaluation; competent authority negotiations

In a domestic APA process, the tax authorities review and evaluate the proposal, may ask for additional information, do their own research on comparables and may visit the taxpayer's office and interview staff, etc., before the APA is agreed on.

Under a MAP APA procedure, a distinction should be made between the evaluation process and the negotiation process. In the evaluation process, the tax administration formulates its view on how to apply the arm's length principle and its terms and conditions for the APA. The negotiations aim at producing one set of terms and conditions for all taxpayers involved. The competent authorities may want to evaluate the proposal completely before entering into negotiations. The JTPF Report (at 78), however, recommends consultation between the competent authorities as early as possible in the process. The tax administration should have a preliminary evaluation in mind at that time.

All information provided to one tax administration should also be given to the other tax administration involved.

An evaluation which differs from the application made by the taxpayer should be discussed with the taxpayer before entering into negotiations. Agreement with the taxpayer should be sought before entering into negotiations with the other competent authority (JTPF Report, at 84).

The JTPF Report refers to the common feature of an exchange of position papers containing the evaluation of the competent authorities involved (at 87). However, flexibility and speed may suffer from such an exchange. The JTPF therefore recommends the production of at least a position paper by one party to which the other party (or parties) can react. The JTPF provides guidance on the contents of a position paper in Appendix D.

21.4.8. Agreements

The MAP APA procedure requires a formal agreement between the tax authorities in which the terms and conditions are specified. A significant element is the critical assumptions and the impact of divergence from the assumptions beyond a certain level. The Guidelines describe the contents of a mutual agreement document in paragraph 66 of the APA Annex. Apart from factual elements and critical assumptions, agreements usually include conditions that must be met by the taxpayer in order for the APA to remain valid (e.g. record keeping and annual reporting), the duty of notifying the tax administration of changes in critical assumptions and a confidentiality clause.

The tax administration may want certainty that the taxpayer accepts the outcome. Before the APA becomes effective, a formal declaration by the taxpayer is typically required, stating that judicial and administrative remedies will be waived concerning tax assessments that correctly implement the APA (JTPF Report, at 92).

21.4.9. Withdrawal, monitoring, revocation, cancellation, duration

Withdrawal from the APA process is possible at any time without any obligation to each party or continued validity of previous understandings. A withdrawing tax administration should explain the reasons and give the taxpayer an opportunity to make further representations, under the Guidelines (paragraph 64 of the APA Annex).

During the lifetime of an APA, tax administrations monitor compliance with the terms and conditions of an APA through compliance audits, which are very specific and considerably shorter than typical transfer pricing audits.

An APA may be revoked by the tax authorities in the case of wilful misrepresentation or omission, or in the case of failure to comply with fundamental conditions. In such a case, the APA is annulled with retroactive effect.

An APA may be cancelled in the case of mistakes or omissions beyond the influence of the taxpayer, or if the taxpayer does not comply with conditions, or in the case of a material breach of critical assumptions. Also, in the event of changes in the tax law or treaties which cannot be coped with under the APA, cancellation is possible. The effective date may vary depending on the situation.

APAs are typically concluded for a period of 3 to 5 years. In the United States, a duration of at least 5 years must be proposed by the taxpayer.

21.5. The post-BEPS approach towards transfer pricing rulings by the European Union

In 2005 and 2006, the EU JTPF worked quite intensively on transfer pricing rulings (so-called APAs). In 2007, this work resulted in the publication of a Communication by the European Commission on the work of the JTPF in the field of dispute avoidance and resolution procedures, including guidelines for APAs within the European Union. In addition, within the JTPF, various attempts were made to collect and publish statistics on rulings and APAs.

The 2012 EU Action Plan to strengthen the fight against tax fraud and tax evasion expressed the aim to promote the automatic exchange of information – though not specifically addressed to tax rulings.

On 18 March 2015, the European Commission presented its Tax Transparency Package, with its cornerstone being the legislative proposal for the mandatory automatic exchange of tax ruling information (the Commission Proposal). In the words of the Commission: "Greater transparency for tax rulings is urgently needed in order to tackle aggressive tax planning and ensure fair tax competition between Member States. This has been highlighted through the Commission's ongoing State aid investigations, work carried out by the Code of Conduct Group for Business Taxation and recent public revelations."

On 17 June 2015, the European Commission presented another Communication, titled A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action, highlighting, once again, the need for tax transparency, inter alia, through the automatic exchange of information on cross-border tax rulings.

21.5.1. The EU mechanism for mandatory automatic exchange of ruling information

The proposed EU mechanism for the mandatory exchange of ruling information is not cast into an entirely new legal framework. Instead, the mechanism is integrated, by way of an amending Directive (the Amending Directive), in the existing Council Directive on administrative cooperation in the field of taxation, i.e. Directive 2011/16/EU (the Directive). Although the Directive, as it stands, allows spontaneous exchange of information on tax rulings affecting other Member States, apparently it has hardly ever been used for such purpose. Practical difficulties, such as discretion as to which Member States to inform, are thought to have been the reasons for that. Also, confidentiality concerns have played a part based on the proposal of the Amending Directive, for which political agreement was reached by the ECOFIN Council on 6 October 2015 (the ECOFIN Proposal). On 8 December 2015, the ECOFIN Council adopted the Amending Directive.

Mandatory automatic exchange instead of spontaneous exchange

A key element of the new EU mechanism is that the exchange of ruling information is no longer left to *spontaneous* exchange, but is brought into the scope of *automatic* exchange, which is defined by the Directive as "systematic communication of predefined information to another Member State, without prior request, at pre-established intervals". The concept of automatism essentially excludes any discretion for the Member State issuing the tax ruling. Obligations are therefore stricter than those under existing income tax treaties.

21.5.2. Scope of exchange mechanism: Advance cross-border rulings and advance pricing agreements

A new article 8a of the Directive lays down the scope and conditions of the mandatory automatic exchange mechanism, i.e. information on advance cross-border rulings and APAs. The Directive provides lengthy definitions for both terms. Moreover, some auxiliary definitions are given, including for cross-border transactions (essentially, any transaction or series of transactions involving non-residents, dual-residents, foreign PEs, *or* having a cross-border impact), associated enterprises (mirroring the definition set forth in article 9(1) of the OECD Model) and transfer pricing.

Which information exactly is subject to the mandatory automatic exchange?

Although one reads from time to time that an automatic exchange of tax rulings must take place, this is not precise. Rather, as the definition of "automatic exchange" provides, a "systematic communication of predefined information" will occur. The list of information on advance cross-border rulings and

APAs to be communicated by the Member State granting the ruling is specified in article 8a(5) of the Directive. The Preamble of the Amending Directive refers to this set of information as "basic information".

However, following the stage of mandatory automatic exchange of information, additional information, including the full text of the advance cross-border ruling or APA, may be requested by Member States in accordance with the procedure for the exchange of information on request (existing article 5 of the Directive).

With whom is the ruling information exchanged? All Member States and to some extent the Commission

The European Union has found an easy solution to determine which states will obtain the basic information on tax rulings subject to mandatory automatic exchange, namely *all* EU Member States. In contrast, the OECD/G20 BEPS Project must make more efforts to determine the right addressees of ruling information. Providing every EU Member State with the basic information has the advantage that when a ruling-issuing Member State erroneously does not mark another Member State as affected in the set of basic information, the overlooked Member State would receive the ruling information anyway. Obviously, however, that Member State must ascertain for itself whether or not it is affected by the ruling.

A special position in the automatic exchange of ruling information has been allocated to the European Commission. The European Commission is also specified as addressee, but only with regard to a limited set of basic information. The European Commission will *not* receive the identification of the person, the summary of the content in generic terms, the description of the transfer pricing criteria in an APA nor the identification of any persons in other Member States likely to be affected. The European Commission must keep confidential the limited set of information received and use it only to determine whether and to what extent Member States comply with the Directive. The reason for the curtailing of access to information for the Commission, which has met with incomprehension and criticism, is not obvious to the authors. Could it perhaps be that actual European Commission knowledge of certain information would trigger (undesired) disclosure obligations towards third states under international agreements concluded by the European Union?

Once the Amending Directive is in force, Member States will have to adopt the necessary national laws, regulations and administrative provisions to comply with its provisions by 31 December 2016. The main rule determines that ruling information must be communicated in respect of advance cross-border rulings and APAs issued, amended or renewed after 31 December 2016. The deadline for the communication of the basic information in this case is 3 months following the end of the half of the calendar year during which the advance cross-border ruling or APA has been granted. As such, information on advance cross-border rulings or APAs granted on, for example, 1 January 2017 will have to be communicated, at the latest, by 30 September 2017. In contrast, pre-2017 rulings may or may not be subject to the mandatory automatic exchange mechanism, pursuant to the provisions of article 8a(2) of the Directive. Generally, rulings from the 5 years before 1 January 2017 fall within the scope. Thus, all rulings issued, amended or renewed on or after 1 January 2012 would be covered. However, there are some statutory or optional exceptions:

- for rulings granted in 2012 and 2013, the automatic exchange applies only if the ruling was still valid on 1 January 2014; and

- for rulings granted in 2014, 2015 or 2016, information generally must be communicated. However, each Member State has the option to exclude advance cross-border rulings and APAs issued, amended or renewed before 1 April 2016, provided that the group-wide annual net turnover is less than EUR 40 million in the fiscal year preceding the date on which the ruling was issued, with no such exclusion being possible in the case of a person or group of persons mainly conducting financial or investment activities.

For all pre-2017 rulings that trigger the communication obligation, information must be communicated before 1 January 2018.

The European Commission is given the task to develop a standard form, including linguistic arrangements, before 1 January 2017. For the development of the standard form, the Preamble of the Amending Directive recommends taking into account the work performed at the OECD's Forum on Harmful Tax Practices on a standard form within the framework of the BEPS Project and, moreover, to take a leading role promoting a broad scope of automatic exchange of advance cross-border rulings and APAs.

By 31 December 2017, the European Commission must also develop and provide a secure Member State central directory on administrative cooperation in the field of taxation. The ruling information to be communicated will be recorded here so as to satisfy the automatic exchange. Access to this directory will be available to the competent authorities of all Member States and, with the limitations mentioned above, to the Commission.

Finally, the Amending Directive sets rules for the building up of effective statistics on the automatic exchange and yearly assessments of the effectiveness and practical results achieved (statistics and assessments are not limited to the exchange of tax rulings).

The ECOFIN Proposal largely resembles the original Commission Proposal presented on 18 March 2015. Perhaps the biggest difference is that the Commission Proposal includes exchange in respect of rulings granted up to 10 years (not only 5 years) before entry into force, if still valid on the date of entry into force. Moreover, the Commission Proposal provides for an earlier commencement date of the exchange mechanism, i.e. 1 January 2016 as opposed to 1 January 2017, and shorter deadlines for the communication (for "new" rulings: 1 month after the quarter end, as opposed to 3 months after the half-year end; for "old" rulings: by 31 December 2016 as opposed to 31 December 2017).

In its opinion of 27 October 2015, the European Parliament criticized the "Council deal" as a "missed opportunity" to take a major step forward in fighting aggressive tax planning and unfair tax competition. In particular, the Parliament would prefer to delete the limitation of cross-border rulings because purely national transactions are also perceived as having a potential cross-border effect. Moreover, the fact that the European Commission is effectively sidelined is disapproved. Finally, the Parliament would prefer more "retroactive effect" for pre-2017 rulings.

On 26 October 2015, the Parliament's Special Committee on Tax Rulings (TAXE) recommended measures to make corporate taxes in the European Union more fair and transparent, urging Member States to systematically share their national rulings and other tax information that has an impact on other Member States, and insisting that "the European Commission should also receive this information to enable it to play its proper role as competition watchdog to the full." According to Members of the European Parliament (MEPs): "The Commission's 21 October verdicts on tax rulings for Starbucks (NL) and Fiat Finance (LU) confirm the need for a stronger Commission role.” The MEPs also point out “that national parliaments should hold governments to account on rulings and other tax issues.”