

**Inter-American Center of Tax Administrations - CIAT**

**Technical Conference - Oporto, Portugal**

**TAXATION VIS-A-VIS INTERNATIONAL RELATIONS AND  
THE USE OF NEW TECHNOLOGIES**

**Topic 2**

**TRANSFER PRICES AT THE BEGINNING OF THE XXI CENTURY**

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**September 20-23, 1999**

Lecture

**Topic 2 TRANSFER PRICING. HISTORY – STATE OF THE ART - PERSPECTIVES**

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## **1. INTRODUCTION**

This article intends to give the history of and the reason for transfer pricing, an outline and comparison of the two main sources of rules in practice -the U.S. Sec. 482 Regulations and the OECD Transfer Pricing Guidelines- and an overview of practical problems and perspectives.

From a financial perspective transfer pricing is probably the most important tax issue in the world. Over 60% of international trade is carried out within multinational enterprises (MNEs). The term MNE in this context not only covers corporate moguls such as Shell, Mitsubishi and IBM, but also smaller companies with one or more subsidiaries or permanent establishments (PE) in countries other than that where the parent company/head office is located.

Although parent companies of MNEs are still located to a great extent in developed countries, companies from developing countries, in particular in Asia, have started to expand abroad in recent years.

Parent companies of larger groups usually have subholdings and intermediary holdings in several countries; research and service activities may be concentrated in centres operating for the whole group or specific parts; intangibles, developed by group entities, may be concentrated at certain group members; finance companies may operate as internal banks; production of parts and assembly of final products may take place in many different countries. From a decision making perspective groups may range from highly centralized to structures with a high degree of decentralization and profit responsibility allocated to individual group members.

Transfer pricing has gained much attention in recent years. Several reasons for this can be given. In the first place, the on-going (re)location of the production of final products and of components to appropriate territories. Production costs, infrastructure, tax incentives and systems, skilled labour force, etc. play a role. In the second place, the concentration of service functions within MNEs as indicated above. Third, the relatively new phenomenon of global, 24 hours per day, trading in commodities and financial instruments, which was made possible by modern means of communication.

Political reasons, in particular in the United States, have also played a role. U.S. politicians alleged (and continue to allege) that foreign enterprises active in the United States paid substantially lower amounts of income tax than comparable U.S. groups. Although the reason for tightening transfer pricing legislation in 1986 was a domestic U.S. one, - tax planning by U.S. groups involving the transfer of intangibles developed in the United States to related companies in tax havens such as Puerto Rico - the political emphasis has shifted to foreign-owned U.S. companies.

New transfer pricing regulations, and in particular the risk of severe penalties, even in case of non-deliberate deviations from the arm's length principle, in the United States, have induced both U.S. and foreign groups to revise their transfer pricing methods. The new U.S. approach, however, may have as result that groups are inclined to give the U.S. Treasury a greater piece of the tax cake - to avoid the risk of penalties - than is reasonable from an objective point of view. Countries with less sophisticated tax systems and administrations run the risk of paying the U.S. transfer pricing bill.

The OECD, fearing to lose its position as a guiding forum on transfer pricing matters, has worked on a revision of its 1979 report on transfer pricing in order to bridge the differences. New OECD Guidelines were published in July 1995.

Transfer pricing is also on the agenda of the ad hoc Group on Taxation of the United Nations but it is doubtful that U.N. Guidelines on this topic will be issued within a reasonable time.

## 2. DEFINITION OF TRANSFER PRICING

The definition of "transfer price" for *business economics* purposes reads: <sup>1</sup> "the amount charged by one segment of an organization for a product or service that it supplies to another segment of the same organization." The economic reason for charging transfer prices is to be able to evaluate the performance of the group entities concerned. By charging prices for goods and services transferred within a group, managers of group entities are able to make the best possible decision as to whether to buy or sell goods and services inside or outside the group.

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<sup>1</sup> See: C.T. Horngren, W.O. Stratton and G.L. Sundem "Introduction to Management Accounting." Prentice Hall International Inc., 1996.

Cost-based systems for the transfer of goods and the rendering of services internally have always been very popular among MNEs. Some MNEs used only variable costs, others full costs, and still others used full costs plus a profit mark-up (cost plus method). Some used standard costs, others actual costs. If there is a competitive open market for the products or services transferred internally, the best solution from a business economics point of view is to use the market price as a transfer price. The market price may be derived from published price lists for similar products and services, or it may be the price charged by a group entity to its (non-related) customers. The latter may be the basis for the transfer price in an earlier stage of production by subtracting costs and a reasonable profit in the last internal stage from the price (the resale price method).

Apart from the cost-based methods and transfer prices based on open market prices, another approach may be distinguished. In various MNEs, group entities negotiate with each other like independent parties because they have their own profit responsibility. The transfer price resulting from such negotiations is equally acceptable from a business economics point of view. In 1990 12.7% of the U.S. companies with foreign activities still used this "negotiated transfer price method."<sup>2</sup>

Since the mid-nineties tax legislation has had a strong an impact on commercial transfer pricing approaches. If the commercial system is in conflict with the pertinent tax rules, companies may either adopt the fiscally correct system or -if allowed- maintain two systems, one for commercial purposes, the other for tax purposes.

The above definition of transfer pricing is also valid for *tax purposes*. The term transfer pricing is, however, sometimes used, *incorrectly*, in a pejorative sense, to mean the shifting of taxable income from a company, belonging to an MNE, located in a high taxing jurisdiction to a company belonging to the same group in a low taxing jurisdiction through incorrect transfer prices in order to reduce the overall tax burden of the group.

Paragraph 3 of the Preface of the 1979 OECD Report on Transfer Pricing and Multinational Enterprises explained that the term "transfer pricing" is neutral: "the consideration of transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes." The 1995 report of the OECD makes this even more clear by using the title "Transfer Pricing *Guidelines* for Multinational Enterprises and Tax Administrations."

Indeed, transfer pricing provides opportunities for MNEs to shift profits from a high taxing country to a country with a low corporate tax rate or with tax incentives for certain activities. One should, however, realize that tax planning is only one of a series of considerations which are relevant for MNEs. Many MNEs prefer to maintain a good

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<sup>2</sup> R.Y.W. Tang, *Transfer Pricing in the 1990s: Tax and Management Perspectives*, Quorum Books, Westport, London, 1993.

relationship with the tax authorities of the countries where they are active. Certainty about the amount of tax to be paid is a top priority for large companies and they usually operate a well-documented, straightforward transfer pricing system, which is -as explained above- in the first place a requirement of sound business economics.

### 3. THE ARM'S LENGTH PRINCIPLE

Prices set for transactions between group entities should -for tax purposes- be derived from prices which would have been applied by unrelated parties in similar transactions under similar conditions in the open market.

This is the so-called "dealing at arm's length" principle, which is the internationally accepted standard for transfer pricing matters. Almost all countries have domestic tax provisions, either general or specific, that will allow tax authorities to adjust transfer prices which deviate from that principle.

The arm's length principle has two different origins:

- 1) In several continental European countries the arm's length principle is the underlying basis for the adjustment of income of shareholders who have received extraordinary benefits from a company which have not officially been declared as dividends. Majority shareholders may be able to derive benefits as a result of their special position. The adjustment in such cases is made by deeming the benefits to be dividends, called constructive dividends or hidden profit distributions, which are not deductible for the company concerned. The focus originally was domestic. This concept is applied in Austria, Germany, Luxembourg, the Netherlands, Switzerland and other European countries.
- 2) Specific transfer pricing provisions with an international focus were first introduced during World War I in the United Kingdom and the United States. These anti-tax avoidance provisions aimed at deterring companies from shifting profits to associated companies overseas through under- or overpricing of cross-border transactions.

Both approaches are based on the concept of equal treatment or the neutrality principle: shareholders with a controlling interest in a company are placed in the same position as other shareholders and controlled taxpayers are placed on a parity with uncontrolled taxpayers through application of the arm's length principle which neutralises the advantage of the former.<sup>3</sup>

In the actual implementation of the arm's length principle in domestic tax laws four

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<sup>3</sup> See Hubert Hamaekers, The Arm's Length Principle and the Role of Comparables, Bulletin for International Fiscal Documentation 1992, at 603.

categories can be distinguished:

- 1) Countries which have included an explicit or implicit reference to the arm's length principle, and to adjustments in case of deviations, in their tax laws, e.g., Australia refers to considerations less than arm's length considerations (Sec. 136 AD Income Tax Assessment Act); the United Kingdom mentions "the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length" (Sec. 770 Income and Corporation Tax Act 1988 - formerly Sec. 485); Italy refers to "the normal value" (Art. 76(5), Testo Unico delle Imposte sui Redditi); and Spain refers to "normal market value" (Art. 16, Ley del Impuesto sobre Sociedades).
- 2) Countries which permit prices to be adjusted in case of associated enterprises, without reference to the arm's length principle, e.g., France (Art. 57 General Tax Code "transferred income") and the United States (Sec. 482: the Secretary "may distribute, apportion or allocate gross income, deductions or credits, or allowances between or among such organizations, trades or businesses).
- 3) Brazil is a special case having specific rules for the deductibility of the cost of imported goods (and rights) and the recognition of revenue arising from exports (Arts. 18-24, Law 9.430 of 27 December 1996).
- 4) Countries with a broad statutory basis, which has been developed for transfer pricing purposes in case law, e.g., Germany (apart from Sec. 1 Foreign Relations Tax Act): excessive payments to, or understated receipts from, shareholders constitute a constructive dividend which is not deductible (Sec. 8(3) Corporate Tax Act); and, similarly, the Netherlands and Switzerland.<sup>4</sup>

#### **4. THE TAX TREATY ASPECT**

The arm's length principle was implicitly included in treaties concluded by France, the United Kingdom and the United States as early as the twenties and thirties of this century.

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

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<sup>4</sup> For detailed analyses and texts of legislation and regulations of 32 countries see: "The Tax Treatment of Transfer Pricing", loose leaf, 6 volumes, IBFD Amsterdam.

of 1943 and in the London Draft of 1946. These articles are substantially similar to Art. 9 of the 1963 OECD Draft Convention and Art. 9, paragraph 1 of the present OECD and U.N. model tax treaties. Arts. 9 of the OECD and U.N. Models are identical. The explicit use of the term "dealing at arm's length" did not return in drafts and models after 1933.

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

Double tax treaties and the OECD and U.N. Model tax treaties use the term "associated enterprises" to cover relationships between enterprises which are sufficiently intimate to allow transfer pricing rules to be applicable. The definition covers the following situations:

1. Enterprise A of Contracting State A, participating in the management, control or capital of enterprise B of Contracting State B, either directly or indirectly;
2. The same person(s) participate in the management, control or capital of both enterprise A and B, either directly or indirectly.

Formally speaking, a PE is not covered by Art. 9 as it is only a part of an enterprise. The relationship of a PE with its head office is covered by Art. 7 of the OECD Model, the separate entity approach. Apart from the exceptions to the separate entity approach, virtually all aspects of transfer pricing, including methods to determine transfer prices, are applicable to PEs as well.

The broad coverage of Art. 9, paragraph 1 is in agreement with the domestic laws of many countries, including the United Kingdom, the United States and Germany. Australia has an extremely broad concept since any international transaction including the acquisition or sale of property or rendering of services is particularly covered by the wording "any connection between the parties to the agreement."

Brazil even includes (independent) exclusive agents and (independent) partners in a consortium in the definition of related party.

In the Netherlands and Switzerland, in principle, only direct and indirect shareholding relationships with a determinant influence on the commercial behaviour of the company are covered.

Broad transfer pricing provisions are based on the anti-avoidance approach. They give power to tax authorities to adjust in cases where a special relationship seems to have influenced the prices applied. A narrow scope for adjustment such as in the Netherlands and Switzerland stems from the constructive dividend approach.

The bottom line should be, but is not clearly indicated in the majority of the laws, that -if the interests of the parties concerned are clearly diverging- no transfer pricing adjustment should be made.

As of 1977, Art. 9 of the OECD Model has been supplemented by a second paragraph which allows for a corresponding (downward) adjustment of the profit of the related entity in the other State. The corresponding adjustment avoids economic double taxation or -in the relationship between head office and PE- juridical double taxation. According to the Commentary to Art. 9, paragraph 2, a corresponding adjustment is only mandatory if state B agrees to the method applied and the amount of the original adjustment made in state A. A general consensus on arm's length transfer pricing methods within the OECD is therefore very important. Cases of disagreement may be resolved through the mutual agreement procedure, although it may take many years before a conclusion is reached. The EC Arbitration Convention provides a more specific solution for transfer pricing disputes between tax authorities.

## **5. THE 1979 AND 1984 OECD REPORTS ON TRANSFER PRICING**

Before 1979, administrative guidance on the application of legal provisions relating to transfer pricing was scarcely available. In 1968, the U.S. Treasury issued elaborate regulations for specific types of intercompany transaction. These regulations had a great influence on the discussions in the OECD on transfer pricing in the seventies.

Because of the increase in the number of MNEs and the increase of transactions within MNEs since the sixties the Member States of the OECD considered it necessary to produce guidelines for their respective tax administrations on how to deal with transfer pricing. It was also considered useful to elaborate on Art. 9 of the Model Treaty and its Commentary. Since one of the two main goals was the avoidance of double taxation, the multilateral framework of the OECD was chosen for developing a consensus on the matter of transfer pricing.

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

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

In brief, the 1979 OECD Report contains the following important considerations and principles:

- The arm's length principle is the appropriate approach to adopt in arriving at profits of related entities for tax purposes;
- The consideration of transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes;
- The dual purpose of the report is to enable the interests of the national tax authorities involved to be protected, and to enable double taxation of the enterprises involved to be prevented;
- The ideal method is the comparable uncontrolled price (CUP);
- If no useful evidence for CUPs is available, cost plus or resale methods (see page 16) are acceptable from an arm's length point of view;
- Other methods are not excluded, but with respect to these other methods the Report is vague and negative:
  - the profit-split method is necessarily arbitrary;
  - profit comparison is only an indication for further investigation;
  - the return on capital invested presents difficulties;
  - net yield expectations are too imprecise.

Such methods may be used as a double check (profit comparison) or as a solution in bilateral negotiations among countries (profit-split);

- Global methods and formulary methods for allocating profits to affiliates are not endorsed, as they are incompatible with Arts. 7 and 9 of the Model; they are arbitrary, disregard market conditions, ignore the management's own allocation of resources, do not bear a sound relationship to the economic facts, and carry the risk of double taxation;<sup>5</sup>
- It is always useful to begin with a functional analysis (actual functions, responsibilities, risks, etc.);
- The approach of the Report is to recognize the actual transaction, not to substitute another transaction for it; (if required) the price for the actual transaction should be adjusted to an arm's length price; and
- Transfer pricing policies of MNEs may in fact be market-oriented and, where the different entities within such groups have their own profit responsibility, they may

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<sup>5</sup> Global formulary apportionment methods allocate the total profits of a group to the various jurisdictions where the group carries out business activities. The allocation is based on a formula usually consisting of the factors turnover, payroll and value of assets. See Sec. 12.

be free to contract either with an associated enterprise or with a third party with the result that there is a degree of bargaining within the group which produces a price effectively indistinguishable from an arm's length price.

The 1979 Report further discusses transfer pricing of goods (Chapter II), technology and trademarks (Chapter III), services (Chapter IV) and loans (Chapter V) in some detail.

The 1984 Report on the allocation of central management and service costs refers to the following issues:

- a definition of shareholders' costs; these are costs which may not be allocated to subsidiaries;
- a description of direct and indirect methods of cost allocation, in particular cost-sharing methods; and
- guidance on the inclusion of a profit mark-up when cost-oriented methods are used.

## **6. IMPACT OF THE OECD REPORTS**

The 1979 Report has been included in a recommendation of the OECD Council of Ministers to the Governments of the Member Countries that their tax administrations take into account the considerations and methods set out in the Report.

Although the recommendation has no immediate legal force, the fact that all Ministries of Finance of the OECD Member States have adopted the 1979 Report without reservations gives it a high level of authority. There is a more than moral obligation for tax authorities not to deviate from the Report in their domestic administrative regulations. In several countries judges look upon the report as binding on the tax administration concerned unless pertinent legislation deviates from it.

It should be noted that in almost all OECD countries regulations, circular letters and other publications of the respective tax administrations are regarded as containing the interpretation of the law by the tax administration, which does not have force of law, but which is binding on the tax administration itself. In the United States, however, transfer pricing regulations have almost the same effect as statutory provisions because of the authority of the Internal Revenue Service (IRS) to make adjustments on the basis of Sec. 482 IRC and the burden of proof resting on the taxpayer to demonstrate that the adjustment was incorrect.

Although administrative regulations based on the OECD report have no force of law they have provided guidance to MNEs as to which pricing methods tax administrations deem to be acceptable.

The adoption of the OECD Report was followed by the publication of regulations and circular letters of Ministries of Finance or tax administrations of several Member States.

To give some examples: in Austria the translated version of the Report was issued as transfer pricing regulations; in Italy two Notices (no. 32 of 22 September 1980 and no. 42 of 12 December 1981) based on the Report were issued (which are still in force).

For around a decade the OECD reports have indeed resulted in a common approach to transfer pricing principles and methods among the tax administrations of industrialised countries. Without such a common approach it is extremely difficult to reach an agreement under mutual agreement procedures on transfer pricing matters. The unfortunate result may be double taxation.

The amendment to the basic transfer pricing provision of the United States, Sec. 482 IRC, in 1986, the publication of the White Paper by the U.S. Treasury and the IRS in 1988 and of draft, temporary and final regulations issued from 1992 to 1995, disrupted this consensus.

## **7. DEVELOPMENTS IN THE UNITED STATES**

### **Until 1986**

Sec. 482 IRC was enacted in 1928 as Sec. 45. Until 1986, it remained substantially unchanged. It gives authority to the Secretary of the Treasury -in the case of two or more organizations owned or controlled by the same interests- to distribute, apportion or allocate gross income, deductions, credit or allowances between or among these organizations if he determines that such a distribution, etc., is necessary to prevent tax evasion or to clearly reflect the income of such organizations. This language is very broad and grants the IRS far-reaching powers to make adjustments.

Detailed regulations were adopted in 1968. To tangible property the regulations apply a rigid hierarchy of methods: comparable uncontrolled price, resale price, cost plus and other methods. For intangibles the comparable transaction method had to be used; if a comparable transaction was not found, 12 factors were to be applied to determine the arm's length price, starting with "prevailing rates in the industry."

### **Commensurate with income**

From the early eighties concern in the IRS, the Treasury and Congress increased about tax planning involving the transfer of intangibles (technology) developed in the United States to subsidiaries of U.S. companies in tax havens. The Tax Reform Act of 1986 added a sentence to Sec. 482 IRC dealing with intangibles. In the case of the

transfer or licensing of intangible property, the income of the transferor or licensor had to be "commensurate with the income attributable to the intangible." This so-called super-royalty provision looks to the future actual profit to determine the price of the transaction at the date of the contract. It means that a price may be adjusted for tax purposes if the profit of the transferee is higher than expected at the time of the transaction.

Critics of the new provisions commented that the use of hindsight was in conflict with OECD principles since prices are normally not recalculated between unrelated parties if the deal is more profitable than expected for one of the parties.

## **White Paper**

In 1988, the IRS and the U.S. Treasury produced a discussion paper on how to implement the new "commensurate with income" rule. The "White Paper" presented four methods: two based on comparable uncontrolled prices, two based on profits.

Exact CUPs were put forward as the primary method but it was admitted that they are very rare in practice. The second price-based method, inexact comparables, whereby the differences from the transaction between the related parties had to be accounted for and quantified via adjustments, was not given a clear priority over the two profit-based methods.

The Basic Arm's Length Return Method (BALRM or "ballroom method"), developed in the White Paper, was a novelty in transfer pricing. It tried to identify an appropriate return for an intangible by applying industry-wide return rates to the assets and functions performed by the parties to the actual transactions. The fourth method was a profit-split method.

The ideas put forward in the White Paper met with severe criticism. In the first place, the ballroom method was considered to be in conflict with the arm's length principle. Independent parties would not use such a method in practice to arrive at a price. In the second place, the method would be difficult to apply without information on returns on assets and functions. Ballroom would also be unfair to corporations with return rates that vary considerably from the industry average. Another comment was that in many cases it is not possible to define exactly the part of the business or the product the profit of which must be compared. Other Member countries of the OECD feared that the method would allocate more profit to U.S.-based companies than is reasonable.

## **Proposed Regulations 1992**

In January 1992, the IRS and the U.S. Treasury proposed Sec. 482 IRC regulations partly replacing the 1968 Regulations. The purpose was to implement the "commensurate with income" clause of Sec. 482 IRC and to improve the litigating

position of the IRS.

The proposed regulations contain two price-based methods and one profit-based method for intangibles. The matching transaction method (MTM) is the same as the exact comparable method of the White Paper. The comparable adjustable transaction method (CATM) is more or less the same as the inexact comparables method of the White Paper. The result of the application of this method should, however, fall within a comparable profit interval (CPI).

Data to establish the CPI are derived from similar companies, or, if not available, from statistical data from the sector.

The fixed priority of methods provided by the 1968 regulations was relaxed.

### **OECD Task Force**

The proposed regulations were strongly criticized. The OECD formed a special Task Force to study the 1992 regulations. The United States served as an observer of the Task Force. In January 1993, the Task Force published its conclusions. The main comments were on the use of hindsight when applying the commensurate with income rule. The arm's length standard is abandoned because under this standard a transfer price depends on the evaluation of the facts and circumstances at the time the transaction takes place. Only events which may be reasonably known and foreseen by the parties may be taken into account. The OECD Task Force was also concerned about the CPI. Profit comparison may only be used as a method of last resort or as a check of the results of other methods.

### **Temporary Regulations 1993**

The 1993 Temporary Regulations, issued in January 1993, are much broader than the 1992 Proposed Regulations as they not only deal with intangibles but also contain revised regulations on transfers of tangible property. For transfers of tangible property five principal methods were given: CUP, resale price, cost plus, comparable profit method (CPM) and profit split.

The so-called "best method" rule is introduced; this means that the arm's length result of a controlled transaction must be determined by the method that provides the most accurate measure of an arm's length result under the facts and circumstances of the transaction.

For intangibles the comparable uncontrolled transaction method (CUT) is introduced, which combines the MTM and CATM of the 1992 proposed regulations. The 1993 regulations are less rigid on comparability than the 1992 regulations. The uncontrolled transactions must be sufficiently similar to provide a reasonable and reliable benchmark

for determining whether the controlled transaction led to an arm's length result.

If CUT cannot be applied because no adequate data are available, the CPM may be used, which is derived from the CPI method of 1992. Other methods, e.g., the profit-split method, may be used, provided that the taxpayer prepares documentation explaining why this other method provides the most accurate measure of an arm's length result.

*OECD Task Force again.*- In December 1993, the OECD Task Force released a report on the 1993 Temporary and Proposed Regulations. The Task Force was still concerned that CPM could become the predominant method used by the IRS, although the Task Force was satisfied with the elimination of CPM as a mandatory check for all methods and with the introduction of the best method rule.

## **8. FINAL U.S. REGULATIONS 1994**

On 1 July 1994, the IRS released final regulations under Sec. 482 IRC, which are effective for tax years beginning after 6 October 1994. According to the Preamble, they clarify and refine provisions of the 1993 regulations where necessary, without fundamentally altering the basic policies reflected in the 1993 regulations.

Under the arm's length standard, taxpayers are expected to realize from their controlled transactions the results that would have been realized if uncontrolled taxpayers had engaged in the same transactions under the same circumstances. The provision, however, recognizes that identical transactions between unrelated taxpayers are usually rare. It will be appropriate to consider comparable rather than identical transactions.

### **Best method rule**

Under this rule, the method must be chosen which, given the facts and circumstances, provides the "most reliable measure" of an arm's length result. In selecting a method two important factors must be considered: comparability and the quality of data and assumptions. Methods relying on uncontrolled transactions with the highest degree of comparability are to be preferred.

In theory, it is possible to determine an arm's length result without checking results of other methods. If, however, the IRS would consider another method producing different results the best, the taxpayer has the burden of proof to demonstrate that the adjustment was wrong. Upon failure to show this, penalties may apply.

### **Comparability analysis**

Comparability is discussed in great detail in the regulations.

Transactions need not be identical, but sufficiently similar to be used for comparison. If there are material differences, adjustments must be made to account for the differences.

In addition to the quality of the product or service itself, five factors are provided which generally affect comparability: functions, contractual terms, risks, economic conditions and property or services.

Comparison of the product itself is important for the CUP method. Comparison of functions is particularly important when applying the resale price and cost plus methods. Comparison of operating profits -via the profit level indicator- is essential for the CPM (see page 16).

### **Arm's length range**

An "arm's length range" may be identified if more than one reliable arm's length result becomes available. The arm's length range may be derived from applying a single method, selected under the best method rule, but also from different methods if this is appropriate under the best method rule. The IRS is not allowed to make adjustments if the results of a controlled taxpayer fall within the arm's length range.

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

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

### **Transfers of tangible property**

The regulations specify five possible methods for the transfer of tangible property. All methods must be applied in accordance with the best method rule, the comparability analysis and the arm's length range.

1. *The comparable uncontrolled price method (CUP)*

Under the CUP method, an arm's length price for the sale of tangible property to

another group member is equal to the price charged in a comparable uncontrolled transaction.

The best method rule must be employed to determine whether the results of applying the CUP method produce the most reliable measure of an arm's length result. The degree of comparability must be determined on the basis of the provisions on comparability.

The CUP method generally provides the most reliable measure of an arm's length result if there are no differences or only minor differences, which can be adjusted for, between the controlled and uncontrolled transaction.

Adjustments may be necessary to arrive at a CUP, but material product differences for which reliable adjustments cannot be made, make the CUP method inappropriate (i.e. a CUP is not a CUP when the products compared differ considerably).

Adjustments for differences may be relevant for the following aspects:

- quality of the product;
- contractual terms;
- level of the market (wholesale, retail etc.);
- geographical market;
- date of the transaction;
- intangibles involved;
- foreign currency risk; and
- alternatives available to buyer and seller.

In certain business sectors data from public exchanges or quotation media may provide evidence for a CUP. Adjustments may be necessary to reflect differences as indicated above.

## *2. Resale price method (RPM)*

The RPM determines an arm's length price by subtracting the appropriate gross profit, derived from comparable uncontrolled transactions, from an actual price (the "resale" price) charged by a group member (the "reseller") to a non-related party. The gross profit represents the value of the functions performed by the reseller including an operating profit for capital investment and risks assumed.

The general rules regarding the best method, comparability and arm's length range are applicable. When applying the RPM, however, similarity of products is less important than under the CUP method. Similarity of functions, the risks borne and the contractual terms are particularly relevant under the RPM.

Examples of factors relevant in determining comparables are:

- inventory levels, turnover rates, price protection offered by manufacturers;
- contractual terms (warranties, volume of sales/ purchases, credit and transport terms);
- sales, marketing, advertising and other services;
- level of the market (wholesale, retail, etc.); and
- foreign currency risk.

The commission earned by a sales agent may be used as a comparable gross profit margin if the controlled taxpayer's functions, terms and risks are comparable. The RPM is ordinarily used in cases where the reseller has not added substantial value to the products involved. Activities of the reseller are usually limited to packaging or minor assembly where valuable intangibles are not involved.

### *Example*

Controlled company A sells goods to controlled company B which resells the goods to unrelated parties. The resale price is \$ 100. The gross profit margin in comparable uncontrolled transactions is 20%. The arm's length price for the sale between A and B is \$ 100 minus (20% x \$ 100) = \$ 80.

### *3. Cost plus method*

The cost plus method measures an arm's length price by adding the appropriate gross profit ("gross profit mark-up") to the controlled taxpayer's costs of producing the property involved. The appropriate gross profit is determined by reference to gross profit mark-ups realized in uncontrolled transactions. The general provisions on best method rule, comparability and arm's length range, are applicable. The gross profit represents the value of the production functions performed including an operating profit for the capital involved and for the risks assumed.

Comparability under the cost plus method is particularly dependent on similarity of functions performed, risks borne and contractual terms, but less on similarity of products.

Examples of factors relevant for comparison are:

- complexity of manufacturing or assembly;
- engineering of production and process;
- procurement, purchasing and inventory control;
- testing;
- selling, general and administrative expenses;
- foreign currency risk; and
- contractual terms (warranties, volume of sales/

- purchases, credit and transport terms).

Commissions earned by purchasing agents may be used as appropriate gross profits mark-ups if the controlled taxpayer's functions, terms and risks are comparable.

#### 4. *Comparable profit method (CPM)*

The three methods discussed above are transaction-based methods. For the transfer of tangible property two profit-based methods, the CPM and the profit-split method, may be used as well.

CPM may be used both for tangible and intangible property. The point of comparison is not a comparable uncontrolled price or transaction, but the level of profitability of uncontrolled taxpayers engaged in similar business transactions under similar circumstances ("profit level indicator").

The CPM is based on the operating profit that the tested party would have earned on intra-group transactions if its profit level indicator were equal to that of an uncontrolled comparable operating profit. The profit level indicator must be applied to the tested party's most narrowly identifiable business activity covering the controlled transaction.

Profit level indicators are ratios that measure relationships between profits and costs incurred or resources employed, usually covering the taxable year under review and the two preceding tax years, e.g., the rate of return on capital employed (the ratio of operating profit to operating assets), the ratio of operating profit to sales, or the ratio of gross profit to operating expenses.

Whether the results of the CPM constitute a reliable arm's length result must be determined under the best method rule. The general provisions on comparability are also applicable. In particular, resources employed and risks assumed are relevant for comparison. Product similarity is less important. Adjustments for differences between the tested party and uncontrolled taxpayers which materially affect profits should be made, e.g., to the value of the assets employed.

#### 5. *Profit-split method*

Profit split may be applied to both tangible property and intangibles. This method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length. Point of reference is the relative value of the contributions of the controlled taxpayers to that profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity covering the controlled transaction.

The relative value of the contributions of each controlled taxpayer must be

determined reflecting the functions performed, risks assumed and resources employed. This is intended to correspond to the division of profit or loss as a result of an arrangement between uncontrolled parties.

There are two profit-split methods: the comparable profit split and the residual profit split.

#### *6. Unspecified methods*

Any other method used to evaluate whether the amount charged in a controlled transaction is at arm's length must be applied in accordance with the general provisions of the regulations, including the best method rule, comparability analysis and the arm's length range.

### **Transfers of intangible property**

Three specific methods are given for determining the arm's length amount charged in a controlled transfer of intangible property: CUT which is to a great extent similar to the CUP method, the CPM and the profit-split method. The fourth category is "unspecified methods." All methods are governed by the general principles of the regulations, including the best method rule, the comparability analysis and the arm's length range.

The commensurate with income clause of Sec. 482 IRC is implemented by requiring periodic adjustments of the consideration for intangible property in the case of arrangements covering more than one year. The IRS may not require periodic adjustments to be made in certain situations, e.g., if the same intangible was also transferred to an uncontrolled taxpayer under substantially the same circumstances, or if the profit of the transferee in the relevant years is not less than 80% or not more than 120% of the foreseeable profits at the time of entering into the agreement.

### **Cost sharing (relating to intangibles)**

Cost-sharing agreements are agreements made by members of MNEs, and occasionally by independent parties, to share the costs and benefits of R&D in proportion to the reasonably expected benefits from the individual exploitation of the developed intangibles. Cost sharing is an alternative to paying licence fees.

New, very detailed, cost-sharing regulations have been incorporated in the main body of transfer pricing regulations in December 1995, becoming effective on 1 January 1996.

## **U.S. rules on documentation and penalties**

The penalties applicable in case of profit allocation by the IRS are set out in the Penalty Regulations of 9 February 1996. If an arm's length price determined by the IRS for goods or services received by a controlled taxpayer is at least 200% higher or -in case of property transferred or services rendered by a controlled taxpayer 50% lower- than the transfer price set by the controlled parties, the IRS may impose a penalty of 20% of the additional tax levied ("substantial misstatement").

A 40% penalty is imposed if prices differ 400% or 75%, respectively ("gross misstatement"). Not charging for services to foreign related entities always results in a 40% penalty.

A 20% penalty (of the portion of underpayment of tax) will be due if the total amount of the allocations in a tax year is over \$ 5 million or 10% of the gross receipts; a 40% penalty will be due if the allocations in a tax year amount to over \$ 20 million or 20% of the gross receipts.

The penalty is excused if the taxpayer, based on the data that was reasonably available to it, reasonably concluded that its analysis was the most reliable and satisfied the documentation requirement of the regulations. In such a case, the taxpayer may be subject to an adjustment if the IRS later employs a different analysis or uses different data leading to a different result, but an adjustment does not necessarily trigger the imposition of the penalty.

To avoid penalties taxpayers must be able to explain - on the basis of contemporaneous documentation - how they selected their pricing method (best method rule) and the reasons for not using the other possible methods.

The IRS and the Treasury take the standpoint that a comparison of methods is inherent in the best method rule. In order to be judged the "best" method, the method must be compared to other methods. The regulations state that "a method may be applied in a particular case only if the comparability, quality of data, and reliability of assumptions under that method make it more reliable than any other available measure of the arm's length result."

One of the factors taken into account in determining whether a taxpayer reasonably selected and applied a specified method is whether the taxpayer made a reasonable search for data. In determining whether a search for data was reasonably thorough, the expense of acquiring additional data may be weighed against the dollar amount of the transactions.

## **9. THE NEW OECD GUIDELINES**

## **Introduction**

Since 1992 a Task Force of Working Party No. 6 of the Committee on Fiscal Affairs (CFA) has worked on an update and consolidation of the 1979 and 1984 Reports on Transfer Pricing. An update was necessary to reflect developments in international trade, e.g., global trading, and technological developments. The new Guidelines also try to bridge the differences which have arisen between the United States and other OECD countries since the publication of the U.S. White Paper in 1988. A worldwide standard on this matter is important in particular to avoid double taxation.

The Guidelines have been presented as discussion drafts first.

The final Guidelines are being released in instalments starting with Chapter I to V in July 1995 covering the Arm's Length Principle (Chapter I), Traditional Methods (II), Other Methods (III), Administrative Approaches (IV) and Documentation (V). The second batch was released in March 1996, covering Intangible Property (VI) and Services (VII). A chapter on Cost Contribution Methods (VIII) was published in October 1997.

The Preface to the new Guidelines emphasizes that the OECD will continue to endorse the separate entity approach and the arm's length principle as guiding principles. The Guidelines are intended to indicate ways for tax administrations and MNEs to find mutually acceptable solutions, thereby minimizing conflict among tax administrations and between tax administrations and MNEs. Tax administrations are encouraged to take the taxpayer's commercial judgement with respect to transfer prices into account in case of tax audits.

The Guidelines are also intended to be used in mutual agreement procedures and arbitration proceedings between OECD Member States. Paragraph 2 of Art. 9 of the OECD Model Tax Convention requires making a corresponding adjustment, in order to avoid economic double taxation, only if the country in question, State B, agrees with the primary adjustment made by the tax administration of State A. The Preface states that State A must prove that the primary adjustment is applied correctly both in principle and as regards the amount.

## **The arm's length principle**

Chapter I deals with the arm's length principle. Important considerations from the 1979 Report are restated. Tax administrations should not automatically assume that associated enterprises manipulate their profits. Determining transfer prices is - according to the Guidelines- very difficult because in many cases it is not possible to make a comparison with an open-market situation.

Furthermore, Chapter I states that arm's length adjustments must be applied, irrespective of any contractual obligation of the parties and of any intention of the parties

to avoid tax. This is the same as in the U.S. regulations. In deciding transfer prices, the aim is not primarily to determine tax fraud or tax avoidance, although transfer prices can be used for such purposes.

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

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

The conclusion should be drawn, in my opinion, that, if evidence is given of bargaining as independent parties, the result of the bargaining should be accepted as an arm's length price ("negotiated transfer price method"). The Guidelines, however, conclude this paragraph with the open-ended remark that evidence of hard negotiation is insufficient to establish that the dealings were at arm's length. It is unfortunate that the Committee on Fiscal Affairs did not follow the recommendation of the International Fiscal Association of 14 October 1992 to investigate the circumstances under which the result of "hard bargaining" can be considered to be an arm's length result.<sup>6</sup>

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

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

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<sup>6</sup> See Hubert Hamaekers, *supra*, note 3.

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

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

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

## **Comparability**

With respect to comparability, the Guidelines follow the structure of the U.S. regulations which contain an extensive treatment of comparability that is applicable to all methods.

The Guidelines state that for comparability it is necessary that:

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

Comparison of prices and of conditions as well as evaluation of the differences is, according to the Guidelines, an essential aspect of deciding on a potential transaction by non-related enterprises. Therefore, tax administrations should also take these differences into account when establishing comparability.

The CUP method compares an intra-group transaction to a similar transaction entered into by non-related enterprises. This method is less reliable if not all the characteristics that significantly affect the price are comparable. The resale price and cost plus methods compare the gross profit margins to establish the arm's length price.

Other methods are based on the comparison of profits which could have been derived if the transacting parties had dealt solely with independent enterprises.

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

The Guidelines list similar aspects to establish the degree of actual comparability as

the U.S. Regulations (see above).

### **Arm's length range**

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

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

The U.S. Regulations are more complicated and less flexible than the Guidelines in this respect.

### **The use of transfer pricing methods**

Important considerations on the use of methods are the following:

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

The third consideration above constitutes the biggest difference in practice compared with the U.S. Regulations. According to the "best method rule", the method

should be used which, under the facts and circumstances of the case, produces the "most reliable measure" of an arm's length result. The U.S. Regulations do not explicitly prescribe trying more than one method: "it may be relevant to consider whether the results of an analysis are consistent with the results of an analysis under another method." However, when the IRS applies a different method with a deviating result, the taxpayer can escape a penalty only if he can certify with contemporaneous documentation that he has tried the other method as well and if he can justify his choice.

## **Transfer pricing methods**

### *1. The comparable uncontrolled price method (CUP)*

Chapter II of the Guidelines describes the three classic transfer pricing methods: the CUP, the RPM and the cost plus method.

The CUP method compares the price charged for property or services in a controlled transaction to the price agreed in a comparable transaction between non-related enterprises in comparable circumstances. Differences between the two prices may indicate that the first price is not at arm's length and that it has to be replaced by the second price. The Guidelines state that, where it is possible to locate a comparable uncontrolled transaction, the CUP method is the most direct and reliable way to apply the arm's length principle. The CUP method is preferable over all other methods in such cases.

The Guidelines, however, do not give a formal order of ranking. They do not answer the question whether tax administrations are allowed to make adjustments on the basis of the CUP method in cases where the RPM or cost plus method are applied correctly and consistently. The Guidelines stipulate elsewhere that, if the difference in the outcome is only minor, the tax administration should not make the adjustment. In the United States, an adjustment is possible because of the authority of the IRS. In some other countries, a formal priority for the CUP method applies. In Germany, it could be said that a good businessman should have used the better price asked or offered by an independent third party. A reasonable solution would be for tax administrations to accept the past if the method applied was acceptable in principle, but to insist on using CUPs, if available, in the future.

### *2. Resale price method (RPM)*

The RPM of the Guidelines is similar to the U.S. Regulations (see Point 8 in page 15).

Aspects of comparability are dealt with extensively by the Guidelines. Like the U.S.

Regulations, the Guidelines stipulate that in applying this method differences in products are less significant for comparison than differences in functions performed, assets used, risks assumed and economic circumstances. The RPM may even be more reliable than the CUP method if all aspects except the product itself are comparable in all characteristics.

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

### *3. The cost plus method*

The cost plus method of the Guidelines is similar to the U.S. Regulations.

This method is useful in the case of the sale of semi-finished products, of joint-facility agreements, long-term buy-and-supply contracts or the provision of services within the multinational group. The mark-up can be derived from the profit mark-up that the same supplier earns in comparable transactions with non-related parties. In addition, the profit earned by an independent enterprise in a comparable transaction may serve as a guide. Like the RPM, the aspects of comparability are more extensively examined than in the 1979 Report. In addition, the nature of the costs to be taken into consideration is examined in great detail.

### *4. Other methods*

The Guidelines consider the three "traditional transaction methods" mentioned above to be the most preferable transfer pricing methods. In exceptional cases, where sufficient reliable data is lacking and therefore these methods cannot be applied, other methods may be used.

The Guidelines distinguish two "other" methods which are based on the profits that arise from transactions between related enterprises: the profit-split method and the transactional net margin method (TNMM). In exceptional cases where the necessary safeguards are observed, a transactional profit method can be applied. In no case, according to the Guidelines, are such methods to be used to impose additional tax on enterprises which make lower profits than average (and vice versa).

The CFA of the OECD will monitor the application of these methods in practice.

### *5. Profit-split method*

This method may be applied where transactions are very interrelated. First, the profit to be split must be identified. Then the profit is split between the related enterprises on an economically valid basis that approximates a division of profits in an arm's length situation.

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

The Guidelines state that this method is useful in the absence of comparables. One of the advantages of this method is that both parties to a transaction receive a reasonable remuneration for the functions performed because the contributions of both are evaluated. A weakness of the method is that comparables are usually not available.

#### 6. *Transactional Net Margin Method (TNMM)*

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

The TNMM replaces the CPM included in the draft Guidelines. The word "transactional" has been inserted in the definition and the words "net profit margin" have replaced "the level of profits", apparently for political reasons. Several Member countries, in particular Germany, remained fiercely opposed to profit methods, probably having in mind the CPI and CPM methods of the proposed U.S. Regulations 1992 and Temporary Regulations 1993, respectively, which could even be based on statistical data from the industrial sector concerned.

The CPM of the final U.S. Regulations of 1994 is based on the level of net operating profits of uncontrolled taxpayers engaged in similar transactions under similar circumstances. The TNMM is related to specific transactions, CPM may be "company-wide."

The net margin of the TNMM should be established by reference to the net margin that the same enterprise earns in comparable transactions with non-related enterprises. Where this is not possible, the net margin of an independent enterprise may serve as a starting point. A functional analysis of both the related enterprise and the non-related enterprise is required to determine the degree of comparability.

The greatest weakness of the method is that the net margin can be influenced by

factors that only have a minor or indirect effect on gross margin or price.<sup>7</sup> Furthermore, the one-sided character of the method can lead to a situation in which a member of a multinational group is left with an implausibly low or high profit level.

A taxpayer normally has little information on transactions between non-related enterprises at the time of the controlled transaction. The tax administration may be in a better position because of information derived from examinations of other taxpayers. The Guidelines state that the tax administration's information can only be used if the data can be disclosed to the taxpayer, provided the confidentiality requirements of the law are observed.

## **Administrative approaches**

Chapter IV deals with the administrative approaches which may minimize and solve transfer pricing disputes, both in the relationship between taxpayers and tax administrations as well as between different tax administrations. The Chapter replaces the 1984 Report on corresponding adjustments and mutual agreement procedures ("Three taxation issues"), which had a more limited scope.

The risk of double taxation if different interpretation and application of the arm's length principle occurs may be solved by administrative procedures as set out in this Chapter.

The Chapter also calls for an understanding of the problems of the taxpayer. Transfer pricing is not an exact science and an unrealistic precision may not be expected. Tax administrations should take the commercial judgement of the taxpayer and business realities as a basis.

In this context I shall only discuss two aspects:

### 1. Burden of proof

With respect to the burden of proof, the Guidelines distinguish three situations:

- the tax administration bears the burden of proof;
- the burden of proof falls on the taxpayer if he did not produce appropriate documentation or if he filed a false return, etc.; and
- the burden of proof is on the taxpayer. The taxpayer must prove that the

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<sup>7</sup> E.g., relatively high costs caused by start ups, inefficiencies, poor management, and less motivated work force.

adjustment made by the tax authorities was wrong. This is the case in the United States and in, amongst others, France (in case of transactions with tax havens).

These differences may cause problems which are hard to solve through mutual agreement procedures. The starting point of the Guidelines in such a procedure is that the state that has made the primary adjustment bears the burden of proof that the adjustment is justified both in principle and as regards the amount.

## 2. Advance Pricing Agreements (APAs)

Since their introduction in the United States in 1991 about 50 APAs have been concluded between the IRS and U.S. taxpayers. Less extensively regulated, this type of advance rulings exists in many countries.

An APA is an agreement between a taxpayer and the tax administration for a fixed number of years that specifies the criteria for determining transfer prices for future transactions between related enterprises. In the process of concluding an APA, applicable methods, the degree of comparability with open-market situations, appropriate corrections to comparables and assumptions as to future events may play a role.

Since a unilateral APA may have consequences for related enterprises in other countries, the Guidelines stress the importance of bilateral or multilateral APAs. If domestic legislation does not provide for agreements between the tax administration and taxpayers, APAs can be concluded under the mutual agreement procedure of applicable tax treaties.

According to the Guidelines, APAs differ from private rulings in that APAs deal with factual issues, whereas rulings are concerned with explaining of the law based on facts presented by the taxpayer. In the case of rulings, the facts may not be questioned by the tax administration, whereas under an APA the facts are subject to investigation. APAs usually cover several or all of a taxpayer's transactions for a given period of time, whereas a ruling covers only one particular transaction.

The related enterprises are expected to provide the tax administrations with the transfer pricing method that they consider most appropriate in a given situation, supported by data relating to the industry, markets and countries concerned. In particular, data on comparability and a functional analysis is desirable.

An APA is valid for the agreed period. According to the Guidelines, the APA should include a provision for revising or cancelling the APA for future years when (internal or external) circumstances change significantly.

APAs provide certainty with respect to the tax treatment of transfer prices for a

specified period of time and reduce the risk of double taxation or non-taxation.

Unilateral APAs produce the risk that the tax administrations of other countries disagree with the APA's conclusions. They may also induce over-allocating profits to the country where the APA has been concluded.

## **Documentation**

Chapter V deals with the important topic of documentation from an OECD perspective. Documentation has become essential because of the link to penalty provisions and the wide-ranging obligations in the United States (see Point 8, pages 13 to 19).

The Guidelines are more lenient than the U.S. Regulations: it would be reasonable for a taxpayer to try to collect information on open-market prices when determining a transfer price. It is explicitly stated that there is no obligation to present supporting documents at the time the transfer price is determined or the tax return is filed. Information requirements that should be provided when filing a return should be limited to information which enables the tax administration to select cases for further examination.

The Guidelines also state that it is not reasonable to burden the taxpayer with disproportionately high costs, e.g., in order to obtain documents from foreign related enterprises or in an exhaustive search for comparables, if the taxpayer believes that no comparables exist or if obtaining comparables would incur disproportionate costs for the taxpayer. The taxpayer should not be expected to provide more documentation than the minimum required for a reasonable determination by the tax administration that the taxpayer has complied with the arm's length principle.

## **Intangibles**

### *1. Introduction*

The topic of intangibles has developed since the issuing of the OECD Transfer Report in 1979. In the Report, a distinction was made between transfer of technology (patents and know-how) and the use of trademarks (see paragraphs 76 to 138). In Chapter VI, the Guidelines focus on commercial intangibles (literary and artistic property rights not being relevant in this context) dividing these into trade intangibles usually developed through research and development which are related to the production of goods (also called manufacturing intangibles) and the provision of services, and marketing intangibles which are related to the commercial exploitation of products and services.

Another development with intangibles has been the introduction of the "commensurate

with income" concept in the United States via an amendment to Sec. 482 IRC in 1986 (see Point 7 in page 10). This provision was negatively received by other OECD Member States. The OECD Guidelines react to "commensurate with income" by stating that "hindsight" should be avoided.

## *2. The arm's length principle as applied to intangibles*

The arm's length principle may be difficult to apply to controlled transactions involving intangibles. The special character may complicate the search for comparables and sometimes it is difficult to determine the value at the time of the transaction. It is also possible that a controlled transfer is structured in a manner that independent enterprises would not contemplate.

For the purpose of comparability, the perspectives of both the transferor and the transferee should be taken into account. The point of comparison for the transferor is at which price a comparable independent enterprise would be willing to transfer the right concerned.

The transferee will evaluate whether the expected benefit is satisfactory in relation to the price. It has to be determined whether an independent enterprise would be prepared to pay the price, considering the expected benefits and expenditure to be incurred.

## *3. Arrangements for the transfer*

Transfers of intangible property can be made in four ways:

- a) sale of the intangible;
- b) a licence agreement under which a royalty will be paid. A royalty is a recurring payment based on the user's output, sales or (rarely) profit. The rate may vary depending on the volume. It may be stipulated that changed circumstances lead to a revision of the conditions;
- c) compensation included in the price of goods e.g., selling unfinished products including experience for further processing of the products. The transfer price may be a package price for the goods and for the intangible property. If a country imposes a withholding tax on royalties, the package may have to be disaggregated to calculate a separate arm's length royalty; and
- d) a package covering remuneration for all kinds of intangibles and related technical assistance and training. The parts of the package may need to be considered separately to verify the arm's length character of the transfer.

Know-how contracts and service agreements may be treated differently for tax

purposes. Service fees are usually not taxed in the source country if paid to non-residents. Some countries, however, levy withholding tax on royalties paid for the use of know-how.

#### 4. *Factors relevant for comparability*

The Guidelines give many factors which should be taken into account, the main ones are:

- Expected benefits from the intangible;
- Limitations of use in a geographical sense;
- Exclusive or non-exclusive character;
- Capital investment (e.g., new plant, special machinery);
- Start-up expenses/development work in the market;
- Whether sub-licensing is allowed;
- the nature of the patent, if any (degree and duration of legal protection e.g.);
- the period during which a patent will maintain its economic value; and
- the contribution of the patented process to the final product (if a patent covers only one component, it would be inappropriate to calculate the royalty by reference to the selling price of the complete product).

#### 5. *Methods*

In the case of a sale or license of intangible property, the CUP method may be used if the same owner has transferred comparable intangibles under comparable circumstances to independent parties. If such information is available, the amount of consideration charged in comparable transactions between independent enterprises in the same industry can be taken as a guide.

The resale price method may be used in the case of sub-licensing by the associated enterprise to third parties.

In cases involving highly valuable intangibles, comparables may not be found. In particular, where both parties own valuable intangibles or unique assets the profit-split method may be used.

Costs may be an aid to determine comparability on the relative value of contributions of each party, but it is stressed that there is no necessary link between costs of an intangible and value. Intangibles may be the result of long-lasting and expensive R&D.

### **Intra-group services**

#### 1. *Introduction*

Chapter VII of the OECD Guidelines discusses services provided by one member of a multinational group to other members and the arm's length consideration for such services. Cost contribution methods for services provided in a group are discussed in Chapter VIII in a broader context, including cost contribution arrangements involving intangibles.

The extent of intra-group services varies considerably among MNEs, depending on the structure of the group. In a highly decentralized group the parent may limit its intra-group activity to monitoring its investments in its subsidiaries in its capacity as a shareholder. In contrast, in an integrated group the management of the parent may make all important decisions concerning the affairs of the subsidiaries and may carry out all marketing, training and treasury functions.

A group member may acquire services from independent service providers, from associated service providers or perform the service for itself. Intra-group services may include management, coordination and control functions for the whole group, typical intra-group services such as central auditing, financing advice and training of staff and also services which are typically available externally from independent parties such as legal and accounting services.

## *2. Characterization of activities as an intra-group service*

Whether an activity performed by a group member for one or more other group members can be recognized as an intra-group service under the arm's length principle depends on whether the activity provides the respective group member(s) with economic or commercial value to enhance its commercial position. The yardstick is whether an independent enterprise in comparable circumstances would have been willing to pay for the activity concerned (or to perform it in-house for itself). If not, the activity concerned should not be considered as an intra-group service under the arm's length principle.

The analysis becomes complex where an associated enterprise undertakes activities relating to more than one group member or to the group as a whole. The activity may be performed even if specific group members do not need the activity and would not be willing to pay for it if they were independent. Such an activity would not justify a charge to the recipient companies.

## *3. Shareholder activities*

The typical example of non-chargeable activities is shareholder activities. Shareholder activities comprise costs of activities relating to the juridical structure of the parent itself and to reporting requirements of the parent. Also, costs of raising funds for the acquisition of participations are shareholders costs.

#### 4. *Arm's length methods for intra-group services*

The direct charge method means that associated enterprises are charged for specific services. It is a convenient method for tax authorities because it allows identification of the service performed and the basis for the payment.

If an MNE also provides specific services to independent enterprises (which normally goes with recording the work done and costs extended), it must be able to use the direct method as well for intra-group services of the same kind. MNEs are encouraged to use the direct charge method in such a situation, but it is accepted that - if the services to third parties are marginal or occasional- another method may be used.

When direct charging is possible the CUP method and the cost plus method are particularly appropriate. The CUP method is likely to be used where comparable services are provided in the open market either between external parties or between the associated enterprise and an independent party. Examples are accounting, auditing, legal and computer services.

In the absence of a CUP the cost plus method is probably appropriate.

Points of comparison with independent enterprises are the nature of the activities concerned, the assets used, the risks assumed and the categories of costs that are included.

In exceptional cases, more than one method may be used to reach a satisfactory arm's length price.

A functional analysis may be helpful to establish the relationship between the relevant services and the group members' activities and performance.

In many cases a direct charge method is too difficult to apply within an MNE, however. In such cases, MNEs apply indirect methods such as cost sharing, or incorporate a service charge into the charge for other transfers, or do not charge at all.

Indirect charge methods are allowed provided that:

- any charging is supported by an identifiable and reasonably foreseeable benefit;
- the method is capable of producing charges or allocation of costs that are commensurate with the actual or reasonably expected benefits to the recipient;
- the allocation key makes sense from a commercial point of view in the case

- concerned;
- the method contains safeguards against manipulation; and
  - it follows sound accounting principles.

Indirect charge methods are necessary where the proportion of the value of the services rendered to the various relevant entities cannot be quantified except on an approximate or estimated basis, e.g., in the case of promotion activities carried out centrally, which may affect the production and sales of a number of affiliates.

Indirect charge methods are also acceptable in cases where a separate recording and analysis of the relevant service activities for each beneficiary would involve a disproportionate administrative burden in relation to the activities concerned.

The allocation and charge in such cases may be based on turnover or staff employed, or some other basis which is connected with the nature and use of the service concerned, e.g., a stand-by arrangement for computer backup should be related to the relative expenditure on computer equipment by the group members, not to payroll.

Both the perspective of the service provider and the recipient should be taken into account when determining an arm's length price for intra-group services. Relevant considerations include the value of the service to the recipient, how much an independent enterprise in comparable circumstances would be prepared to pay and also the costs for the provider.

Not only the immediate impact of a service, but also the long-term effect should be considered. For example, costs of a marketing operation may look too high to be borne by a group member given its current resources. One should also bear in mind that some costs will never actually produce the benefits that were reasonably expected when they were incurred. At the time of incurring the costs the expected benefit may justify the charge. The taxpayer should be prepared to demonstrate the reasonableness of its charges in such cases.

##### *5. Profit element in the charge?*

Should a service charge be such that it results in a profit for the provider? An independent enterprise would normally seek to charge for services in such a way as to generate a profit, rather than providing the services merely at costs.

In certain circumstances an independent enterprise may, however, not realize a profit from the performance of services alone e.g., the costs of the supplier may exceed the market price, but the service complements the range of otherwise profitable activities of the supplier.

When the associated enterprise only acts as an agent or intermediary in the provision of services, the mark-up should relate to the costs of the agency function itself rather than to the costs of the service. For example, an associated enterprise which rents advertisement space on behalf of group members may pass on these costs to the group members without a mark-up but apply a mark-up only to the costs incurred as an intermediary.

For practical reasons, tax administrations and MNEs may agree that all relevant costs are charged rather than trying to find arm's length prices for the services concerned. Tax administrations may, however, not agree to charging costs only if the provision of the service is a principal activity of the associated enterprise, where the profit element is relatively significant or where direct charging is possible.

### **Cost contribution arrangements (CCAs)**

Chapter VIII of the OECD Guidelines was published in October 1997. CCAs e.g., cost sharing, may cover costs of intangible property and costs of services in particular. The U.S. regulations on cost sharing only cover intangibles.

A CCA is a contract and normally not a separate juridical entity or permanent establishment. A CCA is not a transfer pricing method itself, but a CCA must be in accordance with the arm's length principle. The other chapters of the OECD Guidelines are therefore also applicable.

Participants' contribution should be in proportion with the share in the expected benefits from the arrangement. Participants may exploit their share as owners, not as licensees, without paying royalties. Outside parties would be required to pay royalties for exploiting a participant's interest.

In a CCA there is always an expected benefit, but this may be uncertain e.g., in the case of research. The interest of each participant should be established from the outset.

The Guidelines state that contributions must be consistent with what an independent enterprise would have contributed under comparable circumstances given the reasonably expected benefits. Independent enterprises would require that each participant's proportionate share of the overall contribution is consistent with its share of the benefits.

Therefore: first determine whether all the parties have the expectation of benefits; then calculate each participant's contribution; finally determine whether the allocation of contributions is proper (as adjusted for any balancing payments among participants).

Acceptance of a CCA also depends on adequate documentation.

The term "benefit" in Chapter VIII is very broad. Independent parties may share risks, minimise the loss potential from an activity, or minimise costs. This means that the benefit of a CCA is not necessarily a profit.

If until the date of termination all participants have paid their contributions and have received all results from the CCA for their own use, usually nothing remains with the CCA that can be allocated. Each participant's share returns to its individual use.

## 10. RECENT DEVELOPMENTS

Since the adoption of the U.S. Regulations in 1994 and the OECD Guidelines in 1995, many countries have introduced new legislation or regulations. The following overview summarizes the main features for the countries concerned:

### Argentina

#### *Tax Reform Act, effective 1 January 1999*

- broad definition of associated enterprises;
- six methods, including TNMM and two profit split methods;
- "most appropriate method to the type of transaction"; and
- burden of proof on taxpayer.

### Australia

#### *Taxation Ruling TR 97/20*

- puts five methods, including profit split and TNMM, on same level, and allows for "indirect methods" including formulary apportionment as last resort solutions;
- arm's length range: ATO may decide to apply a different point in the range;
- refers to "evaluation of arm's length nature from an "external view" (comparability), a "process view" (would independent party have done this?); and a "performance" view ("profit which might have been expected");
- refers to "business sense" outcomes; and
- secret comparables used (see page 37).

#### *Ruling on Charging for Services Rendered to Related Parties (20 January 1999)*

### Austria

Translated OECD Guidelines serve as regulations.

### Brazil

#### *Art. 18, Law 9430/96 and Regulation no. 38 of 30 April 1997*

- broad associated enterprises concept;
- three methods for importation purposes; four for exportation; all are variations of CUP, cost plus and resale, with fixed margins for cost plus and resale (real margin applied upon proof);
- fixed rates for royalties and technical assistance deduction; and
- limitation of deductible interest.

## Canada

### *Draft transfer pricing legislation of September 1997 (now final)*

- follows OECD Guidelines with respect to methods;
- preference for three main methods;
- profit split and TNMM last resort methods;
- heavy documentation requirements and penalties; and
- use of secret comparables not excluded.

## Chile

### *Law 19,506 of 30 July 1997, amending the Income Tax Law, Art. 38, and Ruling no. 3 of 6 January 1998*

- introduction of a broad associated enterprises concept;
- OECD Guidelines are followed; and
- if accounts are inadequate tax authorities may apply the "proportional method" (gross-net revenue ratio of parent applied to gross revenue of branch etc.).

## China (PRC)

### *Regulation 1998 no. 59 of 23 April 1998*

- broad definition of associated enterprises;
- transactional methods have priority over other methods, e.g., CPM.; and
- APAs introduced.

## Denmark

### *New legislation published on 25 February 1998*

- taxpayer must provide documentation on controlled transactions.

## Korea

### *NTA Notice No. 1996-40 of 7 November 1996*

- follows OECD Guidelines: transactional methods have priority over other methods.

## Mexico

### *Arts. 64-A, 65 Income Tax Law ("LIR")*

- 6 methods (2 versions of profit split) on same level;
- arm's length range consistent with OECD; and
- use of secret comparables allowed.

## New Zealand

### *Guidelines of 30 October 1997*

- 5 methods on same level, including CPM (TNMM allowed as alternative to CPM);
- best method rule;
- arm's length range consistent with OECD;
- onus of proof that he has determined the best method in practice on taxpayer;
- flexible approach; no prescriptive, exhaustive regulations; reference to OECD Guidelines, but also to Australian guidelines and U.S. regulations; and
- no formal documentation requirements, but reasonable care condition (penalty).

## Poland

### *Guidelines of 29 April 1996; amended CIT, effective from 1-1-97, and decree 1997*

- OECD Guidelines followed.

## Russia

### *First Part Tax Code of the Russian Federation, Art. 40, effective from 1 January 1999*

- applies to all taxpayers, to barter trade and in situations where prices fluctuate by more than 30% in a short period of time;
- "market price method", resale price method and cost plus method; and
- no order of priority.

## United Kingdom

### *1998 Finance Act; Schedule 28AA*

- new arm's length provision based on Art. 9 OECD Model (but broader formula);
- OECD Guidelines incorporated in legislation by reference;
- adjustment only if U.K. tax advantage;
- no specific transfer pricing documentation requirements;

- no specific transfer pricing related penalties; and
- APAs to be introduced (1999 Finance Act).

## 11. PROBLEMS WITH THE APPLICATION OF TRANSFER PRICING RULES

Transfer pricing is a matter which raises many problems in its application in practice. Apart from these problems, several major complications arise, in particular, with the strong emphasis on comparables in the legislation and regulations of an increasing number of countries, and -to a lesser extent- in the OECD Guidelines. Some problems of the latter type are described below.

1. In the wake of the U.S. transfer pricing regulations of July 1994, the OECD Guidelines emphasize the necessity of comparison with transactions between unrelated companies. The Guidelines recognize nevertheless that there are clear cases in which this is in fact not possible e.g., with the integrated production of highly specialized goods, with unique patents and other intangibles and with particular forms of service. Another complication is that certain transactions are rarely, or never, conducted between independent companies.

Moreover, the basis for comparison seems to become narrower because the number of cross border transactions between independent companies decreases in relation to group-transactions.

The absence of good reference material in many cases is therefore a serious complication in practice.

2. Another problem, also related to comparables, is the use of "secret comparables" by tax authorities. Secret comparables are obtained by tax authorities in audits. In, for instance, Canada, Japan, and Mexico, these are used for checking transfer prices of other taxpayers, without disclosing their source. Taxpayers are not able to defend themselves against an assessment based on secret comparables. Another complication is that, in a mutual agreement procedure, the tax authorities of the other country may not be prepared to agree to a corresponding adjustment if no clear evidence of comparables is given.

In Germany the situation was clarified by the Düsseldorf Regional Tax Court in a decision of 8 December 1998. The court ruled that the use of secret comparables violates the rights of taxpayers and constitutes a breach of tax secrecy.<sup>8</sup>

3. One of the main problems concerns the heavy administrative burden, resulting from the essential role of comparables in the regulations of an increasing number of countries, in particular, when the best method rule applies.

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<sup>8</sup> See IStR (Germany) 10/99, at 311.

The situation in, for example, the United States is as follows. All methods specified in the regulations - the comparable uncontrolled price (CUP), the resale-price, the cost-plus, the comparable profit and the profit split - are in principle equivalent, but a method must be chosen which gives in the relevant situation the most reliable measure of an arm's length price, or result (best-method rule). In selecting a specific method, two factors have to be considered - the comparability with the free-market situation and the quality of the data and assumptions. In case of incomplete comparability, the difference has to be adjusted. Applying adjustments for differences of comparability is in itself already a complicated process.

In practice the best method rule leads to an investigation of the applicability of all specified methods. In order to prevent an administrative penalty in case of correction by the IRS, the search for the best method has to be evidenced adequately with contemporaneous documentation.

As a consequence of the documentation requirements, for all transactions, or at least similar transactions, reference material must be looked for on a continual basis in a short period - markets do change continuously, indeed - and documentation must be kept. The new speciality of "comparables" experts is a concrete example of this economic waste.

It may be wondered whether the equality principle which, according to the OECD, is the foundation for the arm's length principle is out of balance again these days. After all transactions between not-related companies do not evoke such administrative obligations.

It should be realized that transfer pricing is not only a heavy burden for MNEs, but also for tax administrations. An adequate administration of transfer pricing regulations in many countries requires large numbers of specialised auditors. Several countries have extended the tax administration with agencies specializing in transfer pricing auditing. Countries cannot afford to be relaxed in this matter. They may lose revenue to countries with well-trained tax administrations.

4. The controversy between countries on the use of methods based on (operating) profit comparison seems difficult to resolve.

In an increasing number of cases, the CPM is chosen.<sup>9</sup> The CPM is based on a comparison of the operating profit of the taxpayer with that of independent enterprises with a similar sort of transactions under comparable circumstances. As an indicator of the profit level, the ratio between the operating profit and the value of the operating assets may be taken. Data on operating profits are easier to obtain than data about prices of comparable products or data on gross profit margin, which

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<sup>9</sup> See the survey of the International Bureau of Fiscal Documentation of June 1998, which was made available to the participants of the London IFA Congress in September 1998 (also available from the IBFD library).

are necessary for the cost-plus and resale methods. This explains the choice for CPM. At least problems with the IRS can be avoided in this way.

The OECD Guidelines mention, as a problem in the application of methods which compare the net margin (operating profit), the circumstance that the margin can be influenced by factors which have no or little influence on the gross margin or on prices. For instance, poor management and inadequate cost control generally influence the operating profit in particular. For this reason the OECD Guidelines qualify the TNMM - the OECD clone of CPM- as a method which can only be used if the three main methods are not applicable.

The TNMM is a compromise established with great difficulty between the United States and a number of European countries, with Germany as its exponent. Several European countries were, and still are, opposed against the CPM and its predecessors in provisional versions of the U.S. Regulations. In earlier versions of CPM, for instance, the "basic arm's length return method" (BALRM), the possibility existed that an average net result of the relevant economic sector could be used as a criterion by the IRS to adjust lower results at related companies. Such a standardization of taxable profit is of course not acceptable for the international business world and many OECD Member States. Although CPM, contrary to BALRM, is applied on the "most narrowly identifiable business activity", this risk still exists because of the increasing use of external databases with data on profit levels of companies.<sup>10</sup>

In Germany, transfer pricing is regulated in accordance with sound business practice, which stands diagonally opposite methods based on comparison of "net operating profits."<sup>11</sup> Indeed CPM, as it is based on external factors, may have little or no relationship with the economic reality, the structure and the management accounting system of the taxpayer concerned, which are essential elements of the concept of sound business practice. In the above decision, the Düsseldorf Court implicitly ruled out the application of methods based on profit comparison (CPM and TNMM).

Multinational companies with establishments in the United States and in, for example, Germany or Sweden may face the following problem: on the one hand it is possible that they have to apply the CPM (if this is the "best method"), on the other hand tax authorities in Germany and Sweden may refuse to accept transfer prices which are not based on CUP, cost-plus or resale-price.

The negotiating procedure of Art. 25 of the OECD Model treaty, to which Art. 9, paragraph 2, implicitly refers, provides no solution if the competent authorities continue to disagree on the method to be applied. The result of this disagreement may be that

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<sup>10</sup> See a forthcoming article by M. Cools on the use of databases for transfer pricing purposes, *International Transfer Pricing Journal*, IBFD, 1999.

<sup>11</sup> See H. Becker, "The Arm's Length Principle and the Reasonable Businessman", *Tax Planning International* no. 8. August 1987.

double taxation cannot be avoided. The new OECD Guidelines seem therefore not to meet their goals of bridging the U.S.-European differences and the prevention of double taxation.

5. A relatively new problem in transfer pricing and the application of the arm's length principle is the development of so-called global trade, which has become possible because of the liberalization of trade, the abolition of restrictions on monetary exchange, new communication techniques and information technology.

The problem is not restricted to transfer pricing. With the rise of information networks, the traditional attribution of taxing powers for countries has become hard to apply. Presence by means of a permanent establishment is no longer necessary in order to be active on the market of a particular country. Moreover, the place of effective management and the source of income are becoming extremely difficult to locate.<sup>12</sup>

Transfer pricing problems arise in particular in the 24-hour trade in financial derivatives within financial and other groups. The classic intermediary function of the financial sector -combine supply and demand of capital and retain a profit margin- has partially been replaced by transactions in derivatives at own risk.

Derivatives, such as options and swaps, are contractual rights which take their value from the value of something else, for instance bids, goods or currencies. Transactions of this nature are conducted continuously all over the world, at financial establishments mostly by using permanent establishments. The transfer pricing problems in this sector are discussed in a recent OECD report.<sup>13</sup>

The report describes the various functions fulfilled in the trade in derivatives and states that problems are in particular caused by the diversity of locations where the functions in one transaction are conducted, for instance the structuring and selling of the product in New York and its bookkeeping and control in Tokyo.

Apart from the assessment of functions for transfer pricing purposes the problem of attribution of income occurs: to which countries should the result of a transaction be attributed if various entities of a group are involved in financial transactions in various countries. In some countries, for instance Japan and the United States, the "all or nothing" approach is applied, i.e., if there is adequate activity in relation to a certain transaction the complete result is attributed to the permanent establishment, or the headquarters as the case may be. The report indicates that this approach may be in conflict with the arm's length principle and can lead to double taxation: more than one country involved can after all conclude that sufficient activities have taken place within

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<sup>12</sup> J. Owens, "Taxation within a Context of Economic Globalization", Bulletin for International Fiscal Documentation, at 290 et seq.

<sup>13</sup> "The Taxation of Global Trading of Financial Instruments", first version of 14 February 1997, revised version of 17 March 1998.

the country to tax the whole yield.

The report states - probably erroneously - that in many cases the functions and risks of the people concerned in a global trading transaction can be adequately analysed and compared to those in unrelated situations. The traditional transfer pricing methods would be applicable with if necessary some adaptations.

In case of a high level of integration of functions, the profit split method may qualify according to the report. For the partition in joint profit made in global trading transactions, the following factors in particular must be quantified: the trade and marketing function, the risk factor, and the support function. Because these factors are not of equal commercial interest, they have to be weighed. The report does not supply clear directions for this weighing.

## **12. SOLUTIONS FOR THE TRANSFER PRICING PROBLEM?**

Because of the strong emphasis on comparison with non-related enterprises the shortcomings become obvious:

- if good reference material is not available, in many cases artificial adaptations are necessary;
- tax authorities in certain countries may use comparables which are not accessible to taxpayers;
- there are heavy administrative burdens, both for MNEs and tax administrations;
- there is no consensus on methods and the priority of methods; and
- transfer pricing is difficult to apply to global trade.

Solutions can be sought within the ambit of the arm's length principle, in alternative methods of profit allocation or in reducing the impact of transfer pricing through the introduction of regional rather than national corporate tax systems.

Some possible solutions are as follows.

### *1. Do away with the best method rule*

The best method rule included in the U.S. Regulations is not an obligatory feature of the arm's length principle itself, but in the wake of the United States many OECD and other countries have introduced such a rule. The OECD Guidelines, however, seem not in favour of the best method rule, stating in Art. 1.69 that analyses under more than one method are not required.

As indicated above, in particular the best method rule causes a high administrative burden for MNEs, because of the necessity of collecting external data under all possible methods continuously. Another aspect is that because of the emphasis on external data, transfer pricing methods for tax purposes may have to be applied which have little

relationship with the business reality of the company concerned.

The focus should be more balanced. The intention should be to select a transfer pricing method which fits into the structure of the group concerned and meets management accounting and commercial concerns within the framework of the tax legislation.

Accordingly, tax legislation should specify the three main methods plus the negotiated transfer price method and also profit split (not CPM and TNMM for the reasons given above).

A well-documented transfer pricing system, mandatory for all group members or members of a division of a group and based on methods specified in the tax laws, which is applied consistently, should, in principle, be followed by the tax authorities concerned.

Adjustments should only be made if the transfer prices applied deviate beyond a certain range (safe haven) from CUPs or comparable gross margins evidenced by the tax authorities, and -when the negotiated price method is applied- if the conditions of freely negotiating as independent parties are not met.

## *2. Formulary apportionment methods*

Formulary apportionment methods allocate the consolidated profits of a group among the entities of the group in the various countries by applying a particular formula, for instance, a formula based on a combination of turnover, costs, assets and payroll.

A somewhat less extreme form is unitary taxation. In this case, the attribution concerns the result of a unitary business, a combination of group companies which can be considered an economic entity.

Formulary apportionment methods are, for example, applied in Canada, the United States and Switzerland to apportion the profit made to respectively the provinces, states and cantons.

The OECD report of 1979 does not support the use of formulary apportionment. In Art. 14 it is stated that the use is in conflict with Arts. 7 and 9 of the OECD Model treaty. This is indeed the case with Art. 9 and partly with Art. 7. The fourth section of Art. 7, however, leaves room for the use of other methods than the "separate entity approach."

As material objections against formulary apportionment the report puts forward that:

- there is no clear relationship with the real economic situation of the relevant group companies;
- it leads to random results;

- there will be administrative burdens for the tax authorities and the multinational; and
- the risk of double taxation exists in case of divergent application by tax authorities.

The OECD Guidelines go more deeply into the objections against formulary apportionment (Chapter III, Art. 3.61 et seq.). The main objection is the absence of international consensus and coordination. There should be agreement regarding the composition of the group among which the profits are apportioned, the formula to be applied, the determination of the consolidated profit and the use of a common accounting system.

According to the OECD, countries will tend to emphasize factors in the formula which lead to a favourable result for the country concerned. Moreover, activities which influence factors relatively strongly can be shifted to low taxing countries.

A formulary apportionment method seems, however, to fit in better with the current and expected developments than the arm's length principle. The arm's length principle after all is based on the idea of national economies and independent enterprises, not on that of integrated organizations and global trade.

The basic assumption of formulary apportionment is positive: a reasonable distribution of group profit among the countries where the group is active. The arm's length principle on the contrary is in the first place meant to prevent profit shifts.

Objections against arm's length pricing mentioned in paragraph 11, such as the search for comparables and the difficult applicability to global financial trade, are largely absent. The administrative burden for the MNEs and also the task of the tax authorities could be much lighter because the apportionment takes place on basis of internal, available data.

The "presumptive taxation" character of formulary apportionment is sometimes mentioned as an objection. "Presumptive tax" systems seem to lose, however, their old-fashioned reputation, the more so since reality has become too complicated in many cases to do justice to it for tax purposes.

Many arguments for and against formulary apportionment have been exchanged in literature in the last 20 years.<sup>14</sup> In connection with the developments described above it seems time again to make the applicability of formulary apportionment an official subject of study, especially in the OECD.

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<sup>14</sup> A.o.: H. Kogels, "Unitary taxation: an international approach", Bulletin for Fiscal Documentation, 1983, at 65 et seq; Stanley I. Langbein, "The Unitary Method and the Myth of Arm's Length", Tax Notes 1986 at 625 et seq.; Joann M. Weiner, Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level", Tax Notes International, 1996, at 2113 et seq.

Application inside Europe of a unitary method -e.g., based on the concept of the European company- will be less difficult following the introduction of a single currency and the harmonization of accounting rules.<sup>15</sup>

### 3. *Profit split*

Profit split is recognised in the U.S. regulations as a specified method, subject to the best method rule. The OECD Guidelines treat profit split as a method subordinate to the three main methods, but in principle as an arm's length method. An important consideration in the Guidelines (Art. 3.6) is that "one strength of the profit split method is that it generally does not rely directly on closely comparable transactions, and it can therefore be used in cases when no such transactions between independent enterprises can be identified." External data may, however, be relevant to assess the value of each party's contributions.

Another advantage is that only a real profit can be split. Under other methods the use of external data may lead to the imposition of profits which in reality were not made by the enterprise concerned.

Profit split may be used for one transaction, for a bundle of transactions or even for all dealings between related enterprises. The main difference with formulary apportionment methods is the absence of a predetermined formula. A sound split is based on adequate remuneration for functions and risks of the parties concerned.

As the information needed for the application of profit split is, in principle, available within the group concerned, a burdensome search for comparables is not necessary as a rule. In Japan and Canada, profit split seems to acquire a more prominent position than proposed by the OECD Guidelines.<sup>16</sup>

An increased application of profit split may, therefore, reduce problems in the transfer pricing area.

### 4. *European company tax*

Various authors have made proposals for a EU company tax. Morris Tabaksblat, the chairman of the board of directors of Unilever in 1993 has suggested the introduction of a EU company tax, based on the consolidated results of activities of multinationals within the European Union. The tax would be levied by a EU institution and the revenue

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<sup>15</sup> See J.A.M. Klaver and A.J.M. Timmermans "EU Belastingpolitiek" (Dutch), *Weekblad voor Fiscaal Recht*, 22 April 1999, at 506.

<sup>16</sup> See Tax Management Transfer Pricing Report, 30 June 1999 at 175.

would be apportioned among the member states according to an agreed distribution formula. The EU tax would replace the national company taxes completely for companies opting for this system. At one go a great number of problems would be solved: transfer pricing problems inside the European Union would no longer exist, mergers would take place without tax complications (as far as not already solved by the EC Merger Directive) and also interest and royalties could be paid without withholding at source and losses within the European Union could be compensated.<sup>17</sup>

Plasschaert<sup>18</sup> too describes the advantages of a EU company tax and compares this with the introduction of a unitary tax in the European Union. He concludes that a EU company tax for MNEs is to be preferred to unitary taxation in the European Union, especially because fiscal neutrality is so realized to a higher extent.

Transfer pricing problems with third countries will, however, remain in either case.

Economically speaking, the EU company tax is an attractive option, because the costs will decrease considerably both for EU businesses and the tax authorities, but politically speaking it is unfortunately not realistic. Not a single Member State now seems to be prepared to give up its sovereignty in this field. A small step in the right direction has been achieved, however, with the installation of a committee of Member States that will critically follow tax competition.<sup>19</sup> Moreover, possibly successful actions by the Commissioner for competition of the European Union, using Art. 92 of the treaty against government support in the form of tax measures, may at least take away one incentive to maintain national corporate taxes.

##### 5. *European Home State Taxation*

In a paper dated 18 June 1999,<sup>20</sup> the so-called Stockholm Group put forward the idea of Home State Taxation (HST) in the European Union. HST allows enterprises which have their headquarters in a Member State to adopt the tax system of that Member State and apply it to their activities in those Member States which have joined the system. In this way the tax base for a group of companies operating in various Member States is calculated under the rules of the tax system of the parent company's Home State. Next the tax base is allocated to the Member States where the group conducts its activities on the basis of a formula (e.g., an adjusted VAT base). Each Member State applies its own tax rate to the allocated tax base.

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<sup>17</sup> See M. Tabaksblat, Intertax, 1993, at 16 et seq.

<sup>18</sup> See S. Plasschaert, An EU Tax on the Consolidated Profits of Multinational Enterprises, European Taxation 1997, at 2 et seq.

<sup>19</sup> The so-called Code of Conduct-Group.

<sup>20</sup> To be published in European Taxation; main authors prof. S.O. Lodin and Malcolm Gammie.

This system removes transfer pricing problems among the participating Member States and also the risk of double taxation, and allows full loss compensation. As a consequence, the administrative burden both for MNEs and tax administrations would be reduced. Unlike other formulary apportionment systems, the tax system of the Home State (a concept which needs further development) is the clear and firm basis of HST. An adjusted VAT base seems a better basis for allocation than traditional formulas based on turnover, assets, payroll, etc. If successful in Europe, HST could also be introduced in other countries (provided that there is agreement on the formula).

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