SPECIAL REPORTS

The Arm's-Length Principle and Fair Value: Identical Twins or Just Close Relatives?

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Under domestic tax law, the value of property and services is important in two distinct situations. First, when a transfer of property takes place, the value is decisive for establishing the correct tax base of the parties. If a misvaluation is made, the tax laws may call for transfer pricing adjustments and other consequences. Second, value is pivotal in many situations when *no* transaction takes place. Examples of this include rules on thin capitalization, exit taxation, mark-to-market recognition of capital gains and losses, net wealth taxation, and property taxes. In both situations the question arises as to which standard determines the economic value.

Under perfect competition there would only be one market price in a long-term equilibrium. However, most markets are characterized by imperfect competition, causing market prices to be relative. This is one reason why there is no clear concept of economic value. Valuation in tax law should be legally rooted in a specific valuation standard, since it would otherwise be impossible to predict the tax consequences of genuine business transactions with any degree of certainty. Tax equality also calls for certainty in this field in order to prevent the tax planning opportunities that would be available if taxpayers were allowed to engage in standard shopping, selecting and applying the valuation standard that minimizes their taxation under the circumstances of each case. Either a single valuation standard may be applied throughout domestic tax legislation or several different standards may be adopted to reflect the specific purpose of each tax provision.

The OECD model income tax convention addresses valuation in article 7(2), on business profits of permanent establishments, and article 9(1), on associated enterprises. The central principles underlying both provisions are the separate entity approach and the arm's-length principle.[1] These articles impose a restriction so that domestic tax law may not enforce a valuation standard that triggers more burdensome taxation than would apply under the arm's-length principle.[2] The OECD model does not otherwise touch upon valuation, as this is the prerogative of domestic tax law.[3] For example, article 13, which addresses capital gains, does not govern how capital gains should be calculated.[4]

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[1]Paras. 3 and 16 of the commentary on article 7 of the OECD model; para. 2 of the commentary on article 9 of the OECD model; and para. 1.6 of the OECD guidelines.

[2]J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Alphen aan den Rijn: Kluwer Law International, 2010), p. 193.

[3]However, articles 10(2) and 11(2) of the OECD model limit the tax rate of the source state.

[4]Para. 12 of the commentary on article 13 of the OECD model.

The arm's-length principle of article 9(1) is the valuation standard applicable to transfer prices of multinational enterprises in international and domestic tax law. Although the arm's-length principle has been internationally recognized for nearly 80 years,[5] recent transfer pricing cases show that its basic content is disputed. Key controversies include whether the arm's-length principle is identical to fair value of financial reporting and similar standards of domestic tax law, and whether benefits stemming from the relationship among members of a multinational enterprise must be recognized or disregarded. These issues have been addressed most recently by the Federal Court of Appeal of Canada in *General Electric Capital Canada v. The Queen*.[6] Comments submitted to the OECD in response to its newly launched project on intangibles suggest that uncertainty also exists among practitioners regarding the relationship between the two standards.

Against this background, the goal of this article is to examine the content of the arm's-length principle of article 9(1) of the OECD model in relation to fair value. First, an international analysis is made based on the arm's-length principle of article 9(1) of the OECD model and the fair value standard of the International Accounting Standards Board. Second, a survey and a comparative analysis are made of the valuation standards and the interpretation of the arm's-length principle in the domestic tax laws of 10 jurisdictions, representing different legal traditions. Third, an examination is then undertaken of some of the implications of the proper interpretation of the arm's-length principle of article 9(1).

I. International Valuation Standards

The arm's-length principle and fair value are well-known international valuation standards. A comparison of these two standards is interesting because it may assist in exploring the basic content of the arm's-length principle. Clear definitions of the two standards are also critical, as transfer pricing analyses may incorporate approaches of corporate finance and financial reporting, which may rely on fair value.[7] Further, experts with limited knowledge of taxation and the arm's-length principle are often involved in valuations prepared for transfer pricing purposes. It is therefore critical to ensure that valuation methods that deviate from the arm's-length principle do not affect transfer pricing analyses.

A. The Arm's-Length Principle

The authoritative international definition of the arm's-length principle used in transfer pricing is set out in article 9(1) of the OECD model:

> 1. Where
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> a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
>
> b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
>
> and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

The arm's-length principle is interpreted in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD guidelines). The arm's-length principle of article 9(1) and the OECD guidelines are sources of law for the interpretation of tax treaties as well as domestic transfer pricing provisions in many countries.[8] The arm's-length principle is applied in conjunction with the separate entity approach, under which members of multinational enterprises are recognized as separate entities for tax purposes.[9]

B. Fair Value

The IASB applies the following definition of the fair value standard for financial reporting purposes:

> Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.[10]

[5] The arm's-length principle was introduced in international tax law by articles 3 and 5 of the League of Nations 1933 Draft Convention on the Allocation of Business Income Between States for the Purpose of Taxation. *See Fiscal Committee — Report to the Council on the Work of the Fourth Session of the Committee* (Geneva: League of Nations Document C.399.M.204.1933.II.A, June 26, 1933).

[6] Federal Court of Appeal decision of Dec. 15, 2010, *General Electric Capital Canada Inc. v. The Queen*, 2010 FCA 344.

[7] Para. 9.94 of the OECD guidelines recognizes that valuation methods used in acquisition deals between independent parties may prove useful for transfer pricing purposes.

[8] T. Miyatake, ''Transfer Pricing and Intangibles,'' *Cahiers de droit fiscal international*, vol. 92a (2007), at 19, 21.

[9] Para. 5 of the preface and para. 1.6 of the OECD guidelines. The separate entity approach also underlies article 5(7) of the OECD model.

[10] *See, e.g.*, International Accounting Standard No. 16, ''Property, Plant and Equipment.''

A draft of the international financial reporting standards has been issued, adopting a slightly modified definition of fair value:

> Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.[11]

The IFRS draft definition is identical to the definition of fair value applied under U.S. generally accepted accounting principles by the Financial Accounting Standards Board.[12] The new definition should be seen in light of the goal of the convergence of IASB and FASB accounting standards.

C. Comparison

The OECD guidelines do not compare the arm's-length principle and fair value. At first glance, the arm's-length principle and fair value look alike, as both focus on the price that would be agreed to between independent parties. A more detailed comparison can be made by dividing the two standards into three constituent elements:

- the controlled transaction;
- the reference transaction; and
- the valuation.

The comparison is based on the IFRS draft definition of fair value. Both standards recognize the controlled transaction as actually structured.[13]

Both standards require the reference transaction to be concluded between mutually independent parties.[14] The arm's-length principle establishes a comparability requirement under which the principle must be applied based on the conditions of comparable uncontrolled transactions entered into under comparable circumstances.[15] The arm's-length principle thus requires the object and all the other economically relevant aspects of the transactions to be comparable. The arm's-length test should consider the relative bargaining powers of the parties,[16] economies of integration,[17] synergetic resources,[18] business relationships,[19] and the actual business experience of the parties.[20] This means that there must be a subjective, entity-specific valuation made *ex ante*.[21] Further, the arm's-length principle is based on an assumption of profit maximization[22] and arguably also of informational symmetry.[23] Similarly, fair value establishes a comparability requirement regarding the object of the valuation, requires the valuation to be made on an *ex ante* basis, and assumes informational symmetry and profit maximization.[24] However, fair value is based on a hypothetical market (the most advantageous market), a hypothetical transaction (an orderly transaction), and hypothetical market participants (knowledgeable and willing).[25] This excludes any element of entity-specific value or of value that would not be available in a typical market transaction.[26] Examples of entity-specific factors that may be excluded from fair value are economies of integration, synergetic intangibles, relative bargaining powers, legal rights, tax benefits, and location savings. This means that fair value constitutes an objective, market-based valuation.

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[11]Para. 1 of the IASB Exposure Draft 2009/5, ''Fair Value Measurement.''

[12]Para. 5 of the Statement of Financial Accounting Standards No. 157, ''Fair Value Measurement.''

[13]Para. 1.64 of the OECD guidelines; para. 5 of the IASB Exposure Draft 2009/5; and para. 6 of SFAS 157.

[14]Para. 1.6 of the OECD guidelines; paras. 8-10, ''Uncontrolled Transactions,'' *Comparability: Public Invitation to Comment on a Series of Draft Issues Notes* (Paris: OECD, 2006); para. 13 of IASB Exposure Draft 2009/5; and para. 10 of SFAS 157.

[15]Paras. 1.3, 1.6, and 1.15 of the OECD guidelines.

[16]Paras. 2.122 and 9.149 of the OECD guidelines.

[17]*See* Section III.B of this article.

[18]The profit methods should be applied on the basis of the actual resources of the parties including resources that are not available to market participants such as ''unique'' contributions. *See* paras. 2.4, 2.25, 2.26, 2.32, 2.59, 2.60, 2.61, 2.73, 2.109, 2.112, 2.121, 2.137, 3.19, 3.39, 6.26, and 9.153 of the OECD guidelines.

[19]Paras. 9.127 and 9.128 of the OECD guidelines.

[20]Paras. 3.59-3.62 of *Tax Aspects of Transfer Pricing within Multinational Enterprises — the United States Proposed Regulations* (Paris: OECD, 1992).

[21]G. Maisto, ''Transfer Pricing in the Absence of Comparable Market Prices,'' *Cahiers de droit fiscal international*, vol. 77a (1992), at 19, 28. *See, e.g.*, para. 2.112 of the OECD guidelines:

> Another strength of the transactional profit split method is that it offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises.

Some Belgian writers characterize the arm's-length principle of article 9(1) as relying on an objective approach under which subjective elements of an associated enterprise or the multinational enterprise to which it belongs are not taken into account. *See, e.g.*, L. De Broe, *International Tax Planning and Prevention of Abuse: A Study under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies* (Amsterdam: IBFD, 2008), at 80 and 95; and P. Cauwenbergh, A. Gaublomme, and L. Hinnekens, ''Transfer Pricing in Belgium — Rulings and Practice,'' 62 *Bull. Int'l Tax'n* (2008), at 384, 387. Based on the analysis set out above, this position must be rejected.

[22]Paras. 1.34, 1.35, 1.74, 6.14, and 7.33 of the OECD guidelines.

[23]Wittendorff, *supra* note 2, at 338.

[24]Paras. 5, 7, 8, and 13 of IASB Exposure Draft 2009/5; and paras. 7 and 10 of SFAS 157. On the position on informational symmetry, see *Basis for Conclusions on Exposure Draft Fair Value Measurement*, ED/2009/5 (London: IASB, 2009), at BC44-45.

[25]Paras. 7, 8, and 13 of IASB Exposure Draft 2009/5; and paras. 7 and 10 of SFAS 157.

[26]C. Clark, S. Blough, and W. Williams, ''Reconciliation of Purchase Price Allocation and Transfer Pricing,'' 18 *Tax Mgmt. Transfer Pricing Rep.* (Apr. 22, 2010), at 1235.

Table 1. Comparison of the Arm's-Length Principle and Fair Value

	Arm's-Length Principle	Fair Value
Controlled transaction	Recognized as actually structured	Recognized as actually structured
Reference transaction	Independence requirement	Independence requirement
	Comparability requirement:	Comparability requirement:
	- Actual object	- Actual object
	- Actual transaction	- Hypothetical transaction
	- Actual participants	- Hypothetical participants
	- Actual market	- Hypothetical market
Valuation	Dual perspective	One-sided perspective
	Aggregation of multiple transactions, broad commercial criterion	Aggregation of multiple transactions, narrow technical criterion
	Arm's-length range	Highest and best use principle
	Best method rule	Best method rule
	Profit maximization	Profit maximization
	Motive immaterial	Motive immaterial
End result	Subjective, entity-specific value	Objective, market-based value

Regarding the valuation, both standards are transactional and price-based.[27] An aggregation approach should be applied when the value of an asset in use with other assets exceeds the value of the asset alone.[28] However, under the rules on aggregation,[29] setoff,[30] and multiple-year analyses,[31] the arm's-length principle may require a wider spectrum of assets and transactions to be considered. Fair value is an exit price; it is viewed from the perspective of the seller and relies on a ''highest and best use'' principle.[32] This one-sided aspect of fair value is reinforced by the use of hypothetical market participants that may lead to the value for both parties being identical. In contrast, the arm's-length principle considers the perspectives of both parties,[33] recognizes arm's-length ranges,[34] and rejects the highest and best use principle.[35]

The key similarities and differences between the arm's-length principle of article 9(1) and fair value are outlined in Table 1.

D. Summary

The arm's-length principle of article 9(1) of the OECD model and fair value are distinct valuation standards that diverge from each other in significant respects.[36] The arm's-length principle calls for a subjective, entity-specific valuation, whereas fair value requires an objective, market-based valuation. Thus,

[27]Paras. 1.33 and 1.35 of the OECD guidelines; para. 15 of IASB Exposure Draft 2009/5; and para. 7 of SFAS 157.

[28]Paras. 3.9, 3.13-3.17, and 3.75-3.79 of the OECD guidelines; para. 22 of IASB Exposure Draft 2009/5; and para. 13 of SFAS 157.

[29]Paras. 3.9 and 3.10 of the OECD guidelines.

[30]Paras. 3.13-3.17 of the OECD guidelines.

[31]Paras. 3.75-3.79 of the OECD guidelines.

[32]Paras. 17-21 of IASB Exposure Draft 2009/5; and paras. 12-14 of SFAS 157.

[33]Paras. 6.14, 7.29, 7.30, 7.33, 8.35, 9.63, 9.72, 9.81, 9.84, 9.91, 9.92, and 9.116 of the OECD guidelines.

[34]Paras. 3.55-3.66 of the OECD guidelines.

[35]Para. 6.15 of the OECD guidelines.

[36]Maisto, *supra* note 21, at 29; and J.C. Pagan and J.S. Wilkie, *Transfer Pricing Strategy in a Global Economy* (Amsterdam: IBFD, 1993), at margin 10.13 and 10.24. For another view, see W.F. Finan and S. Work, ''Valuing Intangibles for Transfer Pricing and Accounting Standards Purposes: Similarities and Potential Differences,'' 17 *Tax Mgmt. Transfer Pricing Rep.* (Feb. 5, 2009), at S-2, concluding that the general standard applied in corporate finance and in transfer pricing is the same.

valuations performed under the two standards will not necessarily coincide, as the two standards pursue different objectives. The arm's-length principle is intended to prevent income shifting, tax base erosion, and double taxation; fair value is intended to inform readers of financial statements about the value of booked assets and liabilities. Moreover, the arm's-length principle is always applied to actual transactions, whereas fair value is often used in the absence of an actual transaction that may dictate the contour of the reference transaction. Perhaps the OECD and the IASB recognize the conceptual difference between the standards, as the two organizations have not commented on each other's recent projects. That the two standards may lead to diverging results is evidence of the relative nature of economic value. This is the why the International Valuation Standards Council has adopted an objective standard (market value)[37] and subjective standards (investment value and special value),[38] which may be applied in different contexts.

II. Domestic Valuation Standards

A. United States

The United States applies both the arm's-length principle and a fair market value standard in its tax law. Fair market value is the basic valuation standard under U.S. tax law[39]; it is not defined in the Internal Revenue Code but has evolved in case law.[40] The concept of ''a willing seller and a willing buyer'' was introduced in 1925.[41] In 1927 it was added that neither the seller nor the buyer should be viewed as being under a compulsion to enter into the transaction.[42] In 1929, it was clarified that the seller and the buyer are hypothetical persons, with knowledge of all the relevant facts of the transaction.[43] In 1936, the Supreme Court held that fair market value should be determined on the basis of the best use of the property.[44] Fair market value thus means an objective valuation resembling fair value.[45] According to the IRS:

> The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.[46]

The arm's-length principle is applied to both domestic and cross-border transactions under the transfer pricing provision in section 482 of the code. Section 482 is characterized by the vagueness of its description of the valuation standard, allowing wide authority for the IRS to fill in the gaps in the law.[47] Under the regulations promulgated under section 482, the arm's-length principle has been adopted as the sole valuation standard (''in every case'').[48] Although the IRS claims that the arm's-length principle in the regulations and in the OECD guidelines are wholly consistent,[49] there are some important differences. The key differences relate to rules in the regulations dealing with:[50]

- the economic substance principle;
- the realistic alternative principle; and
- periodic adjustments under the commensurate with income standard.

The application of such rules is outside of the scope of article 9(1) of the OECD model and the OECD guidelines.

An analysis of the arm's-length principle of U.S. tax law may take as its starting point *U.S. Steel Corp.*, which was decided on the basis of the section 482 regulations promulgated in 1968.[51] This case concerned a U.S. parent company that paid the same rate as unrelated steel manufacturers for sea freight provided by a foreign subsidiary, even though the parent company accounted for approximately 73 percent of the gross revenues of the subsidiary. The appeals court held that because the

[37]Para. 3.1 of the International Valuation Standard 1 (London: International Valuation Standards Council, 2007).

[38]Paras. 3.3 and 3.5 of the International Valuation Standard 2 (London: International Valuation Standards Council, 2007).

[39]*See, e.g.*, IRC sections 84A(2), 475(a)(1), 307(b)(1)(B), 684(a)(1), 724(c)(2), 752(c), 755(a)(1), 1060(a)(2), and 1273(b)(3)(B)(ii).

[40]D. Laro and S.P. Pratt, *Business Valuation and Taxes: Procedure, Law, and Perspective* (New York: John Wiley & Sons, 2005), at 7.

[41]*Appeals of Charles P. Hewes*, 9 BTA 1279, 1282 (1925).

[42]*Hudson River Woolen Mills v. Commissioner*, BTA 862, 868 (1927).

[43]*National Water Main Cleaning Co. v. Commissioner*, 16 BTA 223 (1929).

[44]*St. Joseph Stock Yards Co. v. United States*, 298 U.S. 38, 60 (1936).

[45]SFAS 157, at C50.

[46]Treas. reg. sections 1.170A-1(c)(2), 1.704-4(a)(3), and 20.2031-1(b).

[47]The authority of the IRS has been described as follows: ''When I use the words 'arm's length,' it means just what I choose it to mean — neither more nor less.'' *See* R.B. Schrotenboer, ''Arm's Length in Wonderland,'' *Tax Notes Int'l*, Jan. 26, 2004, p. 351, *Doc 2004-557*, or *2004 WTD 16-13*. This statement has been echoed by Edward Kleinbard, chief of staff of the Joint Committee on Taxation: ''We can simply interpret arm's length to mean what we think it should mean, and if we say it correctly, that's what it means,'' in Lee A. Sheppard, *Tax Notes Int'l*, Sept. 22, 2008, p. 970, *Doc 2008-19749*, or *2008 WTD 182-9*. Moreover, in an analysis of the arm's-length nature of the U.S. cost-sharing regulations, the court of appeals has said that ''Congress and regulators may adopt a technical definition of a term that is distinct from its plain meaning.'' *See Xilinx Inc. v. Commissioner*, 567 F.3d 482 (9th Cir. 2009).

[48]Treas. reg. section 1.482-1(b)(1). This was confirmed in the revised opinion of *Xilinx Inc. v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010).

[49]Advisory Memorandum 2007-007, Issue 5.

[50]Wittendorff, *supra* note 2, at 771.

[51]*U.S. Steel Corp. v. Commissioner*, 617 F.2d 942 (2nd Cir. 1980).

subsidiary had performed identical services for the parent company and the unrelated companies, and had charged the same rate for the services, the 1968 regulations did not authorize making any adjustments, even though the other circumstances indicated that the transfer price for the controlled transactions meant that income shifting had occurred. Hence, the Court thus relied on an objective, market-based valuation.

In 1986 Congress addressed the decision as follows:

> Certain judicial interpretations of section 482 have suggested that pricing arrangements between unrelated parties for items of the same apparent general category as those involved in the related party transfer may in some circumstances be considered a ''safe harbor'' for related party pricing arrangements, even though there are significant differences in the volume and risks involved, or in other factors. See, e.g., *United States Steel Corporation v. Commissioner*, 617 F. 2d 942 (2d Cir. 1980).[52]

Congress's concerns led the IRS to emphasize the comparability requirement in the new section 482 regulations promulgated in 1994.[53] Under current law both the transaction and all the economically relevant circumstances must be comparable.[54] The regulations leave little doubt that the arm's-length principle deviates from both fair value and fair market value.[55] Hence, the following factors must be considered under the arm's-length test and should be disregarded under fair (market) value:

- economies of integration caused by the interrelationship among group members[56];
- ongoing business relationships[57];
- market share strategies[58];
- the relative bargaining position of the parties[59];
- the actual market[60];
- arm's-length ranges[61];
- a dual perspective[62];
- realistic alternatives that are not available to market participants[63];
- synergetic resources[64]; and
- the actual profit experience of intangibles under the periodic adjustments rules.[65]

Thus, in U.S. tax law the arm's-length principle requires a subjective, entity-specific valuation just like its OECD counterpart.

The 2012 budget proposals would amend section 482 to codify the realistic alternative principle for intangibles and the aggregation principle for multiple transactions for intangibles.[66] The Joint Committee on Taxation has compared the use of realistic alternatives with the highest and best use principle of fair market value, which was intended to be added to section 482 by the 2010 budget proposals.[67] The committee argued that the two principles are similar because both require consideration of uses of property that may yield a

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[52]General Explanation of the Tax Reform Act of 1986, P.L. 99-514, 99th Cong., House of Representatives 3838 (JCS-10-87).

[53]Preamble, Explanation of Revisions and Summary of Comments, the Final Regulations, in TD 8552 (IRB 1994-31).

[54]Treas. reg. sections 1.482-1(d)(3)(ii)(A)(2) and 1.482-1(d)(3)(iii)(A).

[55]For a contrary view equating the arm's-length principle with fair market value, see H. McClure, ''Alternative Approaches to Determining an Arm's Length Royalty Rate,'' 43 *J.L. & Tech.* (2002), at 111; and the U.S. Council for International Business, Comments on Temporary Cost Sharing Regulations, *available at* http://www.uscib.org/docs/FINAL_Comments_on_Temporary_Cost_Sharing_Regulations.pdf. The Tax Court seems to have equated the arm's-length principle with fair market value in some cases decided under the 1968 regulations. *See, e.g.*, *BTR Dunlop Holdings, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 1999-377 (1999); and *DHL Corporation and Subsidiaries v. Commissioner,* T.C. Memo. 1998-461 (1998). However, this should have no bearing on the interpretation of the 1994 regulations.

[56]Treas. reg. sections 1.482-1(f)(2)(i) (Example 3), 1.482-9(l)(3)(v), and 1.482-9(l)(5) (Example 19). An IRS official has stated that the rules ''are meant to prevent any one parent or subsidiary from taking the benefit from economies of scale that belong to the overall group as a whole.'' *See* D. Stamper, *Tax Notes Int'l*, Nov. 12, 2007, p. 666, *Doc 2007-24560*, or *2007 WTD 215-10*, quoting John M. Breen, former branch chief, IRS branch 6.

(Footnote continued in next column.)

[57]Treas. reg. section 1.482-1(d)(3)(ii)(A)(6).

[58]Treas. reg. section 1.482-1(d)(4)(i).

[59]Treas. reg. section 1.482-1(d)(4)(ii)(C). *See Sundstrand Corp. v. Commissioner*, 96 T.C. 226 (1991); *Compaq Computer Corp. v. Commissioner*, 78 T.C. 20 (1999); *Bausch & Lomb, Inc. v. Commissioner*, 933 F.2d 1984 (2d Cir. 1991); and *Westreco, Inc. v. Commissioner*, T.C. Memo. 1992-561 (1992).

[60]Treas. reg. section 1.482-1(d)(4)(ii)(A).

[61]Treas. reg. section 1.482-1(e).

[62]J.P. Warner and H.B. McCawley, *Transfer Pricing: The Code and the Regulations* (Washington: 887 Tax Management, Foreign Income Portfolio, 2004), at A-78(1).

[63]Treas. reg. sections 1.482-1(d)(3)(iv)(H), 1.482-1(f)(2)(ii)(A), 1.482-3(b)(2)(B)(8), 1.482-3(e)(1), 1.482-4(d)(1), 1.482-7T(g)(2)(iii)(A), 1.482-7T(g)(4)(i)(A), and 1.482-9(h).

[64]The profit methods, including the income method, should be applied based on the actual resources of the parties, including resources that are not available to market participants, such as ''non-routine'' contributions. *See* Treas. reg. sections 1.482-6(c)(3)(i)(B)(i) and 1.482-7T(g)(7)(i).

[65]Treas. reg. section 1.482-4(f)(2).

[66]Treasury, ''General Explanations of the Administration's FY 2012 Revenue Proposals'' (Washington: Mar. 2011), at 45.

[67]JCT, ''Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment'' (Washington: JSC-4-09, Sept. 2009), at 51.

greater return than the current use.[68] However, it is recognized that taxpayers may argue that under the case law on highest and best use, value unique to the owner is not compensable.[69] For example, for intangibles owned by a multinational group, this value may reflect the synergies uniquely available to an integrated enterprise that may not be obtainable in the external market. For this reason the JCT has stated that a codification of the highest and best use principle should ensure that the IRS continues to have the ability to take into account the unique capabilities of the controlled parties. The shift from the highest and best use principle in the 2010 budget proposals to the realistic alternative principle in the 2012 budget proposals may be explained by the following:

- the confusion that would be caused if the content of the highest and best use principle under section 482 diverged from the content of the principle adopted in case law;
- the OECD rejects the highest and best use principle;
- the OECD recognizes the realistic alternative principle[70]; and
- the code, regulations, and other administrative guidance make only limited direct references to the highest and best use principle.[71]

A codification of the realistic alternative principle would mean that section 482 would continue to produce subjective, entity-specific values.

B. Canada

Canada applies the arm's-length principle and a fair market value standard in its tax law.[72] Fair market value is the governing standard under subsection 69(1) of the Income Tax Act, which generally applies to the transfer of property in controlled transactions.[73] However, subsection 247(2)(a) of the ITA applies the arm's-length principle to cross-border transactions. The legislative history of this provision requires the arm's-length principle to be construed in line with article 9(1) of the OECD model and the OECD guidelines.[74]

The relationship between the arm's-length principle and fair market value was addressed in a 1987 circular, which stated:

> The term ''reasonable arm's length price'' in this circular . . . may mean fair market value or another amount depending on the circumstances in a particular case. The presumption is that a reasonable arm's length price would be fair market value but, for example, if a particular supplier were attempting to increase market share, the supplier might temporarily establish an arm's length price that was below the current fair market value.[75]

The tax authorities thus recognized that the arm's-length principle and fair market value are distinct valuation standards. The issue has also been addressed in a couple of cases. In *Indalex*, the Federal Court of Appeal raised the issue regarding ITA subsection 69(2) (predecessor to subsection 247(2)(a)), but without giving an opinion on it:

> Whether an ''expense is reasonable in the circumstances'' for the purposes of section 67 and section 69(2) requires the same test as ''fair market value'' in subsection 69(1)(a) has not been raised. They have been treated by counsel as raising identical considerations.[76]

General Electric Capital Canada concerned whether guarantee fees charged by GE Capital Corp. (GECUS) to GE Capital Canada Inc. adhered to the arm's-length principle under subsection 247(2)(a) (and subsection 69(2)).[77] The tax authorities disallowed a deduction for the fees, based on the argument that in the absence of a guarantee arrangement, the taxpayer's credit rating would be equalized with that of GECUS by reason of affiliation. Reference was made to paragraph 7.13 of the OECD guidelines dealing with passive association, which provides that no service would be received when, by reason of its affiliation alone, an associated enterprise has a higher credit rating than it would have had it been unaffiliated. The taxpayer argued that any benefit enjoyed by the taxpayer by virtue of its affiliation with GECUS should not be considered, because distortions arising from the parties' relationship should be eliminated to arrive at an arm's-length result. The Tax Court noted that it had to choose between two opposite positions:

- whether all the economically relevant factors have to be considered in determining an arm's-length

[68]*Id.* at 51.

[69]*Id.* at 52.

[70]Wittendorff, *supra* note 2, at 174 and 341.

[71]*See supra* note 67, at 45.

[72]On the interaction between the two provisions, see F. Vincent and B. Bloom, ''Fair Value is not 'Arm's Length': Applying and Interpreting Subsections 69(1) and 247(2) of the Canadian Income Tax Act,'' 15 *Tax Mgmt. Transfer Pricing Rep.* (Nov. 22, 2006), at 550.

[73]The case law on fair market value under subsection 69(1) is discussed by N. Boidman, *IBFD Transfer Pricing Database*, Canada, para. 2.1.2.4.4.

[74]Paras. 4, 8, and 29 of Information Circular 87-2R, Canada Revenue Agency, Sept. 27, 1999.

[75]Para. 7 of Information Circular No. 87-2, Feb. 27, 1987, Revenue Canada. This circular has been canceled and replaced by Information Circular 87-2R, Canada Revenue Agency, Sept. 27, 1999.

[76]*Indalex v. The Queen*, 88 DTC 6053 (1988).

[77]*General Electric Capital Canada Inc. v. The Queen*, 2009 TCC 563 (2009).

price for the transaction in order to arrive at a meaningful comparison; or

- whether all factors particular to the non-arm's-length relationship must be disregarded (paragraph 187).

Referring to paragraphs 1.6 and 1.15 of the OECD guidelines (now paragraphs 1.6 and 1.33), the Tax Court stated:

> [205] This is a clear articulation of the importance of maintaining the relevant economic characteristics of the controlled transaction in order to ensure the reliability of the comparisons with uncontrolled transactions.

The Tax Court further held:

> [237] As a result, GECUS, the guarantor, exerted control over the Appellant's default risk. A third-party guarantor would not control the financial function of its debtor. It would not determine how and when the debtor would issue debt. It would not manage the debtor's cash flow and control debt payments.
>
> . . .
>
> [239] Undoubtedly because the parties were not dealing at arm's length, there was no need to agree in advance to a term for the guarantee. However, this situation could not exist, for the reasons noted above, if a third-party arrangement was entered into. Therefore, an arm's length guarantor would assume more risk than GECUS, and this would require either an adjustment in the pricing or the use of an alternative methodology to determine the arm's length price. I believe that all of the above factors would be different for a third-party insurer or guarantor; they would undoubtedly magnify the risk for the insurer or guarantor, thus resulting in a higher premium.

The Tax Court thus concluded that the relationship between the parties should not be disregarded under the arm's-length test. On this basis the court accepted the concept of implicit support, which led to a rating increase of three notches from the stand-alone rating of the subsidiary. (See Section III.F.3 of this article.) Moreover, the court rejected an insurance-based method because, in contrast to GECUS, an independent guarantor would have no control over the debtor's default risk. The Federal Court of Appeal affirmed the Tax Court's decision, noting:

> [54] The concept underlying subsection 69(2) and paragraphs 247(2)(a) and (c) is simple. The task in any given case is to ascertain the price that would have been paid in the same circumstances if the parties had been dealing at arm's length. This involves taking into account all the circumstances which bear on the price whether they arise from the relationship or otherwise.[78]

A key issue in *GlaxoSmithKline* was whether, under ITA subsection 69(2), an aggregated examination should be made of a supply agreement for active pharmaceutical ingredients (API) between a Canadian company and a Swiss sister company (Adechsa), and a license agreement between the Canadian company and its U.K. parent company (Glaxo Group).[79] The license agreement gave the Canadian company the right to use the API to manufacture, market, and sell medicines, as well as to use the trademark associated with the products. The taxpayer argued that an aggregated arm's-length test should be made of the two agreements, since the group's transfer pricing policy involved distribution companies, like the Canadian company, retaining a total gross margin of 60 percent, taking into account both the cost of the API and the royalty. The tax authorities argued that the two agreements should be looked at separately since they covered distinct subject matters and there was no tie-in between the two agreements. On this basis it was argued that the arm's-length test of the supply agreement should not take the license agreement into account. The Tax Court concurred with the tax authorities and denied that an aggregated arm's-length test should be made. The decision was revised by the Federal Court of Appeal, which held that the Tax Court had misunderstood the arm's-length test in subsection 69(2); thus, if the appellant had been dealing with Adechsa at arm's length, the price paid would have been ''reasonable in the circumstances.''[80] The Court stated:

> [73] In my view, the test set out in *Gabo, supra*, requires an inquiry into those cicumstances which an arm's length purchaser, standing in the shoes of the appellant, would consider relevant in deciding whether it should pay the price paid by the appellant to Adechasa for its ranitidine.
>
> [74] Consequently, it is my view that the Judge was bound to consider those circumstances which an arm's length purchaser would necessarily have had to consider. In other words, the test mandated by subsection 69(2) does not operate regardless of the real business world in which the parties to a transaction participate.
>
> [75] This is not what the Judge did. Rather, he determined the ''fair market value'' of ranitidine, which he found to be the price paid by Apotex and Novopharm, and then found that anything paid by the appellant over that amount, save for a $25 per kilo upward adjustment, was in excess of ''the reasonable amount.''

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[78]Federal Court of Appeal decision of Dec. 15, 2010, *General Electric Capital Canada Inc. v. The Queen*, 2010 FCA 344.

[79]*GlaxoSmithKline Inc. v. The Queen*, 2008 TCC 324 (2008).

[80]*GlaxoSmithKline Inc. v. The Queen*, 2010 FCA 201, para. 69.

> [76] Clearly, in the circumstances of this case, the Judge's approach was mistaken. In a real business world, presumably an arm's length purchaser could always buy ranitidine at market prices from a willing seller. However, the question is whether that arm's length purchaser would be able to sell his ranitidine under the Zantac trademark. In my view, as a result of the approach which he took, the Judge failed to consider the business reality which an arm's length purchaser was bound to consider if he intended to sell Zantac.

The Court thus made a clear distinction between the arm's-length principle and the fair market value standard. Referring to the ''circumstances'' that should be considered, the appeals court mandated the Tax Court to render the final decision of whether the transfer prices complied with the arm's-length principle. This case is evidence that in Canadian tax law, the arm's-length principle and the fair market value standard are distinct valuation standards and that the arm's-length principle results in a subjective, entity-specific value.

C. United Kingdom

The U.K. tax laws include the arm's-length principle and a market value standard. The market value standard may be applied to a transaction either because of specific legislation or on the basis of case law.[81] The arm's-length principle is laid down in section 147 of the Taxation (International and Other Provisions) Act 2010[82] and it should be interpreted on the basis of article 9(1) of the OECD model and the OECD guidelines.[83] Section 147 applies to both domestic and cross-border transactions. Market value requires the assumption of a hypothetical willing buyer and a hypothetical willing seller.[84]

The interpretation of the arm's-length principle in domestic U.K. law was addressed in *DSG*, which dealt with the compensation paid to an Isle of Man company (DISL) that assumed insurance and reinsurance risks regarding warranties provided by an affiliated U.K. retail company (DSG). Here, the special commissioners analyzed the differences between Schedule 28AA (predecessor to section 147) and section 770 (predecessor to Schedule 28AA):

> Third, s 770 requires one to determine the price which would have been paid if the parties ''had been independent parties dealing at arm's length.'' It seems clear to us that those words do not require any adjustment to be made in setting the price to the actual characteristics of the parties other than their independence. The actual assets, business and attributes of each party remain constant and may be relevant to the determination of the arm's length price. The language of para. 1(2)(a) is different: ''differs from the provision which would have been made between independent enterprises.'' It is at first sight possible that those ''independent enterprises'' may not be enterprises which do not share the same attributes as the actual parties to the provision. But it is clear to us that that interpretation is not consistent with the OECD model (see in particular the emphasis on comparability in the extracts below which presupposes looking at the actual characteristics of the enterprises between which provision has been made) and therefore that para. 1(2)(a) should be interpreted as requiring consideration of what provision independent enterprises sharing the characteristics of the actual enterprises would have made.[85]

On the basis of their actual characteristics, the relative bargaining positions of the parties were decisive for the outcome of the case. *DSG* suggests that the arm's-length principle in U.K. tax law requires a subjective, entity-specific valuation.

D. Australia

Australian tax law applies the arm's-length principle and a market value standard. There is no general statutory definition of market value, so it is necessary to take into account the context in which the term is used in each case. The meaning of the market value standard was addressed by the High Court in *Spencer*:

> The test of value of land is to be determined, not by inquiring what price a man desiring to sell could have obtained for it on a given day, i.e. whether there was, in fact, on that day a willing buyer, but by inquiring: What would a man desiring to buy the land have had to pay for it on that day to a vendor willing to sell it for a fair price but not desirous to sell?[86]

The Court thus recognized the principles of:

- the willing but not anxious vendor and the willing but not anxious purchaser;
- a hypothetical market;
- the parties being fully informed of the advantages and disadvantages associated with the asset being valued (in the specific case, land); and
- both parties being aware of current market conditions.

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[81] A.J. Casley, *IBFD Transfer Pricing Database*, the United Kingdom, para. 2.1.

[82] Previously Schedule 28AA of the Income and Corporation Taxes Act 1988.

[83] Section 164 of the Taxation (International and Other Provisions) Act 2010.

[84] Casley, *supra* note 81.

[85] *DSG Retail Ltd. v. HMRC,* [2009] SC 3056, 3057, 3060/07, para. 78.

[86] *Spencer v. The Commonwealth of Australia*, (1907) CLR 418.

According to the tax authorities, market value should be determined on the basis of the highest and best use principle, and all interrelated assets should be valued on the same basis.[87] Market value thus calls for an objective, market-based valuation. The tax authorities have stressed that the market value standard is not identical to the arm's-length principle.[88] However, this position has since been called into question by *SNF* (see below).

The arm's-length principle is laid down in Division 13 of Part III of the Income Tax Assessment Act 1936 and applies only to cross-border transactions.[89] The tax authorities generally interpret the arm's-length principle of Division 13 and the Australian tax treaties in line with article 9(1) of the OECD model and the OECD guidelines.[90] However, regarding cost contribution arrangements, the Australian tax authorities have made the following statement, which would lead to the actual circumstances of a controlled transaction being disregarded:

> It might be argued that it is not commercially realistic to expect CCA participants to share information as to their projected benefits from the arrangement, as independent parties would not divulge such confidential information. In other words, the application of the arm's-length principle to a CCA should not assume a degree of information and knowledge sharing that would not exist between independent parties to such an arrangement.[91]

The meaning of the arm's-length principle of Division 13 was examined by the Federal Court of Australia in *SNF*,[92] which dealt with the transfer prices charged by foreign companies to an affiliated Australian distributor company for polyacrylamide products. The tax authorities argued that the proper test was to determine what consideration an arm's-length party in the position of the taxpayer would have paid for the products, rather than to determine their fair value.[93] The court rejected this argument (paragraph 44) as follows:

> I do not accept the Commissioner's submission that the test is to determine what consideration an arm's length party *in the position of the taxpayer* would have given for the products. The essential task is to determine the arm's length consideration in respect of the acquisition. One way to do this is to find truly comparable transactions involving the acquisition of the same or sufficiently similar products in the same or similar circumstances, where those transactions are undertaken at arm's length, or if not taken at arm's length, where suitable adjustment can be made to determine the arm's length consideration that would have taken place if the acquisition was at arm's length. Just as in a valuation, the focus is not on the subjective or special factors of the parties involved in the transaction (e.g. whether they were financially sound or not), but is on the transaction itself and the consideration paid. In this sense, the task is not dissimilar to that undertaken in a valuation — see e.g. *Boland v. Yates Property Corporation Pty Ltd,* [1999] HCA 64; (1999) 167 ALR 575 at [82] to [83] and *Spencer v. The Commonwealth,* (1907) 5 CLR 418. [Emphasis in original.]

The court thus favored an objective valuation in which the focus is on the actual transaction and on the consideration paid, rather than on the subjective or special factors of the parties involved. The court did not rely on the U.K. *DSG* case because, unlike the U.K. transfer pricing legislation, Division 13 does not refer directly to the OECD model and the OECD guidelines (paragraph 48). Although the legislative history of Division 13 refers to the OECD guidelines, the court held that the wording of section 136AD(3) of Division 13 was sufficiently clear for consideration of the OECD material not to be necessary (paragraph 49). The decision suggests that the arm's-length principle of Australian tax law must be characterized as an objective, marked-based standard that deviates from the arm's-length principle of article 9(1) of the OECD model.

E. Germany

German tax law applies a number of valuation standards, including the arm's-length principle and a market value standard. Market value (*gemeiner Wert*) is the basic valuation standard that applies unless the legislation specifies some other standard.[94] Market value is an objective value, because personal circumstances relating to the seller, the buyer, or the relationship between the parties must be disregarded.[95]

The arm's-length principle (*Fremdvergleich*) is laid down in section 1 of the Foreign Tax Act (Aussensteuergesetz) and is generally interpreted in line with

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[87] Part A, *Market Valuation for Tax Purposes*, Australian Taxation Office (ATO), May 28, 2010.

[88] *Id.*

[89] It has been proposed that the arm's-length principle should generally apply to the calculation of taxable profits under the proposed minerals resources rent tax. *See* section 5 of *Issues Paper: Technical Design of the Minerals Resource Rent Tax*, Australian Government, Policy Transition Group, Oct. 1, 2010.

[90] Paras. 156, 157, and 164 of ATO Taxation Ruling 94/14.

[91] Para. 132 of Taxation Ruling 2004/1.

[92] *SNF (Australia) Pty Ltd. v. Commissioner*, Federal Court of Australia 635 (2010).

[93] *Id.* at para. 92.

[94] Section 9 of the Valuation Act (*Bewertungsgesetz*).

[95] S. Kreutziger et al., *Bewertungsgesetz Kommentar* (Munich: Verlag C.H. Beck, 2009), section 9, at margin 10.

the OECD guidelines.[96] Section 1 applies only to cross-border transactions, but other provisions covering both domestic and cross-border transactions normally also rely on the arm's-length principle.[97] It is the prevailing opinion that the purpose of the arm's-length principle is to prevent income shifting between associated enterprises (*Verlagerungsneutralität*), rather than to create tax parity between associated enterprises and independent enterprises (*Konzernneutralitt*).[98] The Federal Fiscal Court has concurred with this view in a case in which no security was offered in a controlled loan transaction:

> An agreement on the provision of security in relation to a loan is not a purpose in itself. It may only be required when an independent creditor, under similar or comparable circumstances, would have required security. This may be avoided when the independent creditor in fact has the possibility of influencing the loan debtor to take care of the loan repayment. For this reason, the Federal Fiscal Court decided in its judgment of 21 December 1994 I R 65/94 (BFHE 176, 571) that in the case of loan transactions between companies in a group, no security may be required when the group association itself provides security. This decision is also in line with the arm's length principle. The latter only requires the close relationship to be disregarded. The continued existence of all other relationships is assumed. This includes, for example, the endowment of the company with equity capital from shareholders, the provisions of the articles of association, the goodwill arising from the group association and actual existing security. [Unofficial translation.][99]

The decision means that the arm's-length test should consider all economically relevant circumstances, including the relationship between the associated enterprises. Economies of integration have been expressly recognized by the transparency clause added to section 1(1) of the Foreign Tax Act in 2007. This provision assumes informational symmetry between associated enterprises.[100] Similarly, a hypothetical arm's-length test under section 1(3) must consider, for example, location savings, synergies, tax benefits, subsidies, and the relative bargaining positions of the actual parties.[101] Hence, in German tax law, the arm's-length principle means a subjective, entity-specific valuation.

F. The Netherlands

The arm's-length principle is the only valuation standard in Dutch tax law.[102] The principle is codified in section 8b of the Corporate Income Tax Act (Wet op de vennootschapsbelasting) and applies to both domestic and cross-border transactions. According to the legislative history, the arm's-length principle of section 8b should be interpreted in line with article 9(1) of the OECD model and the OECD guidelines. The Dutch Supreme Court has upheld a decision on the interpretation of the arm's-length principle under which there must be an evaluation of whether an unrelated company would have accepted the terms of a controlled transaction if it had been in the same situation as the group company.[103] The Court thereby rejected the tax

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[96]Para. 5 of the 2010 transfer pricing circular on relocation of functions (BStBl I 2010 774). *See* O. Wehnert, ''Transfer Pricing and Intangibles,'' *Cahiers de droit fiscal international*, vol. 92a (2007), at 273, 275. However, some amendments to section 1 enacted in 2007 arguably contradict the arm's-length principle of article 9(1), including the new commensurate with income standard.

[97]The other relevant provisions are:
- section 8(3), second sentence, of the Corporate Tax Act, dealing with hidden distribution;
- sections 4(1) and 5(6) of the Income Tax Act, dealing with hidden contributions; and
- sections 4(1) and 5(6) of the Income Tax Act, dealing with the withdrawal of assets.

See Wittendorff, *supra* note 2, at 303.

[98]*See, e.g.*, H. Baumhoff, in: H. Flick, F. Wassermeyer, and H. Baumhoff (eds.), *Aussensteuerrecht* (Cologne: Loose-leaf, 66th release, Oct. 2010), section 1, at margin 117, 261, and 285; D. Gosch, *Die steuerliche Betriebsprüfung* (2003), at 60; K. Sieker, in: H. Debatin and F. Wassermeyer (eds.), *Doppelbesteuerung: DBA*, Band 1 (Munich: Loose-leaf, 109th release, Oct. 2009), article 9, at margin 139 and 218; and T. Rödder, *Steuerberater-Jahrbuch* (1997/1998), at 115, 126.

[99]Federal Fiscal Court decision of Oct. 29, 1997, I R 24/97 (BStBl II 1998 573). *See also* the Federal Fiscal Court decision of Dec. 21, 1994, I R 65/94, *Deutsche Steuerrecht* (1995), at 847. The Fiscal Court of Cologne has confirmed this position in its decision of Aug. 22, 2007, 13-K-4234/03 (EFG 2008 154). The Federal Fiscal Court has accepted that the interest savings arising from the execution of financial transactions without the use of an intermediary bank may be shared equally between the creditor and debtor. *See* the Federal Fiscal Court decisions of Feb. 28, 1990, I R 83/87 (BStBl II 1990 649); Jan. 19, 1994, I R 93/93 (BStBl II 1994 725); and Oct. 22, 2003, I R 36/03 (BStBl II 2004 307).

[100]Para. 149 of the circular on Relocation of Functions of Oct. 13, 2010, IV B5 — S 1341/08/10003.

[101]*Id.* at para. 93.

[102]R. Betten, *IBFD Transfer Pricing Database*, the Netherlands, para. 2.1.

[103]Supreme Court decision of June 28, 2002 (BNB 2002/343). *See* M. van Herksen, ''Applying Group Dynamics in Defining Arm's-Length Principle,'' 11 *Tax Mgmt. Transfer Pricing Rep.* (Aug. 7, 2002), at S-3; and M. van Herksen and M. van der Lande, ''Transfer Pricing in Practice: Conclusions Drawn From a Recent Supreme Court Decision,'' 9 *Int'l Transfer Pricing J.* (2002), at 192.

authorities' argument that there should be an evaluation of whether the terms of the controlled transaction would have been agreed to by unrelated companies. The arm's-length principle was thus construed as a subjective standard.

G. Belgium

Belgium applies the arm's-length principle as well as other valuation standards in its tax law. Before 2004, transfer pricing cases were normally evaluated under articles 26, 49, 54, 207, and 344(2) of the Income Tax Act (Code des impôts sur le revenu).[104] The key provision was article 26, under which ''abnormal or gratuitous benefits'' granted by a resident company to resident or nonresident individuals or companies must be added back to the income of the company. Article 26 does not apply if the benefit is taken into consideration in determining the taxable income of the recipient.[105] The courts have interpreted the arm's-length principle underlying article 26 as requiring a subjective valuation that takes into account the specific circumstances of the transaction, the companies involved, and the multinational group as a whole.[106] However, article 54 dealing with deductions for certain cross-border payments is construed as an objective standard.[107] Articles 26 and 54 still apply to transactions that fall outside the scope of article 185(2). In 2004 the arm's-length principle was laid down in the new transfer pricing provision in article 185(2). This provision applies only to cross-border transactions and should generally be interpreted in line with the OECD guidelines.[108] However, article 185(2)(b) provides an exception under which Belgium refrains from taxing the profits that a Belgian company would not have realized had it not been a member of a multinational group. This means that valuation is made on a stand-alone basis so that no part of economies of integration realized by a multinational group should be allocated to a Belgian group member, and the accounting profits may exceed the tax profits of a Belgian company. For Belgian tax purposes, it is immaterial whether the excess profits are actually subject to tax in the hands of other group members.[109] Hence, although article 185(2)(b) is basically an antiavoidance provision, it also incorporates a tax incentive feature that accommodates a tax-efficient use of Belgium as the country of residence for principal companies in global supply chains.[110]

H. Denmark

Danish tax law applies the arm's-length principle and a market value standard. Under general tax provisions, market value (*handelsværdien*) applies to transactions falling outside the scope of the transfer pricing provision and to other tax provisions (for example, the thin capitalization rules). Market value is not defined in the legislation, and the courts have not established a general definition of it. An administrative ruling suggests that market value involves an objective valuation.[111] The arm's-length principle is laid down in the key transfer pricing provision in section 2 of the Tax Assessment Act (*ligningsloven*), which applies to both domestic and cross-border transactions. The legislative history of section 2 calls for the arm's-length principle to be interpreted on the basis of article 9(1) of the OECD model and the OECD guidelines.

The treatment of transaction cost savings under the arm's-length principle of section 2 has been addressed in two cases. *TT Meditrade* concerned the arm's-length test of the rental for a holiday home that a company had made available for its sole shareholder for a full year without using a rental agency.[112] The Supreme Court decided that the arm's-length rent should be fixed at the net income that the company could have obtained through a rental agency. *A.J. Aamund* also concerned the arm's-length test of the rental of a holiday home that a company had made available for a shareholder for a full year without the payment of normal rental fees.[113] The Supreme Court held that the arm's-length rental should not be reduced by the amount of normal rental fees that were not incurred. Hence, in *TT Meditrade*, the cost savings were fully allocated to the buyer (tenant), since the arm's-length rent

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[104]De Broe, *supra* note 21, at 77; and B. Peeters and P. Cauwenbergh, ''Implementation of the Internationally Accepted 'At Arm's Length' Standard in Belgian Tax Law Regarding Multinational Groups of Companies,'' 23 *Intertax* (1995), at 558.

[105]De Broe, *supra* note 21, at 78; and I. Verlinden, ''Transfer Pricing and Intangibles,'' *Cahiers de droit fiscal international*, vol. 92a (2007), at 101, 104. The tax consequences may be different when the transfer price exceeds the arm's-length price, according to a decision of the Belgian Constitutional Court of Dec. 22, 2010. *See* W. Heyvaert, ''Court Upholds Double Taxation of Non-Arm's Length Advantages,'' *Tax Notes Int'l*, Jan. 17, 2011, p. 185, *Doc 2011-527*, or *2011 WTD 7-1*.

[106]De Broe, *supra* note 21, at 81 and 95; Peeters and Cauwenbergh, *supra* note 104, at 558, 563; and Cauwenbergh, Gaublomme, and Hinnekens, *supra* note 21, at 384.

[107]De Broe, *supra* note 21, at 112; and Peeters and Cauwenbergh, *supra* note 104, at 558, 568.

[108]Para. 5 of Circular Ci.RH.421/580.456 (AOIF 40/2006) of Nov. 14, 2006.

[109]Cauwenbergh, Gaublomme, and Hinnekens, *supra* note 21, at 384; and De Broe, *supra* note 21, at 96.

[110]I. Verlinden and C. Costermans, ''Supply Chain Management,'' 13 *Int'l Transfer Pricing J.* (2006), at 172.

[111]Para. A.2 of Circular 185 of November 17, 1982. *See also* Skattepolitisk redegørelse (Ministry of Taxation, June 1994) at 163. A Supreme Court decision of January 7, 2011, supports the view that the market value means an objective valuation. Hence, under the Danish thin capitalization rules, a major shareholding in a publicly listed company was valued on the basis of the quoted stock price rather than the actual purchase price of the shareholding, which included a control premium. *See* SKM 2011.15.HR.

[112]*Tidsskrift for Skatter og Afgifter* (2004), No. 903.

[113]*Tidsskrift for Skatter og Afgifter* (2008), No. 1337.

was fixed at the market rental reduced by ordinary transaction costs. In contrast, in *A.J. Aamund*, the cost savings were fully allocated to the seller (lessor), since the arm's-length rental was set at the market rental without a reduction for ordinary transaction costs. These two cases thus arrived at opposing results, which may perhaps be due to the lack of recognition of the nature of economies of integration and doubt as to the correct treatment of such advantages for transfer pricing purposes.

Transaction cost savings of a vertically integrated group were at issue in *Haribo Lakrids*.[114] This case concerned a Danish parent company that had adopted integrated production planning whereby it undertook the stock management of its subsidiaries. Because of the benefits of this arrangement for the parent company, the subsidiaries were granted a prolonged fixed credit period. The National Tax Tribunal recognized the arm's-length nature of the combined arrangement and overturned an imputation of interest made by the tax authorities.

There have been several cases in which informational symmetry has been ascribed great importance regarding the valuation of unsecured bonds that were not intended to be and were not traded on the open market.[115] This has been the situation when the creditor was working for the debtor company and when the creditor has had a dominant influence on the debtor company or on the drafting of the terms of the bond. The valuations have focused on the value of the bond for the actual creditor. For the purposes of the valuation, account has not only been taken of the terms of the bonds but also of the fact that the creditor had intimate knowledge of and influence over the affairs of the debtor company. Such circumstances can mean that there is de facto security for the creditor. This security has affected the valuation, and this has meant that the transfer prices of the bonds have been fixed at a higher, subjective value than the objective market value.

I. Sweden

Swedish tax law applies the arm's-length principle and a market value standard. The market value (*marknadsvärdet*) of chapter 61, section 2 of the Income Tax Act (Inkomstskattelagen) generally applies when goods or services are provided by an enterprise at prices below the market value (*uttagsbeskattning*).[116] The wording of the provision and its legislative history suggest that it requires an objective valuation,[117] and this has been confirmed by the Supreme Administrative Court.[118] The taxation of the transferor does not apply to some ''below market value transfers'' (*underprisöverlåtelser*).[119] It is a condition for the application of this exemption that the transferee is liable to Swedish taxation on business profits.[120] Thus, while cross-border transactions must be made at arm's-length prices, domestic transactions can be executed at cost-only prices.

The arm's-length principle applies under the domestic transfer pricing provision in chapter 14, section 19 of the act, which applies only to cross-border transactions. This provision and its legislative history do not require interpretation on the basis of article 9(1) of the OECD model or the OECD guidelines. Nevertheless, the Supreme Administrative Court has held that OECD guidelines may be relied on in interpreting the transfer pricing provision.[121]

The question whether market value and the arm's-length principle are identical standards has not been addressed at an administrative level or by the courts.[122] In Swedish tax law the arm's-length principle deviates from fair value because of the application of the principle of making an overall assessment (*helhetsbedömning*) of the controlled transactions of a taxpayer.[123] This means that there are no requirements for a setoff to be based on a prior agreement between the parties, for the controlled transactions in question to have taken place in the same tax year, for the benefits to be quantified precisely, or for the transactions to be concluded between the same group companies. Further, in *Diligentia*, the Supreme Administrative Court held that the relationship between associated enterprises should not be disregarded under the arm's-length test.[124] The case concerned loans made by a Swedish insurance company to a 100 percent owned Swedish real estate company. The subsidiary was initially financed by third-party debt bearing interest rates of around 4.5

[114]*Tidsskrift for Skatteret* (1996), No. 282.

[115]*Ugeskrift for Retsvæsen* (1974), No. 698; *Tidsskrift for Skatteret* (1984), No. 246; *Tidsskrift for Skatteret* (1984), No. 582; *Tidsskrift for Skatteret* (1984), No. 586; *Tidsskrift for Skatteret* (1985), No. 211; *Tidsskrift for Skatteret* (1986), No. 143; *Tidsskrift for Skatteret* (1993), No. 402; *Tidsskrift for Skatteret* (1993), No. 521; *Tidsskrift for Skatter og Afgifter* (1998), No. 396; *Tidsskrift for Skatter og Afgifter* (2000), No. 96; and *Tidsskrift for Skatter og Afgifter* (2003), No. 732.

[116]Ch. 22, section 7 of the Income Tax Act.

[117]Proposition 1989/90:110, at 319 and 655; Proposition 1998/99:15, at 166; and Proposition 1999/2000:2 Part 2, at 662.

[118]*Regeringsrättens årsbok* (1996): Ref. 75.

[119]Ch. 22, section 11, and Ch. 23, section 9, of the Income Tax Act.

[120]Ch. 23, section 16 of the Income Tax Act.

[121]*Regeringsrättens årsbok* (1991), Ref. 107.

[122]At least one difference is that the arm's-length principle should be applied on the basis of a principle of caution, which is not applicable to the market value standard.

[123]*Regeringsrättens årsbok* (1979), 1:40; *Regeringsrättens årsbok* (1980), 1:59; *Regeringsrättens årsbok* (1984), 1:16; *Regeringsrättens årsbok* (1991), Ref. 107; and *Regeringsrättens årsbok* (2006), Ref. 37. *See* S. Aldén, *Om regelkonkurrens inom inkomstskatterätten* (Gothenburg: Nerenius & Santérus Förlag, 1998), at 165 and 181; and Wittendorff, *supra* note 2, at 370.

[124]Supreme Administrative Court's decision of June 28, 2010, case 2483-2485-09. On this case, see K. Moran and R.P. Österman, *Skattenytt* (2010), at 718.

percent against mortgages on its real property. The third-party loans were replaced by loans from the parent company, and the interest rate was set at 9.5 percent because the mortgage security was removed and the subsidiary did not provide any other security for the new loans. The tax authorities disallowed the portion of the interest expenses that were held to exceed the market interest rate. The relationship between the companies was thus held to reduce the credit risk of the parent company. The Court recognized the reasoning of the tax authorities as follows:

> The risk that a borrower cannot meet his payment obligations and the existence of a need for security are of key importance for the pricing of loans. Different assumptions exist when a parent company makes a loan to a subsidiary than when there is an external lender. While a parent company exercises control over the subsidiary, the external lender will usually only have partial insight. The external lender may also be unsure about the parent company's intentions, for example, its willingness to support the subsidiary financially and in other ways, if necessary. This illustrates that a loan from a parent company to its subsidiary has distinctive features which influence the credit risk and thereby the interest rate, and these features are lacking where the lender and the borrower are unrelated to each other. Under otherwise similar terms, the acceptable interest rate for tax purposes cannot simply be determined on the basis of what would have been market terms if the lender had been external. The Supreme Court finds that the credit risk in this case was lower than it would have been if the loan agreement had been concluded between independent parties. [Unofficial translation.]

The decision means that the arm's-length test of a loan granted by a parent company to its subsidiary should take into account the de facto security that control over a subsidiary gives the parent company. The case is thus evidence of a subjective, entity-specific valuation. Although it was decided on the basis of the tax rules on operating costs, it is likely that a similar reasoning would be applied under the transfer pricing provision.

J. Norway

Norway applies the arm's-length principle and a market value standard in its tax law. The market value standard (*omsetningsverdi*) in section 5-3 of the Tax Act (Skatteloven) is applied for the purpose of valuing income that is not realized in the Norwegian currency, such as goods and services provided by a business (*uttak*). The wording of the provision suggests that market value is an objective value.[125] Norway has also recently enacted another market value standard (*markedsverdien*) under its rules on exit taxation set out in section 9-14 of the act. The law and the legislative history offer little guidance regarding the content of this standard, apart from statements that transactions in the actual market are decisive and that transfer pricing principles may be useful.[126]

The arm's-length principle is provided in the transfer pricing provision in section 13-1(1) of the act and applies to both domestic and cross-border transactions. Section 13-1(4) provides that the arm's-length principle must be construed in line with the OECD guidelines.[127] The same position was adopted by the Supreme Court before the enactment of section 13-1(4) in 2007.[128]

It has been argued that market value (*omsetringsverdi*) and the arm's-length principle are based on the same standard.[129] However, this position is questionable if one accepts that the arm's-length principle of the OECD guidelines requires a subjective valuation, that the arm's-length principle of domestic Norwegian tax law is congruent with the OECD guidelines, and that the market value standard is an objective standard.[130] On this basis, the standard underlying the two provisions can hardly be identical. Support for this view is found in *Storhaugen*, in which the Supreme Court held that the arm's-length principle may dictate a transfer pricing adjustment in excess of the market value.[131] This view is also supported by cases in which the arm's-length principle has been construed as a subjective standard. In *Conoco Norway*, dealing with the interest charged on loans granted by U.S. parent companies to a U.S. subsidiary with a PE in Norway, the court of appeal held:

[125] *See Lignings-ABC* (2010), Uttak, para. 3; and F. Zimmer, *Lærebok i Skatterett* (Oslo: Universitetsforlaget, 2009), at 129.

[126] Para. 8.5.5.1 of Odelstingsproposisjon No. 1 (2008/09). *See* F. Zimmer, ''Exit Taxes in Norway,'' 1 *World Tax Journal* 1 (2009), at 115, 142.

[127] The Ministry of Finance assumed that the OECD guidelines did not contain interpretations that were contrary to the arm's-length principle of section 13-1(1), so a direct reference to the OECD guidelines could be implemented in section 13-1(4) without amending section 13-1(1). *See Høringsnotat om internprising mellom nærstående foretak* (Oslo: Ministry of Finance, Nov. 7, 2006), at 11; and Odelstingsproposisjon 62 (2006-2007), at 15.

[128] Para. 2 of *Norsk Retstidende* 2001/1265 (*Agip*).

[129] F. Zimmer, *Bedrift*, *Selskap og Skatt* (Oslo: Universitetsforlaget, 2010), at 160; and E. Harboe, *Skatterett* (2003), at 115, 120.

[130] The proper interpretation of section 13-1 is further complicated because in *Norsk Retstidende* 2007/1025 (*Statoil Angola*), the Supreme Court stated that the arm's-length principle in section 13-1 and in section 3-9 of the Companies Act (*Aksjeloven*) are identical. For a criticism of this position, see A. Bullen, *Skatterett* (2008), at 110, 133, who points out that the purposes of the two provisions are different.

[131] Paras. 40 and 48 of *Norsk Retstidende* 2003/536 (*Storhaugen*), in which the Supreme Court made an aggregated valuation of the purchase of real estate by a company and its subsequent lease to its main shareholder. *See also Lignings-ABC* (2010), Uttak, para. 3; and Tilsidesettelse, para. 7.8.

> The Court of Appeal agrees with the State that one should not disregard CNI's actual status as a subsidiary. The law must be understood so that "if the community of interest had not existed" refers to the community of interest between the lender and the borrower. It is not possible to identify policy considerations supporting the argument that the provision should be construed differently. Also, an extremely hypothetical assessment would have to be made if one were to disregard CNI's actual status. [Unofficial translation.][132]

This position has been confirmed in subsequent cases on loan transactions.[133] *Fina* dealt with a transfer pricing adjustment of insurance premiums paid by a Norwegian company (Fina) to an affiliated intermediary insurance company (Brittany).[134] The question was whether economies of scale arising from group companies coordinating and taking out insurance policies with the same insurer should be allocated among the insured group companies rather than being retained by the intermediary insurance company. The court of appeal noted:

> when detemining the arm's length price, it is Fina's association with Brittany that must be disregarded, not the coordination with the sister companies. [Unofficial translation.]

A similar interpretation was adopted by the court of appeal in *ConocoPhilips*,[135] which dealt with the benefits of a multi-currency cash pool arrangement. The arrangment with Bank of America meant that the group was charged an interest rate equal to LIBOR plus 25 basis points if the top account was negative, and an interest rate of LIBID minus 25 basis points if the top account was positive. The individual group companies were charged a standard interest rate of LIBID minus 25 basis points on both borrowings and deposits. The case concerned two Norwegian group companies with large deposits in the cash pool. The tax authorities argued that the benefits should be allocated to the group companies in proportion to the capital contribution made by each company. The benefits were claimed to be allocated asymmetrically because the standard interest rate of LIBID minus 25 basis points was close to the stand-alone deposit interest rate. The Norwegian companies were taxed on an imputed interest rate equal to LIBID plus 25 basis points. The taxpayers argued that the arrangement did not cause any income shifting, because the Norwegian companies would have obtained a lower interest rate under the realistic alternative of an ordinary bank deposit. The taxpayers also argued that the arm's-length principle did not mandate an allocation of the benefit because it was created by the parent company. The court of appeal found that the cash pool arrangement was commercially motivated, that the arrangement gave a cost reduction at the group level, and that the standard interest rate exceeded the rate the companies could obtain alone. However, the court held that the decisive question was whether the allocation of the benefits was done at arm's length. The court dismissed the argument that the benefits should accrue to the parent company and noted:

> In other words, it is solely the common control between the parties which should be disregarded while the other circumstances regarding the actual transaction should be recognized. . . . The Court of Appeal undertstands the OECD Guidelines and case law as meaning that, in order to achieve an arm's length price, the comparison must take into account all characteristics of the controlled transaction except the parties' association with each other. [Unofficial translation.]

If the common control were disregarded, the parent company would be in a weak bargaining position relative to its subsidiaries, since capital was the key driver for the benefits. On this basis the court held for the tax authorities because the standard interest rate was close to the market interest rate for deposits on a stand-alone basis.[136] The arm's-length principle is thus interpreted as a subjective, entity-specific standard in Norwegian tax law.[137]

K. Summary

The survey of the valuation standards applicable in transfer pricing cases shows that domestic tax laws normally use at least two standards, including the arm's-length principle and a market value standard. However, in the Netherlands, the arm's-length principle is the only valuation standard.

The arm's-length principle of domestic laws generally requires a subjective, entity-specific valuation, with the possible exception of Australia, where the arm's-length principle has been equated with the market value standard. The arm's-length principle is endorsed by all the countries examined. However, there is no international consensus on the content of the arm's-length principle or on the rules and methods that make

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[132]Decision of Sept. 28, 1992, LE-1990-574.

[133]*Utvalget* 1999/540 (*Nycomed*); *Utvalget* 1999/849 (*Dyno*); and *Utvalget* 2000/613.

[134]*Utvalget* 2003/531 (*Fina*).

[135]*Utvalget* 2010/199 (*ConocoPhilips*). *See* H.M. Andresen, N. Pearson-Wood, and H.-M. Jørgensen, "ConocoPhillips *Case*: Implications in Norway and Beyond," 17 *Int'l Transfer Pricing J.* 6 (2010), at 461.

[136]The decision was appealed by the taxpayers but not accepted by the Supreme Court.

[137]A. Bullen, *Arm's Length Transaction Structures: Recognising and Restructuring Controlled Transactions in Transfer Pricing* (Oslo: University of Oslo, 2010), at 231.

up the arm's-length principle.[138] This may be explained by differences in the force of article 9(1) of the OECD model and the OECD guidelines as a source of law for the interpretation of domestic transfer pricing provisions.[139] In this regard the countries may be divided into four main groups. First, in the United Kingdom and Norway, there are explicit references to article 9(1) and the OECD guidelines in the domestic transfer pricing provisions. Second, in Australia, Belgium, Canada, Denmark, Germany, and the Netherlands, the legislative history or administrative rulings provide a legal basis for relying on article 9(1) and the OECD guidelines when applying the domestic transfer pricing provisions. Third, in Sweden, article 9(1) and the OECD guidelines have not been formally incorporated into domestic law, allowing the courts more latitude in interpreting the arm's-length principle. Fourth, in the United States, the arm's-length principle is defined in autonomous domestic regulations that are primarily aimed at addressing and safeguarding U.S. interests rather than creating an international consensus.[140] Thus, developing and maintaining international consensus regarding transfer pricing requires not only reaching agreement on the OECD guidelines, but also ensuring that the guidelines have a solid anchor in domestic tax law.

The market value standards of domestic tax laws normally require an objective, marked-based valuation. This standard has been implemented differently in domestic tax laws. The first category includes Germany, where an unambiguous definition of the market value standard is provided in the tax legislation. A second category includes the United States, where a body of case law has established a general definition of the fair market value standard. A third category includes Denmark, where neither tax legislation nor case law has provided a general definition of the market value standard. Other countries may fit into one of these categories or fall between them. The existing laws of the countries in the third category are arguably deficient, because the uncertainty associated with the concept of the market value standard may be contrary to basic principles of tax law.

The arm's-length principle applies to cross-border transactions in all the countries examined. However, the arm's-length principle does not apply to domestic transactions in Canada, Australia, and Sweden. In these countries cross-border and domestic transactions are thus subject to different standards. Moreover, the tax laws of Belgium and Sweden do not authorize transfer pricing adjustments of domestic transactions at transfer prices below the arm's-length price (Belgium) or market value (Sweden). The countries covered in the survey may thus be divided into four categories regarding domestic transactions. First, in Denmark, Germany, the Netherlands, Norway, the United Kingdom, and the United States, domestic transactions are generally subject to the arm's-length principle. Second, in Australia and Canada, domestic transactions are subject to a market value standard. Third, in Belgium the transferor will not be subject to a primary adjustment under the arm's-length principle provided the transferee is subject to a secondary adjustment. Fourth, in Sweden neither the transferor nor the transferee will be subject to transfer pricing adjustments under the market value standard. The application of different valuation standards for domestic and cross-border transactions may be well founded. However, to be valid in an international context, such a tax policy must be capable of withstanding charges of discrimination.[141]

III. Implications for Arm's-Length Principle

A. General

The arm's-length principle of article 9(1) of the OECD model requires a subjective, entity-specific

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[138]Wittendorff, *supra* note 2, at 778.

[139]*Id.* at 792.

[140]The U.S. approach is reflected in the following statement of the preamble in T.D. 9088:

> Some commentators urged Treasury and the IRS to postpone finalization of the proposed regulations until the OECD completes its ongoing consideration of the treatment of stock options for transfer pricing purposes and an international consensus begins to form so that the potential for international disputes and resulting negative effects on the U.S. business can be minimized. . . . These suggestions were not implemented. Treasury and the IRS do not believe that international discussion of issues compels the suspension of the regulatory process.

[141]It is outside of the scope of this article to examine whether provisions in bilateral tax treaties akin to article 24 of the OECD model would affect the application of different valuation standards for domestic and cross-border transactions. The use of a more favorable valuation standard for domestic transactions than for cross-border transactions may conflict with article 49 (on freedom of establishment) of the Treaty on the Functioning of the European Union (TFEU). The European Court of Justice has examined the compatibility with EU law of the transfer pricing provision in article 26 of the Belgian Income Tax Act in *SGI* (C-311/08). Article 26 provides that the profits of a Belgian company will be adjusted if it grants ''abnormal or gratuitous benefits'' to a related nonresident company, while the provision does not apply to a domestic transaction when the benefits are included in the taxable income. (See Section II.G of this article.) According to the ECJ, article 26 constitutes a restriction on freedom of establishment within the meaning of article 49 TFEU (formerly article 43) (para. 55). However, article 26 of the Belgian act was held not to conflict with article 49 because the provision pursued legitimate objectives (a balanced allocation of taxing rights together with the prevention of tax avoidance), which were compatible with the treaty and constituted overriding reasons in the public interest. The measure was found appropriate for ensuring the attainment of those objectives and was assumed to comply with the principle of proportionality (paras. 69 and 75). It was for the referring court to determine compliance with the principle of proportionality. The decision is largely based on *Thin Cap Group Litigation* (C-524/04).

valuation. This position finds support in the OECD guidelines and in transfer pricing cases decided by national courts. In contrast, fair value and similar domestic standards require an objective, market-based valuation. Thus, valuations performed under the two standards will not necessarily coincide.

The implications of a subjective, entity-specific valuation under the arm's-length principle are analyzed below, starting with an examination of the concept of economies of integration and whether such economies should be recognized under the arm's-length principle of article 9(1). Since economies of integration are disregarded under fair value, there would be a major difference between the two standards if such economies were recognized under the arm's-length principle. An analysis is then made of the application of the arm's-length principle to centralized purchasing arrangements, transfers of intangibles, financial transactions, and implicit support.

B. Economies of Integration

1. General

The existence of multinational enterprises and the shift from market trade toward internal trade are explained by economies of integration.[142] If the market is imperfect or nonexistent, benefits can be obtained from internalizing transactions.[143] Through internalization, associated enterprises can carry out transactions more effectively economically than independent enterprises that must rely on the market. Imperfection of markets can be caused by natural imperfections, such as informational asymmetry, transaction costs, and economies of scale and scope, or by structural factors such as the negotiating strength of multinational enterprises. However, internalization also brings with it the costs of coordination and control, which reduce the advantages. In imperfect markets the benefits of internalization can mean that associated enterprises obtain greater overall profits than comparable independent enterprises.

The total profits of a multinational enterprise may thus be broken down into a market return, which is attributable to the production factors, and an organizational return, which is attributable to the form of organization.[144] The market return is similar for associated enterprises and independent enterprises, but the organizational return is distinctly different for associated enterprises. The crucial question is whether economies of integration should be considered under the arm's-length principle.

Disregarding economies of integration would mean that the arm's-length principle and fair value would converge more often. This could cause a systematic income distortion between associated enterprises under imperfect competition. This prompted Peggy B. Musgrave to argue that economies of integration pose a *conceptual* flaw in the arm's-length principle.[145] In a controlled transaction, the benefits were said to be allocated fully to the seller or buyer, regardless of whether they should be shared between associated enterprises as the fruits of their organizational form. Later, Stanley I. Langbein introduced the concept of the ''continuum price problem,'' which is the problem of dealing with economies of integration under the arm's-length principle.[146] According to Langbein, when associated enterprises are ascribed a market return for their factors of production, a correct application of one-sided methods (resale price method, cost-plus method, comparable profit method, or transactional net margin method) may result in there being unallocated residual profits (''marginal return to organization'').[147] The arm's-length principle does not answer the question whether the residual profits should be allocated to one, both, or neither of the associated enterprises.

The continuum price problem arises only if different methods are applied to each of the associated enterprises. If a controlled transaction is evaluated under a single method, the allocation of economies of integration depends on the method applied. A one-sided method results in a systematic allocation of the entire benefits to the enterprise that is not the tested party. This will normally mean allocating the benefits to the enterprise that makes the most significant contribution of intangibles to the controlled transaction.[148] The residual profit-split method will normally result in an allocation of the benefits in proportion to the contribution of intangibles to the controlled transaction.[149] The

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[142]J.H. Dunning and S.M. Lundan, *Multinational Enterprises and the Global Economy* (Cheltenham, U.K.: Edward Elgar, 2008), at 93.

[143]Among others, the economic theory of the benefits of internalization is based on R. Coase, ''The Nature of the Firm,'' *Economica* 4 (1937), at 386; O.E. Williamson, *Markets and Hierarchies: Analysis and Antitrust implications* (New York: Free Press, 1975); J.C. McManus, in: G. Paquet (ed.), *The Multinational Firm and the Nation State* (Toronto: Collier-Macmillan, 1972), at 66; and P.J. Buckley and M. Casson, *The Future of the Multinational Enterprise* (London: Macmillan, 1976).

[144]H.-J. Kleineidam, in: Franz Klein et al. (eds.), *Festschrift für Hans Flick* (Cologne: 1997), at 857.

[145]P.B. Musgrave, in: R.A. Musgrave and P.B. Musgrave (eds.), *Public finance in theory and practice* (New York: McGraw-Hill, 1973), at 394.

[146]S.I. Langbein, ''The Unitary Method and the Myth of Arm's Length,'' *Tax Notes*, Feb. 17, 1986, p. 625; and S.I. Langbein, ''Transaction Cost, Production Cost, and Tax Transfer Pricing,'' *Tax Notes*, Sept. 18, 1989, p. 1391.

[147]Langbein, *Tax Notes* (1986), *supra* note 146, at 625, 654; and Langbein, *Tax Notes* (1989), *supra* note 146, at 1391, 1395.

[148]Treas. reg. sections 1.482-3(c)(1), 1.482-3(d)(3)(ii)(B), and 1.482-5(b)(2)(i); paras. 2.29, 2.32, 3.18, and 3.19 of the OECD guidelines provide that one-sided methods are not normally applied to an enterprise that owns valuable intangibles.

[149]Treas. reg. section 1.482-6(C)(3)(i)(B)(2); and para. 2.137 of the OECD guidelines.

comparable uncontrolled price method results in an allocation of economies of integration in proportion to the benefits actually realized by the associated enterprises.[150] For example, if vertical integration between a manufacturing enterprise and a marketing enterprise causes a reduction of the production costs, a transfer price between the associated enterprises that is equal to the market price will mean that the entire benefit is allocated to the manufacturing enterprise. If, at the same time, the marketing enterprise is able to reduce its inventory costs, it will capture part of the benefit. Different methods may thus result in widely differing allocations of economies of integration.

However, recognition of economies of integration under the arm's-length principle may counteract income shifting if the organizational return is allocated in the same way it would have been allocated between independent enterprises with access to similar benefits. This approach was introduced in the 1988 U.S. white paper:

> In other words, if unrelated parties somehow had access to the technology available to related parties, their operations should not result in more or less total taxes than would be paid by a multinational using this technology.[151]

Recognizing economies of integration requires identifying, measuring, and allocating the benefits.[152] Since these benefits are a distinctive feature of associated enterprises, it is usually impossible to make an allocation based on empirical data. This poses a major *practical* challenge for the arm's-length principle. Moreover, if there are economies of integration, the arm's-length principle will not safeguard tax neutrality in the choice of organizational form, since in such cases the market price will not equate to the arm's-length price.[153] Hence, a discrepancy between a market price and the transfer price of a controlled transaction does not necessarily mean that there is income shifting contrary to the arm's-length principle.[154]

2. The Arm's-Length Principle of Article 9(1)

Article 9(1) of the OECD model contains an independence requirement, which could imply that economies of integration should be disregarded since, by definition, they do not exist between independent enterprises (''conditions . . . would have been made between independent enterprises''). However, the comparability requirement provides that the arm's-length test should be made based on the conditions of comparable transactions entered into under comparable circumstances.[155] The comparability requirement dictates that all economically relevant characteristics of the controlled transaction should be considered.[156] Economies of integration may have a significant economic impact on controlled transactions. This suggests that economies of integration should be recognized under article 9(1). Both of these two requirements can be satisfied under a hypothetical arm's-length test in which independent enterprises are deemed to have access to identical benefits.

The OECD guidelines address the issue in several places. First, the guidelines state that economies of integration make it difficult to apply the arm's-length principle in relation to integrated multinational enterprises and that there are no widely accepted objective criteria for their allocation.[157] This statement suggests that, in principle, economies of integration should be taken into account for transfer pricing purposes, otherwise it would be possible to allocate the benefits of economies of integration arbitrarily between associated enterprises. Such arbitrariness would arguably be contrary to the arm's-length principle.[158]

Second, the rules on cost contribution arrangements imply that economies of integration should be considered, since costs must be allocated among participants in proportion to expected benefits.[159] It is not normally possible to allocate the benefits of a cost contribution arrangement to a single participant.

Third, this position is also implied in the services rules, which provide that both indirect benefits and benefits from passive association with a group do not qualify as services.[160]

Fourth, the guidelines explicitly state that the profit-split method may account for economies of integration:

> A further strength of the transactional profit split method is that it is less likely that either party to the controlled transaction will be left with an extreme and improbable profit result, since both

[150]P.B. Musgrave, *supra* note 145, at 403.

[151]Ch. 10, *A study of intercompany pricing under section 482 of the Code*, Department of the Treasury and Internal Revenue Service, Oct. 18, 1988, Notice 88-123, 1988-2 C.B. 485.

[152]Baumhoff, *supra* note 98, section 1, at margin 287.

[153]Para. 1.8 of the OECD guidelines states that a major reason why member countries have adopted the arm's-length principle is that it ''provides broad parity of tax treatment for members of MNE groups and independent enterprises.''

[154]U. Andresen, *Konzernverrechnungspreise für multinationale Unternehmen* (Wiesbaden: 1999), at 204.

[155]Paras. 1.3, 1.6 and 1.33 of the OECD guidelines. Even though article 9(1) does not explicitly state a comparability requirement, there is no doubt that there is such a requirement. *See* Wittendorff, *supra* note 2, at 236.

[156]Para. 1.33 of the OECD guidelines.

[157]Para. 1.10 of the OECD guidelines. *See* J. Owens, 12 *Int'l Transfer Pricing J.* (2005), at 99; and J. Owens, ''Tax Systems in the Millennium,'' in: K. Andersson, P. Mels, and C. Silverberg (eds.), *Liber Amicorum Sven-Olof Lodin* (Stockholm: Kluwer Law International, 2001), at 198.

[158]Para. 1.3 of the OECD guidelines.

[159]Paras. 8.8 and 8.9 of the OECD guidelines.

[160]Paras. 7.12 and 7.13 of the OECD guidelines.

> parties to the transaction are evaluated . . . This two-sided approach may also be used to achieve a division of the profits from economies of scale or other joint efficiencies that satisfies both the taxpayer and tax administrations.[161]

This statement would be nonsense if economies of integration were to be disregarded.

Fifth, the OECD guidelines state that because associated enterprises may engage in transactions that independent enterprises would not enter into, a practical difficulty is created in applying the arm's-length principle.[162] Such transactions may occur because associated enterprises may face different commercial situations than independent enterprises would when transacting with each other. Rather than stating that such special circumstances should be disregarded, the OECD guidelines conclude that they make the arm's-length principle difficult to apply.

The OECD joint working group on business restructurings also touched on the treatment of economies of integration for transfer pricing purposes.[163] The new Chapter IX of the OECD guidelines, on business restructurings, examines groupwide and local synergies, but it fails to propose objective criteria for allocating such synergies under the arm's-length principle.

Other OECD reports have also recognized economies of integration. The 2010 report on PEs states that economies of integration should be taken into account in global trading, both in relation to article 7(2) and article 9(1).[164] The 1987 report on thin capitalization stated that the arm's-length test of an interest rate should consider informational symmetry:

> Too rigid a reliance on this approach may not however be wholly satisfactory since it is possible that a parent company might have a better understanding of the profit potential of its own subsidiary than would a banker looking at the matter from the outside, and it might in consequence be reasonable to accept (if such was in fact the case) that an independent person who was as fully informed as the parent company might lend where a bank would hesitate to do so.[165]

It has been argued that the recognition of economies of integration would be contrary to the separate entity approach.[166] However, the separate entity approach simply means that associated enterprises are treated as separate entities, rather than as a single entity, for tax purposes.[167] For example, in a decision of November 3, 2010, the Supreme Administrative Court of Finland held that the interest rate of a controlled loan transaction should be evaluated on the basis of the stand-alone credit rating of the debtor subsidiary rather than the lower credit rating of the group (KHO: 2010:73). The separate entity approach does not address transfer pricing principles or rules.

To summarize, the wording and purpose of article 9(1) and the OECD guidelines support the view that economies of integration that are attributable to group association should be considered under the arm's-length principle. This view is also supported by judicial decisions in Canada, Denmark, Germany, the Netherlands, Norway, and Sweden (see Section II), as well as in legal literature.[168] This constitutes a major difference between the arm's-length principle and fair value.

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[161]Para. 2.113 of the OECD guidelines. This position was repeated in para. 126 of *Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment* (Paris: OECD, 2008).

[162]Para. 1.11 of the OECD guidelines.

[163]*See* 2nd Annual Centre for Tax Policy and Administration Roundtable: Business Restructuring, *available at* http://www.oecd.org/document/20/0,3343,en_2649_37989760_34535252_1_1_1_1,00.html:

> A more difficult conceptual issue is the relation between the profitability of the ''stripped'' entity and the prior profitability of the ''full fledged'' operation. Assuming that all of the identified functions of the limited function entity have been adequately compensated, what has happened to any ''excess'' profit which was previously earned by the full fledged entity? In part, this may have to be accounted for by focusing on any intangibles transfers which took place at the time of the restructuring. Beyond this, however, what may in fact be involved is some kind of sharing in the economic rent generated by the prior participation in the overall activities of the group which is now not available to the limited function entity. How to account for this ''industrial organization'' intangible is not clear and is an issue which must be considered further as it has important implications for all of the transfer pricing work.

[164]Para. 172 of *2010 Report on the Attribution of Profits to Permanent Establishments*, Part III (Paris: OECD, 2010):

(Footnote continued in next column.)

> However, in some global trading situations, the residual profit split method may not adequately capture the synergy that the integration of functions found in global trading operations creates and so underestimates the value of functions that do not share in the residual profit or loss.

[165]Para. 76 of *Thin Capitalization and Taxation of Entertainers, Artists, and Sportsmen* (Paris: OECD, 1987).

[166]*See, e.g.*, M. Hoffman, S. Dupuis, and K. Rockall, ''Is the CRA Abandoning the Arm's-Length Principle? Potential Implications From *GE Capital Canada v. The Queen*,'' 16 *Tax Mgmt. Transfer Pricing Rep.* (Sept. 6, 2007), at 333.

[167]Article 5(7) of the OECD model. *See* para. 5 of the preface to the OECD guidelines. It is therefore misleading when para. 1.6 of the OECD guidelines states that the separate entity approach treats the members of an MNE group as if they were independent entities. The independence requirement is embodied solely in the arm's-length principle.

[168]M. van Herksen, 11 *Tax Mgmt. Transfer Pricing Rep.* (Aug. 7, 2002), at S-3; A.A. Skaar et al., *Norsk skatteavtalerett* (Oslo: Gyldendal, 2006), at 509; D.L.P. Francescucci, ''The Arm's Length Principle and Group Dynamics — Part 1: The Conceptual Shortcomings,'' 11 *Int'l Transfer Pricing J.* (2004), at 55, 61; Francescucci, ''The Arm's Length Principle and Group Dynamics — Part 2: The Conceptual Shortcomings,'' 11 *Int'l Transfer Pricing J.* (2004), at 235, 239; H.N. Higinbotham and M.M. Levey, ''When Arm's Length Isn't Really Arm's Length: Issues in Application of the Arm's-Length Standard,'' 26 *Intertax* (1998), at 235, 237;

(Footnote continued on next page.)

C. Centralized Purchasing Arrangements

Associated enterprises may obtain economies of integration by pooling their purchasing power. Court cases suggest that volume discounts and other benefits must be allocated between the group companies requiring the goods rather than being retained by one of the companies or by a central purchasing company.[169] The benefits stem from coordination between the associated enterprises and third parties. Transfer prices between a central purchasing company and other group companies that are determined under the arm's-length principle may therefore be below fair value.

U.S. Treas. reg. section 482 also provides an example in which volume discounts must be allocated between the companies requiring the goods.[170]

The 2008 OECD discussion draft on business restructurings stated:

> where independent parties behaving at arm's length set up joint purchasing arrangements (e.g. cooperatives), their objective is generally to share the costs savings among the members.[171]

The 2010 OECD guidelines have adopted a more flexible facts and circumstances approach under which all or part of the cost savings may be allocated to a central purchasing company, depending on the facts.[172] It would have been more appropriate to maintain the position, in line with case law, that conceptually, volume discounts must be allocated among the companies requiring the goods. A central purchasing company must nevertheless be remunerated at arm's length, and no transfer pricing method is automatically excluded. If a central purchasing company makes contributions of non-routine resources or capabilities to the controlled transactions, this should be reflected in its compensation, which could be determined under the residual profit-split method. This would mean that the central purchasing company captures the profits attributable to its non-routine contributions, whereas the group companies requiring the goods would be assigned the profits attributable to volume discounts.

D. Intangibles

A subjective, entity-specific valuation is especially important to specialized assets such as intangibles, for which the economic value is normally the value in use of the property, which is expected to last several years and which depends on the resources and capabilities of the individual enterprise. This may cause the profit potentials of intangibles to differ significantly among enterprises and for the arm's-length price to differ from the fair value.

This is recognized in the U.S. cost-sharing regulations, which state that allocations or other valuations made for accounting purposes (under the fair value standard) may provide a useful starting point, but will not be conclusive for the purposes of the arm's-length test of a buy-in transaction.[173] One of the examples illustrating this point concerns a Company X that is in a start-up phase, so it has no exploitable products or marketing intangibles, and its workforce consists of a team of software developers.[174] Another software developer company acquires Company X for $100 million in order to enhance its software programs. For accounting purposes, $50 million of the acquisition price is allocated to the in-process technology and workforce, and $50 million is allocated to goodwill. According to the example, the $50 million allocated to goodwill for accounting purposes should be allocated to the in-process technology and/or workforce in place for transfer pricing purposes, because Company X has nothing of economic value aside from its in-process technology and workforce in place. The example illustrates that the applications of the arm's-length principle and fair value may yield widely differing results. For one thing, fair value is based on the premise of average market participant resources and synergies, rather than entity-specific characteristics. Moreover, fair value may be more conservative in recognizing and valuing the platform rights of intangibles.[175]

H.N. Higinbotham, D.W. Asper, P.A. Stoffregen, and R.P. Wexler, ''Effective Application of the Section 482 Transfer Pricing Regulations,'' 42 *Tax L. Rev.* (1987), at 293, 330 (on U.S. section 482); Baumhoff, *supra* note 98, section 1, at margins 117, 261, and 285; D. Gosch, *Die steuerliche Betriebsprüfung* (2003), at 60; K. Sieker, in: H. Debatin and F. Wassermeyer (eds.), *Doppelbesteuerung: DBA*, Band 1 (Munich: Loose-leaf, 109th release, Oct. 2009), article 9, at margins 139 and 218; and T. Rödder, *Steuerberater-Jahrbuch* (1997/98), at 115, 126; G. Frotscher and A. Oestreicher, ''The German Approach to Taxing Business Restructurings: An Arm's Length Ahead?'' 37 *Intertax* (2009), at 375, 380; A.J. Bakker and G. Cottani, ''Fourth Issues Note: Sting in the Tail,'' 16 *Int'l Transfer Pricing J.* (2009), at 81, 89; E. Kamphuis, ''How to Deal with Affiliation in Interpreting the Arm's Length Principle: The *GE* Case Reviewed,'' 17 *Int'l Transfer Pricing J.* (2010), at 292; and A. Bullen, *supra* note 137, at 227. For a contrary view, see Cauwenbergh, Gaublomme, and Hinnekens, *supra* note 21, at 384, 387.

[169]Germany: Federal Fiscal Court decision of Dec. 6, 1995, I R 40/95 (BStBl 1997 II 118). The Netherlands: Court of Appeal of Arnhem decisions of Apr. 24, 2003, No. 01/00047, and Mar. 7, 2007, No. AWB 06/288; the 2003 decision was upheld by the Supreme Court in a decision of Apr. 23, 2004, No. 39 542, VN 2004/27.17. Norway: *Utvalget* 2008/19 (*Norsk Hydro Prodoksjon*), *Utvalget* 2003/531 (*Fina*), and *Norsk Retstidende* 2001/1265 (*Norsk Agip*). Canada: *Indalex v. The Queen* (1988), DTC 6053. *See* Wittendorff, *supra* note 2, at 338.

[170]Treas. reg. section 1.482-9(l)(5) (Example 19).

[171]Para. 172 of *Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment* (Paris: OECD, 2008).

[172]Paras. 9.154 9.156, 9.159, and 9.160 of the OECD guidelines.

[173]Treas. reg. section 1.482-7T(g)(vii)(A).

[174]Treas. reg. section 1.482-7T(g)(vii)(B) (Example 1).

[175]C.J. Chandler and S.F. Foley, ''Why the Acquisition Price Method and Income Method Give Different Answers Under the Same Set of Facts,'' 19 *Tax Mgmt. Transfer Pricing Rep.* (Dec. 2, 2010), at 861.

Both the arm's-length principle and fair value assume informational symmetry. This is somewhat surprising regarding fair value, since informational asymmetry and uncertainty often reduce the market values of intangibles.[176] Under both standards this means that the relative reliability of empirical methods that rely on market data (for example, the comparable uncontrolled price method) may be reduced compared with hypothetical methods that rely more on internal data (for example, the income method). However, other aspects of hypothetical methods may be associated with significant uncertainties that do not exist with empirical methods, in particular, assumptions about the projected income stream of an intangible. Thus, under the best method rule, a thorough analysis of the facts of each case is crucial for selecting the most reliable method.[177]

E. Financial Transactions

Informational symmetry, de facto control, and transaction cost savings may reduce the risk and costs associated with controlled financial transactions such as loans and guarantees. These features have been recognized for transfer pricing purposes by the courts in several countries. (See Section II.) The arm's-length interest rate for a controlled loan may thus be below the market interest rate for an otherwise comparable loan between independent enterprises.[178] This position is supported by the 1987 OECD thin capitalization report. (See Section III.B.2.) The same conclusion would generally apply to controlled guarantees. The issue is not addressed in U.S. Treas. reg. section 482.

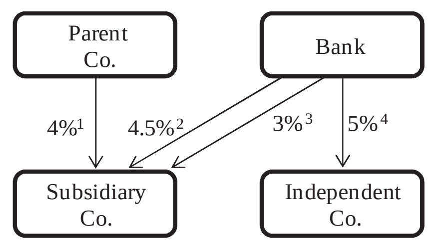
F. Implicit Support

1. General

The concept of implicit support refers to the fact that the credit rating of a company that is part of a group may be higher than it would be if it were a stand-alone company, if a bank or rating agency believes that associated enterprises would support the company in a period of financial stress even in the absence of an explicit guarantee. A parent company may support a subsidiary financially in order to, for example, preserve its own credit rating, protect its reputation, or maintain its supply chain — that is, to safeguard its own business interests.[179] Under Standard & Poor's credit rating criteria, a weak subsidiary owned by a strong parent company will usually enjoy a higher credit rating than it would alone.[180] For relationships characterized as mere investments (for example, a nonstrategic subsidiary), the effect of affiliation on the rating may be low. In contrast, for relationships characterized as an integrated business (for example, a core subsidiary), a consolidation of the financial data for the parent company and subsidiary may be done, and the effect on the ratings of both companies may be high.

Implicit support may be illustrated by the example in Figure 1, in which a subsidiary is able to borrow from its parent company at an arm's-length interest rate of 4 percent, or borrow from an unrelated bank at either 4.5 percent without a parental guarantee or 3 percent with a parental guarantee. A stand-alone company with rating characteristics identical to those of the subsidiary is able to borrow from the same bank at 5 percent.

Figure 1. Implicit Support



Notes:
[1]Arm's-length interest rate with informational symmetry and de facto control.
[2]Market interest rate with implicit support.
[3]Market interest rate with an explicit parental guarantee.
[4]Market interest rate on a stand-alone basis.

Implicit support and the example in Figure 1 give rise to the following questions:

- Does implicit support qualify as a controlled transaction for transfer pricing purposes?
- How should implicit support be priced under the arm's-length principle if it is recognized as a controlled transaction?
- Should implicit support affect the pricing of a controlled transaction, such as a formal legally binding guarantee or a loan transaction?

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[176]B. Lev, *Intangibles: Management, Measurement, and Reporting* (Washington: Brookings Institution, 2001), at 31.

[177]Para. 2.2 of the OECD guidelines; and Treas. reg. section 1.482-1(c).

[178]Musgrave, *supra* note 145; J. Pedersen, *Revision & Regnskabsvæsen*, SM (2004), at 288; A.A. Skaar et al., *Norsk skatteavtalerett*, *supra* note 168, at 511; Baumhoff, *supra* note 98, at margin 742; and X. Ditz and V. Tcherveniachki, *Internationales Steuerrecht* (2009), at 709, 713.

[179]In the Danish *Egnsbank Han Herred* case, six savings banks paid the unsecured debt of their joint venture company because the bankruptcy of the company would have had significant adverse consequences for the credit ratings and business affairs of the owners. The purpose of the joint venture was to provide the customers of the savings banks with specific products at competitive prices. Most of the Supreme Court held in favor for the taxpayer that the losses incurred by the savings banks qualified as ordinary tax-deductible operating expenses. *See Tidsskrift for Skatter og Afgifter* (2000), No. 243.

[180]Standard & Poor's, ''Corporate Ratings Criteria,'' 2006, at 85.

These questions are analyzed below.

2. Recognition and Pricing of Implicit Support

The arm's-length principle of article 9(1) of the OECD model does not govern the object qualification. The term ''commercial or financial relations'' must thus be interpreted on the basis of domestic law under article 3(2), because the term is not defined in the OECD model and the context does not require otherwise.[181] Hence, article 9(1) cannot provide a definitive answer to the threshold question whether implicit support should be recognized as a controlled transaction. However, in practice it is often difficult to distinguish between the definition and the pricing of services. Accordingly, the threshold question may also be analyzed from a pricing perspective, which brings article 9(1) into the loop again.

The OECD guidelines provide a definition of services that may be considered for the purpose of the qualification under domestic law. In essence, both the OECD and the United States define a service as:

- an activity performed by an enterprise; and
- which provides an associated enterprise with economic or commercial value.[182]

According to both sets of rules, the benefit test is deemed not to be satisfied in some situations, including when benefits result solely from passive group association.[183] The discussion of implicit support is largely based on paragraph 7.13 of the OECD guidelines, which deals with passive association under the benefit test:

> Similarly, an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed. For example, no service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member. . . . Each case must be determined according to its own facts and circumstances.

It follows from this statement that the OECD does not treat implicit support as a controlled transaction and that it is taken as evidence of economies of integration. This raises the question whether the OECD is correct in equating the two concepts.

Economies of integration are characterized by associated enterprises reaping benefits that are not available to market participants in uncontrolled transactions. The overall benefit to the group is generally positively correlated to use, and nonusers are not worse off than stand-alone market participants. For example, cost savings arising from the pooling of purchasing power will normally increase with volume. A hypothetical arm's-length test may allocate economies of integration between associated enterprises on the basis that independent enterprises would share such benefits in proportion to the contributions of each enterprise.[184] Thus, in the Norwegian *ConocoPhilips* case, the court of appeal held that the overall benefit of a cash pool arrangement should be allocated among the participants in proportion to the capital contributed by each member. (See Section II.J.)

However, economies of implicit support are characterized by an enterprise obtaining a benefit in an uncontrolled transaction that would not be available in a controlled transaction. Further, the overall benefit to the group of implicit support will normally be negatively correlated to use.[185] Implicit support may expose a strong parent company to economic disadvantages in at least three different ways. First, when a parent company enjoys a higher rating than its subsidiaries, a rating consolidation will lead to raising the ratings of the subsidiaries and downgrading the rating of the parent company. Second, the benefit derived by an enterprise from the use of implicit support may be detrimental to an associated enterprise if the consolidated credit rating is downgraded because of additional debt financing. Third, a parent company's high rating may be achieved by reliance on more equity financing, which is generally more expensive than debt financing. Hence, economies of implicit support may be allocated among associated enterprises in a way that is not in line with the contribution of rating enhancing characteristics by the enterprises.

The fundamental differences between economies of integration and economies of implicit support are illustrated in Figure 2. The differences mean that the use of implicit support as an example of passive association in the OECD guidelines is questionable.[186] It would have been more appropriate to use the example of volume discounts, as in the U.S. services regulations.

Income shifting among associated enterprises may thus occur if implicit support is not recognized as a

[181] J. Wittendorff, ''The Object of Art. 9(1) of the OECD Model Convention: Commercial or Financial Relations,'' 17 *Int'l Transfer Pricing J.* (2010), at 200.

[182] Para. 7.6 of the OECD guidelines; and Treas. reg. section 1.482-9(l)(1).

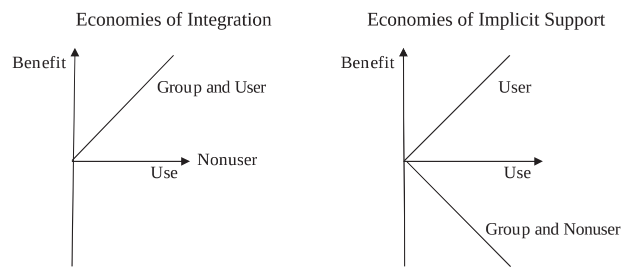
[183] Treas. reg. section 1.482-9(l)(3)(v); and para. 7.13 of the OECD guidelines.

[184] The OECD and U.S. cost sharing rules are based on this premise. *See* paras. 8.9 and 8.19 of the OECD guidelines; and Treas. reg. section 1.482-7T(a)(1).

[185] P. Blessing, ''Divergence of Third Party Pricing from Arm's Length Results,'' in: P. Baker and C. Bobbett (eds.), *Tax Polymath: A Life in International Taxation. Essays in Honour of John F. Avery Jones* (Amsterdam: IBFD, 2010), at 153, 165.

[186] *Id*. at 163 and 184.

Figure 2. Economies of Integration and Implicit Support



compensable controlled transaction. However, income shifting is not necessarily contrary to the arm's-length principle. For example, this has been recognized in the OECD guidelines in relation to the relocation of profit potential in connection with business restructuring.[187] The decisive question is whether the income shifting would have occurred in the context of an independent enterprise. It would be relevant whether the parent company (the strong entity) would be able to prevent a subsidiary (the weak entity) from benefiting from implicit support in the absence of the association of the two enterprises. If consumption of implicit support cannot be prevented, an independent enterprise would not normally be expected to pay compensation. Implicit support may thus be viewed as a classic free-rider problem. The free-rider problem does not necessarily occur in relation to economies of integration, because the benefit often arises in the context of controlled transactions, including arrangements in which associated enterprises act in concert regarding a third party. This prevents a single enterprise from capturing the entire benefit at the expense of the other enterprises. In contrast, a subsidiary may benefit from implicit support in an uncontrolled transaction without any involvement of its parent company. Here it may be argued that the parent company would be in a weak bargaining position and that a subsidiary could get away with relying on implicit support, without paying any compensation.[188]

However, this would not be the case if the realization of the benefit required the parent company to sign a letter of comfort or a similar legally nonbinding statement. In that situation the parent company could prevent its subsidiary from obtaining a higher rating by refusing to sign the letter. Hence, it may be argued that under both the OECD guidelines and the U.S. section 482 regulations, the definition of a controlled service transaction is satisfied if a parent company signs a letter of comfort at the request of a subsidiary or its creditor, and this provides the subsidiary with a benefit otherwise not available. That the letter is not legally binding should not prevent the action from qualifying as a service, though it may affect the benefit obtained and the arm's-length compensation.

In summary, implicit support would not normally command compensation under the arm's-length principle of article 9(1). Hence, compensation would not be due when an associated enterprise obtains a benefit in an uncontrolled loan transaction on account of implicit support. Implicit support will not normally be recognized as a compensable controlled transaction under domestic law, because the threshold and pricing issues are so closely connected for service transactions.

3. Implicit Support and Pricing of Controlled Transactions

The impact, if any, of implicit support on the pricing of a controlled financial transaction is not directly addressed in the OECD guidelines. Although paragraph 7.13 (on passive association) only governs the threshold issue, it is used to underpin the position that implicit support is relevant for the pricing of a controlled transaction.[189] Returning to the example in Figure 1, the question is whether the price for an explicit parental guarantee should be determined on the basis of the stand-alone rating, whereby the benefit for the subsidiary would be 2 percent (5 percent minus 3 percent), or on the basis of the consolidated rating, whereby the compensable benefit would be reduced to its incremental effect of 1.5 percent (4.5 percent minus 3 percent).

On an administrative level, the U.S. service regulations do not apply to loans and guarantees. However, regarding the comparability analysis, the service regulations provide that account should be taken of group association.[190] Commentators have raised the concern that virtually any uncontrolled transaction could be considered unreliable, because it would not generally reflect the same efficiencies and synergies as controlled services transactions.[191] An example was drafted in order to remove this uncertainty so that regarding the uncontrolled transactions of a taxpayer, account should be taken of group association and so that the benefits do not qualify as services.[192] However, the rule does

[187]Para. 9.65 of the OECD guidelines.

[188]The importance of contractual rights for the arm's-length test is recognized in, e.g., paras. 9.67, 9.70, and 9.72 of the OECD guidelines.

[189]J.M. Breen, "Evaluating the Arm's-Length Price of Financial Guarantees: A Review of the OECD Framework," *Tax Notes Int'l*, Sept. 13, 2010, p. 869, *Doc 2010-16643*, or *2010 WTD 176-16*.

[190]Treas. reg. section 1.482-9(l)(3)(v). The same follows from Treas. reg. section 1.482-1(f)(2)(i) (Example 3).

[191]Preamble, Explanation of Provisions, 11 Controlled Services Transactions, in TD 9278 (IRB 2006-34).

[192]Treas. reg. section 1.482-9(l)(5) (Example 19). *See* Wittendorff, *supra* note 2, at 505.

not mean that uncontrolled transactions cannot normally be used as comparables for controlled transactions.[193] If these principles were applied to implicit support, it would arguably mean that the arm's-length test of a controlled financial transaction should not take account of implicit support. However, representatives of the IRS reportedly believe that implicit support should affect the pricing of an explicit guarantee.[194] An official position on the issue may be incorporated in the coming global dealing regulations.

The Canadian tax authorities believe that implicit support must be recognized for transfer pricing purposes, as evidenced by *GE Capital*. (See Section II.B and below.)

The U.K. tax authorities have adopted the following position on implicit support:

> Guarantees, whether explicit or implicit, may be subject to transfer-pricing adjustments, since they constitute a business facility and/or a provision extended to another party, and one which should carry an arm's length price. A guarantee fee is a provision that would be charged for at arm's length.[195]

Implicit support is thus recognized in principle as a compensable transaction. This is in line with the domestic U.K. definition of a transaction, which includes arrangements ''whether or not they are, or are intended to be, legally enforceable.''[196] Further, a guarantee is defined as including:

> (a) a reference to a surety, and (b) a reference to any other relationship, arrangements, connection or understanding (whether formal or *informal*) such that the person making the loan to the issuing company has a *reasonable expectation* that in the event of a default by the issuing company the person will be paid by, or out of the assets of, one or more companies.[197] [Emphasis added.]

However, the U.K. rules also provide that compensation would not normally be due for implicit support under the passive association rule of the OECD guidelines. The U.K. tax authorities are thus formally required to construe the domestic transfer pricing provision in accordance with the OECD guidelines. (See Section II.C.) The U.K. tax authorities have not provided guidelines on the impact of implicit support on the pricing of an explicit guarantee.

The Australian tax authorities believe that implicit support may affect the transfer price of a controlled transaction, as shown in a 2010 ruling:

> Another approach may be to derive an arm's length consideration (for example, an interest rate) by reference to the credit rating of the parent of the taxpayer's corporate group, provided that the terms, conditions and other relevant circumstances of the debt in question reflect those that would be found in an arrangement between parties dealing at arm's length. Depending on the facts, including the credit standing of the borrower company relative to the parent company, a margin above the interest rate that the parent would be expected to pay for the debt may be appropriate. Where, for example, the operations of the borrower are core to the group in the sense that its functions were a vital part of an integrated business, it would generally be expected that the borrower company would have the same credit standing as its parent.[198]

In summary, the tax administrations of several major countries apparently share the view that implicit support should be recognized in the arm's-length test of a controlled financial transaction.

Courts have only reviewed a few cases dealing with implicit support. The best known is the Canadian *GE Capital* case, concerning a U.S. parent company whose credit rating was AAA and which guaranteed commercial papers issued by its indirect subsidiary in Canada in consideration of a guarantee fee of 1 percent per annum. (See Section II.B.) The Canadian tax authorities disallowed the guarantee fee, arguing that ''implicit support'' meant that the parent company and the subsidiary shared the same credit rating, and thus the marginal effect of the explicit guarantee was effectively nil. The Tax Court recognized that implicit support should be considered in the arm's-length test of the guarantee fee. However, the court only accepted a rating increase of three notches to a point between BB+ and BBB- compared with the stand-alone credit rating of the subsidiary of between B+ and BB-. On this basis the guarantee fee of 1 percent was held to comply with the arm's-length principle. The Federal Court of Appeal affirmed the decision with the same reasoning:

> [56] In the present case, it is common ground that in the context of the yield method, implicit support is a factor which an arm's length person would find relevant in pricing the guarantee. It

[193]However, the regulations provide an example of when economies of integration involve controlled transactions of another multinational enterprise are held to be a more reliable reference transaction than uncontrolled transactions. *See* Treas. reg. section 1.482-1(f)(2)(i) (Example 3).

[194]M. Moses, 19 *Tax Mgmt. Transfer Pricing Rep.* (May 20, 2010), at 58, quoting D. Ernick, Associate International Tax Counsel, U.S. Treasury Department.

[195]International Manual (INTM) 502040. *See also* INTM 502030.

[196]Section 150(1) of the Taxation (International and Other Provisions) Act 2010.

[197]Section 154(4) of the Taxation (International and Other Provisions) Act 2010.

[198]Para. 49 of Taxation Ruling 2010/7. *See also* para. 119 of *Discussion Paper on Intra-Group Finance Guarantees and Loans*, Australian Taxation Office, June 2008.

follows that it had to be considered. The suggestions that implicit support should be ignored would require the Court to turn a blind eye on a relevant fact and deprive the transfer pricing provisions of their intended effect.

Implicit support was also recognized in the Norwegian *Conoco Norway* case, dealing with loans granted to a subsidiary (CNI) by its direct and indirect parent companies. The court of appeal stated (unofficial translation):

> Based on the presentation of evidence, the Court takes the view that the group affiliation has some importance for the loan terms, even though the parent company does not guarantee the loan. In practice it is unusual for a robust parent company to let a subsidiary go bankrupt, since this may easily have consequences for the parent company's reputation and credit rating. Based on the evidence, it must be assumed that the group affiliation would have a positive effect for CNI in the event of an external loan.[199]

These two cases support the view that implicit support is relevant for the arm's-length test of controlled financial transactions between a parent company and its subsidiaries. However, it is questionable whether this view conforms to the arm's-length principle of article 9(1).

First, a distinctive feature of article 9(1) is the recognition of the controlled transaction as actually structured.[200] Another distinctive feature is the comparability requirement, under which a reference transaction must be a perfect mirror image of the controlled transaction regarding all economically relevant factors. Taken together, these features arguably mean that implicit support should be disregarded under the arm's-length test of a controlled transaction when, by definition, implicit support is not present. Implicit support is thus a hallmark of uncontrolled transactions. Hence, the tax administrations and courts are barking up the wrong tree. For example, implicit support does not exist in a controlled loan transaction when the lender is the parent company from which implicit support would be expected. It would thus be circular to conclude that the parent company should receive a lower interest rate on the assumption that it would support the subsidiary.[201] Similarly, as a guarantor in a controlled guarantee transaction, a parent company would not be able to benefit from implicit support from itself. In a controlled financial transaction between sister companies, it may also not be possible to rely on implicit support that would be available for a third party, because the parent company may not have the same incentive to support a subsidiary in this situation.

Second, this view relies on the use of a realistic alternative to the borrower as a separate means for evaluating transfer prices. Hence, the transfer price is determined on the basis of a realistic alternative of the borrower taking out a third-party loan rather than a controlled loan. The OECD guidelines recognize that realistic alternatives provide information on the relative bargaining powers of the parties under the comparability test.[202] However, the OECD has also concluded that it would be inappropriate to use realistic alternatives as a separate means for establishing transfer prices under article 9(1).[203] Such a practice is thus in breach of the requirement to evaluate transfer prices from the perspectives of both parties.[204]

Third, when a benefit of a controlled transaction stems from group affiliation, the market price of an uncontrolled transaction is not decisive for the transfer price of the controlled transaction. For example, in the Norwegian *ConocoPhilips* case, the market interest rates of uncontrolled transactions were held not to be decisive for the allocation of economies of integration of the controlled transactions. (See Section II.J.) The flip side of this position is arguably that when a disadvantage of a controlled transaction stems from group affiliation, the market prices of an uncontrolled transaction should not be decisive for the transfer price of the

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199Court of Appeal (Eidsivating) decision of Sept. 28, 1992, LE-1990-574 (*Conoco Norway Inc.*). *See, e.g.*, the Court of Appeal (Borgarting) decision of Oct. 15, 1998, *Utvalget* 1999/540 (*Nycomed AS*); and the District Court (Oslo) decision of Feb. 20, 1998, *Utvalget* 1999/849 (*Dyno Industrier AS*).

200Para. 1.64 of the OECD guidelines.

201Blessing, *supra* note 185, at 166; and F. Vincent, ''GE Capital Canada After GlaxoSmithKline,'' 19 *Tax Mgmt. Transfer Pricing Rep.* (Sept. 8, 2010), who criticizes the Tax Court for turning a blind eye to GE Capital being the guarantor in the controlled transaction, as well as to the wording of subsection 247(2) of the Canadian Income Tax Act. It is argued that it is the actual parties to the controlled transaction that should be treated as if they were independent enterprises. One may conclude that GE Capital would not have provided support in the form of a guarantee without full payment for such support.

(Footnote continued in next column.)

202Para. 1.34 of the OECD guidelines.

203Paras. 3.14-3.18 of the *OECD Task Force Report on Intercompany Transfer Pricing Regulations Under US Section 482 Temporary and Proposed Regulations* (Paris: OECD, 1992). It is unclear whether para. 9.60 of the 2010 OECD guidelines is intended to contradict the 1992 position.

204Breen, *supra* note 189. On the pricing of a guarantee from a dual perspective, see, e.g., R. Plunkett and L. Powell, ''Transfer Pricing of Intercompany Loans and Guarantees: How Economic Models Can Fill the Guidance Gap,'' 16 *Tax Mgmt. Transfer Pricing Rep.* (Feb. 8, 2008), at 785; G. Gill, ''Intercompany Loan Guarantees — Pricing Approaches and the Looming Wave of Controversy,'' 16 *Tax Mgmt Transfer Pricing Rep.* (Nov. 1, 2007), at 532; E.D. Ryan, C.E. Erivona, and D.G. Chamberlain, ''A Transfer Pricing Framework for Loan Guarantee Fees,'' 11 *Tax Mgmt. Transfer Pricing Rep.* (Feb. 5, 2003), at 850; and J.I. Rosenblum, ''Estimating an Arm's-Length Interest Rate on Intercompany Loans,'' 11 *Tax Mgmt. Transfer Pricing Rep.* (Oct. 16, 2002), at 602.

controlled transaction. Hence, neither group-specific benefits nor disadvantages should be allocated according to market prices.

Fourth, as alluded to above, it may be that an enterprise could raise an uncontrolled loan on terms that are more favorable than those that an associated enterprise is able to offer. The arm's-length principle does not generally offer a solution to situations when the minimum price of the seller exceeds the maximum price of the buyer.[205] In a third-party setting, that situation would be a deal breaker. However, the arm's-length principle does not address the expediency of controlled transactions[206] and should not establish barriers to controlled transactions. An appropriate solution to the problem should thus factor in the tax policy considerations underlying transfer pricing regulations (the prevention of income shifting and avoidance of double taxation).

Fifth, tax policy considerations suggest that implicit support should normally be disregarded, because in most cases, this benefit would stem from the parent company as a noncompensable benefit. Otherwise, a parent company may be made a two-time loser. First, the parent company would receive no compensation when its subsidiary makes use of implicit support in an uncontrolled transaction at the expense of the parent. Second, in a controlled financial transaction between the parent company and its subsidiary, the parent would have to accept compensation that does not reflect the risk and capital at stake. Such a situation would distort the income allocation between the associated enterprises and the tax bases of the countries involved.[207]

This analysis suggests that implicit support must be disregarded under the arm's-length test of a controlled financial transaction.[208] In the example in Figure 1, this would mean that the maximum fee of a parental guarantee would be 2 percent (5 percent minus 3 percent). In some situations the issue may be solved when informational symmetry, de facto control, and transaction cost savings mean that a controlled transaction entails a lower level of risk and cost than an uncontrolled transaction. Also, a parent company may offer a guarantee to a subsidiary in its own interest (for example, to secure its supply chain). In that situation the guarantee may not qualify as a controlled transaction under domestic tax law, or the relevant cost of the parent company may be reduced by the benefit it obtains.[209] The benefits of a controlled transaction may thus be more or less offset by the benefit of the implicit support of an uncontrolled transaction. Revisiting the example again, this would mean that the maximum guarantee fee should be 1 percent (4 percent minus 3 percent).

IV. Conclusion

This article has examined and compared the arm's-length principle with fair value, which are internationally recognized valuation standards applied in tax law and accounting law, respectively. Although both standards focus on the price that would have been agreed to in a transaction between independent parties, they diverge from each other in significant respects. The arm's-length principle requires a subjective, entity-specific valuation, whereas fair value requires an objective, market-based valuation. The distinction between subjective and objective valuation standards is also normally reflected in domestic tax law. Thus, valuations performed under the arm's-length principle and fair value will not always coincide.

Multinational enterprises are thus subject to different standards in transfer pricing and financial reporting. The merits of the arm's-length principle are normally analyzed by contrasting the principle to formulary apportionment. Proponents of formulary apportionment argue that a shift to this standard is warranted because:

- it alleviates the conceptual flaw of the arm's-length principle by treating associated enterprises as a single unity for transfer pricing purposes;
- it prevents tax planning from being facilitated by contractual allocations of functions, risks, and intangibles; and
- it reduces administrative burdens.

Another, and less far-reaching, option would be to harmonize the arm's-length principle with fair value. However, this would involve going to the opposite extreme, since fair value would exacerbate the income-shifting issue associated with transfer pricing by disregarding entity-specific facts. Moreover, fair value does not offer any clear advantages over the arm's-length principle. On this basis it cannot be recommended that the OECD should strive to orient the arm's-length principle towards the fair value standard.

The OECD guidelines do not directly differentiate between the arm's-length principle and fair value. However, paragraph 6.27 of the guidelines could be interpreted to mean that the arm's-length principle and fair market value are identical, though this has hardly been

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[205]Baumhoff, *supra* note 98, section 1, at margin 164.

[206]Para. 1.64 of the OECD guidelines.

[207]Blessing, *supra* note 185, at 164.

[208]*Id.*, at 162; Hoffman, Dupuis, and Rockall, *supra* note 166; Vincent, *supra* note 201; and N. Boidman, ''Pricing Canada-U.S. Guarantees After *GE Capital*: Still Evolving,'' 19 *Tax Mgmt. Transfer Pricing Rep.* (Feb. 10, 2011), at 1042.

[209]I.J.J. Burgers and H.M.M. Bierlaagh, ''Some Tax Aspects of Guarantees, Letters of Comfort and Keep-Well Agreements Between Group Companies,'' 52 *Bulletin for International Fiscal Documentation* (1998), at 81.

the intention.[210] International consensus about the basic features of the arm's-length principle is extremely important to prevent disputes and double taxation in cross-border transactions. It would therefore be appropriate for the OECD to modify paragraph 6.27, and clearly differentiate between the two standards in a coming update of the OECD guidelines, incorporating the results of the newly launched project on intangibles.[211]

Economies of integration must be considered under the arm's-length principle. However, there are no internationally accepted objective criteria for the allocation of such economies among associated enterprises.[212] Courts and administrative rulings have addressed the issue on an ad hoc basis regarding centralized purchasing arrangements, cost sharing, services, and loan transactions, but principles for the allocation of transaction cost savings and other economies of integration have not emerged in practice.[213] This may lead to income shifting between associated enterprises. If this occurs systematically to the benefit of foreign enterprises, it will negatively affect tax revenues. However, if the net effect is only modest, the OECD member countries may not consider the issue to be important. The issue deserves a more thorough discussion and a more prominent position in the OECD guidelines.

Implicit support does not qualify as a compensable controlled transaction under paragraph 7.13 of the OECD guidelines. Since the concept of implicit support is fundamentally different from economies of integration, it would be appropriate for the OECD to provide another example of passive association in paragraph 7.13. Contrary to the position adopted by some tax administrations and courts, it is argued that implicit support should also not affect the pricing of a controlled financial transaction in which implicit support is absent. However, recognizing informational symmetry, de facto control, and transaction cost savings of controlled transactions may in fact have an effect similar to implicit support of uncontrolled transactions and thereby resolve the issue. ◆

[210]Para. 6.27 of the OECD guidelines states:

> In assessing whether the conditions of a transaction involving intangible property reflects arm's length transactions. . . . In particular, the actual fair market value of intangible property is frequently not measurable in relation to the costs involved in developing and maintaining the property.

[211]In a comment on the new OECD project on intangibles, the Canadian Institute of Chartered Business Valuators has stressed that one of the key deficiencies of the OECD guidelines is that it does not clearly define the governing standard of value. *See* http://www.oecd.org/dataoecd/38/14/46054702.pdf. Unfortunately, the issue is not mentioned in the OECD document approving the scope of the intangible project. *See Transfer Pricing and Intangibles: Scope of the OECD Project* (Paris: OECD, Jan. 25, 2011).

[212]Para. 1.10 of the OECD guidelines.

[213]It has been suggested that the economies of integration of vertically integrated companies may be allocated on the basis of a profit-split method (economic capital employed method). *See* Higinbotham, Asper, Stoffregen, and Wexler, *supra* note 168, at 356. This application of the profit-split method is not favored by the OECD, see para. 2.145 of the OECD guidelines; or the U.S. regulations, see Preamble, section 1.482-6, in TD 8552 (IRB 1994-31).