Consistency: Domestic vs. International Transfer Pricing Law

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Cross-border transactions between associated enterprises may trigger economic double taxation, or double nontaxation, unless the countries involved are in agreement regarding the following three aspects of law:

- the choice of allocation standard;
- the interpretation of the standard; and
- the application of the standard.

The arm's-length principle is the internationally recognized tax standard for income allocation between associated enterprises. However, the arm's-length principle is interpreted and applied by national tax administrations and courts. This entails the risk that the arm's-length principle may develop in different and inconsistent directions under different domestic laws, and may give rise to uncertainty and cross-border tax disputes. The unresolved competent authority procedure between the United States and the United Kingdom preceding the *GSK*[1] case is perhaps the best example of such a situation. This article will address the second aspect of law — the interpretation of the arm's-length principle. The benchmark for the analysis will be the OECD transfer pricing guidelines.[2]

A domestic interpretation of the arm's-length principle that is less burdensome vis-á-vis the OECD guidelines would generally be welcomed by taxpayers but perceived as a nuisance by tax administrations because of base erosion concerns. This is the situation that the Australian tax authorities are struggling with in the wake of the *Roche*[3] and *SNF*[4] decisions. (See Section I.) By contrast, a domestic interpretation that is more burdensome than the OECD guidelines would be a serious issue for taxpayers. However, if a tax treaty that includes a provision similar to article 9(1) of the OECD model tax treaty is applicable, the more burdensome taxation should, in principle, be waived. Article 9(1) thus requires contracting states not to make transfer pricing adjustments that exceed adjustments under the arm's-length principle. For example, this has been acknowledged in German cases in which transfer pricing adjustments under domestic law triggered by the absence of a ''prior, clear, and unambiguous'' agreement

[1] *GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner*, Tax Court Docket Nos. 5740-04 and 6959-05. The outcome of the case was a settlement; *see* Jens Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Kluwer Law International, 2010), p. 639.

[2] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010.

[3] *Roche Products Pty. Ltd. v. Commissioner*, Administrative Appeals Tribunal 639 (2008).

[4] *SNF (Australia) Pty Ltd v. Commissioner*, Federal Court of Australia, FCAFC 74 (2011).

have been overturned by courts because the adjustments were held to infringe on treaty provisions incorporating the arm's-length principle.[5] However, the issue may be more complex than that, because courts often interpret tax treaty provisions in line with domestic law. Protection under article 9(1) may thus not always be effective. For these reasons, it is generally desirable to ensure consistency between domestic and international transfer pricing laws from the perspectives of both taxpayers and tax administrators.

This article first provides some examples of divergent domestic interpretations of the arm's-length principle (Section I). An analysis of steps that may be taken domestically and by the OECD to align domestic and international transfer pricing law then follows (Section II).

I. Divergent Domestic Interpretations

A. Separate vs. Aggregate Examination

The arm's-length principle of the OECD guidelines is transaction-based and therefore, as a general rule, must be applied separately for each controlled transaction.[6] However, the OECD guidelines outline several exceptions to this rule. Among other things, the guidelines recognize that it may be necessary to make an aggregated examination when separate transactions are so closely linked or continuous that they cannot be adequately examined separately.[7] If there are close business links between transactions, it is reasonable to presume that an overall price determination will be made of market transactions, and in such a case, the arm's-length principle would require an aggregated examination. For example, the OECD guidelines state that it may be necessary to make an aggregated examination of a whole product range, and of the licensing of manufacturing know-how and the supply of vital components. An aggregated examination is valid only for transfer pricing purposes. The substantive tax treatment of the transactions is not affected by an aggregated examination. Even though an aggregated examination of separate transactions may provide that no transfer pricing adjustment is warranted, substantive tax law may authorize a reallocation of the total transfer price between multiple transactions. The aggregation principle has been recognized in several court decisions, including Dutch and Canadian cases.

The Dutch *Automotive*[8] case concerned a subsidiary that imported cars and spare parts from a Japanese sister company. The subsidiary was obliged to purchase all the products in the group's product range. The tax authorities made a transfer pricing adjustment, because the budgeted and actual results for one product were negative for a substantial period. The subsidiary was profitable overall. According to the Dutch Supreme Court, under domestic law and article 9(1) of the Japan-Netherlands tax treaty, an aggregated arm's-length test could be made of the whole product range. The Dutch tax authorities have adopted a narrow, formalistic interpretation of the judgment, whereby it has precedent value only when transactions have their roots in the same contract between the parties.[9]

The Canadian *GlaxoSmithKline* case dealt with the issue whether an aggregated examination should be made of a supply agreement for active pharmaceutical ingredients between a subsidiary and a Swiss sister company, and a license agreement between the subsidiary and its U.K. parent company. The license agreement gave the subsidiary the right to use the ingredients to manufacture, market, and sell medicines, as well as to use the trademark associated with the products. The transfer price paid by the subsidiary for the ingredients exceeded the market price for a similar generic product by approximately five times. The taxpayer argued that an aggregated examination should be made of the two agreements, because the group's transfer pricing policy involved distribution companies retaining a total gross margin of 60 percent, taking into account both the cost of the ingredients and the royalty. The tax authorities argued that the two agreements should be looked at separately because they covered distinct subject matters and there was no formal 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,[10] but the decision was overturned by the Federal Court of Appeal, which held that an aggregate test should be made.[11] The tax authorities have appealed the decision to the Supreme Court.

Both court decisions are in line with the OECD guidelines on an aggregated examination of multiple transactions. The restrictive interpretation adopted by the Dutch tax authorities and the appeal filed by the Canadian tax authorities reveal a fundamental disagreement on the interpretation of the arm's-length principle. The formal perspective relied on by these tax authorities is contrary to the business perspective required under the arm's-length principle as evidenced, for instance, by the following statement from the OECD guidelines:

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[5]Fiscal Court of Cologne, Aug. 22, 2007, 13 K 647/03 (EFG 2008 161); and Fiscal Court of Hamburg, Oct. 31, 2011, 6 K 179/10. *See* Wittendorff, *supra* note 1, at 227 et seq.

[6]Para. 3.9 of the OECD guidelines.

[7]*Id.*

[8]Supreme Court decision of June 28, 2002 (BNB 2002/343).

[9]Dutch Director-General for Fiscal Affairs, Sept. 13, 2002 (IFZ 2002/830M).

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

[11]*GlaxoSmithKline Inc. v. The Queen,* 2010 FCA 201 (2010).

> Where the business restructurings provides for a transfer of an intangible asset followed by a new arrangement whereby the transferor will continue to use the intangible transferred, the entirety of the commercial arrangement between the parties should be examined in order to assess whether the transactions are at arm's length.[12]

B. Dynamic vs. Static Examination

The general rule of a separate examination is also undermined by the requirement in appropriate cases of a dynamic examination that covers multiple taxable years. The arm's-length principle generally requires a dynamic examination if the price of market transactions will be determined on the basis of a period that extends beyond the taxable year in question.[13] Otherwise, the arm's-length principle may lead to arbitrary results.[14]

A distinction should be made between the issue of whether a transaction in one tax year may be adjusted in the tax return for another tax year, and whether a transaction in one tax year may be affected by the transfer price of another transaction in another tax year. In the first situation, an adjustment will presumably be precluded by the procedural rules of most countries. The arm's-length principle will not require a different result. However, in the second situation, it is doubtful whether domestic procedural rules will prevent the valuation being affected by the circumstances in other tax years. The arm's-length principle may dictate that the circumstances of other tax years must be taken into account, since the arm's-length test must be made from a business perspective. Article 9(1) of the OECD model tax treaty thus imposes an obligation on the contracting states to make a dynamic examination covering multiple taxable years in appropriate cases, even though domestic law may lead to a different result.

Courts in Sweden, Denmark, and the United States have sanctioned a dynamic examination. In *Shell*,[15] the Supreme Administrative Court of Sweden recognized a dynamic test of the purchase of oil:

> A general problem in considering the dispute discussed here is what *time perspective* should be used for the assessment. For the purpose of income taxation, the principle of the inviolability of the taxable year is of fundamental importance. With reference to this principle, the Administrative Court of Appeal found that over-pricing in one year cannot be set-off against under-pricing in another year . . . According to the Supreme Administrative Court, the question should not be answered so categorically. It cannot be ruled out that a pricing system that, in a longer term perspective, is fully acceptable from an arm's length point of view will lead to over-pricing in one year and under-pricing in another year, or that in a subsequent year costs in the form of over-prices can lead to improved profits or the absence of losses in a later — maybe considerably later — stage of the enterprise. It cannot be regarded as being compatible with the business perspective which, according to foregoing, should be adopted that the assessment of this and similar cases should be restricted to a taxable year.[16] [Emphasis in original.]

In *BP*,[17] the Danish Supreme Court rendered a similar decision. The U.S. Tax Court also endorsed a dynamic examination in *R.T. French Co.*:

> The Commissioner has focused on the particular taxable years in questions, 1963 and 1964 . . . The point is, however, that it is inappropriate to view the 1963 and 1964 in isolation.[18]

The German[19] and Dutch[20] tax authorities also recognize the use of dynamic examinations.

By contrast, courts in Norway and Australia have held that a static arm's-length test must be applied for each separate tax year. Hence, in *Baker Hughes* the Supreme Court of Norway held:

> To the appellant's argument that the Tax Assessment Appeal Board (*Overligningsnemnda*) should have evaluated the tax assessments for the years 1986-1990 together, in my view, in a case such as this, it is correct to assess each year individually.[21]

Similarly, in *Roche* the Administrative Appeals Tribunal of Australia made a static examination in spite of the fact that both the tax authorities and the taxpayer advocated a dynamic examination:

> The method employed by both Dr Fisch and Dr Becker was to compare the profit margin earned with what they found to be a comparable arm's length profit margin. They took an average profit margin for all years as that comparator, although asking themselves the question whether this was a fair approach. While the approach may be reasonable for an expert considering whether there is evidence of transfer pricing at other than arm's

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12 Para. 9.86 of the OECD guidelines.

13 Paras. 3.9 and 3.75-3.79 of the OECD guidelines.

14 Para. 32, "Timing Issues in Comparability," in *Comparability: Public Invitation to Comment on a Series of Draft Issues Notes*, OECD, 2006.

15 RÅ 1991, ref. 107.

16 *Id.*

17 TfS 1988.292.

18 *R.T. French Co. v. Commissioner*, 60 TC 836 (1973).

19 Para. 3.4.12.9 of the 2005 transfer pricing circular (BStBl I 2005 569).

20 Para. 1.3 of Dutch 2001 transfer pricing decree (IFZ2001/295M).

21 Rt 1999/1087. *See also* Rt 2003/536 (*Storhaugen Invest*).

length prices, I do not think that the Commissioner or this Tribunal can ultimately act on that basis. This is because the task of both the Commissioner and this Tribunal is to consider taxation assessments for separate years. The focus must be on the separate prices in each of the years under consideration. It accordingly seems to me to be necessary to look at each year separately and to the gross profit margin in each year.[22]

Thus there is no international consensus on the choice between dynamic and static examinations.[23]

C. Realistic Alternatives

The OECD guidelines use the concept of realistic alternatives as a factor under the comparability analysis,[24] and have rejected the notion that realistic alternatives may be used as a separate means for determining transfer prices.[25] This use of realistic alternatives may thus be in breach of the principles that the controlled transaction must be recognized as actually structured, and that the arm's-length test must be applied from both parties' perspectives. For the same reasons, the OECD guidelines emphasize that the valuation of intangibles should not be made on the basis of a highest and best use principle.[26]

However, the U.S. regulations make use of realistic alternatives both for the purpose of evaluating comparability[27] and as a separate means for evaluating transfer prices.[28] In the latter capacity, the rules may trigger an adjustment, even though the result of a controlled transaction corresponds to the result of a comparable uncontrolled transaction.[29] The fiscal year 2012 budget proposals would add to section 482 a realistic alternative approach for intangibles, which is intended to achieve a similar result as the highest and best use principle.[30] This may cause the U.S. rules to drift further away from the OECD rules.

D. One-Sided vs. Dual-Sided Valuation

Under the OECD guidelines, valuation must be made from the perspective of both parties.[31] The result of an arm's-length test is thus the result that would have been arrived at by a transaction between two independent enterprises, both acting to maximize their profits.[32] In Germany, the requirement for a dual perspective is generally recognized[33] and underlies the rules on business restructurings.[34] In the United States, the regulations do not expressly require a dual perspective. By contrast, the U.S. rules on intangibles (comparable profit method and commensurate with income (CWI) standard) and cost sharing (realistic alternatives, investor model, and income method) emphasize the transferor's perspective to ensure relatively high valuations in outbound transactions. This difference between the U.S. regulations and the OECD guidelines may be illustrated by an example in which the present value of the profit potential of an intangible is 500 for the transferor and 900 for the transferee. The arm's-length price in this example would be 900 under U.S. tax law and 700 under the OECD guidelines, based on the presumption for the midpoint of the arm's-length range.

E. Ex Ante vs. Ex Post Valuation

The arm's-length principle generally must be applied on an ex ante basis, that is, based on information available at the time of the transaction. This reflects the situation unrelated taxpayers face in the marketplace. The OECD guidelines thus ban the use of hindsight.[35] At the same time, the OECD guidelines open the door to a breach of this principle by arguing that the form of payment for intangibles should conform to market terms when valuation is highly uncertain at the time of the transaction.[36] However, an adjustment of the form of payment would be in breach of the principle of the recognition of the controlled transaction as actually structured.[37]

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[22]*See supra* note 3.

[23]Wittendorff, *supra* note 1, at 384.

[24]Paras. 1.34, 1.35, 9.59-9.64, 9.72, 9.81, 9.85, and 9.116 of the OECD guidelines.

[25]Paras. 3.14-3.18, *OECD Task Force report on intercompany transfer pricing regulations under US section 482 temporary and proposed regulations*, OECD, 1992.

[26]Para. 6.15 of the OECD guidelines.

[27]Treas. reg. sections 1.482-1(d)(3)(iv)(H) and 1.482-3(b)(2)(B)(8).

[28]Treas. reg. sections 1.482-1(f)(2)(ii)(A), 1.482-3(e)(1), 1.482-4(d)(1), 1.482-7(g)(2)(iii)(A), 1.482-7(g)(4)(i)(A), and 1.482-9(h).

[29]Preamble, Explanation of Provisions, section 1.482-1(f)(2), in T.D. 8552 (IRB 1994-31).

[30]*General Explanations of the Administration's FY 2012 Revenue Proposals*, Department of the Treasury, Feb. 2011, p. 45.

[31]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.

[32]F. Wassermeyer, *Steuerberater-Jahrbuch* (1997-1998), p. 79; *id.*, in Debatin and Wassermeyer, *Doppelbesteuerung: DBA*, Band 1, article 9, marginal note 126; H. Baumhoff, in: F. Klein, H.P. Stihl, and F. Wassermeyer (eds.), *Festschrift für Hans Flick* (1997), p. 633; U. Andresen, *Konzernverrechnungspreise für multinationale Unternehmen* (1999), p. 78; and H. Förster, ''Germany's Transfer Pricing Provisions: A Conflict with Internationally Agreed Principles?'' *Tax Mgmt. Transfer Pricing Rep.* (Jan. 28, 2010), p. S-3.

[33]Federal Fiscal Court, May 17, 1995, I R 147/93 (BStBl II 1996 204).

[34]Section 1(4), sixth sentence of the German Foreign Tax Act.

[35]Paras. 2.130, 3.73, 3.74, 5.20, 6.32, 8.20, 9.56, 9.57, and 9.88 of the OECD guidelines.

[36]Paras. 3.72, 3.73, 6.28, 6.32, 9.87, and 9.88, and Annex to Chapter VI of the OECD guidelines.

[37]Wittendorff, *supra* note 1, at 166 and 689.

In the United States, the ex ante principle has been emphasized by two court decisions. In *R.T. French Co.* the Tax Court held:

> The Commissioner does not seriously contend that the 1946 agreement was not representative of an arm's-length bargain . . . What later transpired in no way detracted from the reasonableness of the agreement when it was made.[38]

Likewise, in *Bausch & Lomb, Inc.* the Tax Court held:

> The arm's length nature of an agreement is determined by reference only to facts in existence at the time of the agreement.[39]

In Europe, the ex ante principle has been espoused, for instance, by the Supreme Court of Norway in *Statoil*:

> The assessment of whether an agreement has been entered into on arm's length terms must be made on the basis of the situation as it appeared to the parties when the agreement was entered into.[40]

Similarly, in *DSG Retail*, calculations made by the taxpayer were rejected by the U.K. Special Commissioners because they were on an ex post basis and thus made use of hindsight:

> Mr Bezant considers that Mr Gaysford's approach based on reported profit in DISL's accounts, for example reflecting the accounting treatment of unearned premiums, actual claims experience and revisions to future expected claims in relation to the long-term nature of the policies, may be inappropriate under the OECD Guidelines. Mr Bezant points out that Mr Gaysford's calculations are *ex post* calculations of an expected return on equity rather than an *ex ante* assessment of the terms of an arm's length agreement, as required by the OECD Guidelines. This is relevant given the need to price insurance risk over an extended period. Mr Gaysford considers that the existence of the profit commission is a method of clawing back *ex post* profits and is in accordance with the OECD Guidelines. As before, there is a large measure of agreement between the two experts, the disagreement being, as before, whether Mr Gaysford's method is in accordance with the OECD Guidelines. . . . We do not set out Mr Gaysford's calculations since we agree with Mr Bezant's objections that they used hindsight.[41]

To address information asymmetry, the United States[42] and Germany[43] have enacted CWI standards, which entail evaluating transfer prices in some situations on an ex post basis, that is, based on information available after the time of the transaction. Canada has also enacted a rule that accommodates the application of a CWI standard.[44] By contrast, the U.K. tax authorities have recently decided not to introduce a CWI standard.[45]

Needless to say, valuations on an ex ante and ex post basis may have completely different results.

F. Subjective vs. Objective Valuation

The arm's-length principle establishes a comparability requirement under which it must be applied on the basis of the conditions of comparable uncontrolled transactions entered into under comparable circumstances.[46] The arm's-length principle thus requires the object and all other economically relevant aspects of the transactions to be comparable. This means that there must be a subjective, entity-specific valuation. The arm's-length principle thus differs significantly from fair value and similar objective, market-based valuation standards.[47]

The requirement of subjective valuation has been recognized in several court cases, including the *Automotive* case, in which the Dutch Supreme Court held that there must be an evaluation of whether an unrelated company would have accepted the terms of a controlled transaction had it been in the same situation as the group company.[48] The Court thereby rejected the tax authorities' argument that there should be an evaluation of whether the terms of the controlled transaction would have been agreed to between unrelated companies.

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[38] *R.T. French Co. v. Commissioner*, 60 T.C. 836 (1973).

[39] *Bausch & Lomb, Inc. v. Commissioner,* 92 T.C. 525, 1989. The decision was upheld by the appeal court, *Bausch & Lomb, Inc. v. Commissioner*, 933 F.2d 1984 (2nd Cir. 1991).

[40] Rt 2003/1324.

[41] *DSG Retail Ltd. v. HMRC*, 2009 (SpC 3056, 3057, 3060/07), paras. 133-134.

[42] Section 482, second sentence of the IRC.

[43] Section 1(4), 12th sentence, of the Foreign Tax Act.

[44] Section 247(2)(b) of the Income Tax Act. *See* paras. 150-151, Income Tax Information Circular 87-2R, Sept. 27, 1999.

[45] HM Revenue & Customs, ''Corporate Tax Reform: Delivering a More Competitive System,'' Nov. 2010, p. 34.

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

[47] Jens Wittendorff, ''The Arm's-Length Principle and Fair Value: Identical Twins or Just Close Relatives?'' *Tax Notes Int'l*, Apr. 18, 2011, p. 223, *Doc 2011-4517*, or *2011 WTD 74-12*.

[48] Supreme Court, 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), p. 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), p. 192.

The U.K. Special Commissioners adopted the same position in *DSG Retail*:

> The actual assets, business and attributes of each party remain constant and may be relevant to the determination of the arm's length price.[49]

The German Federal Fiscal Court reached a similar conclusion:

> This consideration 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.[50]

Likewise, in *GlaxoSmithKline* the Federal Court of Appeal of Canada stated:

> In my view, the test set out in *Gabo, supra*, requires an inquiry into those circumstances 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.[51]

By contrast, in *SNF* the Federal Court of Appeal of Australia (first instance) reached the opposite result:

> 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.[52] [Emphasis in original.]

The Australian 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. 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 that consideration of the OECD material was unnecessary. The court's position was contrary to the practice of the Australian tax authorities, which draw a distinction between the market value standard and the arm's-length principle.[53] In response to the decision, the tax authorities have concluded that:

> While it is generally understood that the application of profit allocation rules requires a comparison with comparable, independent dealings, the standard of comparability required, and in particular, to what extent the specific circumstances of the taxpayer are relevant, has been subject to debate. For example, in *Roche* and *SNF* (at first instance) there was discussion that indicated further guidance may be desirable on when arm's-length concepts should depart from market valuation concepts — a market valuation approach would largely ignore special factors relating to the parties to the transaction.[54]

The decision suggests that the arm's-length principle of Australian tax law must be characterized as an objective, market-based standard that deviates from the arm's-length principle of article 9(1) of the OECD model tax treaty. However, this is about to change, as discussed below in Section II.

G. Summary

There is international consensus on the application of the arm's-length principle. However, national courts and tax administrations interpret the arm's-length principle differently in key areas. Thus, the development of the arm's-length principle has followed different routes in domestic law. This exposes taxpayers to uncertainty and risk of economic double taxation, given that international dispute resolution mechanisms are incomplete.

II. Alignment of Transfer Pricing Law

Consistency between domestic and international transfer pricing laws is best achieved under the following circumstances:

- The domestic transfer pricing provision must directly require interpretation in accordance with the arm's-length principle of article 9(1) of the OECD model tax treaty and the OECD guidelines.
- The domestic transfer pricing provision must be dynamic to keep track of developments of the OECD material.
- The OECD guidelines must clearly articulate the constituent elements of the arm's-length principle.

A. Domestic Action

The OECD encourages member countries to follow the OECD guidelines in their domestic transfer pricing practices.[55] A 2011 paper outlines an OECD-suggested approach to the drafting of domestic transfer pricing

[49]*DSG Retail Ltd. v. HMRC*, 2009 (SpC 3056, 3057, 3060/07), para. 78.

[50]Federal Fiscal Court, Oct. 29, 1997, I R 24/97 (BStBl II 1998 573).

[51]*See supra* note 11.

[52]*SNF (Australia) Pty Ltd v. Commissioner*, Federal Court of Australia 635 (2010) para. 44. The decision was upheld by the full Federal Court of Australia, *SNF (Australia) Pty Ltd v. Commissioner*, *supra* note 4, paras. 92-123. However, the Full Federal Court seemed to acknowledge the circumstances in which the actual transaction occurred were relevant to some degree. *See* Australian Tax Office, ''Consultation Paper — Income Tax: Cross Border Profit Allocation — Review of Transfer Pricing Rules,'' Nov. 1, 2011, para. 53.

[53]Part A, *Market Valuation for Tax Purposes*, Australian Taxation Office, May 28, 2010.

[54]Australian Treasury, ''Cross-border profit allocation,'' Consultation Paper, Nov. 7, 2011, para. 53.

[55]Para. I.1 of the Recommendation of the Council on the Determination of Transfer Pricing between Associated Enterprises [C(95)126/final]; and para. 16, preface, OECD guidelines.

legislation.[56] Unfortunately, this approach would cause a relatively weak link between domestic and international law, since neither of the first two conditions mentioned above is met.

The options available for a particular country that wishes to align its transfer pricing law with the OECD guidelines depend, among other things, on constitutional issues such as non-delegation doctrines.

The domestic transfer pricing laws of the OECD member countries may be divided into four broad categories.

First, at one end of the spectrum are countries — such as the United Kingdom and Norway — that have adopted a direct and dynamic reference to article 9(1) and the OECD guidelines in their transfer pricing provisions. In the U.K., the arm's-length principle is laid down in section 147 of the Taxation (International and other Provisions) Act 2010, and it must be interpreted on the basis of article 9(1) and the OECD guidelines, if the controlled transaction in question is subject to a tax treaty article similar to article 9.[57] Changes to the OECD guidelines must be taken into account if the Treasury has approved such changes.

In Norway, section 13-1(4) of the Taxes Act (skatteloven) states that the OECD guidelines should be considered if the controlled transaction is governed by an arm's-length provision of a tax treaty. Changes to the OECD guidelines should be taken into account if Norway has approved the changes and the Minister of Finance has not decided otherwise.

Australia intends to adopt an approach similar to the U.K. by introducing a new Division 815 into the Income Tax Assessment Act 1997.[58] One of the primary purposes of the new law is to ensure that the arm's-length principle is interpreted as consistently as possible with relevant OECD guidance.[59] The impetus for the draft law was provided by the decisions in *Roche* and *SNF*, which the government considers to be inconsistent with the OECD guidelines.[60] The proposed section 815-25 involves a direct reference to the 2010 OECD model tax treaty, the 2010 OECD guidelines, and any other documents prescribed by regulations. The tax authorities would thus be authorized to prescribe further guidance material that may be published by the OECD.

Second, several member countries ensure a link with the OECD material through the legislative history of the domestic transfer pricing provision. This group of countries includes Denmark, where the legislative history of section 2 of the Tax Assessment Act (Ligningsloven) makes several references to article 9(1) and the OECD guidelines, so that OECD materials qualify as a source of law. However, the Danish approach suffers from two shortcomings. First, a reference in the legislative history is not as strong a link as direct reference in the provision would be. This was recently seen in *Swiss Re*,[61] in which the Supreme Court adopted a controversial interpretation of the scope of the arm's-length principle of section 2 without any (express) consideration of OECD material. Second, the approach is static and does not account for significant changes to the OECD guidelines, such as the new Chapter IX on business restructurings. These issues are the reason for the pending reformation of the Australian transfer pricing regime. Belgium, Canada, and the Netherlands also rely on static transfer pricing laws that refer to OECD materials only in the legislative history. Germany and the Netherlands have implemented parts of the OECD guidelines at an administrative level through domestic guidelines that reproduce and refer to the OECD guidelines.[62]

Third, in some countries there is no formal link between the OECD guidelines and the domestic transfer pricing provision. Sweden is an example; courts have more latitude in interpreting the arm's-length principle. However, in *Shell* the Swedish Supreme Administrative Court emphasized that relevant parts of the 1979 OECD transfer pricing report could be relied on for purpose of the application of domestic law.[63]

Fourth, a few countries rely on autonomous interpretation of the arm's-length principle. The United States, the international standard setter in transfer pricing, is in this category.[64] The United States does not refrain from introducing rules that are in conflict with

[56]OECD, ''Transfer Pricing Legislation — A Suggested Approach,'' June 2011.

[57]Section 164 of the Taxation (International and other Provisions) Act 2010.

[58]Exposure draft on Tax Laws Amendment (2012 Measures No. 3) Bill 2012: Cross-border transfer pricing.

[59]Explanatory material on Tax Laws Amendment, Mar. 16, 2012, para. 1.12.

[60]Australian Taxation Office Decision Impact Statement in *SNF (Australia) Pty Ltd*, Nov. 7, 2011.

[61]TfS 2012.151. *See* Jens Wittendorff, ''Darkness Descends on Danish Tax Law: Supreme Court Decision in Swiss Re,'' 19 *Int'l Transfer Pricing J.* 3 (2012), p. 100.

[62]*See* the German transfer pricing circulars of February 23, 1983 (BStBl I 1983 218), and April 12, 2005 (BStBl I 2005 569); and the Dutch 2001 transfer pricing decrees of March 30, 2001 (IFZ2001/295M), and August 21, 2004 (IFZ2004/680M).

[63]RÅ 1991, ref. 107.

[64]The U.S. approach is reflected in the following statement of the preamble, Explanation of Provisions, section 1.482-7(k), in T.D. 9088 (IRB 2003-42):

> 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

(Footnote continued on next page.)

OECD rules. For example, the CWI standard enacted in 1986 was implemented in the 1994 regulations in spite of strong objections from the OECD.[65] The U.S. approach has caused the U.S. and OECD guidelines to be quite different in some areas. Nevertheless, the IRS has proclaimed that the U.S. regulations conform to the OECD guidelines.[66]

B. OECD Action

The OECD, for its part, should provide a clear interpretation of the arm's-length principle and must strike a proper balance between principle-based and rule-based guidelines. If the rule-producing activity gets out of hand at the expense of a clear articulation of the basic principle, this would entail the risk that the OECD starts fumbling around in the dark.

The OECD should also ensure that the guidelines stay within the scope of article 9(1). This is of special importance because the OECD interpretation is relied upon under domestic law. The guidelines should thus solely clarify the meaning of the arm's-length principle. Real changes to the arm's-length principle should not be introduced in the guidelines, disguised as clarifications. In this context, the OECD may be criticized for indulging some tax administrations' wishes to broaden the scope of the arm's-length principle from a price-focused standard to a substance-over-form standard.[67] Such fundamental changes are the prerogative of national parliaments and must be accompanied by changes to the wording of article 9(1) such as the 2010 changes of article 7 of the OECD model tax treaty.

Some examples of divergent national interpretations of the arm's-length principle have been caused by a vague link between domestic law and the OECD guidelines. The remedy in that case is a reform of domestic law. Other situations would warrant a clarification of the OECD guidelines. For example, the issue of a subjective, entity-specific versus an objective, market-based valuation is not clarified in the guidelines. This issue is of particular importance to specialized assets such as intangibles, the economic value of which is normally the value in use of property that is expected to last several years, and which depends on the resources and capabilities of the individual enterprise. Paragraph 6.27 of the guidelines could be interpreted to mean that the arm's-length principle and fair market value are identical standards, though this has hardly been the intention.[68] It would be appropriate for the OECD to modify this paragraph and differentiate between the two standards in a forthcoming update of the OECD guidelines, incorporating the results of the intangibles project currently underway.[69] This view was also put forward in a comment on the intangibles project by the Canadian Institute of Chartered Business Valuators, which stressed that one of the key deficiencies of the OECD guidelines is that they do not clearly define the governing standard of value.[70] It is surprising that this issue is not mentioned in the document approving the scope of the intangible project. Not addressing this question, which is at the very center of the issue of transfer pricing of intangibles, would be a major mistake.

III. Conclusion

There is international consensus about the choice of the arm's-length principle for the purpose of income allocation between associated enterprises. However, the interpretation of the arm's-length principle by national tax administrations and courts diverges in key areas. Aligning domestic and international transfer pricing laws requires effort on both a national and international level. Preferably, domestic law would incorporate a direct reference to the OECD material and be of a dynamic nature. The U.K. and Norway have adopted this approach, which Australia is also likely to follow. Moreover, the OECD should provide a clear articulation of the arm's-length principle and ensure that its rules stay within the scope of article 9(1). ◆

believe that international discussion of issues compels the suspension of the regulatory process.

[65] Paras. 3.6 and 3.63-3.71, ''Tax Aspects of Transfer Pricing within Multinational Enterprises — the United States Proposed Regulations,'' OECD, 1992; and paras. 2.5 and 2.23-2.33, ''OECD Task Force report on intercompany transfer pricing regulations under US section 482 temporary and proposed regulations,'' OECD, 1993.

[66] Issue 5, AM-2007-007.

[67] Wittendorff, *supra* note 1, at 151 et seq.

[68] 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.

[69] ''Transfer Pricing and Intangibles: Scope of the OECD Project,'' OECD, Jan. 25, 2011.

[70] *See* http://www.oecd.org/dataoecd/38/14/46054702.pdf.