International

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The Object of Art. 9(1) of the OECD Model Convention: Commercial or Financial Relations

This article examines two dimensions of the concept of a controlled transaction under Art. 9(1) of the OECD Model. The first part is an examination of the basic object qualification under Art. 9(1), treaty-based limits on the object qualification and the OECD position. Second, the delimitation of the controlled transaction for purpose of the arm's length test under Art. 9(1) is examined.

1. Introduction

Art. 9(1) of the OECD Model Convention governs transfer pricing adjustments of controlled transactions between associated enterprises. The issue most commonly analysed with regard to Art. 9(1) is how to determine the arm's length price of a controlled transaction, i.e. the quantitative aspect. Among other less frequently considered issues is the question of what constitutes a controlled transaction, i.e. the qualitative aspect.

The object qualification issue is addressed in Art. 9(1) by the concept of "commercial or financial relations". Object qualification is an important issue because of the attempts by many countries to expand their national tax base to capture a greater share of the tax revenues from multinational enterprises. Hence, in an Art. 9(1) context, the tax base may not just be enhanced by making transfer pricing adjustments, but also by creating or disregarding controlled transactions. For example, the tax authorities of a country may wish to:
– create a controlled transaction in which an enterprise transfers an asset or services to an associated enterprise, e.g. a relocation of functions;
– disregard a controlled transaction in which an enterprise acquires an asset or services from an associated enterprise, e.g. due to formal requirements; or
– create or disregard an asset, which should affect transfer prices for goods and services exchanged between associated enterprises, e.g. a marketing intangible.

All of these actions may enhance a national tax base. The object qualification was recently addressed in the 2008 OECD Discussion Draft on business restructurings[1] and at the 2009 OECD transfer pricing conference, where discussions took place regarding definitional issues with regard to intangibles such as unprotected "soft intangibles".[2]

This article will look into two dimensions of the concept of a controlled transaction under Art. 9(1) of the OECD Model. The first part is an examination of the basic object qualification under Art. 9(1) (see 2.), treaty-based limits on the object qualification (see 3.) and the OECD position (see 4.). Second, the delimitation of the controlled transaction for purpose of the arm's length test under Art. 9(1) is analysed (see 5.).

2. The Object Qualification

2.1. General

The objective scope of Art. 9(1) is defined in terms of "commercial or financial relations", a concept that is not defined in Art. 9(1) or elsewhere in the OECD Model.[3] Under Art. 9(1), the profits of an enterprise may be adjusted, and the adjusted profit may "be included in the profits of that enterprise and taxed accordingly". Art. 9(1) is thus concerned with the taxation of profits of enterprises. The distributive articles allocating the right to tax profits of enterprises are Arts. 7(1) and 8 (the discussion below refers only to Art. 7(1)). Thus, Art. 9(1) generally functions as a supplement to Art. 7(1) by providing for a quantification of the income between associated enterprises to which the contracting states are ascribed taxing rights under Art. 7(1).[4] The profits from "commercial or financial relations" governed by Art. 9(1) are thus identical to the "business profits" governed by Art. 7(1).

2.2. Business profits under Art. 7(1)

The term "business profits" is not defined in the OECD Model, but should be given a broad interpretation to include all income derived from carrying on an enterprise.[5] Prior to 2000, the term "enterprise" was not defined in the OECD Model, and under Art. 3(2) it had

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1. Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment (Paris: OECD, 2008).
2. *Transfer Pricing and Treaties in a Changing World*, OECD Congress held on 21-22 September 2009 in Paris. See www.oecd.org/document/3/0,3343,en_2649_33753_43744835_1_1_1_1,00.html.
3. The Commentary uses the term "transactions" and the OECD Guidelines use the term "controlled transactions" synonymously with "commerical or financial relations" in Art. 9(1). See Para. 1 Commentary on Art. 9 of the OECD Model and Glossary of the OECD Guidelines.
4. P. Baker, *Double Taxation Conventions* (London: Sweet & Maxwell, December 2009), No. 9B.14; F. Wassermeyer, in Debatin and Wassermeyer, *Doppelbesteuerung: DBA* (Munich: C.H. Beck, October 2009), Art. 9, m.no. 2; A. Hemmelrath, in Vogel and Lehner, *Doppelbesteuerungsabkommen* (Munich: C.H. Beck, 2008), Art. 7, m.no. 7; U. Andresen, *Konzernverrechnungspreise für multinationale Unternehmen* (Wiesbaden: Deutscher Universitäts-Verlag, 1999), at 2.
5. Para. 59 Commentary on Art. 7 of the OECD Model. Under the functionally separate entity approach, which underlies the authorized OECD approach, the term "profits of an enterprise" in Art. 7(1) does not impose any limitations on the quantum of profits that are attributable to a permanent

to be interpreted on the basis of domestic law.[6] The 2000 revision of the OECD Model added Art. 3(1)(e), which defines the term "enterprise" as the "carrying on of any business", and Art. 3(1)(h), which defines the term "business" so that it "includes the performance of professional services and of other activities of an independent character". These definitions were inserted as a result of the deletion of Art. 14 to ensure that income from independent personal services was covered by Art. 7 rather than Arts. 15 and 21.[7] Against this background it has been argued that the application of Art. 3(2) of the OECD Model is now precluded because the new definitions mean that the terms should be subject to autonomous interpretation.[8] This argument must be rejected for the following reasons:

- the definition of an "enterprise" refers to the definition of "business", which is non-exhaustive;
- the purpose of both definitions is solely to ensure that professional services qualify as a "business" under Art. 7(1); and
- the Commentary clearly states that both terms should be interpreted on the basis of domestic law.[9]

For these reasons, the terms "enterprise" and "business" should remain subject to a domestic law interpretation.[10] Both Art. 3(2) and the context thus also require the concept of business profits in Art. 7(1) to be defined on the basis of domestic law.[11]

The Commentary dealing with the definition of royalties under Art. 12(2) states that certain payments, such as payments for computer software, exclusive distributions rights, the development of a design, model or plan, may be covered by Art. 7.[12] The Commentary fails to clarify that the qualification ultimately depends on the domestic law definition of the concept of business profits.

The OECD Model provides for two departures from this basic rule of domestic law interpretation. First, the performance of independent personal services and other businesses of an independent character are deemed to qualify as a "business" under Art. 3(1)(h), without regard to domestic law definitions (autonomous interpretation). Income from such activities is thus covered by Art. 7(1).[13] Second, dividends, interest, royalties and other income from rights or property effectively connected with a permanent establishment are deemed to constitute business profits as set out in Art. 7(1), under the throwback rules of Arts. 10(4), 11(4), 12(3) and 21(2) (autonomous interpretation).[14]

To summarize, under Art. 7(1), business profits include:

- income qualifying as business profits under domestic law;
- income from professional services and other activities of an independent character; and
- dividends, interest, royalties and other income covered by the throwback rules of Arts. 10(4), 11(4), 12(3) and 21(2).

2.3. Commercial or financial relations of Art. 9(1)

Business profits of Art. 7(1) may logically be the result of internal dealings of an enterprise; transactions with independent enterprises; and transactions with associated enterprises covered by Art. 9(1).[15] Because under Art. 7(1) business profits in an associated enterprise context are the result of commercial or financial relations

establishment. See Paras. 69 and 79 *Report on the Attribution of Profits to Permanent Establishments*, Part I (Paris: OECD, 2008). Art. 7(7) of the 1996 US Model clarified that the term "business profits" means income from any trade or business. This provision is not included in the 2006 US Model, but an equivalent statement has been inserted in the Technical Explanation to Art. 7(1). In 1992 the United States deleted its observation, that Art. 9 could apply not only to "profits", but also to "income, deductions, credits or allowances". See Para. 12 Commentary on Art. 9 of the 1977 OECD Model.

6. Para. 4 Commentary on Art. 3 of the OECD Model from 1977 to 2000; Para. 12 of Issues Related to Art. 14 of the OECD Model Tax Convention, in 7 *Issues in International Taxation* (Paris: OECD, 2000). The legislative history of Danish Law 763 of 27 November 1991, ratifying the EU Arbitration Convention, suggests that Danish domestic tax law is decisive on the issue of whether an activity qualifies as an enterprise when applying a treaty. See the general comments on Art. 1 in Bill L 21 of 3 October 1991. This is justified by the *Siggaard Andersen* case from 1988 (*Tidsskrift for Skatteret* (1989), no. 38), where the Danish Supreme Court arguably interpreted the concept of "profits of an enterprise of a contracting state" in Art. 7(1) of the 1972 Denmark–Spain tax treaty on the basis of Danish domestic tax law. This meant that pension payments from a general partnership to a retired partner resident in Spain qualified as business profits under Art. 7(1) rather than as a pension under Art. 18, because the payments were calculated as a percentage of the profits of the partnership. Similarly, in a 1975 decision, the French Supreme Administrative Court interpreted the concept of an enterprise under the France–Canada tax treaty on the basis of French domestic law pursuant to Art. 3(2). See the decision of 26 November 1975, no. 93 187, Droit Fiscal 1976, at 733 (*Latournerie*). In contrast, the Australian High Court in *Thiel v. Federal Commissioner of Taxation*, 90 Australian Tax Cases, 4717 (1990) made an autonomous interpretation of the terms "enterprise" and "profits". However, this approach was adopted because those words had no particular meaning under the laws relating to Australian income tax. On the case, see T. Ferrers, 19 *Intertax* (1991), at 184.; J.F.A. Jones et al., in *The Taxation of Business Profits under Tax Treaties*, ed. B.J. Arnold, J. Sasseville and E.M. Zolt (Montreal: Canadian Tax Foundation, 2003), at 25, 40.
7. Para. 63 of Issues Related to Art. 14 of the OECD Model Tax Convention, in 7 *Issues in International Taxation* (Paris: OECD, 2000).
8. K. Vogel, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Einleitung, Art. 3, m.no. 41; A. Hemmelrath, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Art. 7, m.no. 29.
9. Paras. 4 and 10.2 Commentary on Art. 3 of the OECD Model. See B.J. Arnold, "At Sixes and Sevens: The Relationship between the Taxation of Business Profits and Income from Immovable Property", 60 *Bulletin for International Taxation* 1 (2006), at 5, 9; F. Zimmer, *Internasjonal inntektsskatterett* (Oslo: Universitetsforlaget, 2009), at 167.
10. F. Wassermeyer, in Debatin and Wassermeyer, *Doppelbesteuerung: DBA*, note 4, Art. 7, m.no. 16 a; B.J. Arnold, "Fearful Symmetry: The Attribution of Profits 'in Each Contracting State'", 61 *Bulletin for International Taxation* 8 (2007), at 312, 320 et seq.; J.F.A. Jones et al., in *The Taxation of Business Profits under Tax Treaties*, note 6, at 25, 42; J.F.A. Jones et al., "Treaty Conflicts in Categorizing Business Profits Caused by Differences in Approach between Common Law and Civil Law",57 *Bulletin for International Fiscal Documentation* 6(2003), at 237, 244; F. Zimmer, *Internasjonal inntektsskatterett*, note 9, at 166.; A.A. Skaar et al., *Norsk skatteavtalerett* (Oslo: Gyldendal Norsk Forlag, 2006), at 158 and 207; Aa. Michelsen, *International skatteret* (Copenhagen: Forlaget Thomson, 2003), at 91; N. Winther-Sørensen, *Skatteretten* 3 (Copenhagen: Forlaget Thomson, 2009), at 154.
11. Para. 46 Discussion Draft on the Attribution of Profits to Permanent Establishments (Paris: OECD, 2004). See B.J. Arnold, note 10, at 312, 320 et seq.; J.F.A. Jones et al., in *The Taxation of Business Profits under Tax Treaties*, note 6, at 25, 28 and 42; J.F.A. Jones et al., note 10, at 237, 238, 244; A. Hemmelrath, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Art. 7, m.no. 21; H-K. Kroppen, in Gosch, Kroppen and Grotherr, *DBA-Kommentar Internationales Steuerrecht* (Herne/Berlin: NWB, November 2009), Art. 7, m.no. 42; N. Winther-Sørensen, *Beskatning af international erhvervsindkomst* (Copenhagen: Forlaget Thomson, 2000), at 130.
12. Paras. 8.2, 9, 10.1, 10.2, 11.2, 14, 14.1, 14.4, 16, 17.3 and 18 Commentary on Art. 12 of the OECD Model.
13. B.J. Arnold, note 10, at 312, 321; B.J. Arnold, note 9, at 5, 6.
14. Para. 31 Commentary on Art. 10; Para. 24 Commentary on Art. 11; and Para. 20 Commentary on Art. 12 of the OECD Model. See B.J. Arnold, note 10, at 312, 320 et seq.; J.F.A. Jones et al., in *The Taxation of Business Profits under Tax Treaties*, note 6, at 25, 43 et seq.
15. Para. 20 *Report on the Attribution of Profits to Permanent Establishments*, Part I (Paris: OECD, 2008).

referred to in Art. 9(1), Art. 3(2) and the context also require this concept to be interpreted on the basis of domestic law. Accordingly, the existence, form and content of a controlled transaction under Art. 9(1) should be determined on the basis of domestic law.[16] The object qualification under domestic law must therefore be made prior to the application of the arm's length principle of Art. 9(1).[17]

The *Cytec Norge* case (Utv 2007/1440) in Norway is an example of a dispute in which both the existence of a controlled transaction and the arm's length test of the controlled transaction were at stake.[18] The case involved a Norwegian company that had been a full-fledged manufacturer and seller of goods. Following a change of ownership, the company was converted into a toll manufacturer of an associated enterprise in the Netherlands which caused a significant decrease in taxable income. The tax authorities made a transfer pricing adjustment of NOK 374 million because the conversion was held to involve a transfer of intangibles in the form of the customer base, technology, trademarks and goodwill to an associated enterprise. The taxpayer argued that there had been no controlled transaction because the Norwegian company was not the owner of the intangibles. The Court of Appeal found that the intangibles were critical for the business of the company and that it had the right to exploit the intangibles prior to becoming a toll manufacturer. The crucial issue was whether the rights had an intrinsic value for the company through ownership or licence rights and, if so, whether those rights were transferred to an associated enterprise due to the conversion. The majority of the Court upheld the decision. The majority found that under licence agreements with the former owners, the company had obtained royalty-free, exclusive, irrevocable and indefinite rights to exploit the technology, and that the company was also the owner of its own technology. The licence rights were held to have an intrinsic value. In addition, the company was found to be the owner of the customer base, trademarks and goodwill. Based on the contractual terms and the actual conduct of the parties, the intangibles were held to have been transferred in connection with the conversion to a toll manufacturer, i.e. a controlled transaction was found to exist. The Norwegian Supreme Court declined to hear the case.[19]

An object qualification under domestic law may give rise to unintended results if income does not constitute business profits under domestic law. For example, capital gains are not always treated as business profits under domestic law, and Art. 13(2) merely provides that capital gains from the alienation of movable property forming part of the business property of a permanent establishment may be taxed by the source state. Capital gains on business assets are thus not deemed to be business profits for treaty purposes, and a throwback rule is not established for situations in which a permanent establishment exists. The Commentary states that it is not necessary to have special provisions as to whether Art. 13 or Art. 7 should apply.[20] On this basis, a situation may arise where royalty payments under a licence agreement entered into by associated enterprises are covered by Art. 9(1), whereas a capital gain on the transfer of ownership of the intangible property, which forms the basis for the licence agreement, between the associated enterprises is not covered by Art. 9(1). In contrast, if the economic ownership of an item of intangible property is subject to a dealing between a permanent establishment and head office, the authorized OECD approach including the arm's length principle is applicable. The latter follows from the Commentary, which provides that the taxation triggered by a dealing regarding business assets should be in accordance with Art. 7.[21] The diverging results under Arts. 7(2) and 9(1) cannot be intended because the purpose of the two provisions generally is to fulfil the same function (see 2.4.).

2.4. Impact of Art. 7(7) on Art. 9(1)

Sometimes, income qualifying as business profits under Art. 7(1) may also be subsumed under other income categories of the OECD Model. It follows from Art. 7(7) that when profits include items of income that are dealt with separately in other articles of the OECD Model, the provisions of those articles are not affected by the provisions of Art. 7, i.e. the specific articles take precedence. How is Art. 9(1) affected when income is subsumed under a specific article rather than Art. 7(1)?

Franz Wassermeyer argues that income covered by the specific articles is outside the scope of Art. 9(1) because it does not constitute business profits under Art. 7(1).[22]

16. B.J. Arnold, note 10, at 312, 334. Referring to Para. 21 of the Commentary on Art. 7, it has been added that Art. 9(1) does not address the issue of when income is realized. See S.P. Hannes, "Transfer Pricing Discussion Group Comments on OECD's Business Restructurings Draft", 53 *Tax Notes International* (2009), at 973.

17. In an EU context it is essential how Art. 4(1) of the Arbitration Convention (90/436/EEC), which corresponds to Art. 9(1) of the OECD Model, should be interpreted. In contrast to the OECD Model, the Arbitration Convention calls for effective resolutions of transfer pricing disputes. An interpretation of the Arbitration Convention is beyond the scope of this article. The author's tentative view, however, is that the object qualification under the Convention should also be made on the basis of domestic law. Art. 3(2) of the Convention thus provides that any term not defined in the Convention shall, unless the context otherwise requires, have the meaning it has under the tax treaty between the states concerned. The undefined concept of commercial or financial relations in Art. 4(1) of the Convention must therefore be interpreted on the basis of the tax treaties, and these are normally interpreted on the basis of Art. 9(1) of the OECD Model. It should be noted that the ECJ has no jurisdiction under Art. 267 of the Treaty on the Functioning of the European Union to interpret and enforce the Convention because it was drawn up pursuant to Art. 293 of the EC Treaty. See N. Winther-Sørensen, *Skatteretten3*, note 10, at 531; S.N. Jensen, *EU-selskabsskatteret* (Copenhagen: Jurist- og Økonomforbundets Forlag, 1997), at 346; B.J.M. Terra and P.J. Wattel, *European Tax Law* (Alphen aan den Rijn: Kluwer Law International, 2008), at 568; A.J.M. Jiménez, *Towards Corporate Tax Harmonization in the European Community* (New York: Kluwer Law International, 1999), at 131. For a contrary view, see L. Hinnekens, "Different interpretations of the European Tax Arbitration Convention", 7 *EC Tax Review* (1998), at 247.

18. For a detailed analysis of the judgment, see H. Flood, "Business Restructuring: The Question of the Transfer of Intangible Assets", 15 *International Transfer Pricing Journal* 4 (2008), at 174.

19. F. Zimmer, "U.S. company loses transfer pricing case in Norway", 49 *Tax Notes International* (2008), at 338.

20. Para. 4 Commentary on Art. 13 of the OECD Model.

21. Para. 21 Commentary on Art. 7 and Para. 10 Commentary on Art. 13 of the OECD Model.

22. F. Wassermeyer, in Debatin and Wassermeyer, *Doppelbesteuerung: DBA*, note 4, Art. 7, m.nos 160 and 160 c, and Art. 9, m.nos. 22 and 63. This position is supported by A. Chebounov, *Internationales Steuerrecht* (2002), at 586.

For example it has been argued that the payment of interest and royalties between associated enterprises is not covered by Art. 9(1) unless the throwback rules of Arts. 11(4) and 12(3) apply. This position is based on the wording of Arts. 11(4) and 12(3), under which Art. 11(1) and (2) and Art. 12(1) do not apply. On this basis it is argued that Arts. 11(3) and 12(2) still apply. Interest is therefore considered to qualify as interest (and royalties as royalties), even though under Arts. 11(4) or 12(3) the taxing rights to the income are covered by Art. 7(1).

This argument must be rejected for the following reasons. First, income (including interest and royalties) can qualify as business profits under Art. 7(1) and at the same time be covered by other income categories.[23] The purpose of Art. 7(7) is to resolve such conflicts between rules when the same income can fall within more than one distributive article. Second, Art. 9 does not provide for a rule similar to Art. 7(7) because the purpose of Art. 9 is not to allocate taxing rights between the contracting states. The objective scope of Art. 9(1) is thus not affected by Art. 7(7). Hence, when income qualifies as business profits under domestic law, Art. 9(1) is applicable irrespective of whether the taxing rights are allocated under Art. 7(1) or a specific article.[24] Third, the need for Art. 9(1) originally arose because associated enterprises were carved out of the concept of permanent establishments in the 1928 League of Nations Model.[25] The purpose of Art. 9(1) is thus to fulfil the same function in an associated enterprise context as Art. 7(2) fulfils in a permanent establishment context. For example, as Art. 7(2) is applicable to "interest" calculated with respect to a lending between a head office and a permanent establishment of a banking enterprise, Art. 9(1) should be applicable to interest payments between associated banking enterprises. Fourth, principles of logic and good sense necessarily mean that interest income is covered by Art. 9(1) because the wording of the provision refers to "financial relations".[26] Fifth, the OECD has confirmed that interest and royalties are covered by Art. 9(1). The Commentary states that Art. 9 is relevant for determining whether the interest rate for a loan transaction corresponds to an arm's length interest rate.[27] The OECD report on thin capitalization states that Art. 9 is "clearly applicable" to interest.[28] In addition, interest and royalties are dealt with in the 1979 OECD Report on Transfer Pricing and Multinational Enterprises and in the OECD Guidelines.

Wassermeyer's view, however, is rejected by most German authors.[29] The starting point for the debate has been how Germany, as the residence state, must grant relief for double taxation of dividends, interest and royalties, which must be allocated to a permanent establishment in the source state. Should Germany use the relief method applicable for permanent establishments (exemption method) or the method applicable for dividends, interest and royalties (credit method) for such income? The question is thus whether Arts. 11(4) and 12(3) also have legal effect in the residence state. According to Wassermeyer, the question must be answered in the negative. This issue has not been settled by the German courts.[30]

Income derived from real property has also been regarded as falling outside the scope of Art. 9(1).[31] This conclusion must be rejected because, depending on the definition of business profits under domestic law, income from real property can qualify as business profits under Art. 7(1).[32]

To summarize, Art. 9(1) is relevant to all categories of income that qualify as business profits under Art. 7(1), regardless of whether the income is subsumed under another income category of the OECD Model under Art. 7(7).

2.5. Conflicts of qualification

The next question to ask is whether the object qualification should be made on the basis of the domestic law of each of the contracting states or whether the domestic law of one of the contracting states takes precedence. In an Art. 7 context, a conflict regarding the object qualification may be resolved under Art. 23 dealing with juridical double taxation and aresidence state and a source state. Hence, the 2000 Commentaries added that the residence state should grant relief for double taxation under Art. 23 based on the income classification of the source state, even when the income is classified differently in

23. Para. 62 Commentary on Art. 7 of the OECD Model. See A Hemmelrath, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Art. 7, m.no. 168; H. Becker, in Gosch, Kroppen and Grotherr, *DBA-Kommentar Internationales Steuerrecht*, note 11, Part II, Art. 9, m.no. 14; A. Eigelshoven, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Art. 9, m.no. 35; H. Baumhoff, in Flick, Wassermeyer, Wingert and Kempermann, *Doppelbesteuerungsabkommen Deutschland-Schweiz* (Cologne: Verlag Dr. Otto Schmidt, November 2009), Art. 9, m.no. 26; 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 510 et seq. In contrast, the German Federal Fiscal Court has stated that the income of an enterprise covered by the specific articles does not qualify as business profits under Art. 7(1). See decision of 23 October 1996, I R 10/96 (BStBl II 1997 313). However, the decision did not address Art. 9(1).

24. N. Mattsson, *Svensk internationell beskattningsrätt* (Stockholm: Norstedts Juridik, 2004), at 180.

25. *Double Taxation and Evasion – Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion* (Geneva: League of Nations Documents C.562M.178.1928.11, October 1928). See F. Wassermeyer, in Debatin and Wassermeyer, *Doppelbesteuerung: DBA*, note 4, Art. 9, m.no. 2; A. Eigelshoven, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Art. 9, m.no. 5.

26. Paras. 3-5 Commentary on Art. 27 of *Yearbook of the International Law Commission*, 1966, vol. II., at 218 (New York: United Nations, 1967).

27. Para. 3(b) Commentary on Art. 9 of the OECD Model.

28. Paras. 22, 28 and 48 *Thin Capitalization and Taxation of Entertainers, Artists, and Sportsmen* (Paris: OECD, 1987).

29. For a discussion of German theory on the question, see e.g. V. Kluge, in *Festschrift für Franz Wassermeyer*, ed. R. Gocke, D. Gosch and M. Lang (Munich: Beck Juristischer Verlag, 2005), at 663; F. Wassermeyer, *Internationales Steuerrecht* (2010), at 37; K. Vogel, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Art. 10-12, m.no. 32.

30. The Federal Fiscal Court raised the issue without resolving it in a decision of 7 August 2002, I R 10/01 (BStBl II 2002 848).

31. F. Wassermeyer, in Debatin and Wassermeyer, *Doppelbesteuerung: DBA*, note 4, Art. 7, m.nos. 160 and 160 cc, and Art. 9, m.no. 2; H. Becker, in Gosch, Kroppen and Grotherr, *DBA-Kommentar Internationales Steuerrecht*, Part II, note 11, Art. 9, m.nos. 14 and 97.

32. N. Winther-Sørensen, *Beskatning af international erhvervsindkomst*, note 11, at 135; H. Baumhoff, in Flick, Wassermeyer and Kempermann, *Doppelbesteuerungsabkommen Deutschland-Schweiz*, note 23, Art. 9, m.nos. 19 and 26; B.J. Arnold, note 9, at 5. For a contrary view, see R-A. Papotti and N. Saccardo, "Interaction of Articles 6, 7 and 21 of the 2000 OECD Model Convention", 56 *Bulletin for International Fiscal Documentation* 10 (2002), at 516.

the state of residence.[33] The 2000 Commentaries are supported by the wording of Art. 23 and have attained broad support among legal writers.[34]

However, the new interpretation of Art. 23 does not resolve all conflicts of qualification.[35] In an Art. 9 context, Art. 23 does not normally solve the problem because this provision does not apply to Art. 9.[36] Art. 9(2) is not worded in the same way as Art. 23, so that it is not possible to derive from it an obligation for a contracting state to follow the qualification of the other contracting state under Art. 9(1). On the contrary, according to the Commentary on Art. 9, the state where a corresponding adjustment can be relevant is not bound by the qualification of the other contracting state.[37] The question must therefore be resolved on the basis of an interpretation of Art. 3(2).

With regard to Art. 9, the choice is between domestic law in the state applying the tax treaty (*lex fori*) or in one of the two residence states. It has been argued that a treaty is "applied" only in the contracting state that makes the primary adjustment under Art. 9(1).[38] Under this view, the other contracting state that makes a corresponding adjustment under Art. 9(2) is therefore bound by the qualification made by the first contracting state under Art. 9(1). This argument cannot be accepted. First, a domestic law interpretation of Art. 9 must in any case be made on the basis of the law of the state applying the treaty (*lex fori*).[39] Second, a treaty is "applied" when making a corresponding adjustment under Art. 9(2), also in the narrow sense that has been argued in support of qualification under the domestic law of the source state under Art. 3(2).[40] Thus, through a corresponding adjustment, the treaty restricts taxation under domestic law. Third, it is clear from the Commentary on Art. 9 that the contracting states are not bound by each other's qualifications. Against this background, Art. 9 must be interpreted on the basis of the domestic law of the state applying the treaty (*lex fori*) when Art. 3(2) applies, e.g. regarding the object qualification.[41]

A domestic law object qualification under Art. 9(1) is thus prone to creating conflicts of qualification between the contracting states.[42] This may give rise to economic double taxation that is not relieved by the OECD Model. For example, one contracting state may determine under its domestic law that a controlled transaction has taken place and make a primary adjustment sanctioned by Art. 9(1), whereas the other contracting state may argue that no controlled transaction exists and refuse to make a corresponding adjustment under Art. 9(2). Such problems arise due to the lack of international harmonization of domestic laws, and they are not addressed by the arm's length principle.

3. Limits on the Object Qualification

Given that the object qualification is governed by domestic law, the question arises as to whether tax treaties impose any limits on domestic laws. In the absence of treaty restrictions, the object qualification under Art. 9(1) may encourage countries to adopt an overly broad definition of controlled transactions to enhance tax revenues. The arm's length principle of Art. 9(1) provides a de facto limitation on the tax revenues that may be generated by an expansion of the national tax base. A discussion of treaty-based limits on the object qualification is presented below. An initial examination of the issue in general is followed by considering of whether unilateral transactions may be covered by Art. 9(1). Also discussed are the issues of whether omissions may be covered by Art. 9(1) and whether Art. 9(1) imposes formal requirements on controlled transactions or whether domestic law may impose such requirements.

3.1. General

There may be a tension between the object qualification under domestic law and the requirement of Art. 9(1) to

33. Para. 32.1-32.7 Commentary on Art. 23 of the OECD Model, which was added on the basis of The Application of the OECD Model Tax Convention to Partnerships, in 6 *Issues in International Taxation* (Paris: OECD, 1999). See B.J. Arnold, note 10, at 312, 322.

34. A discussion of the new interpretation of Art. 23 adopted by the OECD Commentaries is beyond the scope of this article. On the discussion, see e.g. K. Vogel, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Einleitung, m.nos. 176 et seq., Art. 3, m.nos. 112 et seq., and Art. 23, m.nos. 37 and 126; M. Lang, *The Application of the OECD Model Tax Convention to Partnerships, A Critical Analysis of the Report Prepared by the OECD Committee on Fiscal Affairs* (Boston: Kluwer Law International, 2000), at 40; M. Lang, *Einführung in das Recht der Doppelbesteuerungsabkommen* (Vienna: Linde Verlag, 2002), m.no. 145; M. Lang, "2008 OECD Model: Conflicts of Qualification and Double Non-Taxation", 63 *Bulletin for International Taxation* (2009), at 204; M. Lang, "Qualifikations- und Zurechnungskonflikte im DBA-Recht", *Internationales Steuerrecht* (2010), at 114.

35. K. Vogel, "Conflicts of Qualification: The Discussion is not Finished",57 *Bulletin for International Fiscal Documentation* 2 (2003), at 41; K. Vogel, "Response by Prof. Vogel", 57 *Bulletin for International Fiscal Documentation* (2003), at 186; A. Rust, "The New Approach to Qualification Conflicts has its Limits", 57 *Bulletin for International Fiscal Documentation* 2 (2003), at 45; J.F. Avery Jones, "The 'One True Meaning' of a Tax Treaty", 55 *Bulletin for International Fiscal Documentation* 6 (2001), at 220; J.F. Avery Jones, "Conflicts of Qualification: Comment on Prof. Vogel's and Alexander Rust's Articles",57 *Bulletin for International Fiscal Documentation* (2003), at 184, 186.

36. However, in the unusual situation where one of the associated enterprises has a permanent establishment in the other contracting state and the controlled transactions between the two associated enterprises should be allocated to the permanent establishment, the object qualification of the source state is binding on the residence state with regard to Art. 7. In this situation, a contextual interpretation of Art. 9 must mean that the object qualification of the source state also takes precedence with regard to Art. 9.

37. Para. 6 Commentary on Art. 9 of the OECD Model, under which a corresponding adjustment may be made only if "the adjustment made in State A is justified both in principle and as regards the amount". The expression "in principle" refers to qualifications for tax purposes. See A. Eigelshoven, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Art. 9, m.no. 164; F. Wassermeyer, in Debatin and Wassermeyer, *Doppelbesteuerung: DBA*, note 4, Art. 9, m.no. 380.

38. C. Rotondaro, "The Application of Art. 3(2) in case of Differences between Domestic Definitions of 'Associated Enterprises'", 7 *International Transfer Pricing Journal* 5(2000), at 166.

39. See e.g. K. Vogel, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Einleitung, m.nos. 160 et seq., and Art. 3, m.nos. 110 et seq.; K. Vogel and R. Prokisch, *Cahiers de droit fiscal international*, vol. 78a (1993), at 45.

40. See e.g. J.F.A. Jones et al., "The Interpretation of Tax Treaties With Particular Reference to Article 3 (2) of the OECD Model,*British Tax Review* (1984), at 14, 48 et seq.; J.F.A. Jones, "Article 3(2) of the OECD Model Convention and the Commentary to it: Treaty Interpretation",33 *European Taxation* 8 (1993), at 252.

41. B.J. Arnold, note 10, at 312, 334.

42. For example, a domestic law interpretation can give rise to conflict between civil law jurisdictions and common law jurisdictions. See J.F.A. Jones et al., "The Non-Discrimination Article in Tax Treaties",31 *European Taxation* 10 (1991), at 310, 329; J.F.A. Jones et al., in *The Taxation of Business Profits Under Tax Treaties*, note 6, at 25 et seq. In civil law jurisdictions, it is quite common for companies to be regarded per se as carrying on a business for tax purposes. In common law jurisdictions, companies are not necessarily regarded as carrying on a business.

recognize the controlled transaction as actually structured. The issue may seem circular, as the actual controlled transaction does not appear out of the blue, but comes into existence based on the domestic object qualification. The starting point is that Art. 9(1) does not restrict the qualification of "commercial or financial relations" under domestic law. The object qualification may take into account substance-over-form and other similar doctrines, as well as general anti-avoidance rules that are part of domestic law because such doctrines and rules are generally not addressed in tax treaties and are therefore not affected by them.[43] There is widespread support for this understanding of the relationship between domestic anti-avoidance rules and tax treaties.[44] The interpretation in the Commentary is of a general nature and affects all the articles of the OECD Model, including Art. 9(1). A recharacterization of a controlled transaction that is valid under private law (transactional adjustment) based on domestic substance-over-form rules must thus be made prior to the application of the arm's length principle of Art. 9(1).[45]

An example of this is seen in the Norwegian *Statoil Angola* case (Rt 2007/1025). In that case a Norwegian parent company had provided an interest-free loan to a Norwegian subsidiary that carried on the business of oil extraction abroad. At the same time, a low-taxed Belgian sister company had provided an interest-bearing loan to the subsidiary. On the basis of this, the tax authorities taxed the parent company on imputed interest in accordance with the transfer pricing provision in Sec. 13-1 of the Norwegian Tax Law. The majority of the Supreme Court concluded that the domestic transfer pricing provision could not be invoked because the debt was recharacterized as surrogate equity for tax purposes. The decision in *Statoil Angola* accords with German cases based on Sec. 1 of the pre-2003 Foreign Tax Act. Accordingly, the Federal Fiscal Court rejected a transfer pricing adjustment of a parent company that had provided a financial guarantee to a thinly capitalized subsidiary free of charge because the guarantee replaced an injection of the equity needed by the subsidiary to perform its functions.[46] For this reason, the guarantee did not qualify as a business relation for tax purposes, and Sec. 1 of the Foreign Tax Act was not applicable.[47] Sec. 1 was amended in 2003 and now applies to any private law relation that does not qualify as a company law agreement.[48]

However, Art. 9(1) may restrict a transactional adjustment based on domestic anti-avoidance rules if there are no substance-over-form conflicts.[49] Art. 9(1) would, for instance, restrict a transactional adjustment that is triggered solely by a transfer price that deviates from the arm's length price. This is the core area of Art. 9(1) which the contracting states must respect in order to comply with their treaty obligation to apply the arm's length principle.

Art. 9(1) may also constitute a barrier to the application of domestic anti-avoidance rules specifically aimed at controlled transactions unless there are substance-over-form issues or there is a clearly abusive situation.[50] Hence, a contracting state should not be able to avoid its treaty obligations under Art. 9(1) by recharacterizing all transactions meeting certain standard conditions, without any regard to whether the transactions lack substance. Thus, at some point, the recharacterization under domestic law should not be adopted under Art. 3(2) because "the context otherwise requires".[51] This principle is set out in the Commentary with regard to the choice between a dynamic and static interpretation of domestic law. Thus, a contracting state should not be able to undermine the content of a treaty by amending in its domestic law the scope of terms not defined in the treaty.[52] Art. 9(1) could, for instance, be a barrier to the

43. Paras. 9.1, 9.2 and 22-22.2 Commentary on Art. 1 and Para. 21.1 Commentary on Art. 11 of the OECD Model.

44. K. Vogel, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Einleitung, m.nos. 188-192; R. Prokisch, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Art. 1, m.nos. 103-118; D.A. Ward, in *Essays on International Taxation*, ed. H.H. Alpert and K. van Raad (Deventer and Boston: Kluwer Law International, 1993), at 397; A.M. Jiménez, "The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A Case for the Declining Effect of the OECD Commentaries?", 58 *Bulletin for International Fiscal Documentation* 1 (2004), at 17; A.M. Jiménez, "Domestic Anti-Abuse Rules and Double Taxation Treaties: a Spanish Perspective – Part I", 56 *Bulletin for International Fiscal Documentation* 11 (2002), at 542; A.M. Jiménez, "Domestic Anti-Abuse Rules and Double Taxation Treaties: a Spanish Perspective – Part II", 56 *Bulletin for International Fiscal Documentation* 12 (2002), at 620; B.J. Arnold, "Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model", 58 *Bulletin for International Fiscal Documentation* 6 (2004), at 244; F. Zimmer, "Domestic Anti-Avoidance Rules and Tax Treaties – Comment on Brian Arnold's Article", 59 *Bulletin for International Fiscal Documentation* 1 (2005), at 25; L. De Broe, note 23, at 287. According to a majority of the branch reporters at the 2002 IFA Congress, domestic anti-avoidance rules are not restricted by tax treaties. See F. Zimmer, *Cahiers de droit fiscal international*, vol. 87a (2002), at 60.

45. F. Wassermeyer, in Debatin and Wassermeyer, *Doppelbesteuerung: DBA*, note 4, Art. 9, m.nos. 46, 76, 77 and 77a; H. Schaumburg, *Internationale Verrechnungspreise zwischen Kapitalgesellschaften* (Cologne: Verlag C.H. Beck, 1994), at 7; H. Becker, in Gosch, Kroppen and Grotherr, *DBA-Kommentar Internationales Steuerrecht*, note 11, Part II, Art. 9, m.nos. 124-126; H. Becker, in H-K. Kroppen, *Handbuch Internationale Verrechnungspreise* (Cologne: Verlag Dr. Otto Schmidt, May 2009), II. Internationale Vorschriften, m.no. 1.37; A. Eigelshoven, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Art. 9, m.no. 51; K. Sieker, in Debatin and Wassermeyer, *Doppelbesteuerung: DBA*, note 4, Art. 9, m.no. 146; J. Wittendorff, "The Transactional Ghost of Article 9(1) of the OECD Model", 63 *Bulletin for International Taxation* 3 (2009), at 107, 115 et seq.; G.M.M. Michielse, *Cahiers de droit fiscal international*, vol. 81b (1996), at 583, 599.

46. Federal Fiscal Court decision of 29 November 2000, I R 85/99 (BStBl II 2002 720).

47. The Fiscal Court of Düsseldorf reached the same conclusion in its decision of 19 February 2008, 17-K-894/05-E; see *Internationales Steuerrecht* (2008), at 449.

48. Tax Incentive Reduction Act (*Steuervergünstigungsabbaugesetz*) of 16 May 2003 (BStBl I 2003 660).

49. H. Baumhoff, in Flick, Wassermeyer and Baumhoff, *Außensteuerrecht* (Cologne: Verlag Dr. Otto Schmidt, August 2009), § 1, m.no. 269; A. Eigelshoven, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Art. 9, m.no. 51; H. Becker, in H-K. Kroppen, *Handbuch Internationale Verrechnungspreise*, II. Internationale Vorschriften, note 45, m.no. 1.37. For a contrary view, see A.A. Skaar et al., *Norsk skatteavtalerett*, note 10, at 383; A. Bullen, *Skatterett* (2008), at 110, 112.

50. In this respect, it should not be lightly assumed that a taxpayer has entered into a transaction that constitutes an abuse of tax treaty provisions. See Paras. 9.3, 9.4 and 22.2 Commentary on Art. 1 of the OECD Model.

51. J. Li and D. Sandler, "The Relationship Between Domestic Anti-Avoidance Legislation and Tax Treaties", *Canadian Tax Journal* 45 (1997), at 891, 908, 958; B.J. Arnold, note 44, at 244, 250; B.J. Arnold, note 10, at 312, 321; L. De Broe, note 23, at 288 et seq.

52. Para. 13 Commentary on Art. 3 of the OECD Model. One of the most famous cases on this issue is the Canadian case of *The Queen v. Melford Developments Inc.*, (1982) CTC 333, 82 DTC 6281, concerning the Canada–Germany tax treaty. The Canadian Supreme Court concluded that an amendment of Canadian domestic tax law to include guarantee fees under the concept of interest income should not affect the interpretation of the tax treaty because that would authorize the contracting states to unilaterally amend the tax treaty from time to time as their domestic needs dictated.

application of a commensurate-with-income standard under domestic law adopted to overcome the problems associated with the valuation of intangibles under the arm's length principle.[53]

The requirement to recognize the controlled transaction as actually structured therefore imposes some limits on the object qualification pursuant to domestic law not to erode the treaty obligations under Art. 9(1).[54]

3.2. Unilateral transactions

A commercial or financial relation between associated enterprises that leads to a transfer of an asset or the provision of services for private law purposes can take various forms. The transaction will normally take the form of a bilateral sale under contract law, where there is an exchange of some substantive performance for money. However, a transaction can also take the form of a non-cash contribution, a contribution in kind or a distribution in kind. A non-cash contribution can be part of a bilateral transaction, so that it can be examined whether the valuation of the contribution and the issued shares are of equivalent value. In contrast, contributions and distributions in kind are, by definition, unilateral transactions, so the legal relationship precludes any consideration.

The question is whether the form of a transaction for the purpose of private law and company law is determinative for the interpretation of Art. 9(1). In support of that conclusion, reference can be made to the fact that under Art. 9(1) there must be a comparison of the conditions of the controlled transaction with the conditions of a comparable uncontrolled transaction. A unilateral transaction does not include any terms on pricing, and such transactions will not normally take place between independent enterprises. On that basis, it can be argued that an arm's length test of a unilateral transaction is impossible. On the other hand, it can be argued that there is no clear authority in the wording of Art. 9(1) to exclude unilateral transactions. On the contrary, the provision does not contain any requirements as to the form of commercial or financial relations for private or company law purposes. There is still the same need to prevent economic double taxation, regardless of whether the transfer of property or the performance of services takes the form of a bilateral or unilateral transaction. A distribution in kind means, for example, that it is necessary to determine both a sales price and a purchase price for the goods or services for tax purposes. If the same price is not used in both situations, there can be either economic double taxation or double non-taxation. Moreover, in principle the commercial or financial relations between associated enterprises could be entirely couched in the form of unilateral transactions. On this basis, the purpose of Art. 9(1) and its effectiveness suggest that an object qualification under domestic law to include unilateral transactions is not restricted.

The interpretation under Danish domestic law means that the scope of Art. 9(1) includes both bilateral and unilateral transactions. Thus, the term "commercial or economic transactions" in the transfer pricing provision in Sec. 2 of the Danish Tax Assessment Act applies, for example, to contributions and distributions in-kind.[55] The Danish interpretation of Art. 9(1) should be the same because the objective scope of the two provisions is fundamentally identical. Conversely, according to the German tax authorities, Art. 9(1) covers only transactions which are based on a mutuality of consideration under contract law.[56] As a result, Art. 9(1) does not apply, for example, to a shareholder's transfer of assets to a company, unless there is a prior, clear and unambiguous agreement under which there must be performance for money or money's worth; see 3.4. Thus, under domestic German tax law the private/company law structure of a transaction is important for transfer pricing purposes. This means that a domestic law interpretation of Art. 9(1) can lead to different results under Danish and German tax law.

3.3. Omissions

Under contract law, performance can take the form of duty to act or a duty to refrain from acting.[57] A duty to act means that the party must take some positive action, such as providing goods or performing services. Conversely, a duty to refrain from acting means that the party binds itself to refrain from taking some specific action. Refraining from acting can be said to be active when some specific action is not carried out, and can be called passive if some specific asset is not exploited. Art. 9(1) unquestionably applies to transactions between associated enterprises when the performance consists of a duty to act. The question is whether Art. 9(1) may be extended to cover transactions when the performance is in the nature of refraining from acting. For example, there can

53. The commensurate-with-income standard is laid down in Sec. 482, second sentence, of the US Internal Revenue Code, and Sec. 1(3), 12th sentence, of the German Foreign Tax Act. The UK tax authorities have outlined a proposal for a commensurate-with-income standard that would impose an additional tax charge in limited circumstances for a finite period where the transfer price of an intangible at the date of transfer is difficult to calculate and the value of the intangible has significantly increased following the transfer from the UK See para. 4.9 of *Proposals for controlled foreign companies (CFC) reform: discussion document* (London: HM Revenue & Customs, January 2010).

54. Under Art. 27 of the Vienna Convention on the Law of Treaties, a party may not invoke the provisions of its internal law as a justification for its failure to perform its treaty obligations.

55. For discussions in this direction, see L. Rasmussen, *Skattepolitisk Oversigt* (2000), at 182; Aa. Michelsen, *International Skatteret*, note 10, at 366; Aa. Michelsen, *Revision & Regnskabsvæsen*, SM (2005), at 260; H. Dam, *Rette indkomstmodtager – fiksering og allokering* (Copenhagen: Forlaget Thomson, 2005), at 600; J. Pedersen, *Skatteretten 1* (Copenhagen: Forlaget Thomson, 2009), at 434. This view finds support in the decision referred to in *Tidsskrift for Skatter og Afgifter* (2004), no. 126, in which the Danish National Tax Assessment Council concluded that a transfer of shares to a company in exchange for newly issued shares was covered by Sec. 2 of the Danish Tax Assessment Act.

56. Para. 6.1.1 2005 German Transfer Pricing Circular (BStBl I 2005 569); Para. 1.4.1 1983 German Transfer Pricing Circular (BStBl I 1983 218). See F. Wassermeyer, in Debatin and Wassermeyer, *Doppelbesteuerung: DBA*, note 4, Art. 9, m.no. 61-63; H. Baumhoff, in Flick, Wassermeyer and Kempermann, *Doppelbesteuerungsabkommen Deutschland-Schweiz*, note 23, Art. 9, m.no. 44; H. Becker, in Gosch, Kroppen and Grotherr, *DBA-Kommentar Internationales Steuerrecht*, note 11, Part II, Art. 9, m.no. 26. For a contrary view, see A. Eigelshoven, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Art. 9, m.no. 48; H. Schaumburg, *Internationales Steuerrecht* (Cologne: Verlag Dr. Otto Schmidt, 1998), m.no. 16.297, who also considers that Art. 9(1) applies in the area of company law.

57. M.B. Andersen, *Praktisk aftaleret* (Copenhagen: Gjellerup, 2003), at 280.

be a non-compete clause or a duty of confidentiality. Such restraint on action can have an economic value for an enterprise which may be paid for in a market transaction. Refraining from acting can therefore be of an income-generating nature.

The ordinary meaning of the term "commercial or financial relations" does not exclude performance in the nature of refraining from acting. The purpose of Art. 9(1) also suggests that acts and omissions should be treated in the same way. Thus, income shifting between associated enterprises can take place through either acts or omissions. Profits derived from refraining from acting that are acquired in the course of carrying on an enterprise may also be covered by Art. 7(1).[58] Refraining from acting may therefore also be covered by Art. 9(1), as income covered by Arts. 7(1) and 9(1) is identical. The OECD Guidelines deal only with the question of refraining from acting in connection with the hedging of the currency and interest rate risks of a multinational enterprise.[59] The peripheral treatment of refraining from acting can be explained by the fact that acts are of the greater practical relevance. It must be concluded that an obligation to refrain from acting is of an income-generating nature and may be covered by Art. 9(1).

In practice, a duty to act is often associated with a duty to refrain from acting. An example of this is a sole distributorship agreement, whereby the supplier has a duty to act (to supply goods) and a duty not to act (not to supply goods to other distributors). When there is a close connection between the duty to act and the duty not to act, given the nature of the legal relationship, it is possible to refer to the main obligation and the subordinate obligation.[60] In this case it is possible to carry out an arm's length test of the goods, taking into account the duty not to act, in the course of the comparability analysis.

It can sometimes be difficult to distinguish between acts and omissions. However, as both types of performance of obligations are covered by Art. 9(1), the distinction is not important in principle. An omission can arise from a legal right, contractual right or a business opportunity.

A legal right can be, for example, a company law right to subscribe for shares. If an enterprise refrains from exercising its right to subscribe for shares in a wholly owned subsidiary at a discount, for the benefit of an associated enterprise, there will be a shifting of income between the two enterprises. In an open market situation, payment would normally be made for such a subscription right. In this example it is questionable whether there is an act or an omission in the transfer of the subscription right. In the *Espholin* case, the Danish Supreme Court concluded that a majority shareholder's refraining from subscribing for shares in his company at a discount, in favour of his son, qualified as a private law transaction between the father and son rather than a company law transaction between the company and the son for tax purposes.[61] As the son had not paid any compensation for the subscription right, the transaction was subject to gift tax.

A contractual right can concern, for example, a loan at a fixed interest rate repayable on demand, which both parties may terminate at any time. In the event of a rise in interest rates, an economically rational creditor would claim redemption of the loan to protect its financial interests. Conversely, an economically rational debtor would redeem the loan if interest rates go down. If the loan is not terminated in these situations, it would give one of the enterprises an economic benefit in the form of interest income above or interest payments below the market rate.

There can also be a right to claim customary remedies for breach of contract. A failure to make such claims would give the other party an economic benefit. In the Danish *Shipping* case, the district court decided that the failure of a Danish parent company to seek recourse against a UK subsidiary for damages caused by the subsidiary was in breach of the arm's length principle of Sec. 2 of the Danish Tax Assessment Act.[62] Hence, the parent company had not substantiated that it would also have waived its claim if the counterparty had been a third party. The *Bausch & Lomb, Inc. v. Commissioner* case touched upon the issue of whether the transfer pricing provision of Sec. 482 of the US Internal Revenue Code can apply to omissions.[63] This case concerned a licence agreement between a US parent company and a subsidiary in Ireland that was to manufacture contact lenses for the European market. The parties had agreed on a royalty of 5%, based on an assumption that the subsidiary would supply the European market. Later it was decided that the subsidiary would also manufacture for the US market, so the company had the prospect of earning considerably larger profits. According to the Internal Revenue Service (IRS), it was contrary to the arm's length principle that the royalty was not changed, as the licence agreement could have been terminated. The Court of Appeals judged the facts as follows:

> We are not persuaded... Here... the Tax Court was entitled to conclude that "[w]hat later transpired in no way detracted from the reasonableness of the agreement when it was made." *Id.* at 852. It is true that in *R.T. French Co.* the agreement had a fixed term, *see id.*, whereas here the agreement between the parties was terminable at will. We regard this as too thin a foundation, however, for the Commissioner's argument that B & L would surely have terminated the agreement and negotiated new terms if dealing with an independent licensee, at least in the absence of a fuller record as to the manufacturing alternatives available to B & L at the time it was decided to increase lens production at B & L Ireland. *Cf. Sundstrand Corp.*, slip op. at 169 (rejecting ready availability of alternative source of manufacture in view of specialized manufacturing know-how required to produce complex

58. E. Reimer, *Der Ort des Unterlassens* (2004), at 204; E. Reimer, "How Tax Treaties Deal with Income from Omissions",60 *Bulletin for International Taxation* 3 (2006), at 110; A. Hemmelrath, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Art. 7, m.no. 75; H-K. Kroppen, in Gosch, Kroppen and Grotherr, *DBA-Kommentar Internationales Steuerrecht*, note 11, Part II, Art. 7, m.no. 47.
59. Para. 1.27 OECD Guidelines.
60. E. Reimer, note 58, at 110 See Para. 6.20 of the OECD Guidelines on the valuation of intangible property, under which account should be taken of the exclusive or non-exclusive character of any rights transferred.
61. *Ugeskrift for Retsvæsen* (1958), at 1164.
62. SKM2010.172.BR.
63. *Bausch & Lomb, Inc. v. Commissioner*, 933 F.2d 1984 (2d Cir. 1991).

avionic device). Accordingly, we perceive no basis to reject the Tax Court's carefully considered determination as clearly erroneous.

On the one hand, the Court of Appeals denied that there was in fact a basis for making a transfer pricing adjustment, even though the parent company had a right to terminate the agreement. On the other hand, the reasoning does not exclude the possibility that, under other circumstances, it would be possible to make an adjustment if a taxpayer were to fail to require renegotiation of a transfer price which, because of subsequent circumstances, departed from the market price. On this basis, the judgment can be seen as support for the proposition that, in principle, omissions may be subject to adjustment under Sec. 482.

A business opportunity can consist, for example, in an enterprise having negotiated a favourable sales arrangement with a third party. In that situation, an enterprise can refrain from closing the deal itself, and instead pass the opportunity to an associated enterprise. If the associated enterprise is able to deliver the goods in question, it may obtain an economic benefit. Depending on the circumstances, this situation can be characterized as: an omission, an act (acting as an agent) or a transfer of an intangible asset (the sales agreement) (see 4.4).

In all the examples given, the result of a failure to exercise a right results in the shifting of income between associated enterprises. According to the arguments presented above, such omissions may be covered by Art. 9(1).

3.4. Formal requirements

Art. 9(1) does not establish formal requirements for commercial or financial relations to be acknowledged. Conversely, domestic tax law often has more or less burdensome formal requirements for controlled transactions. Under Danish tax law, the burden of proof with regard to the facts of controlled transactions normally rests with taxpayers. If the content of a controlled transaction is not clearly documented, or if the taxpayer fails to cooperate in the provision of information, it can have damaging procedural consequences for the taxpayer. In German tax law there has been a debate about whether the formal requirements under domestic law are compatible with treaty obligations under Art. 9(1). According to the German tax authorities, the scope of Art. 9(1) is confined to transactions that have a basis in contract law.[64] The adjustment of a controlled transaction that is not based on a "prior, clear and unambiguous agreement" (*vorheriger, klarer und eindeutiger Vereinbarungen*) is normally regarded as falling outside the scope of Art. 9(1). The legal effect of this interpretation is that an adjustment may be made under domestic law, even if the transfer price complies with the arm's length principle of Art. 9(1).

The interpretation of the German tax authorities is based on Sec. 8(3), second sentence, of the German Corporate Tax Act on hidden distributions. A number of criteria have been developed by the courts for the application of the arm's length test (*Fremdvergleich*) in connection with hidden distributions. Under one of these criteria, there is a presumption of a hidden distribution if a company's payment to a controlling shareholder is not based on a prior, clear and unambiguous agreement. If an agreement is made subsequently to pay or on the amount of payment, the payment as a whole will be presumed to be a hidden distribution, due to the prohibition on retroactive agreements applicable to controlling shareholders (*Rückwirkungsverbot*). The reason for a requirement of a prior, clear and unambiguous agreement is that transactions between shareholders and their company can be a matter of company or contract law. According to the courts, the requirement should prevent income shifting.[65] If a transaction is made on a contract law basis, there must be both a performance in goods or services and cash consideration. If, on the other hand, a transaction is made on a company law basis, any payment will be unreasonable and will qualify as a hidden distribution. This means that the form of a transaction can be significant for tax purposes in Germany.[66]

In support of the interpretation of the German tax authorities, it is argued that Art. 9(1) does not apply to payments based on company law.[67] The test of this is assumed to be made prior to the arm's length test under Art. 9(1). It is also argued that even if an adjustment may be covered by Art. 9(1), the formal requirements will nevertheless conform to the arm's length principle. Thus, an independent enterprise is assumed not to be willing to pay for something unless it is legally obliged to do so. Further, it is argued that it is not possible to carry out an arm's length test in the absence of a prior agreement setting forth the rights and obligations of the parties.[68] Thus, the transfer price cannot be assessed in isolation from the other conditions. However, the prevailing view in German theory is that the interpretation of the tax authorities is contrary to Art. 9(1). This is justified on the grounds that Art. 9(1) is concerned only with the amount of a payment.[69] The provision specifies no for-

64. Para. 6.1.1 2005 German Transfer Pricing Circular (BStBl I 2005 569); Para. 1.4.1 1983 German Transfer Pricing Circular (BStBl I 1983 218).
65. See the reasoning in the Federal Fiscal Court decision of 17 December 1997, I R 70/97 (BStBl II 1998 545): "However, this does not affect the recognition of the fact that, as a consequence of the typical absence of competing interests, agreements that intentionally do not give a prior, clear and unambiguous statement of the amount of the payment to be made by the company create possibilities for income shifting that are specifically to be prevented by Sec. 8(3), second sentence" (unofficial translation).
66. H. Becker, in Gosch, Kroppen and Grotherr, *DBA-Kommentar Internationales Steuerrecht*, note 11, Part II, Art. 9, m.no. 117.
67. F. Wassermeyer, in Debatin and Wassermeyer, *Doppelbesteuerung: DBA*, note 4, Art. 9, m.nos. 2, 22, 46, 62, 67, 76, 77 and 128; F. Wassermeyer, in Flick, Wassermeyer and Baumhoff, *Außensteuerrecht*, note 49, § 1, m.no. 98; F. Wassermeyer, *Steuerberater-Jahrbuch* (1998/99), at 167; M. Kempermann, in Flick, Wassermeyer, Wingert and Kempermann, *Doppelbesteuerungsabkommen Deutschland-Schweiz* (Cologne: Verlag Dr. Otto Schmidt, July 2003), Art. 9, m.nos. 220 et seq.; A. Chebounov, *Internationales Steuerrecht* (2002), at 586
68. R. Schreiber, in H-K. Kroppen, *Handbuch Internationale Verrechnungspreise*, I. Nationale Vorschriften, note 45, m.nos. 348 and 379.
69. H. Baumhoff, in Flick, Wassermeyer and Kempermann, *Doppelbesteuerungsabkommen Deutschland-Schweiz*, note 23, Art. 9, m.no. 218 et seq.; A. Eigelshoven, in Vogel and Lehner, *Doppelbesteuerungsabkommen*, note 4, Art. 9, m.no. 27 and 28; H. Schaumburg, *Internationales Steuerrecht*, note 56, m.no. 16.291; O.H. Jacobs, *Internationale Unternehmensbesteuerung* (Munich: C.H. Beck, 2002), at 669 et seq., 687 et seq.; S. Rasch, *Konzernverrechnungspreise im nationalen, bilateralen und europäischen Steuerrecht* (Cologne: Verlag Dr. Otto Schmidt, 2001), at 192; V. Kluge, *Das Internationale*

mal requirements for the transaction. Reference is made to the OECD Guidelines, under which a transaction must normally be recognized as actually structured.[70] An adjustment will be regarded as justified only if a given transaction would never have been carried out between independent enterprises.[71] As independent enterprises also carry out unusual transactions, not always on a sound legal basis, the extension of the courts' doctrine to cover cross-border transactions is considered contrary to German treaty obligations under Art. 9(1).

The tax authorities' interpretation of Art. 9(1) finds support in a case decided by the Fiscal Court of Munich in 2002.[72] In that case the Court upheld an adjustment based on the formal requirements of a German subsidiary that had concluded a technical assistance and licensing agreement with its Italian parent company. In 2005, the case came before the Federal Fiscal Court on appeal, but the Court did not rule on the disputed question because the 1925 Germany–Italy tax treaty did not contain a provision similar to Art. 9(1).[73] The lower court had apparently overlooked the fact that the new 1989 tax treaty between the two countries was not effective for the fiscal years in question.

The Fiscal Court of Cologne arrived at the opposite conclusion in a case from 2007, in which there was no prior, clear and unambiguous agreement that a German company should pay its ultimate UK parent company for services.[74] According to the Court, the conditions were fulfilled for finding that there was a hidden distribution under domestic tax law. However, the Court also found that it would be in breach of Art. 4 of the 1964 Germany–United Kingdom tax treaty, which corresponds to Art. 9(1). This conclusion was based on a reasoning that the term "financial relations" in Art. 4 can be extended to cover company law relations where there is a subsequent contractual agreement. To support this conclusion, the Court pointed out that Art. 4 distinguishes between "commercial" and "financial" relations. The Court also referred to the fact that Art. 4 distinguishes between conditions that are "made" and those that are "imposed". Finally, the interpretation was seen as being in line with the purpose of Art. 4, seeking to avoid economic double taxation by setting up barriers to domestic law.

The conclusions reached by the Fiscal Court of Cologne must be rejected for several reasons. First, as discussed, the term "commercial or financial relations" must be interpreted on the basis of domestic law, including domestic anti-avoidance rules.[75] In this context, that would include the German doctrine on hidden distributions. Second, domestic tax law is decisive when a transaction qualifies differently under tax law and under non-tax law. Third, the term "imposed" only has the function of not excluding the application of Art. 9(1) to transactions that qualify as commercial or financial relations under domestic law.

To summarize, a domestic doctrine, such as the German doctrine on formal requirements for controlled transactions, cannot be contrary to Art. 9(1). In this context, it makes no difference whether the transfer price conforms to the arm's length principle.

4. The OECD Position

4.1. General

The OECD Guidelines provide examples of the objective scope of Art. 9(1), covering transactions for goods and other tangible property, intangible property, services, and cost contribution arrangements. This approach of providing examples is consistent with the proposition that the objective scope of Art. 9(1) should be determined on the basis of domestic law.

4.2. Intangibles

In terms of the definition of intangible property, a distinction may be made between (1) the transfer of an intangible and (2) the transfer of goods and services where an intangible is exploited. The OECD Guidelines generally adhere to the approach of merely providing examples of intangible property in a traditional legal sense that may be the object of controlled transactions.[76] The definition of royalties set out in Art. 12(2) has no influence on the interpretation of the concept of commercial or financial relations in Art. 9(1). For example, the granting of an exclusive distribution right may qualify as controlled transaction under Art. 9(1) even though such rights are not covered by Art. 12(2).[77]

With regard to the transfer of intangibles, the concept of commercial or financial relations in Art. 9(1) should be interpreted in accordance with domestic tax law.[78] Hence, domestic law is crucial to the question of whether a compensable intangible exists and whether the concept

Steuerrecht (Munich: C.H. Beck, 2000), S 122-123; D. Gosch, in *Festschrift für Klaus Korn*, ed. D. Carlé, R. Stahl and M. Strahl (Bonn, Stollfuβ, 2005), at 402; C. Bellstedt, *Finanz-Rundschau* (1990), at 65 et seq.; B. Knobbe-Keuk, *Bilanz- und Unternehmenssteuerrecht* (Cologne: Verlag Dr. Otto Schmidt, 1993), at 695.

70. Para. 1.36 OECD Guidelines.
71. E-A. Schneider, *Internationales Steuerrecht* (1999), at 65.
72. Fiscal Court of Munich decision of 16 July 2002, 6-K-1910/98 (EFG 2003 952). See A. Eigelshoven and A. Nientimp, *Der Betrieb* (2003), at 2307; A. Eigelshoven and A. Nientimp, "German Court Ruling Focuses on Transfer Pricing Formalities", 31 *Tax Notes International* (2003), at 667; H-K. Kroppen & S. Rasch, "Interpretation of the Arm's Length Principle under Art. 9 of the OECD Model Tax Treaty: Does the Arm's Length Principle Cover Formal Requirements?", 11 *International Transfer Pricing Journal* 1 (2004), at 26.
73. Federal Fiscal Court decision of 9 November 2005, I R 27/03 (BStBl II 2006 564).
74. Fiscal Court of Cologne decision of 22 August 2007, 13 K 647/03 (EFG 2008 161). The decision has not been subject to appeal. See H. Baumhoff and M. Greinert, *Internationales Steuerrecht* (2008), at 353; S. Rasch, "Germany: formal requirements for an adjustment "10 *Tax Planning International Transfer Pricing* 2 (2009), at 21.
75. See H. Becker, in Gosch, Kroppen and Grotherr, *DBA-Kommentar Internationales Steuerrecht*, note 11, Part II, Art. 9, m.no. 121.
76. Paras. 6.2-6.12 OECD Guidelines. See T. Miyatake, *Cahiers de droit fiscal international*, vol. 92a (2007), at 19, 22.
77. Para. 10.1 Commentary on Art. 12 of the OECD Model.
78. For a contrary view, see I. Verlinden and Y. Mondelaers, "Transfer Pricing Aspects of Intangibles: At the Crossroads between Legal, Valuation and Transfer Pricing Issues", 17 *International Transfer Pricing Journal* 1 (2010), at 49, who argue that when evaluating whether a certain concept should be regarded as an intangible asset, the arm's length principle is decisive. This position must be rejected because the arm's length principle does not address the object qualification.

of intangible property is identical for transfer pricing purposes and for substantive tax purposes. The growing trend to rely on the aggregation approach[79] and full-value methods[80] (e.g. the income method) to identify and value intangibles puts pressure on the domestic law definition of intangibles because under such methods, the mere existence of above-normal profits is equated with the presence of intangibles, i.e. a purely economic definition of intangibles. This means that an object qualification is made that is not sensitive to the fact that above-normal profits may be caused by extraordinarily good management of the resources of a company, which do not necessarily include valuable intangibles, whereas below-normal profits may be triggered by poor management of the resources of a company, which may include valuable intangibles. In contrast, the domestic tax laws of many countries rely, to varying degrees, on legal criteria to define intangibles. For example, under Sec. 482 of the US Internal Revenue Code the existence of an intangible cannot be evaluated solely from an economic perspective.[81] Full-value methods may thus cause the valuation to include items that are not recognized as transferred intangibles under domestic law. Things are thereby turned upside down because the valuation approach affects the definition of the subject matter of the valuation. This may lead to results that are contrary to the principle that the object qualification should be made prior to the arm's length test. For example, in the recent case of *VERITAS Software Corp. v. Commissioner*, the application of the income method led the US Tax Court to conclude that a transfer pricing adjustment by the IRS took into account intangible items not transferred or of insignificant value.[82]

With regard to the transfer of goods and services where intangibles are exploited, the definition of intangibles in the OECD Guidelines has value as a source of law for the purpose of tax treaty interpretation. In this context, in reality the definition relates to the arm's length test of the transfer price of goods and services that constitutes the core area of the arm's length principle of Art. 9(1). For example, if a distributor owns a valuable trademark which is exploited in the course of the resale of goods purchased from an associated enterprise, this should affect the transfer price of the goods. Here, the OECD Guidelines expand the traditional definition of intangible property by introducing concepts from economic theory such as human capital and organizational capital.[83] Thus, the Guidelines state that a marketing organization may constitute an intangible.[84] Accordingly, a broad definition applies to intangibles that are exploited in connection with the transfer of goods and services.[85] However, the OECD Guidelines do not outline general criteria for the identification of intangibles; it is left for domestic law to fill the gap. Items that are recognized as intangibles in economic theory may fully or partly converge with traditional legal concepts such as know-how.[86] It is also possible that some special expertise or quality of service may be considered an intangible in economic theory. The distinction between special expertise and an intangible is also blurred in the OECD Guidelines.[87] For purposes of applying Art. 9(1), it does not matter whether an associated enterprise is considered to possess an intangible or special expertise in connection with the sale of goods or services. In both cases, the decisive factor is the market value of the item in question rather than its qualification.

A dramatic case on the definition of intangibles that are exploited in relation to the transfer of goods and services is *GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner*.[88] In that case the IRS made a transfer pricing adjustment with regard to goods etc. purchased by a US subsidiary from its UK parent company because the US subsidiary was held to be the owner of valuable trademarks and other marketing intangibles. The taxpayer argued that all marketing intangibles were owned by the UK parent company. The case was subject to a mutual agreement procedure between the competent authorities in the United States and the United Kingdom from 1999 to 2004, when the negotiations broke down because the UK authorities supported the taxpayer's position. The outcome of the US case was a settlement.[89]

4.3. Services and cost contribution arrangements

In terms of services and cost contribution arrangements, the OECD oversteps its authority by defining these terms in the OECD Guidelines.[90] Thus, to the definitions cannot be ascribed any importance as a source of law for the interpretation of tax treaties. That being said, the OECD definitions may be taken into account for purposes of domestic law interpretations of the term "com-

79. Para. 1.42 OECD Guidelines; Paras. 85, 99, 136 and 177-180 Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment (Paris: OECD, 2008); Treas. Reg. Sec. 1.482-1(f)(2)(i)(A). Sec. 1(3), 9th sentence, of the German Foreign Tax Act provides that an aggregated arm's length test (transfer package) of a cross-border relocation of functions should normally be made, where a hypothetical arm's length test is applicable. The fiscal year 2011 budget proposals in the United States imply a clarification of the Internal Revenue Code that, in a transfer of multiple intangibles, the IRS may value the intangibles on an aggregated basis when that achieves a more reliable result. See "General Explanations of the Administration's FY 2011 Revenue Proposals" (Washington D.C.: Department of the Treasury, February 2010), at 44.

80. On the discussion of full-value methods, see D.N. Bowen, "Full-Value Methods: Has the IRS Finally Hurled the Holy Hand Grenade? A Critical Analysis of the Scope of §§ 482, 367(d), and 936(h)(3)(B) in Relation to Goodwill, Going Concern Value, and Workforce in Place", 37 *Tax Management International Journal* (11 January 2008), at 1; R.V. Femia and D. Blair, "Hazards Ahead: The IRS's Coordinated Issue Paper on Cost Sharing Buy-In Payments",*Tax Management Memorandum* (5 December 2008), at 195; *APA 2003 Study Guide* (Washington D.C.: IRS, 2003), Exhibit F.

81. Treas. Reg. Sec. 1.482-4(b).

82. *VERITAS Software Corp. v. Commissioner*, 133 TC 14 (2009). On the case, see A. Lin and D.R. Wright, "The Tax Court Decision in *VERITAS*: A Comment", 17 *International Transfer Pricing Journal* 2 (2010), at 147.

83. B. Lev, *Intangibles – management, measurement, and reporting* (Washington D.C.: Brookings Institution Press, 2001), at 6.

84. Para. 2.25 OECD Guidelines.

85. On this basis, the view of M. Markham, *The Transfer Pricing of Intangibles* (New York: Kluwer Law International,2005), at 46 et seq., that the definition of intangibles in the OECD Guidelines is too narrow, must be rejected.

86. Para. 6.5 of the OECD Guidelines defines know-how in accordance with Para. 11 of the Commentary on Art. 12 of the OECD Model.

87. Paras. 2.24 and 2.25 OECD Guidelines. See correspondingly the US case *G.D. Searle & Co. v. Commissioner*, 88 TC 252 (1987).

88. *GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner*, Tax Court Docket Nos. 5740-04 and 6959-05.

89. GlaxoSmithKline, press release of 11 September 2006.

90. Paras. 7.6 and 8.3 OECD Guidelines.

mercial or financial relations" and they thereby contribute to an international consensus and a reduced risk of double taxation.[91] With regard to a distributor that incurs extraordinarily high marketing expenses, the OECD Guidelines state that if such expenses are clearly incurred as a separate service, the cost plus method may supplement the resale price method.[92] Hence, excess expenses may be treated as a separate service transaction distinct from the distribution transaction. The Committee on Fiscal Affairs has also stated that a stock option arrangement, offered by a parent company to the employees of its subsidiaries, may constitute services under Art. 9(1), i.e. a "commercial or financial relation".[93] The question as to whether excess expenses and a stock option arrangement qualify as a separate service should be determined under domestic law.

4.4. Business restructurings

With regard to business restructurings, whether a business opportunity may qualify as a controlled transaction is an issue. The OECD Guidelines do not address the question. Art. 9(1) does not prevent a business opportunity from qualifying as an income-generating activity or omission that may be evaluated under the arm's length principle (see 3.3.). However, the Committee on Fiscal Affairs has stated that a "profit/loss potential" is not an asset requiring compensation per se under Art. 9(1).[94] This statement runs afoul of the requirement of a domestic law object qualification.

There is no international consensus regarding the question of whether a business opportunity or profit potential should be regarded as a separate compensable transaction. On the one hand, US tax law does not recognize a business opportunity as a compensable transaction in a transfer pricing context.[95] On the other hand, the German courts have developed the concept of a compensable business opportunity (*Geschäftschancen*) based on the arm's length principle.[96] A distinction is made between singular business opportunities (*singuläre Geschäftschancen*), covering isolated transactions in the form of a purchase or sale of assets or services, and ongoing business opportunities (*unternehmerische Geschäftschancen*), covering the opportunity to realize profits from undertaking a function. There is no general definition of a business opportunity. In theory, a compensable business opportunity is held to require that the following cumulative requirements be satisfied: (1) the existence of a business opportunity (2) which belongs to the company and (3) which the shareholder or a related person has exploited for its own account.[97] Accordingly, under German domestic tax law a business restructuring may mean that a compensable business opportunity is deemed to be shifted between associated enterprises.[98] In 2007, the new concept of profit potential (*Gewinnpotenzialen*) was introduced in Sec. 1(3), sixth sentence, of the German Foreign Tax Act as a tool for the aggregated valuation of a relocation of functions.[99] In principle, a relocation of functions does not require the transfer of any assets.[100] The concept of a profit potential was arguably enacted to broaden the German tax base vis-à-vis the more narrowly defined concept of a business opportunity.

5. The Arm's Length Test

If a controlled transaction has passed the threshold for being recognized under Art. 9(1) as a commercial or financial relation, an arm's length test of the transfer price may be carried out. If an associated enterprise engages in several controlled transactions, whether the arm's length test should be applied on a transactional or an aggregated basis must be determined. In a transfer pricing context, the delimitation of the controlled transaction in space and time is couched in terms of aggregation, set-offs and multiple-year analyses of transactions.[101] Art. 9(1) and the arm's length principle (as well as practical considerations) govern this issue. For example, if an aggregation approach is expected to produce a more reliable arm's length result because an aggregated price determination is made in market transactions, the arm's length principle will dictate an aggregated arm's length test. Art. 9(1) therefore provides the legal basis for the creation of international consensus regarding the delimitation of the controlled transaction for purpose of the arm's length test. Nevertheless, the OECD Guidelines dealing with this issue are not interpreted consistently across national borders.

For example, there is no international consensus on the choice between dynamic and static arm's length tests. A dynamic arm's length test is favoured, for example, in the

91. For example, the US domestic definition of a service transaction was amended in 2003 to be in line with the definition in the OECD Guidelines. See Preamble, Explanation of provisions, B. Services Transactions, Sec. 1.482 9(l)(3), in REG-146893-02 and REG-115037-00 (IRB 2003-44).
92. Para. 2.24 OECD Guidelines. This approach is clearly inspired by the excess-expenditure test introduced in US tax law in 1994, which provided that expenses incurred by a controlled taxpayer that significantly exceeded the expenses incurred by independent taxpayers could be treated as a separate service transaction. See Treas. Reg. (1994) Sec. 1.482-4(f)(3)(iii). A service transaction was thus determined on the basis of a purely quantitative approach. The excess-expenditure test has been repealed by a test for incremental marketing activity, which also calls for a determination of whether a distributor's marketing expenditures exceed the norm for the industry. See Treas. Reg. Sec. 1.482-4(f)(4)(i).
93. Paras. 35 and 151 Report on Employee Stock Option Plans: Impact on Transfer Pricing (Paris: OECD, 2004).
94. Para. 64 Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment (Paris: OECD, 2008).
95. *Hospital Corporation of America v. Commissioner*, 81 TC 520 (1983). See J.L. Andrus, *Cahiers de droit fiscal international*, vol. 92a (2007), at 634; D.R. Hardy, "Assignment of corporate opportunities - the migration of intangibles", 100 *Tax Notes* (2003), at 527. The business opportunity represented by participation in a cost sharing arrangement does not qualify as a platform contribution. See Preamble, Explanation of Provisions, Sec. 1.482-7(b)(3), in REG-144615-02 (IRB 2005-40). However, the creation of a business opportunity for an associated enterprise may qualify as a service transaction under Sec. 482.
96. O. Wehnert, *Cahiers de droit fiscal international*, vol. 92a (2007), at 273, 282.
97. E.g. T. Rödder, *Steuerberater-Jahrbuch* (1997/98), at 115, 124 et seq.
98. X. Ditz, *Deutsches Steuerrecht* (2006), at 1625.
99. Para. 2.1.2.4 2009 German Draft Circular on Relocation of Functions (BMF, IV B 5, 17 July 2009). See H. Förster, "Germany's Transfer Pricing Provisions: A Conflict with Internationally Agreed Principles?" 18 *Tax Management Transfer Pricing Report* (2010), at S-3.
100. M. Greinert, in *Unternehmensteuerreform 2008*, ed. Schaumburg and Rödder (Munich: C.H. Beck, 2007), at 541, 559; H. Baumhoff and M. Puls, *Internationales Steuerrecht* (2009), at 73, 80.
101. Paras. 1.42, 1.49-1.51 and 1.60-1.64 OECD Guidelines.

United States,[102] Denmark,[103] the Netherlands,[104] Germany,[105] and Sweden,[106] whereas a static arm's length test is favoured in Norway[107] and Australia.[108] Art. 9(1) of the OECD Model mandates a dynamic arm's length test that takes into account the circumstances of other taxable years that would be taken into account for purposes of the price determination of a market transaction. Another example relates to set-offs; Sweden,[109] Norway,[110] France,[111] and Belgium,[112] apply a lenient standard, whereas Germany[113] and Canada[114] apply a more restrictive standard. Art. 9(1) of the OECD Model requires a controlled transaction to be recognized as actually structured. The recognition of a controlled transaction extends to its payment form. Accordingly, if the intention of associated enterprises is to settle a controlled transaction wholly or partially by way of a set-off, this should be recognized under Art. 9(1). The question of whether the associated enterprises intended to apply a set-off must be determined under domestic law.

6. Conclusion

There are two dimensions of the object qualification under Art. 9(1) of the OECD Model. The object qualification must be made on the basis of domestic law of the contracting state applying the treaty (*lex fori*). The existence, form and content of a controlled transaction must thus be determined on the basis of domestic law prior to the application of the arm's length principle of Art. 9(1). Hence, the arm's length principle does not address the object qualification, and Art. 9 does not safeguard against economic double taxation caused by conflicts of qualification. However, the principle under Art. 9(1) of the recognition of the controlled transaction as actually structured imposes some limits on the domestic law object qualification. In contrast, the delimitation of the controlled transaction for purposes of the arm's length test is governed by the arm's length principle of Art. 9(1).

The risk of double taxation caused by conflicts of qualification may be addressed in various ways. The problem could be solved by establishing an autonomous definition of the concept of commercial or financial relations under Art. 9(1). This approach would necessarily involve the concept of business profits of Art. 7(1) because of the intimate link between the two provisions. However, as pointed out by other authors, it would be very difficult to introduce an autonomous treaty definition of the concept of business profits.[115]

Another approach would be to amend Art. 9 so that the domestic law object qualification of one of the contracting states would take precedence. This approach would correspond to the interpretation of Art. 23 introduced by the 2000 Commentaries, whereby the object qualification of the source state is decisive, for instance with regard to Art. 7. However, the object qualification under Arts. 7 and 9 should be aligned and cannot be separated from each other. Moreover, it is questionable whether this approach would be acceptable from a tax policy perspective.

A third approach would be for the OECD to establish soft-law autonomous definitions of controlled transactions on an ad hoc basis. Arguably, this would mirror the OECD's current approach, as the organization is increasingly interfering in the object qualification under Art. 9(1) without providing any discussion of the legal basis for this approach. Unintentionally, this may create rather than remove uncertainty regarding the proper interpretation of Art. 9(1). It may also give rise to a double standard vis-à-vis the object qualification, one being applied in mutual agreement procedures between competent authorities on the basis of the OECD Guidelines and another being applied by the courts on the basis of Art. 9(1). It follows from the discussion that a solution to the qualification problem under Art. 9(1) is not straightforward.

A fourth approach would be to accept the imperfect nature of the OECD Model and the inherent risk of double taxation. Under this approach, an appropriate course of action for the OECD would be to amend the Commentary to clarify the interaction of Art. 9(1) with the other articles of the OECD Model, the principle that the object qualification should be based on domestic laws (*lex fori*) and that Art. 9(1) imposes limits on the domestic law qualification. On this basis the OECD could focus its work on genuine arm's length rules, including the rules dealing with the delimitation of the controlled transaction, where international consensus is currently lacking.

102. Treas. Reg. Sec. 1.482-1(f)(2)(iii)(D).
103. *BP* (*Tidsskrift for Skatteret* (1988), no. 292.
104. Para. 1.3 Dutch Transfer Pricing Decree (IFZ2001/295M)(2001).
105. Para. 3.4.12.9 2005 German Transfer Pricing Circular (BStBl I 2005 569).
106. *Shell* (RÅ 1991, ref. 107).
107. *Baker Hughes* (Rt 1999/1087).
108. Para. 133 (see also Para. 166) *Roche Products Pty. Ltd. v. Commissioner*, Administrative Appeals Tribunal 639 (2008).
109. *Öberg* (RÅ 1979 1:40); *LM Ericsson* (RÅ 1980 1:59); *Edet* (RÅ 1984 1:16); *Shell* (RÅ 1991, ref. 107); *Dow* (RÅ 2006, ref. 37).
110. Official Norwegian governmental report, Odelstingsproposisjon 26 (1980-81), at 66.
111. Supreme Administrative Court decisions of 27 July 1988, no. 50020, RJF 1988, no. 628 (*Boutique 2 M*); 3 March 1989, no. 77581, RJF 1989, no. 340 (*Sociéte Laniniere de Picardie*); 2 June 1982, no. 23342, RJF 1982, no. 328.
112. Court of Appeal of Liège (21 May 1997).
113. Para. 2.3 1983 German Transfer Pricing Circular (BStBl I 1983 218). See also the Federal Fiscal Court decisions of 8 June 1977, I R 95/75 (BStBl II 1977 704); 9 March 1983, I R 182/78 (BStBl II 1983 744); 28 February 1990, I R 83/87 (BStBl II 1990 649); 1 August 1984, I R 99/80 (BStBl II 1985 18).
114. Paras. 25-26 Information Circular 87-2R of the Canada Revenue Agency (27 September 1999). See also *GlaxoSmithKline Inc. v. The Queen*, 2008 TCC 324 (2008).
115. J.F.A. Jones et al., in *The Taxation of Business Profits Under Tax Treaties*, note 6, at 25, 52 et seq.; B.J. Arnold, note 9, at 5, 15.