

자료 96-05

最近의 國際租稅動向에 관한 國際워크숍

International Workshop on the Recent Developments in International Taxation

1996. 4. 30

Korea Institute of Public Finance

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PROGRAM

Tuesday, April 30, 1996

- 09:30 ~ 09:40 **Opening Address**
Dr. Kwang Choi, President, Korea Institute of Public Finance
- 09:40 ~ 10:40 **Session 1 : Globalisation : The Implications for Tax Policies**
Chairman **Dr. Il Ho Yoo**, Vice President, KIPF
Presentation **Mr. Jeffrey Owens**
Director, Fiscal Affairs Division, OECD
Discussants **Sung Tai Kim**, Professor, Chongju Univ.
 Woo Taik Kim, C.P.A., Kim & Chang
 Yu Chan Kim, Associate Fellow, KIPF
 Joosung Jun, Professor, Ewha Womans Univ.
- 10:40 ~ 10:50 **Coffee Break**
- 10:50 ~ 11:50 **Session 2 : Developments in OECD Transfer Pricing Guidelines**
Chairman **Dr. Il Ho Yoo**
Presentation **Ms. Frances Horner**
Fiscal Affairs Division, OECD
Discussants **Jongseok An**, Associate Fellow, KIPF
 Dong-Jun Yeo, C.P.A., Kim & Chang
 Sai Ree Yun, Attorney at Law, Yoon & Partners
 Yong Sun Choe, Professor, Seoul City Univ.

Session 1

Globalisation : The Implications for Tax Policies

Jeffrey Owens

(Director, Fiscal Affairs Division, OECD)

My theme today is the tax implications of increased interdependency between nations. If there is any general message that I wish to come through my presentation it is that with some strengthening the existing international arrangements can deal with the new tax issues that arise in an integrated world, but changes will be required.

First I will look at the characteristics of the “new world order” and then at the broad implications for tax policy. I will then examine tax competition for economic activities. The concluding section will set out some options for governments to deal with these issues.

Let me say at the outset that my perspective is not limited to developments in the OECD. It is much broader. This is because I believe that most of the problems that come from a great interdependency can only be resolved by including all major players, including those who are at present outside the OECD area.

I. The Globalisation of National Economies

Today’s world is a small place. Policymakers in both large and small countries are accepting that the international dimension of economic policy has become increasingly important. Small and not so small countries can find their economic choices being severely constrained by decisions which are taken outside of their border. But even in a large country like the United States, the international dimension of domestic policies cannot be ignored.

Whilst internationalisation of economic policies has advanced, nations continue to guard their political sovereignty. It is understandable that the newly emerging democracies in the former Socialist countries, in Asia and in many Latin American countries feel the need to re-assert their sovereignty. But even many of the old, well-established democracies are concerned about losing the right to shape their own economic destiny.

Globalisation is not a new phenomena. But its dimensions are radically changing. Five examples come to mind:

- First, Foreign Direct Investment (FDI) and cross border acquisitions and mergers have increased dramatically. (*Figure 1*) Figure I shows how since 1985 FDI has outstripped exports. Between 1970 and 1980 FDI as a percentage of GDP remained more or less constant. In the next decade, this percentage tripled. (*Table 1*)
- Secondly, it is now very common to find transnational alliances and joint ventures amongst firms.
- Thirdly, technological developments in the areas of transportation and communications have changed substantially the way firms operate.
- Fourthly, intra-firm trade now accounts for 60% of international trade in goods, services and technology, and today the top 100 MNEs own approximately 16 percent of world assets.
- Fifthly, integration of financial markets is now at an advanced stage. In the 1970's most OECD countries still had in place exchange controls and restrictions on inward and outward investment. Today most of these restrictions have been removed.

II. What are the Tax Implications of Greater Interdependency?

Until relatively recently, economic policies fit conveniently into self-contained boxes. Certain of these "boxes" were labelled international: trade policies, for example. Other "boxes" were labelled domestic: social policies, tax policy. For each box, there was a specific conceptual framework, a terminology and, usually, a separate government department. Policymakers had well-defined ideas of what was national policy and what was international policy. Little attention was paid to the effects of domestic policies on other countries and the constraints imposed on national policies by international considerations were not well understood.

Globalisation has broken down these barriers and taxation is but one area where the effects of this are being felt. To take one example the borderline between trade and tax policy is now blurred, bringing pressures to develop new sets of rules and many have argued that tax is perhaps the last trade barrier: an issue that we at the OECD are going to have to deal with in developing the Multilateral Agreement on Investment. Few would disagree that taxes on income and wealth have powerful effects on trade and capital flows. But there is no world body to monitor how governments use direct taxes to influence trade flows.

It is clear that greater interdependency will have profound implications for tax systems. Three stand out:

- First, the base for taxes on income and capital will become more geographically mobile and therefore more sensitive to tax differentials. This in turn will lead to a greater danger of tax competition between countries, with each country trying to attract a larger share of the global tax base.

- Secondly, it will become more difficult to determine and to collect taxes on activities which take place outside of a country's tax jurisdiction. This is not just a question of the volume of cross-border transactions increasing, but of their changing nature.

- Thirdly, the ways in which tax administrations carry out their "business" will change. New technologies open up new ways of assessing and of collecting taxes and for co-operation between tax authorities in different countries. To take advantage of these new technologies will require far greater co-operation between tax authorities than in the past. OECD is well placed to meet this challenge.

I will deal with the first point only, since the impact of globalisation on tax administration is sufficiently broad to justify a separate discussion.

III Tax Competition and Internationally Mobile Resources

There are many aspects to tax competition: but I will only deal with how taxes influence the location decision of manufacturing investment and on the structuring and financing of investment; Though I will not refer to non-tax factors this should not be taken to mean that such factors are less important than taxation. In fact, most often the reverse is true.

a) Tax competition for foreign direct investment

But let's now look at tax competition for manufacturing investment. To oversimplify, a potential foreign investor will ask "How much tax will I pay?" and "What is the likelihood that this will increase or decrease over the lifetime of my investment?" Answering these questions is far from easy and will be influenced by the way the investment is structured and financed. Most investors would first look at the corporate tax, asking questions about the rules for the determination of the tax base; the statutory rate of corporate income taxes; the treatment of losses, the treatment of distributions, international taxation arrangements, particularly the tax treaty network.

A potential investor will also look at corporate wealth taxes, taxes on business properties and assets. In some countries, particularly in Latin America, taxes on assets can be far more important than the corporate profit tax.

The impact of these tax rules will very much depend upon how they are administered. The disincentive effects of a "high" tax regime can be offset by poor enforcement (the current situation in many formerly socialist countries), whereas the attraction of a "moderate" tax regime may be offset by vigorous and intensive enforcement procedures.

The above list only concerns those features of the tax system which form part of the normal tax regime. Many countries provide favorable tax regimes for specific kinds of

investment. These may take the form of reduced rates, tax allowances, tax credits and tax holidays (the approach mistakenly favored by the former socialist countries).

It is all of these features taken together that determine the tax climate for foreign direct investment.

The question remains, however, whether FDI flows are sensitive to tax differentials? Work at the OECD in the 70's and early 80's suggest the answer is "not very much". But with the removal of exchange controls and the development of regional blocs (eg., NAFTA) one would expect that location decisions will become more sensitive to tax differentials.

I would also expect that within Europe and NAFTA, competition will shift from being between countries to being between regions and cities. We will see localities competing for investment by offering exemptions from local taxes, particularly property taxes.

This form of tax competition may be far more difficult to monitor and to control.

In this new global environment there is a risk that countries will be tempted to introduce special tax incentives targeted at particular sectors. Many countries in Asia and Latin America have succumbed to these temptations. They should, I believe, read a recent report¹ that my colleagues at the OECD issued which shows that such tax regimes have little influence on the overall investment within the region. But they do have very negative effects on the tax system:

- The revenue base is undermined
- Foreign investors are able to compete unfairly against domestic investors;
- It becomes more difficult to build up support for sensible tax reforms and tax enforcement is more difficult.

Our Member countries may have implicitly encouraged countries to engage in this competitive bidding process by providing far too generous tax sparing provisions. Again an area that we need to explore.

b) Tax competition for financial and commercial activities

I have so far focused on competition for manufacturing investment. Countries in the OECD, however, are increasingly concerned about tax competition for financial and commercial activities.

Such activities include:

- head offices of MNEs and co-ordinating centers;
- distribution centers;
- financial holding companies;
- offshore banking centers (some of which are not so “offshore”);
- captive insurance companies.

The common characteristics of these activities is that they are not “location specific”. With the introduction of new technologies and advanced communication networks, and with the removal of non-tax barriers, MNEs and Financial Institutions have a very wide choice of where to locate these central services. In these decisions taxation is one of the key factors.

In recent years, special regimes have proliferated and we now find that countries which have “normal” tax systems nevertheless have one or more “tax niches” for carefully delineated activities -- the gruyere cheese phenomenon.

I am not criticising MNEs for taking advantage of these regimes and it clearly makes economic sense to centralise certain group services when a company operates in a highly integrated market. But the choice of where to locate these service centres should not be tax driven. Also one can question what countries gain by attracting such activities: the revenue and employment efforts must be small, although I suppose the countries' image as an international financial centre is re-inforced.

The country that is losing this activity may be tempted to retain the activity within its jurisdiction by matching the favorable tax regime in the other country. Herein lies the danger: a competitive bidding by different tax jurisdictions for these types of activities, which undermines the revenue base, distorts the decisions of MNEs as to where to locate these activities, and open up new avenues for tax minimisation strategies.

The response of the countries which develop these tax regimes is that they are merely responding to what is happening in other countries. Australia, for example, which has always adopted a "responsible" attitude toward tax competition, nevertheless had to match the favorable tax (and financial) regimes offered by an increasing number of Asian countries for banking activities because it felt that it could not afford to see a large portion of its financial activity go offshore to Singapore, Hong Kong or elsewhere in the region.

Again what this example shows is that this issue of tax competition will not be resolved at the level of the OECD. We must engage in a constructive dialogue with major non Members in Asia and Latin America to identify areas where we have a mutual interest to constrain excessive tax competition. This will not be an easy task, but many of these countries are now beginning to suffer the same revenue losses to tax havens as do our Member countries and perhaps we can build upon this common concern.

IV Options open to Governments

Identifying problems is always far easier than putting forward solutions. Whilst there is no shortage of proposals--ranging from full harmonisation to multilateral tax treaties--the difficulty arises that few of these solutions succeed in reconciling the five criteria that governments will use to evaluate any proposals:

- First, they must not imply a substantial revenue loss;
- Secondly, they must not constrain unduly fiscal sovereignty;
- Thirdly, they must not open up new avenues for tax evasion and avoidance;
- Fourthly, they must not impair a country's competitive position;
- Fifthly the transitional costs of change must not be too high.

It is these criteria, rather than the question of improving the world-wide efficiency of the allocation of capital, that will determine the acceptability of any proposals.

If unilateral actions are ignored, there are three choices open to governments to deal with problems that arise under the present tax arrangements:

- to enter into a process of formal harmonisation of tax systems;
- to allow competitive forces to determine the design of each country's tax system;
- to undertake greater co-ordination between the tax policies followed by countries;

Formal harmonisation would require a standardisation of the corporate tax system and is not presently a realistic option. Even within the EC or NAFTA it is unlikely that Member States would be prepared to give up a substantial part of their sovereignty in tax matters. This would go against the principle of subsidiarity and to be effective it would require harmonisation not just of the corporate income tax but of all other taxes which directly affect business. Because business taxation is used to implement social and economic policies, it is very unlikely that governments would accept constraints on their use of these policy instruments.

Under the *competitive option* governments would be free to compete for mobile resources by lowering their taxes and developing preferential tax regimes. One can argue as to whether lower taxes are desirable in their own right, but this should be a choice for governments, rather than an action which is forced upon them by policies determined in other countries.

The reliance on competition to encourage a convergence of corporate tax regimes also encounters the dangers that the tax burden would be shifted from mobile to immobile factors of production and this could increase the regressivity of the tax system.

More generally, small open economies would probably find it unacceptable that their tax policies are determined by what happens in larger economies.

Even if the competitive option is chosen, we should not expect that this would lead to a complete convergence of tax systems because MNEs are concerned with effective tax rates and not the ways in which these rates are achieved. Thus those who favor harmonisation of tax systems should not look to the market to achieve this. In practice, competition may even lead to less tax base harmonisation as countries introduce specific tax regimes to attract particular types of activities.

This leaves the option of *co-ordination* or “peaceful co-existence”. Here the objective is to have tax systems which are responsive to market forces, which can reflect the specific situation found in each country and which at the same time do not interact in ways which adversely affect the international allocation of resources. Co-ordination can play a useful role in preventing large

countries taking unilateral actions which impose costs on other countries, particularly on small, open economies (in fact, the countries need not be so large: look at the impact of the Dutch Antilles on US policy in the 1980s and the effect of Luxembourg policies on Germany at the moment). Only by co-ordination can a certain degree of national autonomy be maintained in tax policy. Put in this way it is difficult to disagree that this is the most desirable of the three options. The question is can this be achieved and if so, how?

A first point to make is that any new initiatives should build upon the existing instruments and institutions. There is now a large network of tax treaties and the vast majority of these treaties follow very closely the OECD Model Convention. Tax treaties provide an effective way of limiting tax competition and encouraging co-ordination. They provide guidelines for the sharing out of taxing rights, for reaching agreement on sourcing and jurisdictional rules, for avoiding discrimination and also put in place mechanisms for resolving dispute. There is also a number of institutions where tax policy issues are discussed: the ECOFIN in the European Community, the Committee on Fiscal Affairs at the OECD, the Executive Board of the International Monetary Fund and the United Nation's Group on Tax Matters.

The question is what can be usefully added to this network of instruments and institutions? There are several additions that could be usefully examined:

1. **Developing guidelines for the use of tax incentives.** Regional informal agreements could be developed to limit the use of tax and other incentives, or at least too improve their transparency. In the first instance this would require agreement in what constitutes a tax incentive, how its cost should be measured and its likely effects. Guidelines could then be formulated on what is an acceptable incentive. The NIS, the Eastern European Countries, Asia and EC and NAFTA countries -- or more ambitiously the OECD countries -- could initiate discussions in this area. Countries could be encouraged to move from tax allowances and holidays toward tax credits since this would improve the transparency of the subsidies. Agreements could be reached on the types of tax incentives which would be eligible for tax sparing

provisions (although another solution would be to follow the United States approach which denies tax sparing altogether).

2. Convergence of taxes on income and capital. The OECD and other international organisations could encourage a long-run convergence by:

-- monitoring developments and trying to get agreement on the economic and other effects of different taxing techniques.

-- examining new developments, eg, new financial instruments, with the aim of reaching an international consensus on how these developments should be treated for tax purposes and thereby setting a common framework for national legislation.

3. A consistent implementation of the new OECD Transfer Pricing Guidelines.

I would emphasise the importance not only of having universally agreed Guidelines, but also, an internationally consistent approach to their application.

4. Facilitating exchange of information. A new framework should be put in place to facilitate the exchange of information. In a global economy even an extensive network of bilateral treaties is a second-best solution to a multilateral approach which provides a uniform application and interpretation of provisions. Such a new framework could start from the OECD-Council of Europe Multilateral Convention on Mutual Administrative Assistance on Tax Matters. But even within the framework of bilateral treaties, efforts should be made to improve the operation of existing exchange of information provisions. These efforts could take the form of applying new technologies to such exchanges; making more intensive use of the OECD standards; the introduction of matching programmes; pooling of information on the operations of key industries. Particular attention should be paid to counteracting the use of tax havens, perhaps building upon the successful experience of the United States with its exchange of information programme with the Caribbean basin

countries. It is also clear that the time is approaching when the international tax community will need to re-examine the tax policy implications of bank secrecy.

5. Improved dispute resolution procedures. Although the Mutual Agreement Procedure set out in the Article 25 of the OECD Model works reasonably well, it can be time consuming for both taxpayers and tax administrators and there are a very small number of cases where no agreement is reached. Tax authorities need to address these concerns by examining how to speed up such procedures. (The US has already taken a lead in this area). We also need to look at experience with the increasing number of arbitration provisions now found in the bilateral agreements and to examine how the EU arbitration convention will apply in practice.

6. From bilateralism to multilateralism. It is unlikely that countries would accept replacing the existing bilateral treaty network with a series of multilateral treaties. Most commentators, including myself, would also question the desirability of such a goal. There are, however, a number of measures which could improve the operation of the existing bilateral treaty network, either by providing for more uniform provisions or for a more uniform interpretation. These include:

-- Encouraging OECD and other countries, especially in Latin America and Asia, to follow more closely the provisions in the OECD Model Tax Convention.

-- Examining the feasibility of putting certain Articles (eg., non-discrimination) onto a multilateral basis.

-- Butressing the status of the OECD commentaries by giving them greater legal force.

-- Examining new ways of adapting treaties to changes in national legislation (eg., multilateral exchanges of letters, protocols, etc.).

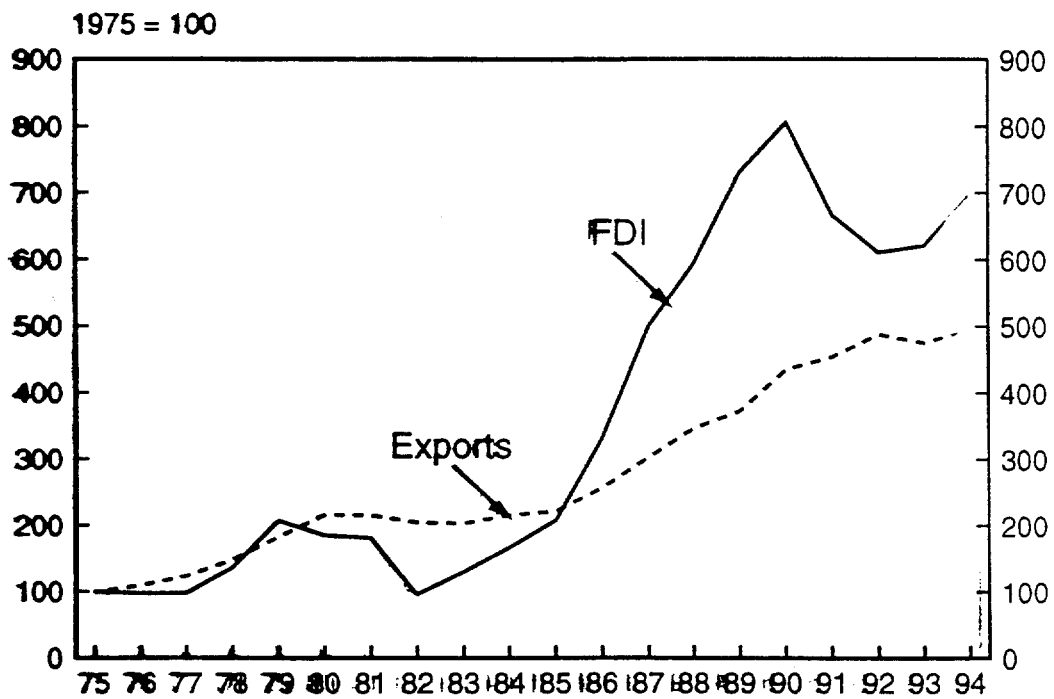
-- Bringing in non-Member countries to the discussion of the OECD's Committee on Fiscal Affairs so that they obtain a better understanding of the interpretation of the OECD Model and have an impact on its on-going revision.

To conclude, I believe that the present arrangements for co-ordination can be improved so that we attain a peaceful co-existence of diverging tax systems. Most of my suggestions involve evolutionary rather than revolutionary changes. The challenge facing policymakers in the 21st century will be whether they are prepared to see national policies developed within a multilateral framework. If they fail to respond to this challenge, they may find that a "little tax competition" is far more constraining than a "small amount of co-ordination".

Thank you

Figure I

**INDEX OF CURRENT VALUE OF EXPORTS AND
FOREIGN DIRECT INVESTMENT OUTFLOWS
Total OECD countries 1975-1994**



Source : OECD, Secretariat.

Table 1
OUTWARD DIRECT INVESTMENT FLOWS
(AS A PERCENTAGE OF GDP)

	1970	1980	1990	1991	1992	1993	1994
United States	0.7	0.7	0.6	0.6	0.7	0.9	0.9
Canada	0.4	1.0	0.8	1.0	0.7	1.3	0.9
Japan	0.2	0.2	1.6	0.9	0.5	0.3	0.4
France	0.3	0.5	2.3	1.7	1.4	1.0	0.1
Germany	0.5	0.5	1.5	1.3	0.9	0.6	0.9
Italy	0.1	0.2	0.6	0.6	0.5	0.7	0.4
United Kingdom	1.4	2.1	1.7	1.6	1.9	2.7	2.9
BLEU	0.6	0.1	3.4	3.1	5.0	1.8	1.8
Netherlands	1.7	2.3	4.6	4.2	4.4	3.3	3.5
Denmark	0.2	0.3	1.2	1.4	1.6	1.0	2.8
Norway	0.3	0.4	1.4	1.7	0.4	0.9	1.5
Sweden	0.7	0.5	6.2	2.9	0.1	0.7	3.2
Finland	0.7	0.3	2.4	0.9	0.4	2.2	3.9
Austria	0.1	0.1	1.1	0.8	1.0	0.8	0.6
Switzerland			2.8	2.8	2.4	2.8	2.8
Spain	0.1	0.1	0.6	0.7	0.2	0.5	0.9
Portugal		0.1	0.3	0.6	0.7	0.1	0.2
Australia	0.3	0.3	0.4	0.1	0.2	0.7	1.3
New-Zealand	0.3	0.4	5.4	3.5	1.0	3.3	4.3
OECD average	0.5	0.6	2.0	1.6	1.3	1.3	1.8

Source: OECD Secretariat.

Table 2

FUNDS RAISED ON THE INTERNATIONAL MARKETS
(In millions of US dollars)

	1975	1980	1985	1992	1993	1994
International bonds (1)	18725.7	29994.2	13654.3	276080.0	394588.5	368410.5
Foreign bonds (2)	111217.1	17924.2	31229.1	57613.3	86409.2	58441.6
Issues of bonds (total)	220411.3	59759.2	169072.4	333693.3	480997.8	426852.1
International bank loans	20607.2	81003.8	36135.7	116176.4	136069.1	201873.7
Foreign bank loans	-	-	6938.3	1692.5	607.1	926.2
Other international facilities	-	-	48920.5	6692.9	8161.9	4852.1
Loans (total)	20607.2	81003.8	91994.5	124561.8	124561.8	124561.8
TOTAL	426418.5	120768.0	261066.9	458255.1	458255.1	458255.1

1. An international bond issue is one that is placed simultaneously on the market of at least two countries and is denominated in a currency which need not be that of either, usually through international syndicates of financial institutions of several countries.

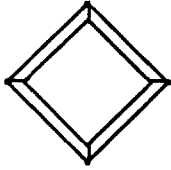
2. A foreign issue is one of which is placed, generally by a domestic syndicate, on the market of a single country.

Source : OECD Financial Affairs Division.

Session 2

Developments in OECD Transfer Pricing Guidelines

Frances Horner
(Fiscal Affairs Division, OECD)



*OVERVIEW OF THE
OECD TRANSFER PRICING
GUIDELINES*

Seoul, S. Korea

April 1996

OECD



Status of the Guidelines

- ❖ An agreed consensus
- ❖ Adopted by a Recommendation of OECD Council
- ❖ Not legally binding but agreed to be followed in mutual agreement proceedings
- ❖ Encouraged to follow in domestic practices
- ❖ Peer reviews and monitoring

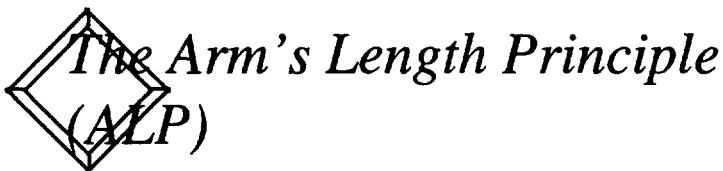
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Subjects

- ❖ The Arm's Length Principle
- ❖ Pricing Methods
- ❖ Administrative Aspects
- ❖ Documentation
- ❖ Intangible Property
- ❖ Services

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*The Arm's Length Principle
(ALP)*


- ❖ Article 9 of the OECD Model Tax Convention

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 *ALP: Article 9*


- ❖ If conditions made or imposed between associated enterprises in their commercial or financial relations differ from those which would have been made between independent enterprises, then profits that, but for those conditions, would have accrued to one of the enterprises may be included in the profits of that enterprise and taxed.

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 *ALP: Article 9 paragraph 1*

- ❖ Associated enterprises
 - an enterprise participates directly or indirectly in the management, control or capital of the other enterprise, or
 - the same persons participate directly or indirectly in the management, control or capital of both enterprises

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ALP: Article 9 paragraph 2

- ❖ Corresponding adjustment
 - to minimize or eliminate double taxation
 - a downward adjustment to tax liability by the other state to reflect a transfer pricing adjustment by the first state
 - no obligation to make corresponding adjustment unless agree with primary adjustment


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ALP: Implications of Article 9


- ❖ Analysis must be transactional
 - global formulary apportionment rejected
- ❖ comparability analysis required

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 *ALP: Transactional - aggregation rules*

- ❖ aggregation permitted where separate transactions are so closely linked that they cannot be evaluated on a separate basis
- ❖ Examples
 - range of closely linked products when individual pricing is impractical
 - cross-rights to use intangible property
 - licensing of know-how and supply of components

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 *ALP: Comparability (1)*

- None of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (i.e. price or margin), or reasonably accurate adjustments can be made to eliminate the effect of any such differences


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The logo consists of a diamond shape with a double border. Inside the diamond, the text "ALP: Comparability (2)" is written in a serif font. The "ALP" is in a larger, bold font, and "Comparability (2)" is in a smaller font to its right.

ALP: Comparability (2)

- ❖ characteristics of property or services
- ❖ functional analysis
- ❖ contractual terms
- ❖ economic circumstances
- ❖ business strategies

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The logo consists of a diamond shape with a double border. Inside the diamond, the text "ALP: Recognition of Actual Transactions" is written in a serif font. The "ALP" is in a larger, bold font, and "Recognition of Actual Transactions" is in a smaller font to its right.

ALP: Recognition of Actual Transactions

- ❖ Cannot disregard or restructure transactions unless exceptional circumstances
- ❖ Exceptional cases:
 - economic substance differs from form
 - form would not have been used by independent enterprises AND
 - actual structure practically impedes the tax administration from determining an appropriate transfer price


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ALP: Range

- ❖ TRANSFER PRICING IS NOT AN EXACT SCIENCE!
- ❖ May arise when there is more than one comparable transaction
- ❖ May arise from the application of more than one method
- ❖ Important when using profit methods

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ALP: Multi-year data

- ❖ Generally useful to examine data from year under examination and prior years
- ❖ Discover patterns, business and product cycles
- ❖ Data from subsequent years may also be used, but with care


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Traditional Transaction Methods

- ❖ CUP
- ❖ Cost Plus
- ❖ Resale Price

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Traditional: New aspects

- ❖ comparability standard explained
- ❖ application clarified


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Transactional Profit Methods

- ❖ Transactional Net Margin Method (TNMM)
- ❖ Profit Split Method
- ❖ These are LAST RESORT

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Administrative Aspects

- ❖ examination practices
- ❖ burden of proof
- ❖ penalties
- ❖ safe harbours
- ❖ APAs
- ❖ mutual agreement procedure

OECD



Admin: Examination practice



- ❖ Recognize that transactional profit methods are not used by taxpayers to set prices
- ❖ Begin with taxpayer's method
 - Take account of taxpayer's commercial judgment
 - Don't demand precision
- ❖ Important that corresponding adjustments can be calculated

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Admin: Burden of Proof

- ❖ Should not be misused as a justification for making groundless or unverifiable assertions about transfer pricing
- ❖ Both taxpayer and tax administration should be prepared to make a good faith showing of consistency with ALP
- ❖ In MAP, state proposing adjustment has the burden of proof

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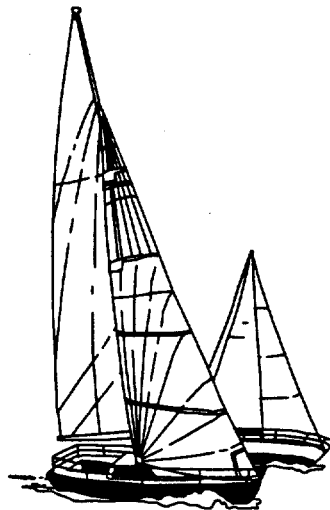
Admin: Penalties

- ❖ Fairness requires that penalties be proportionate to the offense
- ❖ Sizeable no-fault penalties can be too harsh
- ❖ Sizeable penalties unfair where taxpayer made reasonable efforts in good faith to set prices consistent with ALP.

OECD

Safe Harbours

- ❖ Rejected!



OECD

Advance Pricing Arrangements

- ❖ great care needed to extend beyond methods
 - examine critical assumptions and reliability of predictions
- ❖ should be bilateral whenever possible
- ❖ should be administered in a manner that protects taxpayer rights

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Documentation

- ❖ determined under same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance
- ❖ required documents should not impose costs and burdens disproportionate to the circumstances

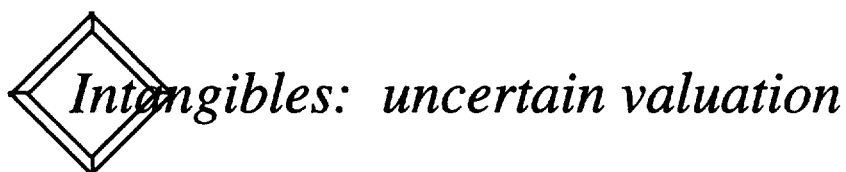
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Intangibles

- ❖ Pricing when valuation is uncertain at the time of the transaction
- ❖ Marketing activities


OECD



Intangibles: uncertain valuation

- ❖ Use anticipated benefits, where subsequent developments can be reasonably predicted
- ❖ Shorter-term agreements, price adjustment clauses
- ❖ Bear risk of unpredictable developments, but major unexpected events changing fundamental assumption lead to renegotiation

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Intangibles: Use of subsequent developments

- ❖ Subsequent developments that materially affect arm's length price may prompt tax administration to inquire what independent enterprises would have done on the basis of information available to them at the time of the transaction.

OECD



Intangibles: Marketing activities

- ❖ e.g. manufacturer owns trademark and distributor owns product
- ❖ distributor who bears marketing costs must be able to share in potential benefits from marketing activities, but not as owner of the trademark
- ❖ incurring extraordinary marketing expenditures may require additional return

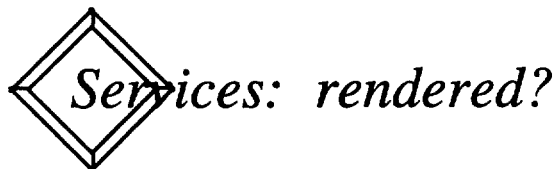
OECD



Services

- ❖ Are intra-group services rendered?
- ❖ What is an arm's length charge
 - is a “profit” required?


OECD



Services: rendered?

- ❖ Would an independent enterprise in comparable circumstances pay for or perform activity for itself?
- ❖ Shareholder costs are limited

OECD

 *Services: arm's length charge*

- ❖ Apply the ALP strictly
- ❖ What would service recipient pay, what would service provider charge
- ❖ Not always a profit
- ❖ Caution for agent or intermediary functions

Background Note :

OECD Work on Transfer Pricing

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INTRODUCTION

On the 13th July 1995 the OECD approved new transfer pricing Guidelines for multinational enterprises and tax administrations¹. The 1995 Guidelines updated and revised the OECD's 1979 Report on transfer pricing.² This Article describes in Part I the background to the decision to revise the 1979 Report and in Part II the approach used to finalise the Guidelines. Part III examines the contents of the Guidelines and the significant changes from the 1979 Report, and Part IV describes the on-going and future work of the OECD in the transfer pricing area.

Transfer pricing issues are not new. By the beginning of the 20th Century a number of countries had developed transfer pricing rules, sometimes in the form of enabling tax administrations to consolidate the activities of related trades or businesses. In some countries the initial focus was on domestic transactions, which is still the case in many non-Member countries, where regional incentive schemes make it attractive to shift profits into associated enterprises operating in such regions.

The spread of MNEs since the 1960s - such enterprises now account for 60 per cent of world trade and the top one hundred MNEs own 20 per cent of world assets - has resulted in an increasing volume of trade between members of the same multinational group, so that today attention is focused on the pricing practices of these companies. Countries are concerned to ensure that transfer prices do not mis-allocate the tax base between the countries in which an MNE operates and thereby undermine the tax base and distort competition. Tax administrations are also concerned to minimise any tax avoidance opportunities that arise from the manipulation of transfer prices. MNEs are concerned to minimise the risk of double taxation arising from internationally inconsistent rules.

The precise concerns of a country will vary with its economic position. Large capital exporting countries may fear that transfer pricing practices will be used to minimise the repatriation of profits, whilst countries which are large importers of capital may be concerned that transfer pricing will be used to transfer profits outside of their jurisdiction. Countries that are both large capital importers and exporters have experienced both of these concerns.

In the 1960s and 1970s other countries also began to review their legislation and administrative practices in this area. These country developments led to work being undertaken by the OECD's Committee on Fiscal Affairs (CFA), which is the main tax policy body of the Organisation.

The OECD's position on transfer pricing is founded on the arm's length principle. The basis of this principle in international tax arrangements is set out in Article 9 of the OECD Model Tax Convention. This article states that when "conditions are made or imposed between...two [associated] 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 that enterprise and taxed accordingly".

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1. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, (OECD, July 1995) ("1995 Guidelines").
 2. *Transfer Pricing and Multinational Enterprises*, (OECD, May 1979) ("1979 Report").

This reference to conditions established in the commercial and financial relationships of independent enterprises is the arm's length principle. By seeking to determine the profits that would have accrued to independent enterprises in the same circumstances, the arm's length principle is consistent with the approach of treating the members of an MNE group as separate entities and not as a single unified business.

The OECD 1992 Model Tax Convention is primarily concerned with addressing cases which would give rise to international double taxation, whereas double taxation is only one of the concerns which is behind most national legislation and the OECD Guidelines on transfer pricing.

The 1992 Model follows closely the formulation of Article 9 of the 1963 Model, although in 1977 the current paragraph 2 of Article 9 was added requiring that an appropriate corresponding adjustment be made in the other contracting state to relieve double taxation in cases where the transfer pricing adjustment is made by the other contracting state. Apart from this change, the OECD Model has in this area remained unchanged since 1963 and provides the basis for the separate entity approach followed by all OECD Member countries in their bilateral treaties and by most non-Member countries. The UN Model in Article 9 adopts a similar approach.

PART I

BACKGROUND TO THE 1995 GUIDELINES

a. The OECD's 1979 Report

The 1979 Report was drafted and finalised by the OECD's Working Party on Taxation and Multinational Enterprises (Working Party No.6) of the CFA, which was created in 1973 (see Annex II for a description of the subsidiary bodies of the Committee on Fiscal Affairs). The Working Party, made up of senior delegates from national tax administrations, finance departments and treasuries, worked for six years on the 1979 Report, which was unanimously adopted by the OECD Council on 16 May 1979.

The 1979 Report was subject to intensive discussions between Member countries and also benefitted from input by the private sector in the form of comments from the OECD's Business Industry Advisory Council (BIAC). The 1979 Report has been translated in many languages and has been used extensively by tax authorities and taxpayers around the world. In many Member countries the 1979 Report forms the basis for national legislation.

b. Related work between 1979 and 1992

At the inception of its work on the 1979 Report, Working Party No.6 decided that the application of the Report to specific sectors should be postponed until after the Report's completion. Thus in 1984 the OECD published a follow-up report entitled *Transfer Pricing and Multinational Enterprises: Three Related Issues* (hereafter referred to as the 1984 Report). The 1984 Report dealt with the application of the 1979 Report to the banking sector, the problem of corresponding adjustments and central management and service costs.

With the completion of the 1984 Report, the pace of work on transfer pricing slowed down. In 1984 and 1985 the Working Party examined the use of unitary taxation by certain states of the United States and submitted a report on the problems encountered with a global unitary approach.

Between 1986 and 1991 very little further work was undertaken on transfer pricing, although the Working Party did examine current developments in a number of countries. Work was also underway on a report (published in 1994) on the attribution of income to permanent establishments. In this period, the CFA also organised two meetings of tax inspectors, the first focusing on transfer pricing issues and the second on a number of sector studies.

In 1991, the Working Party No.6 reviewed its work programmes and decided that a series of "peer reviews" of the transfer pricing legislation, practices and operations of selected OECD countries should be undertaken.

During these years, greater attention was drawn to transfer pricing issues as a consequence of developments in several countries. The United States issued proposed transfer pricing regulations in 1992 that prompted many countries to express concerns at OECD about the application of the arm's length principle. These concerns led to the assurance by the CFA of two reports, one published in December

1992 under the title *Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations* and the second as a supplement in July 1993.

The project to revise the 1979 Report was initiated in light of all these developments between 1979 and 1992 and was intended as a fundamental review of the underlying principles of international transfer pricing and their application.

PART II

BACKGROUND TO THE REVISION OF THE OECD GUIDELINES

a. Why revise the 1979 Report?

The decision to undertake a revision of the 1979 Report was taken by the Committee on Fiscal Affairs only after considerable debate. Part of the reluctance to initiate a revision was due to the fact that the 1979 Report continued to be widely referred to by both taxpayers and tax authorities and in many countries formed the basis for their national legislation. At the same time, there was an increasing body of case law implementing the Guidelines. It was also clear that any revision of the Guidelines would require a re-assessment of the ways in which the arm's length principle can be applied in practice: a discussion which was already apparent during the Committee's review of the US Draft 482 Regulations.

Despite these reservations, in January 1993 the Committee instructed its Working Party No.6 to begin a review of the Guidelines.

The decision was influenced by:

(i) the need to consolidate the work undertaken since 1979 on transfer pricing issues (see Part I above).

(ii) Legislative developments in Member countries since 1979. At that time many OECD countries did not have any legislation specific to transfer pricing issues. Similarly new administrative approaches to minimising the risks of transfer pricing disputes have developed over the last 15 years (eg. simultaneous examinations; advance transfer pricing arrangements).

(iii) Recent developments in the economic, business and technological environment within which MNEs operate. The removal of regulatory barriers to the integration of capital markets and the improved global communication technologies facilitated, for example, the development of global trading and large MNEs were quick to exploit the opportunities offered by these developments which were not foreseeable in 1979.

(iv) The need to re-establish a consensus on the status of the "other methods" referred to in the 1979 Report. As will be seen from Part III below, the 1979 Report was ambiguous in distinguishing between these "other methods" and unitary taxation and did not provide clear guidelines as to which methods were acceptable or unacceptable in terms of consistency with the arm's length principle. This lack of clarity, which was perhaps inevitable for a first set of internationally agreed guidelines, was rapidly becoming a source of friction between countries, as could be seen over the debate in a number of countries as to whether recent proposals on the use of profit methods were consistent with the 1979 Report.

(v) The desire to provide more practical guidelines on the application of traditional methods in the light of the experience gained over the last 15 years and to illustrate how these Guidelines could be applied to particular areas (eg. intangibles). It was also recognised that the 1979 Report provided little on the ways in which transfer pricing disputes could be resolved, either by way of better exchange of information, more effective Mutual Agreement Procedures, Advance Pricing Agreements or Arbitration.

These were the principal reasons which led the Committee to revise and to expand the coverage of the original 1979 Report.

b. The revision process

Users of the 1995 Guidelines may find it helpful to have a brief review of the way in which the OECD undertook the revision since this will in part explain the structure of the Guidelines and the decisions taken both on issues of form and substance.

The revision process worked from the 1979 Report, keeping its policy decisions unless there were good reasons to deviate therefrom. In practice, this proved feasible for much of the revised Guidelines, and particularly for Chapters I and II. Chapter III had to address issues not fully treated in 1979, so the policy comparison is more difficult. Even for the earlier chapters, a large number of drafting and clarifying changes were made. Further, a number of new subjects were examined.

A second important decision was that all 25 Member countries should be actively involved in the revision. This led the Committee to give overall responsibility for the revision to its Working Party No.6, on which all Member countries are represented. The Committee recognised, however that drafting of text would be easier to undertake by a small group and therefore created a Task Force which, working with the Secretariat, would prepare first drafts for discussion by the Working Party. The Task Force consisted of representatives from the Ministries of Finance, Treasuries and Revenue Services from Australia, Canada, Finland, France, Germany, Japan, the Netherlands, Switzerland, United Kingdom and the United States. The Committee itself took responsibility for making broad policy decisions on the format and substance of the revised Guidelines. The Task Force met nine times, usually for a duration of four days, and the Working Party met five times to discuss drafts.

A third key decision taken by the Committee was that the business community and taxpayers generally should have an unprecedented level of involvement in the revision. This was achieved in three ways. First, there were extensive contacts between tax administrations and business associations in each country. In some countries, special consultative groups were created. Secondly, the OECD's Business Industrial Advisory Committee (BIAC) was consulted at each stage of the revision. At the beginning of the revision process they were asked for the views on what should be the main focus of the review, which controversial areas should be examined and what problems had been encountered with the 1979 Report by the business community. There were also a series of joint meetings between the BIAC Fiscal Committee and the Working Party No. 6/Task Force. Thirdly at the initiation of the project, a conference was jointly sponsored with the Canadian Tax Foundation to examine the broad policy issues that arose in the allocation of income and expenses between the associated enterprises of an MNE³.

A fourth decision was that as far as possible discussion drafts of the key parts of the Reports should be issued for public comment. In July 1994 a discussion draft of what was referred to as Part I of the revised Guidelines was issued for public comments (Part I contained the basic principles and the methods used to apply them). Section C below discusses in more detail the response to the July discussion draft. In February 1995 a draft of Part II (application: namely to services, intangibles, cost sharing and administrative arrangements) was derestricted.

A fifth decision made by the Committee was that major non-Member countries should be associated with the draft. Thus, in the context of the OECD's dialogue with Dynamic non-Member Economies (DNMEs), a meeting was organised in Seoul in April 1994 to discuss the work undertaken on

3. 41 Canadian Tax Journal, No. 5 (1993).

the revised Guidelines, the particular interest of non-Member countries and the ways in which this dialogue would be carried forward. That Workshop was attended by 16 Member countries, 10 DNME Economies [Hong Kong, Malaysia, Singapore, South Korea, Chinese Taipei, Thailand, Argentina, Brazil, Chile, and Mexico (now a full member)], as well as IFA, CATA, and CIAT. Part IV provides more details on how the Committee proposes to associate major non-Member countries more closely with this work. It should also be recalled that Korea, Czech Republic, Hungary, Poland, and Slovakia have participated as observers in the Working Party No. 6 meetings.

A controversial decision taken at the outset of the project was that the Guidelines should, if possible, be finalised early in 1995. It was recognised that this was a tight timetable - especially since the 1979 Report had taken four years to complete - and would require an intense pace of meetings. Nevertheless, it was considered that there were a number of advantages of having this timetable:

(i) Knowing that the project would have to be completed in two years would lead countries to allocate the necessary resources to the project. It was also likely that during this relatively short period the staff allocated to this project would remain unchanged (many countries established a team of two or more people to work on the project and for the most part these people did not change over the project).

(ii) A number of countries had already announced in 1993 their intention to finalise new guidance in this area by 1995. It was clearly desirable to have the revised Guidelines available before such legislation was finalised. The Committee was also aware that a number of non-Member countries were in the process of introducing transfer pricing legislation.

(iii) The divergent interpretations of the 1979 Report were leading to conflicts between tax administrations. This increased the risk of double taxation for the business community. Resolving these uncertainties as quickly as possible was a priority for enterprises.

(iv) In the context of the request by Korea, the Czech Republic, Hungary, Poland and Slovakia it was desirable that the revised Guidelines should be available prior to their accession (all 5 countries have given commitments that they will follow the Guidelines).

In retrospect, having a precise deadline was conducive to getting the compromises required to re-establish a new consensus on the application of the arm's length principle. But there were drawbacks. For many countries, the pace of work did place a strain on their resources. The business community did not have enough time to comment on a few chapters in the draft of Part II, namely the chapters on services, intangibles and cost contribution arrangements. This, in turn, was one factor that led the Committee to exclude these chapters from the 1995 Guidelines at this time (with the hope that they could be inserted within a year).

c. Dealing with public comments

The decision to release Part I of the Guidelines as a Discussion Draft was taken by the Committee on Fiscal Affairs at its meeting in June 1994. The purpose was to solicit input from a broader range of interested parties than had occurred under the more traditional OECD procedures. This course, which was unprecedented in the OECD, was thought appropriate for Part I because it addresses fundamental principles as regards the basic approach to the division of the tax base between associated enterprises and issues on appropriate methodologies for establishing transfer pricing. The Committee also felt that it was important to provide prompt and accurate information to the public on the status of the OECD work in this area, given the uncertainty that existed on the collective position of OECD Member countries. The decision was

to defer final approval of Part I until it could be considered in light of the public comments and the completion of work on part II of the Guidelines.

A total of 45 comments were received on the Discussion Draft. Of this total, 23 were provided by trade or business associations, 6 by academic individuals or institutions, 7 by accounting firms, law firms, or individual lawyers, and 9 from specific companies spread throughout the OECD area.

With one exception (an academic) the comments all supported and welcomed the strong endorsement of the arm's length principle and the rejection of global formulary apportionment.

Comments generally accepted the need to revise extensively the 1979 Report and many commented favourably on the overall structure, style, and clarity of the Discussion Draft. A number of comments expressed appreciation for the greater level of detail in the Discussion Draft, and a few requested that even more guidance, in particular on practical implementation, be added over time. All commentators welcomed the role of the OECD in monitoring the implementation of the Guidelines.

The comments did not, however, raise any major new issues that had not previously been brought to the attention of the Committee, either from BIAC, the ICC or Member governments but they included many suggestions for detailed changes as well as general commentaries that improved the practical usefulness of the Guidelines.

Nearly every comment gave significant attention to the Conclusions on Profit Methods of the Discussion Draft. A number of the comments objected to any use of profit methods for establishing transfer pricing, while a number of other comments were willing to accept the Conclusions, either enthusiastically or in recognition of the need for compromise and the importance of international consensus. The attention to profit methods was to be expected, given that the issue has been the basis of much controversy and concern in the international tax community for the past several years. These comments were helpful in finalising Chapter III of the Guidelines.

The public comments were also useful in identifying areas where the draft text was open to mis-interpretation. This was the case, for example, with the issue of restructuring transactions. The comments also identified a number of issues (eg. post-audit set-offs, consistency with customs valuation, the need for more practical guidance) which would at one point need to be addressed in more detail. Overall these public comments provided a useful input into improving the revised Guidelines.

d. The loose-leaf format

The decision to produce the Guidelines in a loose-leaf format was taken in June 1994. This decision was much more than a question of how should the Guidelines be issued. It reflected a change in the way that the Committee saw the Guidelines. By June 1994 it was already clear that unlike the 1979 Report, the revised Guidelines would require a continual monitoring in their application - in part because countries had very little experience with profit methods and in part because of the increased complexity of transfer pricing issues. Monitoring would likely require amendments and additions to the revised Guidelines. It was also clear by that date that what was referred to in the discussion draft as Part III (Special Topics) would not be ready by 1995. In fact, the Committee decided to abandon the structure set out in the discussion draft (Part I Principles and Methods; Part II Application and Part III Special Issues); seeing the Guidelines as a series of continuous chapters, with the first five chapters (ie. the chapters published in July 1995) as forming the core of the Guidelines.

In taking this decision the Committee was influenced by its successful experience with the OECD Model Tax Convention which in 1992 was moved from a static to dynamic format.

Such an approach has the advantage that the Guidelines can be regularly reviewed, modified and added to, particularly important in a rapidly evolving area such as transfer pricing.

e. The status of the Guidelines

The revised Guidelines were unanimously approved at a technical level by Working Party No. 6 in April 1995, then by the senior officials in the Committee on Fiscal Affairs (CFA) on the 26 June 1995 and finally by the decision making body of the OECD - the Council on the 13 July. Thus all 25 Member countries have agreed to the text, which should lead to a consistent interpretation and application of the arm's length principle across countries. Within the OECD area these Guidelines represent a consensus position both on the superiority of the arm's length principle over alternative approaches and on the methods that can be used to apply this approach.

When the Council of the OECD approved the Report setting out the Guidelines it also adopted a Recommendation to Member governments. The Recommendation, which is reproduced in Annex I, includes seven key points:

- (i) Tax administrations of OECD countries should follow, when reviewing, and if necessary, adjusting transfer pricing between associated enterprises for the purposes of determining taxable income, the guidance in the 1995 Report -- considering the integrity of the Report and the interaction of the different chapters -- for arriving at arm's length pricing for transactions between associated enterprises;
- (ii) Tax administrations should encourage taxpayers to follow the guidance in the 1995 Report and to that end that they give the 1995 Report publicity in their country and have it translated, where necessary, into their national language(s);
- (iii) Member countries should develop further co-operation between their tax administrations, on a bilateral or multilateral basis, in matters pertaining to transfer pricing.
- (iv) They are also invited to notify the Committee on Fiscal Affairs of any modifications to the text of any laws or regulations that are relevant to the determination of transfer pricing or of the introduction of new laws or regulations.
- (v) The CFA is instructed to monitor the implementation of the 1995 Report in cooperation with the 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 in the light of this monitoring;
- (vi) The CFA further instructed to develop its dialogue with non-Member countries, consistently with the policy of the Organisation, with the aim of assisting them to become familiar with the 1995 Report and where appropriate encourage them to associate themselves with the 1995 Report.
- (vii) The Recommendation on the determination of Transfer Prices between Associated enterprises issued on the 29th May 1979 (C(79)83/Final) is repealed.

The first point, which is almost identical to that of the 1979 Report, is that Member countries should follow the Guidelines. Those countries which have based their legislation and administrative practices on the 1979 Report (many countries, particularly with rather general and short legislation, had merely incorporated the 1979 Report into their legislation and generally in these countries the domestic courts have looked to the 1979 Report for interpretative material) may find it necessary to review their legislation. Countries with more extensive national rules on transfer pricing will also wish to ensure that these rules are applied in a way consistent with the revised OECD Guidelines. This is made clear in paragraph 16 of the Guidelines which states that "Member countries are encouraged to follow these Guidelines in their domestic transfer pricing practices".

The Guidelines do not supersede national rules. Nevertheless, when a transfer pricing case comes into a Mutual Agreement Procedure, the OECD Guidelines should be used as the basis for resolving the case, since once a conflict arises between countries it is legitimate for taxpayers to expect that Member governments will stand by their agreement on the Guidelines.

The second recommendation is addressed to taxpayers and is intended to encourage them to follow the Guidelines in the determination of their transfer prices, including the documentation standards set out in Chapter 5. The Committee sees this as an effective way of minimising conflict in the transfer pricing area and it is no coincidence that the title of the Guidelines specifically refers to the fact that these are Guidelines for both MNEs and Tax Administrations.

The third recommendation recognises that tax administrations need to explore further the means of co-operation between countries set out in Chapter 4 of the Guidelines, particularly in the areas of Advance Transfer Pricing Agreements, Simultaneous Examinations, Mutual Agreement Procedures and the possibility of Arbitration (see Part IV below).

Points (iv) and (v) should be read together, since successful monitoring will require that countries notify Working Party No.6 (the body responsible for the monitoring) of changes to the legislation, regulation and administrative practices in the transfer pricing area. But the monitoring is not limited to examining how far changes are consistent with the revised Guidelines. It will also examine whether existing rules are applied in a way which is consistent with the Guidelines. This will be done in part by Peer Reviews and in part by Delegates raising in Working Party No. 6 problematic issues where they believe the Guidelines have not been followed. It is significant that the business community will be involved in this process.

The point (vi) is consistent with the now long-standing policy of the Committee to involve non-Member countries in its work. Many major non-Member countries may find it attractive to commit themselves to the revised Guidelines (see Part IV below).

The last point states that the 1979 Report has now been superseded by the Revised Guidelines.

Although an OECD Recommendation is not a legal binding instrument (only very rarely are OECD instruments legally binding and these are referred to as "Decisions" of the Council), Member Governments are expected to follow the Recommendation and in practice this is the approach usually adopted.

It is not intended that the OECD, by means of this Recommendation, should be seen as some form of Arbitration Tribunal which would give decisions to taxpayers as to whether a particular determination of a transfer process is consistent with the Guidelines.

PART III

COMPARISON OF THE 1995 GUIDELINES WITH THE 1979 REPORT

a. Introduction

The OECD Guidelines have been heralded as a new international consensus, an important achievement for the 25 Member countries and for the business community. Countries agreed about the principle for analysing transfer pricing, and on the means of implementing the principle. This is the crucial step towards minimising disputes and avoiding double taxation.

But this agreement can hardly be said to be new. The same principle was embodied in the OECD's 1979 Report on transfer pricing. The reaffirmation of the arm's length principle is notable, of course, given the doubts that had been cast on its continuing viability as described above. But one hardly needs all 140+ pages of the revised Guidelines to deliver this message. What, then, is new? How, and why, does this document differ from the 1979 Report?

In answer, there are many ways that the revised Guidelines differ from the 1979 Report, but these differences reflect not a deviation from the 1979 concepts but rather an endorsement, elaboration and extension thereof. In distinguishing the revised Guidelines from the 1979 Report, most attention has focused on the Guideline's third Chapter, addressing "Other Methods", including profit methods. This focus is not surprising, since profit methods took center stage in the development of the Guidelines. Their use was one reason prompting the revision of the 1979 Report, because in this key area the 1979 Report needed further elaboration and discussion in light of developments in international trade. The 1979 Report's treatment of profit methods, while appropriate for its time, was altogether too brief to meet the challenges and demands of modern international practice. Regardless whether profit methods were to be condemned or embraced, OECD's judgment had to be rendered with a complete and thoughtful analysis, bringing all countries to respect the conclusion and to commit themselves to a common international view. As discussed in more detail below, the 1979 Report contained very little of analysis on this point and its conclusions were considered by some as ambiguous.

Yet, it would be unfortunate indeed if the considerable attention given to developments affecting profit methods were to conceal other substantial advances made by the revised Guidelines, and indeed, given the role to which profit methods are relegated in the new consensus, it might be said that other analytic developments will be far more important in terms of daily practice. Readers have given less attention to the other Chapters of the revised Guidelines; one goal of this article is to bring to light these other important developments. To this end, the discussion below describes all the most significant developments in the revised Guidelines as compared with the 1979 Report including, of course, the question of profit methods.

b. Statement of the arm's length principle

The revised Guidelines indicate expressly, for the first time, that Article 9 of the OECD Model Tax Convention is the "authoritative statement" of the arm's length principle.⁴ In the 1979 Report, arm's

4. 1995 Guidelines paragraph 1.6 at page I-3.

length prices were defined⁵ and, in another place, Article 9 was reproduced as a "relevant text"⁶. The 1979 Report also indicated that the arm's length principle is "the underlying assumption" of Article 9⁷ and stated that "the arm's length principle as expressed in the OECD Model Double Taxation Convention has to be followed".⁸ Thus, the import of the 1979 Report was that Article 9 and the arm's length principle are equivalent. In the revised Guidelines this point becomes explicit, and the wording of Article 9 forms the basis of the discussion of methods by which the arm's length principle can be applied.

The relevance of this development is that it helps clarify the means for determining conformity with the arm's length principle. The language of Article 9 makes clear that an adjustment satisfies the arm's length principle when the adjustment includes in the profit of an associated enterprise any profits that would have accrued to that enterprise "but for" conditions made or imposed between the associated enterprises in their economic or financial relations that differ from the conditions that would be made between independent enterprises. It follows that Article 9 does not *per se* preclude adjustments that arise from examining the profits accruing to an associated enterprise. This should hardly be surprising, given that two of the traditional methods endorsed in 1979, namely resale price and cost plus, look at gross profit margins.

At the same time, Article 9 requires a "but for" connection between the improper accrual of profits and the existence of improprieties in the conditions imposed in the economic and financial relations of the associated enterprises. This proposition excludes the non-transactional use of profit methods (indeed, the non-transactional use of any method). The overall profits by an independent enterprise can be affected by many factors, some of which could be wholly unrelated to the controlled transaction for which transfer pricing is in question. To the extent that a transfer pricing inquiry goes beyond profits of the controlled transaction⁹, it necessarily looks at conditions not limited to those between the associated enterprises involved in that transaction, thereby risking a violation of the arm's length principle. This analysis ultimately led the OECD to articulate for the first time the concept of a "transactional profit method", and to reject any profit-based analysis inconsistent with this concept.

c. Comparability analysis and business strategies

The revised Guidelines include over eight pages of discussion about the factors that can influence comparability for purposes of applying the arm's length principle.¹⁰ Most of this material is new and has no counterpart in the 1979 Report. It is the natural result of experience of tax administrations and

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5. "The prices which would have been agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions in the open market". 1979 Report paragraph 2 at page 7.
 6. – 1979 Report Chapter I at 23.
 7. 1979 Report paragraph 3 at page 8.
 8. 1979 Report paragraph 37 at page 28.
 9. The controlled transaction could be several controlled transactions that are appropriately aggregated. The new Guidelines include a discussion of aggregation rules, as discussed later in this Article.
 10. 1995 Guidelines Chapter I, Subsection i) of Section C.

businesses in applying the arm's length principle since 1979, and generally was perceived by the business community as a positive addition, providing useful guidance and direction.

The 1979 Report had recognised the need for comparability of geographic market¹¹, market levels¹², product¹³, functions performed and risks assumed¹⁴, and "other considerations" such as product innovativeness, market condition, custom of the trade, how the MNE is organised, economic functions more generally, and "all other relevant facts and circumstances of each individual case"¹⁵. The revised Guidelines provide much more detail about the types of relevant factors, including a discussion of functional analysis that would be relevant for all transfer pricing methods. For this discussion, interested parties are advised to refer directly to the actual text of the Guidelines and not to a condensation thereof, because the value of the discussion is in its technical detail.

All that might be usefully added here beyond the reference to the actual text is a mention of an important development regarding business strategies. The 1979 Report had a very limited recognition of the possible effect of business strategies on pricing policy, and the need to make adjustments for any differences in business strategies in the controlled transaction as compared with the uncontrolled transaction. The 1979 Report acknowledged two examples of business strategies that might be acceptable as properly influencing price. One is where payment is waived from a customer "in temporary difficulties in order to preserve a potentially valuable outlet for [goods]".¹⁶ The other is where the "seller's object is market penetration", or a "start-up" strategy.¹⁷

The revised Guidelines recognise that a whole catalog of business strategies could have an influence on price.¹⁸ Market penetration schemes are given as only one example, and the list included in the Guidelines is not meant to be exhaustive. There is a specific acknowledgement that market penetration schemes themselves may fail, and guidance is given on how to evaluate a strategy that results in temporarily decreased profits in return for expected higher long-run profits.

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11. 1979 Report paragraph 49 at page 35.
 12. 1979 Report paragraph 50 at page 35.
 13. 1979 Report paragraphs 51-54 at pages 36-37.
 14. 1979 Report paragraph 59 at page 39 (resale price method); this is only implicit in the discussion of cost plus (see paragraph 65 at page 41). However, functional analysis is specifically mentioned as a "useful" way to "begin" for purposes of "examining the transfer prices adopted within a multinational enterprise." 1979 Report paragraph 17 at page 17.
 15. 1979 Report paragraph 55 at pages 37-38.
 16. 1979 Report paragraph 40 at page 29.
 17. 1979 Report paragraph 43 at page 31.
 18. 1995 Guidelines paragraphs 1.31 through 1.35 at pages I-13, I-14.

d. Recognition of the actual transactions

The revised Guidelines provide instruction on when a tax administration may disregard the actual structure adopted by a taxpayer in entering into a controlled transaction.¹⁹ In this respect, the revised Guidelines are both more precise and limiting than was the 1979 Report. The 1979 Report had indicated that a tax administration "as a general principle" should base the search for arm's length pricing on actual transactions, while acknowledging that "there may be some circumstances where the form of transaction has effectively to be ignored".²⁰ Those circumstances, although described as "exceptional cases"²¹, seem to extend to any arrangements, admittedly encountered "frequently" between associated enterprises, that "are not or very rarely encountered between unrelated enterprises."²² The 1979 Report states that "[i]n such instances tax authorities would have to determine what is the underlying reality behind an arrangement in considering what the appropriate arm's length price would be."²³

This language from the 1979 Report, while open to differing interpretations, could be read to suggest that restructuring could occur whenever the associated enterprises enter into an arrangement that differs from what independent enterprises would have done -- the tax administration would be free in such a case to search for the "reality" as reflected by the behaviour of independent enterprises.

The revised Guidelines incorporate this guidance from the 1979 Report, but elaborate and limit it. First, the revised Guidelines state directly that "[i]n other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them".²⁴ The cases when, exceptionally, restructuring may be appropriate and legitimate are limited to two. The first is "where the economic substance of a transaction differs from its form", giving as an example an investment in an associated enterprise structured as debt in economic circumstances where the substance is a subscription of capital. The second circumstance is where the "arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price."²⁵

This rule is far more restrictive than a simple rule that allows restructuring whenever the parties have arranged their affairs in a different manner than independent enterprises. It sets up two additional hurdles -- first, that independent enterprises would not have considered the arrangements "commercially rational" under the circumstances, and second, that the tax administration effectively has no other recourse for fixing arm's length pricing. Both of these conditions must be met to restructure in a case where the form and substance of a transaction are the same.

19. 1995 Guidelines paragraphs 1.36 through 1.41 at pages I-15 through I-17.

20. 1979 Report paragraph 15 at page 16.

21. 1979 Report paragraph 32 at page 19.

22. 1979 Report paragraph 24 at page 20.

23. *Id.*

24. 1995 Guidelines paragraph 1.36 at page I-15.

25. *Id.*

e. Evaluation of separate and combined transactions

In keeping with the Article 9 articulation of the arm's length principle, the revised Guidelines provide that "[i]deally" the principle "should be applied on a transaction-by transaction basis."²⁶ At the same time, the Guidelines recognise that there are some circumstances in which it would be appropriate to aggregate transactions. A specific standard is articulated for when this could occur: "where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis".²⁷ A number of examples are given, such as long-term contracts for the supply of commodities or services, rights to use intangible property, and pricing a range of closely linked products where the determination of pricing for each individual's product or transaction is "impractical".

The 1979 Report provided less instruction on this point. It stated that "[i]t may be reasonable in some circumstances to analyse the transfer prices for product lines or other groupings rather than to ascertain an arm's length price for each individual product or sale."²⁸ The examples given are where some products are sold below market to allow a higher profit on other related products. There is also a discussion of "package deals", where "a single charge is made for a variety of benefits", such as licensing patents, providing technical and administrative services, and selling or leasing production facilities, "all for an undifferentiated payment."²⁹

The main difference is that the revised Guidelines provide a standard for determining whether aggregation of controlled transactions is appropriate. This standard is important for both taxpayers and tax administrations. From the taxpayer perspective, the standard will serve as a protection against the non-transactional application of pricing methods by tax administrations. The arm's length principle will require a transaction-by-transaction analysis except where transactions are "so closely linked or continuous" that a separate analysis will not work. However, the revised Guidelines recognize that in some cases transactions in a package may need to be evaluated separately, although after such an analysis the tax administration should still consider "whether in total the transfer pricing for the entire package is arm's length".³⁰ This latter qualification should prevent tax examiners from inappropriately selecting ("cherry-picking") the part of the package that is not arm's length for adjustment without looking to whether offsets can be found in other parts of the package.

In short, both taxpayers and tax administrations need a flexible rule allowing separate transactions to be combined, for purposes of permitting a practical analysis in keeping with business realities. At the same time, a standard is needed to ensure that aggregation is properly applied. The revised Guidelines have attempted to set such a standard.

f. Use of an arm's length range

The concept of using an arm's length range of transfer pricing is perhaps one of the most important additions made by the revised Guidelines that had not been fully discussed in the 1979 Report.

26. 1995 Guidelines paragraph 1.42 at page I-17.

27. Id.

28. 1979 Report paragraph 41 at page 29.

29. 1979 Report paragraph 19 at pages 17-18.

30. 1995 Guidelines paragraph 1.43 at page I-18.

The 1979 Report had acknowledged that "an arm's length price will in many cases not be precisely ascertainable and that in such circumstances it will be necessary to seek a reasonable approximation to it".³¹ The 1979 Report had used this observation to justify the conclusion that it may be useful to take into account more than one method to reach a satisfactory approximation of an arm's length price, but it still seemed to envision one price (albeit an approximate one). The 1979 Report also had indicated that, in light of the need for judgment in determining transfer pricing, "there would be no justification for making merely minor or marginal adjustments".³²

The revised Guidelines continue to instruct that "[t]ax administrators should hesitate from making minor or marginal adjustments."³³ However, they also go further, to recognize specifically that on "many occasions" the application of the arm's length principle will produce a range: "However, because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are equally reliable."³⁴ Several paragraphs elaborate on the concept of the arm's length range. All these paragraphs are new compared to the 1979 Report. Paragraph 1.48 states specifically that "[i]f the relevant conditions of the controlled transactions (e.g. price or margin) are within the arm's length range, no adjustment should be made." Where the taxpayer's pricing is outside the range determined by the tax administration, the taxpayer may present evidence that the range should be expanded. Adjustments are to be made to "the point within the range that best reflects the facts and circumstances of the particular controlled transaction"³⁵, where this is possible.

g. Set-offs

The revised Guidelines and the 1979 Report are very much alike in their discussion of set-offs, both acknowledging that, in the terminology of the revised Guidelines, "intentional" set-offs should be allowed. An "intentional" set-off is one where the associated enterprises knowingly include a balancing of benefits in their arrangements with each other.³⁶ Under the revised Guidelines, intentional set-offs are discussed only in the context of transactions between two associated enterprises. No explicit instruction is given about whether set-offs involving more than two parties (ie. a triangular arrangement) should be recognized. The revised Guidelines differ slightly from the 1979 Report in the reference to unintentional over-reporting of income on a transaction that a taxpayer puts forward to obtain a reduction in a transfer pricing adjustment on another transaction. For this type of unintentional set-off, the Guidelines leave the decision whether to grant the request to the discretion of tax administrations, making a clear distinction from intentional set-offs.³⁷ The 1979 Report did not discuss this issue.

31. 1979 Report paragraph 46 at pages 33-34.

32. 1979 Report paragraph 15 at page 16.

33. 1995 Guidelines paragraph 1.68 at page I-27.

34. 1995 Guidelines paragraph 1.45 at page I-19.

35. 1995 Guidelines paragraph 1.48 at page I-20.

36. 1995 Guidelines paragraph 1.60 at page I-24.

37. 1995 Guidelines paragraph 1.64 at page I-26.

h. Selection of transfer pricing methods

The revised Guidelines are more specific in their guidance on the selection of transfer pricing methods than was the 1979 Report, although broadly the two documents are consistent. The 1979 Report set forth a clear preference for the use of the comparable uncontrolled price (CUP) method, but recognised that "there may be cases where the evidence of resale profit mark-ups, production costs or other data may be more complete, more conclusive and more easily obtained than undisputable evidence of open market prices."³⁸ The 1979 Report continued: "There should always be the possibility, therefore, of selecting the method which provides the most cogent evidence in a particular case ... Frequently, it may be useful to take account of more than one method of reaching a satisfactory approximation to an arm's length price in the light of the evidence available."³⁹

The revised Guidelines similarly establish a clear preference for the CUP method: "Where it is possible to locate comparable uncontrolled transactions, the CUP Method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP Method is preferable over all other methods."⁴⁰ The 1995 Guidelines also establish a clear preference for the traditional transaction methods (CUP, cost plus and resale price) over transactional profit methods (transactional net margin method and profit split), and these latter methods are considered appropriate only in cases of last resort. Thus, the methods do not all have equal standing. Still, like the 1979 Report, the revised Guidelines do not set up a rigid hierarchy of methods that would force a taxpayer, for example, to disprove the application of one method before using another. The approach of the revised Guidelines is to have an order of preference based on "higher degrees of comparability and a more direct and closer relationship to the transaction."⁴¹ The Guidelines specifically instruct that "[n]o one method is suitable in every possible situation and the applicability of any particular method need not be disproved."⁴²

The Guidelines further provide: "[T]his Report does not require either the tax examiner or taxpayer to perform analyses under more than one method."⁴³ The revised Guidelines also recognise there will be difficult cases where "no one approach is conclusive", and in such circumstances "an attempt should be made to reach a conclusion consistent with the arm's length principle that is satisfactory from a practical viewpoint to all the parties involved, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration."⁴⁴

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38. 1979 Report paragraph 46 at page 33.
 39. 1979 Report paragraph 46 at 33-34.
 40. 1995 Guidelines paragraph 2.7 at page II-3.
 41. 1995 Guidelines paragraph 1.70 at page I-28.
 42. 1995 Guidelines paragraph 1.68 at page I-27.
 43. 1995 Guidelines paragraph 1.69 at page I-27.
 44. *Id.*

i. Traditional transaction methods

i) The comparable uncontrolled price (CUP) method

The CUP method continues to be preferred among transfer pricing methods as the most theoretically pure application of the arm's length principle, and so, as indicated above, it continues to be the preferred method. However, there was an often-heard complaint during the revision process (coming from the business community and tax administrations alike) that in practice the CUP method was becoming obsolete for all but the simplest cases, an historical vestige, because the standard of comparability was too rigid. The standard should not be so rigidly defined as to prevent reasonable application of the CUP method. This concern would argue in favour of a more relaxed standard of comparability for the CUP Method (and the other traditional methods). The 1995 Guidelines take a practical approach, making clear that the standard is not as rigid as has perhaps been thought in the past, but still insisting on "reasonably accurate adjustments" for any material effects of differences between the controlled and uncontrolled transactions.

Thus, the revised Guidelines provide: "The difficulties that arise in attempting to make reasonably accurate adjustments should not routinely preclude the possible application of the CUP Method. Practical considerations dictate a more flexible approach to enable the CUP Method to be used and to be supplemented as necessary by other appropriate methods, all of which should be evaluated according to their relative accuracy."⁴⁵

The revised Guidelines also adopt a general formulation of the comparability standard for determining whether "an uncontrolled transaction is comparable to an controlled transaction (i.e. it is a comparable uncontrolled transaction)".⁴⁶ The standard requires that "none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect" whatever measure is being used to determine the transfer pricing, i.e. open market price in the case of the CUP method, resale price margin or cost plus mark-up for the other two traditional methods, or net margin in the case of the TNMM.⁴⁷ This generally applicable formulation makes it clear that concern must be taken with comparability no matter what method is being used, so that, for example, comparability is an equal concern for both the CUP Method and TNMM.⁴⁸

ii) Resale price and cost plus methods

The two sections of the revised Guidelines describing the resale price and cost plus methods perhaps bear the greatest similarity to the 1979 Report of all the sections. Very little change was necessary for these two traditional methods; experience seemed to indicate that they have been operating well enough.

45. 1995 Guidelines paragraph 2.9 at page II-3.

46. 1995 Guidelines paragraph 2.7 at page II-2.

47. See 1995 Guidelines paragraphs 2.7 (CUP), 2.16 (resale price), 2.34 (cost plus).

48. This result is important in making sure comparability is not too rigidly applied for the CUP Method, as already described in the text, and also for making sure that comparability is not overlooked or treated seriously once the case is treated as "last resort". It was a principal concern of the delegates that comparability concerns be stressed for the TNMM, and a special section of the Guidelines is devoted to this topic. See paragraphs 334. - 3.40 at pages III-12 through III-14.

Only one point seemed to require substantial new attention: the treatment of operating expenses and whether the profit margins compared in these traditional methods should be net or gross. This question grew in importance when the OECD replaced its discussion of the comparable profits method with the transactional net margin method (TNMM) that allows only a transactional comparison of net profit margins in last resort cases. The question for the traditional methods centred around the cost plus method, necessitating a clarification of the extent to which operating expenses (below-the-line expenses) could be accounted for in the cost plus mark-up, and how the analysis would differ from what was being allowed (subject to more severe restrictions) in the TNMM.

The revised Guidelines deal with this issue by recognizing first that accounting consistency is important in applying any transfer pricing method. Because accounting standards and terms may vary, precluding a precise definition of operating expenses, it may be necessary in some cases to take some operating expenses into account to achieve consistency and comparability. The level and types of expenses should also be examined generally for purposes of comparability, and may suggest some adjustment for purposes of comparability.

Perhaps most importantly, the revised Guidelines set forth a clear yet flexible distinction between cost plus and a net margin approach, acknowledging that there is a spectrum, and the more operating expenses that are taken into account, the more the cost plus method "starts to approach a net rather than gross margin."⁴⁹ The conclusion of the Guidelines is perhaps best conveyed by quoting the entire relevant paragraph:

The distinction between gross and net margin analyses may be understood in the following terms. In general, the cost plus method will use margins computed after direct and indirect costs of production, while a net margin method will use margins computed after operating expenses of the enterprise as well. It must be recognised that because of the variations in practice among countries, it is difficult to draw any precise lines between the three categories described above. Thus, for example, an application of the cost plus method may in a particular case include the consideration of some expenses that might be considered operating expenses, as discussed in paragraph 2.39. Nevertheless, the problems in delineating with mathematical precision the boundaries of the three categories described above do not alter the basic practical distinction between the gross and net margin approaches.⁵⁰

The foregoing paragraph helps explain the difference between the cost plus method and the TNMM, yet at the same time shows that they both proceed from the same premise. Indeed, it would appear that some countries use a fully net cost plus analysis that had never been precisely described in the 1979 Report⁵¹ and that would probably qualify as an application of TNMM under the revised Guidelines. The

49. 1995 Guidelines paragraph 2.39 at page II-14.

50. 1995 Guidelines paragraph 2.41 at page II-14.

51. See, e.g., 1979 Report paragraph 12 at page 14 ("cost plus method starts from the cost of providing the goods or services, etc. and add[s] whatever cost and profit mark-up is appropriate") and paragraph 69 at page 42 (profit mark-up may be determined by estimating seller's "gross profit"). Both paragraphs imply (without directly stating) that the cost plus mark-up is a gross margin. Although there is room for the contrary interpretation, most tax administrations and taxpayers had interpreted the method as a gross margin method with exceptions for a few types

explanation also helps illustrate that the TNMM is not quite as new a concept as might at first glance be thought, but one that has been used by both tax administrations and taxpayers when data is not sufficiently detailed to perform a traditional cost plus or resale price analysis.

iii) Transactional profit methods

The revised Guidelines accept the two types of "transactional profit methods", namely the profit split method and the transactional net margin method, as methods of last resort. Both methods must be "transactional", that is, applied to the profit arising from the controlled transaction (or controlled transactions that are appropriate to aggregate).⁵²

Last resort status means that the transactional profit methods cannot be used when the traditional transaction methods can be reliably applied alone. However, the Guidelines make clear that even in such cases, "it would be inappropriate to automatically apply a transactional profit method without first considering the reliability of that method."⁵³

The revised Guidelines represent the first clear and unambiguous international acceptance (albeit limited) of profit methods, and at the same time provide the first articulation of a distinction between profit methods that are transactional and profit methods that are global.

The 1979 Report was more ambiguous about profit methods, and included some language that was open to diverse interpretation. For example, paragraph 13 indicates that "[t]he complexities of real life business situations" may require the application of "other methods still" than the traditional transaction methods, but those "other methods" are not clearly articulated. Paragraph 70 similarly refers to the possible use of "other reasonable approaches" to arrive at an arm's length price in cases where the CUP, cost plus, and resale price methods are not satisfactory. Methods "used in practice" are described but said to be "by no means exhaustive". Those methods include comparable profits, the profit split, and a return on capital approach. While paragraph 70 suggests that the foregoing methods may be used (but only "with care"), some of the specific language describing each of the methods could be interpreted more negatively. Thus, the 1979 Report took a somewhat indefinite position on profit methods, perhaps because at the time there was less experience with the types of cases for which these methods would be necessary.

iv) The profit split method

The revised Guidelines accept the profit split method as a method of last resort, and describe in some detail two approaches (a "contribution analysis" and a "residual analysis") for applying the method.⁵⁴ The 1979 Report was satisfied to provide a simple reference to a method that attempts "to allocate some proportion of the combined net income arising from a sales transaction to the various associated enterprises

of operating expenses. The new Guidelines offer a rational means for resolving this issue by allowing both gross margins and net margins to be used, but as the margin gets close to fully net, it is necessary to take additional precautions in determining comparability, to account for the potential effect of the company's characteristics (e.g. competitive position, management efficiency) on operating expenses.

52. 1995 Guidelines paragraphs 3.5 (profit split) and 3.26 (TNMM) at pages III-2, III-9.

53. 1995 Guidelines paragraph 3.50 at page III-17.

54. See 1995 Guidelines part c) of subsection i) of Section B, pages 3.11 through 3.25.

concerned it on the basis of their proportionate contribution to the final profit."⁵⁵ There is no analysis, but instead a somewhat confusing reference to paragraph 14 of that Report, which is concerned primarily with global formulary apportionment.

In its paragraph 14, the 1979 Report rejects global formulary apportionment (sometimes called "unitary taxation") as a method of arm's length pricing, and the revised Guidelines share fully in that conclusion. Indeed, a whole section of Chapter III of the Guidelines is devoted to a discussion of this approach and the reasons for its rejection.⁵⁶ The Guidelines differ from the 1979 Report only by avoiding the confusion between the profit split method and global formulary apportionment. The latter method operates according to a pre-determined formula; the former method determines a division of profits based upon the specific facts and circumstances of the case and not by reference to a pre-determined formula. And perhaps most importantly, the profit split method of the Guidelines is not global, as already stated. It is a transactional method and in this respect clearly distinct from the approach being described in paragraph 14 of the 1979 Report.

The 1979 Report therefore does not give full and thorough consideration to the type of profit split method described in the revised Guidelines. That method was neither rejected nor accepted explicitly in 1979; it was simply acknowledged as one of the possible alternatives "used in practice". With a degree of prescience, the 1979 Report through its reference to paragraph 14 underlines the concern over a non-transactional application of this method, thereby making the "transactional" limitation developed in 1995 seem like a completely natural and logical progression.

v) Transactional net margin method

Much of the interest in the revised Guidelines has focused on the introduction of a "new" method, the transactional net margin method. As discussed above, it is unclear how "new" the method really is, given the apparent use in practice of fully net resale price and cost plus analyses for some years. What is "new", however, is the articulation of the method by the OECD. This method is to operate in a manner similar to the cost plus and resale price methods, only looking at fully net margins rather than gross or semi-gross margins. It is subject to the same "last resort" status as the profit split method, and further it has been adorned with a specific discussion of concerns over finding transactions that are adequately comparable. Thus, while the use of the method is permitted it is also subject to several important safeguards.

The 1979 Report did not discuss this method at all (except to the extent some might find it inherent in the discussion of cost plus). The 1979 Report did address a "comparable profits" approach, but this approach was described as an overall comparison of profits, not at all what is envisioned by the TNMM. In fact, in the 1979 Report an overall comparable profits approach was not fully rejected. Paragraph 71 of the 1979 Report states that "[t]ax authorities may find some help in a comparison of an enterprise's overall performance with that of other similar enterprises in the same or similar circumstances." It concludes that such profit comparisons "could normally be regarded only as pointers to further investigation." The 1979 Report does not say whether in exceptional (i.e. last resort) cases the method could be used -- the question what should happen outside of the "normal" circumstances is not addressed.

Here is one area where there is a clear change from 1979 -- a method that compares overall levels of profits is explicitly rejected in the revised Guidelines, even in cases of last resort: "In particular, so-called 'comparable profits methods' or 'modified cost plus/resale price methods' are acceptable only to the

55. 1979 Report paragraph 72 at page 43.

56. See 1995 Guidelines Section C, pages III-19 through III-24.

extent that they are consistent with these Guidelines."⁵⁷ The TNMM allows only a comparison of net margins (not absolute profits), only on a transactional basis, and only in situations of last resort. These restrictions impose a substantial discipline upon profit comparisons that was lacking in the 1979 Report. Most importantly, the discussion removes any ambiguity that had been present about the boundaries for the use of such methods.

j. Administrative issues

Chapter IV of the revised Guidelines discusses a whole host of administrative issues that were not covered in 1979.⁵⁸ One important new section covers transfer pricing compliance practices. In this section, tax examiners "are encouraged to be flexible in their approach" and "to take into account the taxpayer's commercial judgment ... so that transfer pricing is tied to business realities. Therefore, tax examiners should undertake to begin their analyses of transfer pricing from the perspective of the method that the taxpayer has chosen in setting its prices."⁵⁹ The section also cautions that neither tax administrations nor taxpayers should misuse the burden of proof and so should "use restraint" in relying on it in the course of the examination of a transfer pricing case". Both sides should be prepared to make "a good faith showing" that the proposed transfer pricing is consistent with the arm's length principle.⁶⁰

The section on compliance practices also discusses penalty systems, again a new development not addressed in 1979. The discussion makes clear that the severity of a penalty should be balanced against the conditions upon which it is imposed, and that "the harsher the penalty the more limited the conditions in which it would apply".⁶¹ The discussion concludes as follows:

First, imposition of a sizable 'no-fault' penalty based on the mere existence of an understatement of a certain amount would be unduly harsh when it is attributable to good faith error rather than negligence or an actual intent to avoid tax. Second, it would be unfair to impose sizable penalties on taxpayers that made a reasonable effort in good faith to set the terms of their transactions with related parties in a manner consistent with the arm's length principle. In particular, it would be inappropriate to impose a transfer pricing penalty on a taxpayer for failing to consider data to which it did not have access, or for failure to apply a transfer pricing method that would have required data that was not available to the taxpayer. Tax administration are encouraged to take these observations into account in the implementation of their penalty provisions.⁶²

57. 1995 Guidelines paragraph 3.1 at page III-1.

58. One of these issues -- corresponding adjustments and the mutual agreement procedure, was addressed in part in the 1984 Report (*Transfer Pricing and Multinational Enterprises: Three Taxation Issues*).

59. 1995 Guidelines paragraph 4.9 at page IV-4.

60. 1995 Guidelines paragraph 4.16 at page IV-6.

61. 1995 Guidelines paragraph 4.27 at page IV-9.

62. 1995 Guidelines paragraph 4.28 at pages IV-9, IV-10.

Other significant developments in the chapter on administrative issues are the expression of concerns about double taxation and other difficulties raised by secondary adjustments⁶³, the rejection of safe harbours⁶⁴, and guidance (with cautions) about the use of advance transfer pricing arrangements.⁶⁵ In respect of advance transfer pricing arrangements, one important recommendation concerns the scope of APAs. The Guidelines include a strong preference that APAs be bilateral rather than unilateral, and they recommend that taxpayers and tax administrations "pay close attention to the reliability of any predictions so as to exclude unreliable predictions. In general, great care must be taken if the APA goes beyond the methodology, its application, and critical assumptions."⁶⁶

The Guidelines also indicate that the Committee on Fiscal Affairs has agreed to undertake a study of arbitration, and to supplement the Guidelines when that study is completed.⁶⁷

k. Documentation

The issue of documentation was touched upon only tangentially in the 1979 Report. The revised Guidelines devote a separate chapter (albeit a brief one) to this important topic. The main significance of the chapter is the articulation of a new standard for determining the appropriate level of documentation from a taxpayer. The Chapter acknowledges that "[t]axpayers should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm's length principle."⁶⁸ However, in determining what constitute reasonable efforts, the Chapter provides that "[t]he Taxpayer's process of considering whether transfer pricing is appropriate for tax purposes should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance."⁶⁹

The Chapter further makes clear that documents that "would not have been prepared or obtained other than for tax purposes" should be expected "only if they are indispensable for a reasonable assessment of whether the transfer pricing satisfies the arm's length principle and can be obtained or prepared by the taxpayer without a disproportionately high cost being incurred."⁷⁰ This envisions a type of cost-benefit analysis by tax administrations when asking for documents other than those kept in the ordinary course of business. The Chapter also provides non-prescriptive detail about the type of information that may be relevant to a transfer pricing inquiry.

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63. 1995 Guidelines paragraphs 4.67 through 4.77, pages IV-22 through IV-26.
 64. 1995 Guidelines paragraphs 4.94 through 4.123 at pages IV-31 through IV-40.
 65. 1995 Guidelines paragraphs 4.124 through 4.166 at pages IV-41 through IV-53.
 66. 1995 Guidelines paragraph 4.162 at page IV-52.
 67. 1995 Guidelines paragraph 4.171 at page IV-55.
 68. 1995 Guidelines paragraph 5.28 at page V-9. See also paragraph 5.3 at page V-2.
 69. 1995 Guidelines paragraph 5.4 at page V-2.
 70. 1995 Guidelines paragraph 5.7 at page V-3.

PART IV

FOLLOW-UP, MONITORING AND CONTACTS WITH NON-MEMBER COUNTRIES

a. Follow-up

Follow-up will take four forms. The first task is to complete work on the chapters on which work has already begun. In the case of the chapters on intangibles and on services text is already well advanced and comments have already been received from the business community. It is hoped that these texts can be finalised early in 1996. The chapter on cost contributions is at a more preliminary stage, although it too should be finalised in the first half of 1996.

A second area for follow-up is to provide more detailed illustrative examples of how the different methods referred to in Chapters 2 and 3 operate in practice. Work has already begun on examining how different countries would apply these methods to stylised quantitative examples. It is envisaged that these examples will be published in 1996 and should assist taxpayers in their practical application of the five acceptable methods used to apply the arm's length principle.

The third set of tasks involves examining how the general guidelines set out in the first five chapters can be applied in specific areas. At the time of writing, these special issues include the problems raised by permanent establishments, interest and loans, banking institutions, insurance companies, and global trading.

The fourth area for follow-up is to examine how the administrative procedures intended to minimise conflicts and to resolve them when they arise, as discussed in Chapters IV and V, can be improved. Some of this work will go beyond transfer pricing (eg. improving exchange of information and speeding up mutual agreement procedures), but some will be specific to transfer pricing. Some of the issues to be examined include:

- Would it be useful to establish OECD procedures for the carrying out Advance Transfer Pricing Arrangements?
- If it were felt that an OECD wide Arbitration Procedure were desirable, an issue in which the Committee has not yet taken a decision, how should this be pursued?
- What further guidance is required on documentation issues as set out in Chapter V?
- How can greater consistency be achieved between the valuation of intra-group transactions for income tax and custom duties?

b. Monitoring

The OECD has never had an explicit monitoring role in the tax area, although such a role is implicit in the Recommendations attached to the OECD Model Tax Convention. Consequently, the decision to give Working Party No.6 an explicit role of monitoring the application of the revised Guidelines should be seen as a significant step forward in developing consistent transfer pricing practices in the OECD area.

The Committee has already decided upon the broad principles which should govern the monitoring. Namely that:

- the monitoring should be carried out by the full Working Party not the Task Force;
- it should focus both on the application of existing rules as well as the consistency of new rules with the Guidelines;
- the business community should be involved in the exercise;
- part of the monitoring would take place in the context of peer reviews
- monitoring would cover the use of APAs;
- in view of the controversy over profit methods particular attention would be paid to the use of such methods and the frequency with which tax administrations have recourse to them.

Over the coming months decisions will be taken on how in practice these principles will be applied.

c. Deepening contacts with non-Member countries

i) Background

MNEs play a major role in the economies of major non-Member countries. An increasing number of these countries (eg. Korea, Chinese Taipei, Indonesia, Argentina, Brazil, Russia, Israel) have their own MNEs with extensive operations in both OECD countries and other non-Member countries. The tax administrations in these countries have an interest in the way in which these MNEs determine their transfer pricing and, in turn, MNEs have an interest in the criteria used by these tax administrations to assess the acceptability of transfer prices for tax purposes.

The majority of non-Member countries currently have no specific legislation dealing with transfer pricing. A number of reasons have been put forward for this:

- The desire to attract foreign investment overcomes any concerns that MNE may manipulate transfer prices to shift profit abroad;
- The continual existence of exchange controls and controls on inward and outward investment in many non-Member countries may have been sufficient to prevent profit shifting;
- The rates of corporate income taxes in these countries were generally lower than that found in the "home" countries (usually in the OECD area) of the MNE and therefore there was no incentive to shift profits out of these countries by manipulating transfer pricing (although the existence of exchange controls could provide a non tax incentive for such manipulation)
- The tax administrations in some (but certainly not all) of these countries may lack the resources and expertise to challenge the claims of MNEs
- In the case of primary products the transfer prices were relatively easily verified since for many of these products there were global markets with well-defined comparable prices.

This situation is now changing. Non-tax barriers to inward and outward investment are being removed. Major market players are emerging from the former Soviet Union. As OECD countries have cut their schedule rates of corporate income tax (although effective rates have not always fallen since rate reductions have been accompanied by base broadening) the relative rates of corporate income taxes in non-Member countries may now appear high.

At the same time the range and sophistication of tax havens, particularly in the Asian and Latin American regions, have increased. Tax administrations in many non-Member countries have become more sophisticated and the extensive discussions of transfer pricing issues in major OECD countries has helped to increase the awareness of transfer pricing issues.

It is in this changing environment that a number of major non-Member countries (eg. Brazil) have begun to develop legislation relating to transfer pricing.

ii) The Response of OECD to date

The response of the Committee on Fiscal Affairs to these developments has to be seen in the context of OECD's changing attitude towards non-Member countries generally. Over the last five years the Organisation has deepened its contact with non-Member countries.

In 1989 the OECD initiated a dialogue with the Dynamic Asian Economies (Chinese Taipei, Hong Kong, Malaysia, Singapore, South Korea and Thailand). These Asian countries are some of the fastest growing economies in the world and many of them are already major trading partners of the OECD countries. They share with OECD countries a strong commitment to the multilateral trading and investment system. The dialogue is an opportunity to build mutual confidence.

In 1993 this dialogue was extended to four Latin American countries (Argentina, Brazil, Chile and Mexico) in recognition of their growing economic links with OECD countries. The group of 9 countries (Mexico being now a full Member of the Organization) is collectively referred to as the Dynamic Non-Member Economies (DNME's). The dialogue has stimulated a discussion on a wide range of topics, including trade, financial markets, investment, competition, privatisation, macro-economic policy, labour markets, environment and taxation.

The next step in the "opening-up" of the OECD to non-Member countries was the creation in 1990 of the OECD's Centre for Cooperation with European Economies in Transition. The Centre was intended to provide assistance to the Eastern European countries (Albania, Bulgaria, Czechoslovakia, Hungary, Poland and Romania) in their move towards a market economy based on the wide experience of the OECD Member countries in the operation of market economies from which these countries could benefit. In 1992 this programme was extended to the former Soviet Union Republics and Mongolia (to reflect this extension the Centre name was changed to Centre for Co-operation with Economies in Transition : CCET), with particular emphasis being placed on Russia. Further extension to other countries moving towards a market economy, such as Vietnam, is underway in 1995.

In 1993, the OECD Ministerial meeting recognised that other non-Member economies, such as China, are becoming increasingly important players in the world economy and their further integration into the multilateral trading systems should be fostered. It invited the OECD to consider broadening its knowledge and understanding of these economies. These interests were further emphasised at the 1994 Ministerial. Ministers agreed that given the rapid development of a market economy in China, the Organisation should develop a better understanding of that country and explore possibilities for a dialogue and co-operation where mutual interests exist. As a result, China, India and Indonesia have been invited to attend some workshops of the OECD/DNME Policy Dialogue in 1995. One of the conclusions of the

High-Level Meeting with the Dynamic Non-Member Economies held in Tokyo in October 1994 was that the dialogue "would seek to involve the DNMEs more closely in OECD's work by, for example, familiarising the DNMEs with OECD's binding and non-binding instruments, and working towards the joint elaboration of non-binding policy Guidelines, where appropriate". The success of the dialogue with the DNMEs led Ministers to ask the Organisation to remain attentive to all possibilities for intensifying relations with regional groupings. They also encouraged the Organisation to continue its study of economic and other linkages with major developing countries (other than the DNMEs). At the May 1995 Ministerial considerable prominence was given to extending the outreach activities of the OECD as can be seen from the extracts from the Ministerial Communiqué referred to in paragraph 1 above.

This "opening up" of the OECD has been reflected in the contacts between the Committee on Fiscal Affairs and non-Member countries. Thus:

- (i) In 1990 the Committee organised, in co-operation with the IMF, a conference on "Taxation and International Capital Flows". This was attended by 21 non-Member countries including a number of Asian-Pacific countries (eg. Singapore, Hong Kong, Korea, Chinese Taipei, Thailand, Malaysia) and focused on four sets of issues: recent Tax Reforms; the Impact of Reforms on International Capital Flows; Tax Treaties and Investment Flows; Tax Obstacles and Incentives to Inward Investment in non-Member Countries.
- (ii) In November 1991 the CCET, in co-operation with the Committee, launched a major programme of assistance and training for the Economies in Transition. In that context, the Working Parties of the Committee have held regular meetings with the Economies in Transition, and the Committee itself has had a series of high-level meetings with representatives from these countries. This policy dialogue and networking function has been particularly active in the area of tax treaties and the tax treatment of foreign direct investment. Many Delegates have also participated actively in the OECD tax network which now has centres in Ankara, Budapest, Copenhagen and Vienna and in the Steering Group on Taxation.
- (iii) In the context of the dialogue with the DNME's, the Committee organised in conjunction with Australia a Workshop on "Taxation and Investment Flows" (November 1992) and in April 1994 a second Workshop was organised in Seoul on Transfer Pricing issues. Both Workshops were very well attended and provided an informal forum in which contacts with the DNME's were intensified. A third workshop on "Tax Treaties: Linkages with non-Member and Member countries" took place in Mexico in October 1995 and included as observers a number of Latin American countries which have not so far participated in the Dialogue. Increasingly the participants at these Workshops are senior government officials.
- (iv) The Secretariat in cooperation with Member countries has carried out a number of regional tax policy seminars. In November 1995, the seminar on international taxation was organised in cooperation with Japan in Tokyo for 25 non-Member countries. In May 1995 a seminar on tax treaties was carried out in cooperation with Mexico for 10 Central and Latin American countries.

At the outset of the revision of the 1979 Transfer Pricing Guidelines a decision was taken that non-Member countries should be involved in this process. In April 1994 a Workshop was organised in Seoul to discuss the revision and the experience of major non-Member countries in the transfer pricing area.

d. Future co-operation

Any co-operation between Member and non-Member countries should be based upon the premise that all tax administrations have a mutual interest to avoid transfer pricing disputes, to minimise the risks that transfer pricing will be used to shift profits to low-tax jurisdictions, to avoid excessive compliance burdens on MNE and to ensure that the tax rules for transfer pricing do not distort investment patterns. These objectives will be easier to achieve if there are one set of rules accepted by all major economies.

The rules developed by the OECD could form the starting point for globally accepted transfer pricing Guidelines. This may require additions and possible amendments to the Guidelines recently issued. Amendments may be required to reflect the special situation of some non-Member countries, including:

- lack of a comprehensive tax treaty network which both limits the possibility for exchange of information and to resolve transfer pricing disputes
- lack of experience in the determination of transfer pricing
- weaker negotiating position vis à vis MNEs
- specific economic circumstances (eg. being reliant on primary products.)

The development of globally accepted Guidelines will require an intensive period of dialogue. In that context the OECD will hold a Workshop with non-Member countries in Spring 1996 and will also over the coming months organise a series of regional meetings. Contacts will also be intensified with such regional organisations as CIAT and CATA and the UN Group of Experts on Tax Matters. This dialogue will need to be two way; with OECD countries being responsive to the specific concerns of non-Member countries and those countries being prepared to draw upon the extensive experience of Member countries in the transfer pricing domain.

ANNEX I

RECOMMENDATION OF THE COUNCIL ON THE TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS

(Adopted by the Council on 13th July 1995)

I. RECOMMENDS to the Governments of Member countries:

I.1. that their tax administrations follow, when reviewing, and if necessary, adjusting transfer pricing between associated enterprises for the purposes of determining taxable income, the guidance in the Report referred to above – considering the integrity of the Report and the interaction of the different chapters – for arriving at arm's length pricing for transactions between associated enterprises;

I.2. that tax administrations should encourage taxpayers to follow these Guidelines and to that end that they give the 1995 Report publicity in their country and have it translated, where necessary, into their national language(s);

I.3. that they develop further co-operation between their tax administrations, on a bilateral or multilateral basis, in matters pertaining to transfer pricing;

II. INVITES the Governments of Member countries:

II.1. to notify the Committee on Fiscal Affairs of any modifications to the text of any laws or regulations that are relevant to the determination of transfer pricing or of the introduction of new laws or regulations.

III. INSTRUCTS the Committee on Fiscal Affairs:

III.1. to pursue its work on issues pertinent to transfer pricing and to issue 1 additions to the Guidelines referred to in the 1995 Report.

III.2. to monitor the implementation of these Guidelines in co-operation with the tax authorities of Member countries and with the participation of the business community and to amend and update (with the approval of the Council), if necessary, these Guidelines in the light of this monitoring.

III.3. to report periodically to the Council on the results of its work in these matters together with any relevant proposals for improved international co-operation.

III.4. to develop its dialogue with non-Member countries, consistently with the policy of the Organisation, with the aim of assisting them to become familiar with the Guidelines and where appropriate encourage them to associate themselves with the Guidelines.

IV. DECIDES to repeal the Recommendation on the determination of Transfer Prices between Associated enterprises issued on the 29th May 1979 (C(79)83/Final).

ANNEX II
THE COMMITTEE ON FISCAL AFFAIRS AND ITS WORKING PARTIES

Working Party No. 3
on Company Taxation
1971-1975

Working Party No. 1
on Double Taxation and
related questions
1971-

Special Sessions on
Innovative Financial
Transactions
1994-

Working Party No. 4
on Taxation of Interest
paid on International Bond
Issues
1971-1975

Working Party No. 2
on Tax Policy Analysis
and
Tax Statistics
1971-

Special Sessions on
Taxation
and Environment
1992-

Working Party No. 5
on the tax treatment of the
issue and negotiation of
securities
1971-1975

Working Party No. 6
on Taxation and
Multinational
Enterprises
1973-

Task Force on Transfer
Pricing
1993-

Working Party No. 7
on Taxation and Energy
1975-1977

Working Party No. 8
on Tax Avoidance and
Evasion
1977-

Special Sessions on
Consumption Taxes
1993-

COMMITTEE
ON
FISCAL
AFFAIRS

ANNEX III

THE NEW GUIDELINES: THE ARM'S LENGTH PRINCIPLE AND ITS APPLICATION A SUMMARY

a. The arm's length principle

i) Definition

Somewhat surprisingly, one will not find a definition of "the arm's length principle" in the 1979 Transfer Pricing Report. There is a definition of "arm's length prices" and the Report discusses whether a particular transfer price would "conform" to the arm's length principle, but there is no guidance on what this principle actually means.

The revised Guidelines are based on the definition of the arm's length principle on the wording of Article 9(1) of the OECD Model Tax Convention. Article 9(1) reads:

"Where

- i) 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
- ii) 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, and 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 that enterprise and taxed accordingly".

In applying the arm's length principle, tax administrators and taxpayers generally share the same view of this concept even if it is not articulated. But in recent years, the question has been raised whether the arm's length principle must focus only on determining prices or whether it can encompass a broader approach that examines the effect of the wider intra-relationships between associated enterprises on the conditions imposed between them in their dealings. Under such a broader approach, one could consider whether the profits earned by a member of an MNE group conformed to the arm's length principle without needing to substantiate whether the prices of the individual transactions were "arm's length prices".

The theoretical debate continues. But the revised Guidelines are based upon finding a practical resolution to this debate by determining whether the conditions imposed between associated enterprises reflect arm's length dealings. Clearly, the most direct way to do this is by examining the price of a transaction, and in the majority of cases this will be the approach used. However, there may be occasions when it will be necessary to employ other methods and look beyond the prices of transactions in order to assess whether the enterprises concerned are dealing with each other at arm's length, although even with these other methods it should be possible to work back to an appropriate price.

ii) Theoretical Basis

When independent enterprises deal with each other, the conditions of their commercial and financial relations are generally determined by market forces of supply and demand. However, where

associated enterprises deal with each other, the very fact that through the ownership of capital one enterprise may be able to exercise a significant influence over the activities of the other, and both may benefit from the sharing of knowledge and resources, may counteract the influence of market forces on their dealings. The degree to which this can happen will vary from case to case. A lot will depend upon the group's underlying motivation and philosophy, i.e. whether their relationships are defined by a high or low degree of internal competition and the extent to which the MNE group aims at a distribution of profits to its various members based on the real value of their individual contribution, or seeks to concentrate those profits at the centre. The type of business will also influence the degree to which external market forces are relevant. In particular, the degree of vertical integration will affect this. In highly integrated MNE groups, especially those sharing valuable intangible property, the division of functions can often make it difficult to find an external comparable. In addition, enterprises may be subject to government restrictions in the form of exchange or price controls, anti-dumping duties etc which can override the laws of supply and demand. Finally, the effect of market forces may be distorted because of tax considerations and in particular any efforts to reduce the overall tax burden of the MNE group.

What the arm's length principle does is to try to eliminate the effect of the above factors by treating each associated enterprise as though it were a separate entity and not as a member of a single unified business. This is the fundamental difference between the arm's length method of allocating profits earned by multi-national enterprises and the so-called "unitary" approach which will be considered in subsequent paragraphs.

iii) OECD acceptance of the arm's length principle

Since the inception of work on taxation at the OECD Member countries have endorsed the separate entity approach, not just in the field of transfer pricing but also as the fundamental basis for the allocation of taxing rights between nations. Consequently, Member countries have agreed that for tax purposes the profits of associated enterprises may be adjusted as necessary to ensure a distribution of the tax base which is consistent with the arm's length principle. This is a view shared widely outside of the OECD area.

One can identify a number of reasons why the countries have preferred the arm's length principle to other methods. Firstly, it has been accepted that the market forces of supply and demand are the best way to allocate resources and reward effort. Secondly, the arm's length principle provides broadly equal treatment for MNE groups and independent enterprises, thereby avoiding the creation of tax advantages by the concentration of economic power in large MNE groups. Thirdly, and perhaps most important, at a practical level, the arm's length principle has been successfully applied in the majority of cases. For example, there are many cases involving the purchase and sale of commodities and the lending of money where an arm's length price can readily be found.

iv) Criticisms of the arm's length principle

The major theoretical criticism of the arm's length principle is that it is inherently flawed because it adopts the separate entity approach. Consequently, the arm's length principle cannot account - at least comprehensively - for the economies of scale or other benefits of integration that accrue to integrated businesses. Another objection is that the arm's length principle cannot cope in situations where associated enterprises engage in transactions that independent enterprises would simply not undertake. Such transactions can be motivated by tax avoidance, but many occur as a consequence of the commercial differences between MNE groups and independent enterprises. In such circumstances, the arm's length principle is difficult to apply because there is no direct evidence of what conditions would have been established between independent enterprises.

A related problem is that because the arm's length principle requires taxpayers and tax administrators to evaluate the transactions and business activities of independent enterprises, this can require access to information which may be extremely difficult to obtain, even if it does exist. Often this information is confidential to the particular taxpayer and cannot be disclosed to others without revealing business secrets.

v) Reaffirming the international consensus

Over the years there has been much discussion of the advantages and disadvantages of using the arm's length principle. Indeed, the problems with its application in increasingly complex situations, which reflect the technological progress of the last two decades and the globalisation of the world economy, are to a considerable extent the reason for the revision of the 1979 Report. However, these problems do not present any convincing reason to abandon the arm's length principle and to switch to an alternative method of allocating profits.

The arm's length principle is sound in theory because it adopts as a benchmark the normal operation of external market forces. Moreover, applying the arm's length principle has in general been remarkably successful over the years. The strong consensus on this point has laid the foundation for much of the growth and development of international trade and investment over the years. As such, it is extremely unlikely that the member countries of OECD would want to adopt an alternative approach - even if such an alternative might resolve some of the difficulties in applying the arm's length principle. Consequently, the revised Guidelines reaffirm the international consensus on the arm's length principle.

vi) Contrast with the unitary approach

The only widely discussed theoretical alternative to the arm's length principle is a unitary approach. Emphasis is placed on the "theoretical" since this method has never been applied as between nations, but only in a number of sub-national jurisdictions. And even in these cases, international disapproval of this method has generally resulted in such authorities restricting the application of the method so as to exclude the results of "foreign" Members of the MNE group from its scope.

The unitary approach is in fundamental contradiction to the separate entity approach. It starts from the premise that because of the economies of scale and benefits of integration achieved by an MNE group, the allocation of profits can only be considered on a consolidated basis. Therefore, rather than looking for comparable independent enterprises or transactions, the unitary approach begins by determining the scope of the "unitary business" which may or may not include all of the activities of an MNE group. It then ascertains the global profit of the unitary business and using a predetermined formula, usually based on some proportion of turnover, payroll and assets, allocates the global profit to the various entities. Normally, the same formula is applied regardless of the nature of the business concerned.

The Member countries of OECD and the vast majority of non-Member countries have not considered the unitary approach to be a realistic alternative to the arm's length principle in the allocation of profits between nations. A major concern is that a predetermined formula is arbitrary and disregards market conditions, the particular circumstances of the individual members of the MNE group, and management's own allocation of resources. It is therefore quite likely to produce an allocation of profits that bears no relationship to the specific facts and circumstances of the case. This method could assign profits to an entity that on an arm's length basis has incurred a loss.

Difficulties also arise in the valuation of assets, especially in the valuation of intangible property. As yet, no solution has been found to address this problem. In addition, difficulties can arise in determining where a sale actually takes place and the solutions adopted may be quite different from that

based on the normal allocation of taxing rights. Adoption of a unitary approach is likely to conflict with many of the rules contained in existing bilateral tax treaties.

However, perhaps the most significant concern with the unitary approach would be the difficulty of implementing this in a way in that would protect against double taxation and ensure single taxation of profits. This would require substantial international consensus on the formula to be used and on the composition of the unitary business. It is doubtful whether such consensus could be achieved without a very significant reduction in fiscal sovereignty since without a supranational body each country would want to weight the factors in the formula to its best advantage. The transition to a unitary approach would therefore present a change of enormous political and administrative complexity. And unless the move was total, MNEs would be faced with the equally enormous burden of complying with two different systems for the allocation of profits. This would inevitably run the risk of producing double taxation in every case.

It is not only the member countries of OECD who have rejected the unitary approach - the business community also oppose it. This was evidenced most recently in the comments from the BIAC on revised Guidelines. These comments made it clear that the unitary approach may in fact present intolerable compliance costs and information requirements because information has to be gathered about the entire unitary business and presented in each jurisdiction in accordance with the accounting and tax rules of that particular jurisdiction. The view of business is that the documentation and compliance requirements under a unitary approach would be more burdensome than under the separate entity approach. An MNE group would be required, in any event, to maintain separate accounting records for entities that were not part of the unitary business. Moreover, other commercial and accountancy rules would still require the use of arm's length prices, for example customs rules, so that in many instances, an MNE group would have to still retain its records in accordance with the arm's length principle.

It is also fallacious to assume that the opportunities for profit shifting under a unitary approach are any different from under the separate entity approach. The motivation remains the same: to shift profits into lower tax regimes. The mechanisms may differ, with MNE under a unitary approach attempting to manipulate the factors that make up the profit allocation formulae (or even the definition of what constitutes a unitary business). There is also no reason to believe that the powers available to tax administration under these systems would differ, although if Unitary and Separate Entity approaches were operated in parallel control would be more difficult.

None of these criticisms have been adequately answered by the advocates of Unitary Taxation and no detailed proposals have ever been put forward on how one could achieve an orderly transition from the present system to a globally acceptable unitary system. This at least for the foreseeable future (and in particular, as long as countries are not prepared to give up their fiscal sovereignty in the income tax area) the arm's length principle will continue to be used.

b. Application of the arm's length principle

i) General approach

The application of the arm's length principle using the definition provided in Article 9(1) invites us to compare the conditions made or imposed between two associated enterprises in their commercial or financial relations with those which would have been made between independent enterprises. Traditionally, this comparison has centred upon the conditions made or imposed between the two associated enterprises in the transactions between them, and has compared this with the conditions which would have been made or imposed in the transactions between independent enterprises.

Over the years three main methods have evolved which compare the conditions in a controlled transaction to the conditions which would have been made or imposed in transactions between independent enterprises. The comparable uncontrolled price method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price which could have been obtained if the parties were independent. Similarly, the resale price and cost plus methods compare the gross profit margin earned in the controlled transaction to gross profit margins earned in similarly uncontrolled transactions in order to estimate the gross profit margin which could have been earned had the parties been independent.

There will be few cases where there are no differences between the controlled and uncontrolled transactions or between the associated and independent enterprises undertaking those transactions. Normally there will be differences, but sometimes these differences will not have a material effect on either the price or the gross margin. Even if these do have a material effect, such differences can often be accounted for by reasonably accurate adjustments. In all these situations the Committee has agreed that there is comparability between the controlled and uncontrolled transactions or the associated or independent persons concerned.

The 1979 Report considers comparability in the context of each of the three methods referred to above, but does not set out any general standard against which the application of the different methods in any particular case could be evaluated. The 1979 Report is lacking in this respect, which is why the revised Guidelines includes a separate section on comparability. It is only by setting out such a general standard that the reliability of any method to arrive at result which accords with the arm's length principle can be tested. The reliability of a method will depend upon the degree of comparability that can be achieved using that method with those particular facts and circumstances.

ii) Factors determining comparability

The extent to which each of the factors discussed below influences the degree of comparability will depend upon the nature of the controlled transaction and the pricing method adopted. The relevance of these factors in the application of the three transactional-based methods is discussed below.

It almost goes without saying that differences in the specific characteristics of the goods or services transferred often account for the major part of any difference in their value in the open market. Differences in the physical characteristics of products, their quality and reliability and their availability all need to be taken into account as do the nature and extent of any services provided. In the case of intangible property, the form of the transaction (licensing or sale) the type of property involved (patent, trade mark etc) and the anticipated benefits from the use of the property will all be relevant.

As well as comparing the characteristics of the goods or services transferred, it will normally be important to compare the activities and responsibilities undertaken by the associated and independent enterprises. This is done by analysing the functions undertaken by each party, the assets that are employed in carrying out the functions performed by each party and the risks assumed by each party. In addition, any comparability standard must take into account the contractual terms of a transaction as these generally define how the responsibilities, risks and benefits are to be divided between the parties. Such a consideration of the contractual terms is usually a part of a functional analysis.

A comparability standard should also take into account the business strategy of the enterprises concerned. This aspect was covered in the 1979 Report (see for example paragraph 43 which deals with "start up" or "market penetration" prices) but more emphasis is given to this issue in the revised Guidelines because of the importance it has assumed in transfer pricing. As a result, the revised Guidelines highlight a number of factors to be considered when evaluating a taxpayer's claim that it is following a business strategy that results in reduced profits over the short term in return for higher profits in the long run. One

consideration is whether there is a plausible expectation that adherence to the chosen business strategy will indeed produce an acceptable return with a reasonable period of time. In determining what would constitute a reasonable period of time, tax authorities may wish to consider the commercial strategies evident in the country in which the associated enterprise pursuing this strategy is located as an indication of the behaviour which could reasonably have been expected if that party had indeed been independent.

iii) Recognition of the actual transactions

The 1979 Report covered this point in just one paragraph and stated that, except in exceptional cases, it was inappropriate to disregard the actual transaction undertaken or to substitute another transaction for it. (See paragraph 23.) Given developments in transfer pricing case law since 1979 - the so-called "make or buy" argument which surfaced in the Bausch and Lomb case for instance - this subject is given deeper analysis in the revised Guidelines.

This proved one of the more difficult parts of the Guidelines to draft. As in 1979, restructuring controlled transactions is generally inappropriate, unless there is a lack of economic substance to the transaction and it has been structured deliberately in that way to avoid or minimise tax. An example of this type of transaction would be the case of thin capitalisation where an investment in an associated enterprise is structured as an interest bearing loan whereas at arm's length the investment, having regard to the economic circumstances of the enterprise, would have been made by way of an injection of capital rather than through the use of debt.

However, there may be a difference between disapproving generally of the restructuring of the controlled transactions and using different transactions undertaken between independent enterprises to help determine whether the transfer price of a controlled transaction (as structured) would satisfy the arm's length principle. For example, take the case where in all similar transactions between independent enterprises, the allocation of risk (eg currency risk) was different from the existing allocation in the case of the associated enterprise. The fact that no independent enterprise had allocated risk in that way could be a reason to scrutinise the economic substance of that transaction if it was felt that this had been done so in such a way to avoid tax. Normally, this would not be the case and it may well be that the uncontrolled transactions with their alternative allocation of risk could provide a comparable uncontrolled price, if sufficiently accurate adjustments could be made to reflect this difference.

iv) Other aspects: ranges, multiple year data and use of multiple methods

Chapter 1 of the 1979 Report deals with a number of other aspects to be taken into consideration in applying the arm's length principle. Most of these are just as valid today as they were in 1979 and are taken up in the revised Guidelines without much change. However, the Guidelines does expand the discussion on some of these points (for example losses and the effect of government regulations on the arm's length principle) and introduces two new key factors that can be crucial to a correct application of the arm's length principle. These concern the use of an arm's length range and the use of multiple year data.

On many occasions the application of the most reliable method or methods will inevitably produce a range of figures. This may be simply because more than one transfer price can satisfy the arm's length principle for a particular transaction. Independent enterprises engaged in comparable transactions under comparable circumstances may not always establish the exact same price for the transaction yet each price will necessarily be at arm's length. Another possibility is that even the method may result in a range because the application of the arm's length principle in a particular case can only produce an approximation of the conditions that would have been established between independent enterprises. A range of figures

could also result when more than one method is being used and produces a different outcome or indeed its own range of outcomes.

If the price of the controlled transaction falls outside the range, it would normally be appropriate to make an adjustment to a point inside the range. There was considerable debate as to what the appropriate point would be, because any point in the range could be said to satisfy the arm's length principle. The solution adopted in the Revised Guidelines is the following:

"1.48 If the relevant conditions of the controlled transactions (e.g. price or margin) are within the arm's length range, no adjustment should be made. If the relevant conditions of the controlled transactions (e.g. price or margin) fall outside the arm's length range asserted by the tax administration, the taxpayer should have the opportunity to present arguments that the conditions of the transaction satisfy the arm's length principle, and that the arm's length range includes their results. If the taxpayer is unable to establish this fact, the tax administration must determine how to adjust the conditions of the controlled transaction taking into account the arm's length range. It could be argued that any point in the range nevertheless satisfies the arm's length principle. In general, and to the extent that it is possible to distinguish among the various points within the range, such adjustments should be made to the point within the range that best reflects the facts and circumstances of the particular controlled transaction."

There are a number of possibilities, including making adjustments to the point in the range which best reflects the facts and circumstances of the controlled transaction.

The 1979 Report considers the problem of sustained losses in paragraph 28. This recognises that in an arm's length situation losses may last for a relatively long period in the anticipation of future compensating profits. The revised Guidelines acknowledge that this multi-year approach could be applied more widely and would give a better and more complete understanding of the facts and circumstances surrounding a controlled transaction. In general, therefore, it can be useful to examine data from both the year concerned and previous years. This information may well help explain what has influenced the determination of the transfer price in question. It will also show whether different economic conditions in an earlier year had a material effect on the price of the controlled transaction. Moreover, differences in business or product life cycles can have a material effect on price that has to be assessed in determining comparability. Such an approach can be particularly helpful if a transaction profits method is applied. However, using data from years following the year of the transaction should be undertaken with care in order to avoid the use of hindsight.

The 1979 Report provides little guidance on the desirability of using more than one method. The revised Guidelines note that the arm's length principle does not require the application of more than one method, and in fact undue reliance on such an approach could create a significant burden for taxpayers. Thus, the Guidelines do not require either the tax examiner or taxpayer to perform analyses under more than one method. While in some cases the choice of a method may not be straightforward and more than one method may be initially considered, generally it will be possible to select one method that is apt to provide the best estimation of an arm's length price. However, for difficult cases, where no one approach is conclusive, a flexible approach would allow the evidence of various methods to be used in conjunction. In such cases, an attempt should be made to reach a conclusion consistent with the arm's length principle that is satisfactory from a practical viewpoint to all the parties involved, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration.

As regards the choice as between traditional methods, it is not possible to provide specific rules that will cover every case. In general, the Guidelines recommend that parties should attempt to reach a reasonable accommodation keeping in mind the imprecision of the various methods and the preference for higher degrees of comparability and a more direct and closer relationship to the transaction. It should not be the case that useful information, such as might be drawn from uncontrolled transactions that are not identical to the controlled transactions, should be dismissed simply because some rigid standard of comparability is not fully met. Similarly, evidence from enterprises engaged in controlled transactions with associated enterprises may be useful in understanding the transaction under review or as a pointer to further investigation. Further, any method should be permitted where its application is agreeable to the members of the MNE group involved with the transaction or transactions to which the methodology applies and also to the tax administrations in the jurisdictions of all those members.

c. Reaffirming a preference for traditional transaction-based methods

i) General

The description of and comments on the three traditional transaction-based methods in the revised Guidelines follow very closely the remarks made in the 1979 Report. As stated above, in the majority of cases tax administrations and taxpayers are looking at specific transactions and they will be able to apply a transaction-based method, particularly if the standard of comparability is not applied too rigidly. Any adjustment will naturally involve some element of subjectivity, but can still be possible to make adjustments and produce reliable results.

The revised Guidelines made it clear that there remains an overwhelming preference in favour of these methods. The reason for this is that these methods provide a more direct way of establishing whether the conditions made or imposed between the associated enterprises in their commercial or financial relations differ from those which would have been made between independent ones, because in the majority of cases, those relations will be primarily based on transactions. In many of these cases, the differences between controlled and uncontrolled transactions are identifiable and can be taken into account with reasonably accurate adjustments.

On the other hand, the use of transactional based profit methods requires a high degree of comparability in relation to the characteristics of the associated and the independent enterprises. For example, adjustments may need to be made to take into account factors such as differences in business strategies, the efficiency of management, the competitive position etc. Accounting for these differences is often far more difficult than making the kind of adjustments required in using the transaction based methods. This is why, whilst there are cases where traditional transaction-based methods cannot be applied alone, generally, the use of profit methods is not to be encouraged.

ii) The comparable uncontrolled price method

As the 1979 Report makes clear, this method offers the most direct way of determining an arm's length price. This method compares the price in a controlled transaction to the price charged in a comparable uncontrolled transaction between independent enterprises. Any difference between the two prices may lead to the conclusion that the associated enterprises are not operating at arm's length and the price in the uncontrolled transaction may be substituted for the price in the controlled one.

The comparable uncontrolled price method proves to be a highly reliable method if a comparable uncontrolled transaction exists and either there are no differences between the transactions being compared or where such differences exist, reasonably accurate adjustments can be made to eliminate their effect.

However, whilst this method may be preferable to all other methods, it can often be difficult to find an uncontrolled transaction that is sufficiently similar such that the differences have no material effect on price. In many respects, this method is far more sensitive to differences in price than other methods, such as the cost plus and the resale price methods. A minor difference in the nature of the goods which are the subject of the controlled and uncontrolled transactions can have a material effect on price, even though the goods may be sufficiently similar that the transactions produce the same overall gross profit margin. Another problem is that it may also be difficult to determine reasonably accurate adjustments to eliminate the effect on price of differences between the controlled and uncontrolled transactions. However, it is particularly important that the need to make accurate adjustments is not interpreted too strictly. Consequently, the revised Guidelines recommend a flexible approach in this particular area so that the comparable uncontrolled price method can be used if at all possible, even if it needs to be supplemented by other methods.

iii) Resale price and cost plus methods

The resale price method begins with the price at which a good that has been bought from associated enterprise is resold to an independent one. The price is then reduced by an appropriate mark-up known as the "resale price margin" which will represent what the reseller needs to cover his costs and to make an appropriate profit on the transaction. By subtracting this mark-up from the final price we can work back towards the arm's length price of the original sale within the MNE group.

The cost plus method estimates an arm's length price by adding an appropriate mark-up to the costs incurred by an associated enterprise which is providing goods or services to another member of the MNE group. The result should be an arm's length price for the transaction. As in the case of the resale price method, determining an appropriate mark-up can be problematic. However, the cost plus method is also less satisfactory because it is often difficult to determine the relevant costs and, furthermore, the extent to which costs are determinative of gross profits is somewhat debatable.

Both the resale price and cost plus methods can be highly reliable ways of applying the arm's length principle. An uncontrolled transaction will be comparable to a controlled one if there are either no differences between the transactions being compared, or between the enterprises undertaking those transactions, that materially affect the gross margin, or where such differences do exist, reasonably accurate adjustments can be made to eliminate their effect. In making comparisons in respect of both these methods, fewer adjustments are usually needed to account for differences in the nature of the goods (or services) than under the comparable uncontrolled price. This is because differences in the nature of the goods are less likely to have a material affect on gross profits margins, which are usually more influenced by the nature of the functions performed and the risks assumed by the parties concerned.

In summary, traditional transaction-based methods are preferable because they provide the best means of establishing whether the arm's length principle as expressed in Article 9 is being observed. The 1979 Report recognised that there would be occasions when such methods would not in themselves be reliable because of the difficulty in finding suitable comparable transactions and in making sufficiently accurate adjustments to account for differences. The 1979 Report suggested that in these circumstances a mixture of these methods or other methods still might have to be used. Beyond that, the 1979 Report gives very little guidance except to say that the object of using a mixture of methods or other methods altogether should be to arrive at a figure which is acceptable for practical purposes. Whilst the OECD endorses the essentially practical nature of transfer pricing, events have moved on since 1979, and consequently the revised Guidelines devotes a considerable amount of our space to the consideration of other methods and whether these might produce a figure that is acceptable for practical purposes.

d. Other acceptable methods

This section provides a discussion of other approaches that might be used to approximate arm's length conditions when traditional transaction methods cannot be reliably applied alone or exceptionally cannot be applied at all. The other approaches are referred to as "transactional profit methods," i.e. methods that examine the profits that arise from particular transactions among associated enterprises. The only profit methods that satisfy the arm's length principle are those that are consistent with the profit split method or the transactional net margin method as described in the revised Guidelines. In particular, so-called "comparable profits methods" or "modified cost plus/resale price methods" are acceptable only to the extent that they are consistent with the Guidelines.

i) Why other methods might be necessary

Other methods become relevant when there are no comparable transactions available to apply traditional transaction-based methods reliably. This point is best explained in the context of the definition of the term "comparable", which is set forth above and repeated for purposes of convenience here. A transaction among independent enterprises is comparable to a transaction among associated enterprises provided that (1) there are no differences between the controlled and uncontrolled transactions themselves or between the associated and independent enterprises undertaking the transactions; (2) there are such differences but those differences do not have a material effect on the measure being used (e.g., prices or gross margins) to determine whether the conditions of the controlled transactions reflect arm's length dealings; or (3) there are differences that have such a material effect, but the differences can be accounted for through reasonably accurate adjustments.

As stated above, this standard for comparability is not intended to be applied too rigidly, because perfectly comparable transactions are more the exception than the rule, and adjustments naturally involve some degree of approximation and imprecision. Consequently, even when controlled and uncontrolled transactions are not comparable within the strict meaning of the definition given above, a transaction-based method might still be used, depending upon the degree of comparability, i.e., the degree of reliability of any adjustments that can be made, and the degree of the material effect of any differences.

Even with this flexible approach, there will be cases where the degree of comparability that can be achieved with a traditional transaction-based method will not be considered satisfactory. It may not be possible to achieve a satisfactory degree of comparability because there are many aspects of a transaction that can have a material effect on prices and gross margins. A tax authority or taxpayer may feel that there are too many material differences between the controlled and uncontrolled transactions, and that adjustments cannot be made with sufficient accuracy, to justify relying on a transaction-based method alone, or perhaps at all, in a particular case. These cases are considered cases of last resort on the revised Guidelines.

ii) The general nature of other methods

Other methods have evolved in response to the constraints in applying the transaction-based methods. The goal has been to seek measures or indicators of arm's length dealings that are less adversely affected than the transaction-based methods are to differences between controlled and uncontrolled transactions. This search has led to other methods that focus on net profitability. Since it is clear that net profits are more directly influenced by the characteristics of the enterprises and the functions being performed, the assets used, and the risks assumed in the transactions than the nature of the transaction. This means that profit methods are not as directly connected to the conditions of the controlled transactions as are the traditional transaction-based methods, and so are not preferred. However, because they depend less on transactional similarity, profits methods have been used in difficult and complex cases.

The use of profit methods, even in complex cases of last resort, has proven to be extremely controversial. Tax authorities and taxpayers alike have expressed serious concerns about profit methods and in particular about whether they are consistent with the arm's length principle as articulated in Article 9 of the OECD Model Convention. One of the most difficult tasks of the OECD has been to articulate and to understand fully the basis for these concerns: an issue extensively discussed by both Working Party No. 6 and Working Party No.1 on the Model Tax Convention. In general, the concerns are that profit methods will be applied in a manner that is too distant from the actual controlled transactions at issue, and without adequate reference to external data from independent enterprises with an acceptable degree of comparability. Both these aspects – a strong connection to the controlled transactions and a reliance on third party data with adequate comparability – are integral to the arm's length principle.

The OECD therefore has been faced with the challenge of reconciling these concerns about satisfying the arm's length principle with the reality that traditional transaction-based methods sometimes cannot be reliably applied alone, or perhaps at all. It was recognized that without an agreement on the use of profit methods, there would be continuous disputes about transfer pricing cases by Member countries with each other and with non-Member countries as well, and there would be a high likelihood that taxpayers would be subjected to economic double taxation. Thus, resolving the issue of profit methods has become central to the work of the OECD in this area. The approach has been to examine and discuss profit methods in detail, both as a general matter and in terms of the specific aspects presented by each of the two methods that have emerged.

In its general consideration of profit methods, the revised Guidelines acknowledge that it would be necessary to take precautionary steps to prevent the overly broad use of net profits as an indicator of whether the conditions of controlled transactions reflect arm's length dealings. The most straightforward example is the case where the net profits being examined include income and/or expenses from parts of the business not involving the controlled transactions (e.g., where a tax authority seeks to determine a division of the combined profit of the entire business). A tax authority or taxpayer might be tempted to rely on an over inclusive figure for net profits because of difficulty in determining the net profits from the controlled transactions separately from the net profits from other parts of the business.

When the net profits being used to apply a profit method extend beyond the controlled transactions, there is a natural question whether the result of the method will be consistent with the arm's length principle. The arm's length principle involves establishing whether the conditions of controlled transactions reflect arm's length dealings. Profit experience must be a relevant indicator of the arm's length nature of those conditions if it is to be used to apply this principle. However, profit experience that goes beyond the controlled transactions will necessarily be influenced by factors unrelated to the conditions of those transactions and so may not be wholly reliable as an indicator of whether those conditions are arm's length.

This example is just one instance of the concern about an overly broad application of profit methods, and it helps illustrate why the revised Guidelines accept only the use of profit methods which are tied to a particular transaction or a small group of highly selected transactions.

iii) Two Acceptable transactional based profit methods

A transactional profit method examines the profits that arise from particular controlled transactions. The transactional profit methods for purposes of the revised Guidelines are the profit split method and the transactional net margin method. It is unusual to find enterprises entering into transactions in which profit is a condition "made or imposed" in the transactions. In fact, enterprises rarely if ever use a transactional profit method to establish their prices. Nonetheless, profit arising from a controlled transaction can be a relevant indicator of whether the transaction was affected by conditions that differ from

those that would have been made by independent enterprises in otherwise comparable circumstances. Thus, in those exceptional cases in which the complexities of real life business put practical difficulties in the way of the application of the traditional transaction methods and provided all the safeguards set out in the Guidelines are observed, application of the transactional profit methods (profit split and transactional net margin method) may provide an approximation of transfer pricing in a manner consistent with the arm's length principle. However, the transactional profit methods may not be applied automatically simply because there is a difficulty in obtaining data. The same factors that led to the conclusion that it was not possible to reliably apply a traditional transaction method must be reconsidered when evaluating the reliability of a transactional profit method. Rather, the reliability of a method should be assessed taking into account the principles discussed in the Guidelines, including the extent and the reliability of adjustments to the data used.

The revised Guidelines explains that methods based on profits can be accepted only insofar as they are compatible with Article 9 of the OECD Model Tax Convention, especially with regard to comparability. This is achieved by applying the methods in a manner that approximates arm's length pricing, which requires that the profits arising from particular controlled transactions be compared to the profits arising from comparable transactions between independent enterprises. The Guidelines note that in no case should transactional profit methods be used so as to result in over-taxing enterprises mainly because they make profits lower than the average, or in under-taxing enterprises that make higher than average profits.

iv) The profit split method

The profit split method identifies the combined profit of associated enterprises from the controlled transactions in which they are engaged, and splits that profit among the participants based on the relative value of the contribution that each of the enterprises expected to make to those controlled transactions. The expected contribution, rather than the actual contribution, is used in this description because taxpayers should not be penalized if their reasonable expectations are not realized. The relative value of the contributions made by the enterprises is to be determined to the extent possible by external market data. The contributions that each enterprise makes are determined based upon a functional analysis.

On the positive side, the profit split method can take into account the actual division of functions and responsibilities between the associated enterprises, and therefore can reflect any unique characteristics of those enterprises of their business. Also the method evaluates both parties to a controlled transaction, thereby helping to ensure that neither party is left with an extreme and improbable result.

On the negative side, there are several concerns. The first is derived from the importance of external market data to the arm's length principle. There is some concern that the profit split method will be applied without adequate reference to external market data. The more tenuous the nature of the external market data used in the profit split analysis, the more subjective will be the resulting allocation of profits. The second relates to data availability, a problem for all methods. In the context of the profit split method, the data availability problem may arise in seeking information from foreign affiliates necessary to carry out a thorough functional analysis, or in determining combined profit from the controlled transactions separately from the profit for other parts of the business. There may also be administrative burdens associated with stating books and records on a common basis and making adjustments to accounting practices and currencies.

The profit split method also needs to consider what the division of profits would have been had actual profits been more in keeping with the profits that could have been reasonably foreseen. Such an approach is important to prevent taxpayers from being penalized by the use of hindsight on the part of a tax authority.

If the profit split method were to be used by associated enterprises to establish transfer pricing in controlled transactions, then each associated enterprise would seek to achieve the division of profits that independent enterprises would have expected to realize in a joint venture relationship. Generally, conditions established in this manner would have to be based upon projected profits rather than actual profits, because it is not possible for the taxpayers to know what the profits of the business activity would be at the time the conditions are established.

The evaluation of the conditions of the controlled transactions of associated enterprises using a profit split method will be easiest for a tax administration where the associated enterprises have originally determined such conditions on that basis. The evaluation may then begin on the same basis to verify whether the division of actual profits is in accordance with the arm's length principle.

Where the associated enterprises have determined the conditions in their controlled transactions on a basis other than the profit split method (as will almost always be the case), the tax administration would evaluate such conditions on the basis of the actual profit experience of the enterprise. However, the revised Guidelines emphasises that care would need to be exercised to ensure that the application of a profit split method is performed in a context that is similar to what the associated enterprises would have experienced.

There are a number of approaches for estimating the division of profits, based on either projected or actual profits, as may be appropriate, that independent enterprises would have expected, two of which are discussed in the following paragraphs. These approaches – contribution analysis and residual analysis - are not necessarily exhaustive or mutually exclusive.

Under the contribution analysis, the combined operating profits, constituting the total combined profit from the controlled transactions, is divided based upon the relative value of the functions performed, assets used, and risks assumed by each of the associated enterprises participating in the controlled transactions. The relative value is determined by assigning a percentage based on a comparison of each party's contribution and external market data.

Under the residual analysis, the combined profit is divided in two stages. In the first stage, each participant is allocated sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged. Ordinarily the basic return would be determined by reference to market returns achieved in similar types of transaction. In the second stage, any residual profit or loss remaining after the first stage would be allocated among the parties based upon what independent enterprises might have done in similar circumstances. The relative value of the parties' contributions and their bargaining positions would be important to this analysis.

Other approaches are possible, for example a division of profit based upon capital employed, using the division of profits that actually has resulted from comparable transactions among independent enterprises or by examining discounted cash flow from the controlled transactions over the anticipated life of the business. There are, however, not discussed in the Guidelines.

v) The Transactional Net Margin Method (TNMM)

The transactional net margin method examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that are appropriate to aggregate under the principles set out in Chapter I of the Guidelines). Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods. This similarity means that in order to be applied reliably, the transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied. A functional analysis

of the associated enterprise and the independent enterprise is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results.

On the positive side, the TNMM relies on external measures of profitability that are less adversely affected by transactional differences than are prices or gross margins. Also the method can be simpler to apply than the profit split method because the least complex of the parties can be analysed. This approach simplifies the functional analysis that must be undertaken and also avoids the need for a common statement of books and records for all the participants involved in the controlled transactions.

On the negative side, there are several concerns. First, it is especially critical in the context of the TNMM that sufficient attention be paid to characteristics of the enterprises in determining comparability. Any application of the TNMM would have to consider a number of factors in making that determination. Another problem relates to data availability, a common problem to all the methods. In the context of the TNMM, it may be difficult to locate specific information on profit measures from the controlled transactions separate from other parts of the business, or similarly from the transactions of comparable independent enterprises. It also may be difficult for a corresponding adjustment to be determined when the TNMM is being used, although it should be possible to work back to a transfer price if the method focuses on a specific transaction.

Finally, there may be concerns about applying the comparable profits method to only one side of the transaction. A two-sided analysis would act as a strong counter-check of the comparability standard being applied and would ensure that the overall profitability of the MNE group were being taken into account. Further, where the analysis will be one-sided, the associated enterprise to which the method is applied should be the least complex of the enterprises and should not own valuable intangible property or unique assets that distinguish it from potential comparables.

There may also be serious difficulties in determining an appropriate corresponding adjustment when applying the transactional net margin method, particularly where it is not possible to work back to a transfer price. This could be the case, for example, where the taxpayer deals with associated enterprises on both the buying and the selling sides of the controlled transaction. In such a case, if the transactional net margin method indicates that the taxpayer's profit should be adjusted upwards, there may be some uncertainty about which of the associated enterprises' profits should be reduced.

The revised Guidelines note that the transactional net margin method may afford a practical solution to otherwise insoluble transfer pricing problems if it is used sensibly and with appropriate adjustments to account for differences of the type referred to above. They emphasise, however, that the transactional net margin method should not be used unless the net margins are determined from uncontrolled transactions of the same taxpayer in comparable circumstances or, where the comparable uncontrolled transactions are those of an independent enterprise, the differences between the associated enterprises and the independent enterprises that have a material effect on the net margin being used are adequately taken into account. Many countries were concerned that the safeguards established for the traditional transaction methods should not be overlooked in applying the transactional net margin method.

The revised Guidelines also indicate which considerations should influence the choice of margin used. For example, these considerations would include how well the value of assets employed in the calculations is measured (e.g. to what extent there is intangible property the value of which is not captured on the books of the enterprise), and the factors affecting whether specific costs should be passed through, marked up, or excluded entirely from the calculation.

The revised Guidelines note that an analysis under the transactional net margin method should consider only the profits of the associated enterprise that are attributable to particular controlled transactions. Therefore, it would be inappropriate to apply the transactional net margin method on a company-wide basis if the company engages in a variety of different controlled transactions that cannot be appropriately compared on an aggregate basis with those of an independent enterprise. Similarly, when analysing the transactions between the independent enterprises to the extent they are needed, profits attributable to transactions that are not similar to the controlled transactions under examination should be excluded from the comparison. Finally, when profit margins of an independent enterprise are used, the profits attributable to the transactions of the independent enterprise must not be distorted by controlled transactions of that enterprise.

The associated enterprise to which the transactional net margin method is applied should be the enterprise for which reliable data on the most closely comparable transactions can be identified. This will often entail selecting the associated enterprise that is the least complex of the enterprises involved in the controlled transaction and that does not own valuable intangible property or unique assets.

Because of the amount of discussion over the use of profit methods, it may be helpful to quote extensively from the conclusions of these methods set out at the end of Chapter III of the revised Guidelines:

"iii) Conclusions on transactional profit methods

3.49 Traditional transaction methods are to be preferred over transactional profit methods as a means of establishing whether a transfer price is at arm's length enterprises.... To date, practical experience has shown that in the majority of cases, it is possible to apply traditional transaction methods.

3.50 There are, however, cases where traditional transaction methods cannot be reliably applied alone or exceptionally cannot be applied at all. These would be considered cases of last resort. Such cases arise only where there is insufficient data on uncontrolled transactions (possibly because of uncooperative behaviour on the part of the taxpayer relative to these Guidelines), or where such data are considered unreliable, or due to the nature of the business situation. In such cases of last resort, practical considerations may suggest application of a transactional profit method either in conjunction with traditional transaction methods or on its own. However, even in a case of last resort, it would be inappropriate to automatically apply a transactional profit method without first considering the reliability of that method. The same factors that led to the conclusion that it was not possible to reliably apply a traditional transaction method must be reconsidered when evaluating the reliability of a transactional profit method.... Therefore, for the reasons set out in this Report and particularly those in paragraphs 3.52-3.57 below, as a general matter the use of transactional profit methods is discouraged.

3.51 A transactional profit method also may be used in cases where application of the method is agreed to be appropriate by the associated enterprises affected by the transactions and by the tax administrations in the jurisdictions of those associated enterprises. Transactional profit methods may also provide a useful means of identifying cases that may require further investigation.

3.52 In most countries the application of transactional profit methods has been limited to the profit split method, the use of which has not been frequent and has taken place largely in bilateral agreement procedures -- situations where the risk of unrelieved double taxation is minimal. Very few countries have much experience in the application of the transactional net margin method and

most consider it experimental and therefore prefer to use the profit split method in cases of last resort.

3.53 As discussed in this Report, there are substantial concerns regarding the use of the transactional net margin method, in particular that it may be applied without adequately taking into account the relevant differences between the associated enterprises and the independent enterprises being compared. Many countries are concerned that the safeguards established for the traditional transaction methods may be overlooked in applying the transactional net margin method. Thus, where differences in the characteristics of the enterprises being compared have a material effect on the net margins being used, it would not be appropriate to apply the transactional net margin method without making adjustments for such differences....

3.54 The recognition that the use of transactional profit methods may be necessary is not intended to suggest that independent enterprises would use these methods to set prices. Instead, transactional profit methods are being recognised as methods that assist in determining in cases of last resort whether transfer pricing complies with the arm's length principle. As with any method, it is important that it be possible to calculate appropriate corresponding adjustments when transactional profit methods are used, recognising that in certain cases corresponding adjustments may be determined on an aggregate basis consistent with the aggregation principles in Chapter I.

3.55 The present lack of experience with the application of transactional profit methods across a representative number of OECD Member countries makes it difficult to fix, with precision, all the limitations on the use of these methods that it may prove appropriate to establish. For this reason, and because of concerns with transactional profit methods more generally, the Committee on Fiscal Affairs will undertake an intensive period of monitoring the application of both traditional transaction methods and transactional profit methods over the coming years....

3.57 A tax administration that is asserting the application of a transactional profit method should be particularly conscious of its burden in demonstrating to the tax administration of the other State in any mutual agreement proceedings that such approach is being appropriately applied and achieves the best approximation of arm's length pricing in all the facts and circumstances of the case. Tax administrations also should be conscious of relevant burden of proof rules in applicable arbitration proceedings."

e. Administrative approaches to avoiding and resolving transfer pricing disputes

Chapter IV of the revised Guidelines provides an extensive examination of various administrative procedures that could be applied to minimise transfer pricing disputes and to help resolve them when they do arise between taxpayers and their tax administrations, and between different tax administrations. These were issues which for the most part were not discussed extensively in the 1979 Report, although separate reports from the CFA did deal with specific issues (eg. the 1984 Report on corresponding adjustments). Disputes may arise even though the OECD Guidelines are followed in a conscientious effort to apply the arm's length principle. It is possible, for example, that taxpayers and tax administrations may reach differing determinations of the arm's length conditions for the controlled transactions under examination given the complexity of some transfer pricing issues and the difficulties in interpreting and evaluating the circumstances of individual cases.

Where two or more tax administrations take different positions in determining arm's length conditions, double taxation may occur which is undesirable and should be eliminated whenever possible, because it constitutes a potential barrier to the development of international trade and investment flows.

The Chapter discusses several administrative approaches to resolving disputes caused by transfer pricing adjustments and for avoiding double taxation. Section B discusses transfer pricing compliance practices by tax administrations, in particular examination practices, the burden of proof, and penalties. Section C discusses corresponding adjustments (Paragraph 2 of Article 9 of the OECD Model Tax Convention) and the mutual agreement procedure (Article 25). Section D describes the use of simultaneous tax examinations by two (or more) tax administrations to expedite the identification, processing, and resolution of transfer pricing issues (and other international tax issues). Sections E and F describe some possibilities for minimising transfer pricing disputes between taxpayers and their tax administrations. Section E addresses the possibility of developing safe harbours for certain taxpayers, and Section F deals with Advance Pricing Arrangements, which address the possibility of determining in advance a transfer pricing methodology or conditions for the taxpayer to apply to specified controlled transactions. Section G considers briefly the use of arbitration procedures to resolve transfer pricing disputes between countries. The following paragraphs do not attempt to describe in detail each of these issues.

i) Examination practices

Examination practices vary widely among countries, and transfer pricing cases can present special challenges to the normal audit practices, both for the tax administration and for the taxpayer. Transfer pricing cases are fact-intensive and may involve difficult evaluations of comparability, markets, and financial or other industry information.

The revised Guidelines acknowledge that in a difficult transfer pricing case, even the best-intentioned taxpayer can make an honest mistake. Moreover, even the best-intentioned tax examiner may draw the wrong conclusion from the facts. They therefore encourage tax administrations to be flexible in their approach and not demand from taxpayers in their transfer pricing a precision that is unrealistic under all the facts and circumstances and to take into account the taxpayer's commercial judgment about the application of the arm's length principle.

ii) Burden of proof

In most jurisdictions, the tax administration bears the burden of proof both in its own internal dealings with the taxpayer (e.g. assessment and appeals) and in litigation. In some of these countries, the burden of proof can be reversed, allowing the tax administration to estimate taxable income, if the taxpayer is found not to have acted in good faith, for example.

In particular, the burden of proof should not be misused by tax administrations or taxpayers as a justification for making groundless or unverifiable assertions about transfer pricing. A tax administration should be prepared to make a good faith showing that its determination of transfer pricing is consistent with the arm's length principle even where the burden of proof is on the taxpayer, and taxpayers similarly should be prepared to make a good faith showing that their transfer pricing is consistent with the arm's length principle regardless of where the burden of proof lies.

iii) Penalties

Whilst it was originally intended to have an extensive section on penalties, the discussions showed that was not necessary since it was recognised that the issue of penalties is far broader than transfer pricing and therefore only very general Guidelines could be provided, particularly in the area of no-fault penalties. The nature of tax penalties may be affected amongst other things, by the judicial system of a country. In some countries, for example, the imposition of a no-fault penalty would be against the underlying principles of their legal system.

Improved compliance in the transfer pricing area is of some concern to OECD Member countries and the appropriate use of penalties may play a role in addressing this concern. The revised Guidelines suggest, however, that care should be taken to ensure that the administration of a penalty system as applied in such cases is fair, not unduly onerous for taxpayers and does not give taxpayers an incentive to overstate taxable income in any jurisdiction.

The revised Guidelines conclude the discussion on penalties by noting that:

- First, imposition of a sizable "no-fault" penalty based on the mere existence of an understatement of a certain amount would be unduly harsh when it is attributable to good faith error rather than negligence or an actual intent to avoid tax;
- Second, it would be unfair to impose sizable penalties on taxpayers that made a reasonable effort in good faith to set the terms of their transactions with related parties in a manner consistent with the arm's length principle. In particular, it would be inappropriate to impose a transfer pricing penalty on a taxpayer for failing to consider data to which it did not have access, or for failure to apply a transfer pricing method that would have required data that was not available to the taxpayer. Tax administrations are encouraged to take these observations into account in the implementation of their penalty provisions." (paragraph 4.28)

iv) The mutual agreement procedure

Chapter IV of the revised Guidelines provide in Section C an extensive discussion of the operation of the Mutual Agreement Procedure, highlighting its strengths and weaknesses. The reader is referred to that section for a discussion of these issues. The main conclusions which are from this discussion can be summarised as follows:

- OECD Member countries are encouraged as far as possible to extend domestic time limits for purposes of making corresponding adjustments when mutual agreement procedures have been invoked. Where a bilateral treaty does not override domestic time limits for the purposes of the mutual agreement procedure, tax administrations should be ready to initiate discussions quickly upon the taxpayer's request, well before the expiration of any time limits that would preclude the making of an adjustment. Furthermore, OECD Member countries are encouraged to adopt domestic law that would allow the suspension of time limits on determining tax liability until the discussions have been concluded. More generally, the competent authorities should be prepared to enter into discussions under the mutual agreement procedure relating to transfer pricing issues at as early a stage as is compatible with the economical use of their resources.
- A number of suggestions set out to reduce the duration of mutual agreement proceedings.
- It would be helpful to taxpayers if competent authorities were to develop and publicise their own domestic rules or procedures for utilizing the mutual agreement procedure so that taxpayers may more readily understand the process. The development and publication of such rules could also be helpful to tax administrations, especially if they are faced with the possibility of a large or growing number of cases in which mutual agreement with other tax administrations may be necessary or desirable, possibly saving them the need to answer a variety of enquiries or to develop procedures afresh in every case.
- When secondary adjustments are considered necessary tax administrations are encouraged to structure such adjustments in a way that the possibility of double taxation as a consequence

thereof would be minimised, except where the taxpayer's behaviour suggests an intent to disguise a dividend for purposes of avoiding withholding tax.

v) Arbitration

Tax disputes have become increasingly international, and frequently concern disagreements between tax administrations. In many of these situations, the MNE group is primarily a stakeholder and the real parties in interest are the governments involved. Traditionally, problems of double taxation have been resolved through the mutual agreement procedures, as discussed above. However, relief is not guaranteed under the mutual agreement procedure if the tax administrations, after consultation, can reach no agreement and dissatisfaction with the wording of this procedure have led to some commentators to advocate the extension of arbitration procedures.

Thus, there is the "Convention dealing with Transfer Pricing agreed by Member States of the European Community's (the "Arbitration Convention"), which came into force on 1 January 1995, but, in addition, some bilateral tax conventions have provisions for arbitration. It is noteworthy that neither the Arbitration Convention nor these bilateral treaty provisions have yet been applied.

The possibility of the use of arbitration in tax disputes has been recognized for some time in the work on the OECD Model Tax Convention. In 1977, the Commentary on Article 25 mentioned the possibility of "independent arbitrators" who could be asked to give "advisory opinions." The current version of the Commentary on Article 25 also refers to the possible "solution" of arbitration and the Arbitration Convention as well as the developments in bilateral conventions concerning arbitration.

It is in the context of transfer pricing that arbitration has received the most attention by the OECD. The 1984 Report contains a discussion of the use of arbitration procedures to ensure that corresponding adjustments would be made on a consistent basis. After discussing some of the advantages and disadvantages of arbitration, the Report concluded that "for the time being" it was not appropriate to recommend an arbitration procedure. However, as indicated above, a number of changes have taken place since the 1984 Report was written. The Arbitration Convention referred to above was at that time only in draft form, the trade agreement dispute resolution procedures had not been so fully developed, bilateral tax conventions had not begun to adopt arbitration procedures, and the dramatic increase of interest in transfer pricing questions with their attendant potential for tax controversy had not yet occurred. Accordingly, it seems appropriate to analyze again and in more detail whether the introduction of a tax arbitration procedure would be an appropriate addition to international tax relations. The Guidelines note, therefore, the Committee on Fiscal Affairs "has agreed to undertake a study of this topic and to supplement these Guidelines with the conclusions of that study when it is completed" (paragraph 4.171).

vi) Simultaneous Tax Examinations

A simultaneous tax examination is a form of mutual assistance, used in a wide range of international issues, that allows two or more countries to cooperate in tax investigations. Simultaneous tax examinations can be particularly useful where information based in a third country is a key to a tax investigation, since they generally lead to more timely and more effective exchanges of information. Historically, simultaneous tax examinations of transfer pricing issues have focused on cases where the true nature of transactions was obscured by the interposition of tax havens. However, in complex transfer pricing cases, the revised Guidelines suggest that simultaneous examinations could serve a broader role since they may improve the adequacy of data available to the participating tax administrations for transfer pricing analyses and could help reduce the possibilities for economic double taxation, reduce the compliance cost to taxpayers, and speed up the resolution of issues.

With the increasing internationalization of trade and business and the complexity of transactions of MNEs, transfer pricing issues have become more and more important. Simultaneous tax examinations can alleviate the difficulties experienced by both taxpayers and tax administrations connected with the transfer pricing of MNEs. Taking into account these considerations, the revised Guidelines recommend that countries may wish to consider a greater use of simultaneous tax examinations in the examination of transfer pricing cases and encourage those countries that are able and wish to engage in this type of cooperation to use the Model Agreement, approved by the OECD Council in 1992 and which provides Guidelines on the legal and practical aspects of this form of cooperation.

vii) Advance Pricing Arrangements

An advance pricing arrangement ("APA") is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax administrations. APAs are intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues. They may be most useful when traditional mechanisms fail or are difficult to apply.

One key issue in the concept of APAs is how specific they can be in prescribing a taxpayer's transfer pricing over a period of years, for example whether only the transfer pricing methodology or more particular results can be fixed in a particular case. In general, the revised Guidelines note great care must be taken if the APA goes beyond the methodology, (to specify, for example, a profit split formula between associated enterprises if it is expected that the allocation of functions between the enterprises will be unstable) the way it will be applied, and the critical assumptions, because more specific conclusions rely on predictions about future events.

As with Simultaneous Examinations the revised Guidelines provide an extensive discussion of the pros and cons of APA, concluding that:

- "While it is too early to make a final recommendation whether the expansion of such programmes should be encouraged, it seems likely that in certain circumstances they will aid in resolving transfer pricing disputes. The Committee on Fiscal Affairs intends to monitor carefully any expanded use of APAs and to promote greater consistency in practice among those countries that choose to use them." (paragraph 4.161).

"When considering the scope of an APA, taxpayers and tax administrations need to pay close attention to the reliability of any predictions so as to exclude unreliable predictions. (paragraph 4.162)

"Wherever possible an APA should be concluded on a bilateral or multilateral basis between competent authorities through the mutual agreement procedure of the relevant treaty. A bilateral APA carries less risk of taxpayers feeling compelled to enter into an APA or to accept a non-arm's-length agreement in order to avoid expensive and prolonged enquiries and possible penalties. A bilateral APA also significantly reduces the chance of any profits either escaping tax altogether or being doubly taxed. Moreover, concluding an APA through the mutual agreement procedure may be the only form that can be adopted by a tax administration which lacks domestic legislation to conclude binding agreements directly with the taxpayer." (paragraph 4.163)

- "Tax administrations also may need to consider the possibility of adopting a streamlined access for small taxpayers. Tax administrations should take care to adapt their levels of inquiry, in evaluating APAs, to the size of the international transactions involved." (Paragraph 4.164)
- "Between those countries that use APAs, greater uniformity in APA practices could be beneficial to both tax administrations and taxpayers. Accordingly, the tax administrations of such countries may wish to consider working agreements with the competent authorities for the undertaking of APAs. These agreements may set forth general Guidelines and understandings for the reaching of mutual agreement in cases where a taxpayer has requested an APA involving transfer pricing issues." (paragraph 4.165)

f. Documentation requirements

Chapter V of the Revised Guidelines provides general guidance for tax administrations to take into account in developing rules and/or procedures on documentation to be obtained from taxpayers in connection with a transfer pricing inquiry. It also provides guidance to assist taxpayers in identifying documentation that would be most helpful in showing that their controlled transactions satisfy the arm's length principle and hence in resolving transfer pricing issues and facilitating tax examinations.

The Guidelines note that taxpayers should endeavour to determine transfer pricing for tax purposes in accordance with the arm's length principle, based upon information reasonably available at the time of the determination. The taxpayer's process of considering whether transfer pricing is appropriate for tax purposes should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. It would be expected that the application of these principles will require the taxpayer to prepare or refer to written materials that could serve as documentation of the efforts undertaken to comply with the arm's length principle, including the information on which the transfer pricing was based, the factors taken into account, and the method selected. It would be reasonable for tax administrations to expect taxpayers when establishing their transfer pricing for a particular business activity to prepare or to obtain such materials regarding the nature of the activity and the transfer pricing, and to retain such material for production if necessary in the course of a tax examination. Such actions should assist taxpayers in filing correct tax returns. Note, however, that there should be no contemporaneous obligation at the time the pricing is determined or the tax return is filed to produce these types of documents or to prepare them for review by a tax administration. The documents that it would be appropriate to request with the tax return should be limited to requiring the taxpayer to provide information sufficient to allow the tax administration to determine approximately which taxpayers need further examination.

The revised Guidelines recommend that in particular transfer pricing cases it may be useful to refer to information relating to each associated enterprise involved in the controlled transactions under review, such as:

- i) an outline of the business;
- ii) the structure of the organization;
- iii) ownership linkages within the MNE group;
- iv) the amount of sales and operating results from the last few years preceding the transaction;

- v) the level of the taxpayer's transactions with foreign associated enterprises, for example the amount of sales of inventory assets, the rendering of services, the rent of tangible assets, the use and transfer of intangible property, and interest on loans;

This list should not be seen neither as a minimum compliance requirement or as a exhaustive list of the information that a tax administration is entitled to request.

Information on pricing, including business strategies and special circumstances at issue, may also be useful. This could include factors that influenced the setting of prices or the establishment of any pricing policies for the taxpayer and the whole MNE group. For example, these policies might be to add a mark up to manufacturing cost, to deduct related costs from sales prices to end users in the market where the foreign related parties are conducting a wholesale business, or to employ an integrated pricing or cost contribution policy on a whole group basis. Information on the factors that lead to the development of any such policies may well help an MNE to convince tax administrations that its transfer pricing policies are consistent with the transactional conditions in the open market. The Guidelines also note that it could also be useful to have an explanation of the selection, application, and consistency with the arm's length principle of the transfer pricing method used to establish the transfer pricing.

The revised Guidelines conclude by noting that:

"Taxpayers should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm's length principle. Tax administrations should have the right to obtain the documentation prepared or referred to in this process as a means of verifying compliance with the arm's length principle. However, the extensiveness of this process should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. Moreover, the need for the documents should be balanced by the costs and administrative burdens, particularly where this process suggests the creation of documents that would not otherwise be prepared or referred to in the absence of tax considerations. Documentation requirements should not impose on taxpayers costs and burdens disproportionate to the circumstances. Taxpayers should nonetheless recognize that adequate record-keeping practices and voluntary production of documents facilitate examinations and the resolution of transfer pricing issues that arise." (paragraph 5.28)

"Tax administrations and taxpayers alike should commit themselves to a greater level of cooperation in addressing documentation issues, in order to avoid excessive documentation requirements while at the same time providing for adequate information to apply the arm's length principle reliably. Taxpayers should be forthcoming with relevant information in their possession, and tax administrations should recognize that they can avail themselves of exchange of information articles in certain cases so that less need be asked of the taxpayer in the context of an examination. The Committee on Fiscal Affairs intends to study the issue of documentation further to develop additional guidance that might be given to assist taxpayers and tax administrations in this area." (paragraph 5.29)