International

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The Transactional Ghost of Article 9(1) of the OECD Model

This article analyses the purpose and scope of Art. 9(1) of the OECD Model and specifically the nature of the transfer pricing adjustments covered by Art. 9(1). After summarizing the historical development of this provision, the article analyses the purpose of Art. 9(1) and examines the relationship between Art. 9(1) and the other articles of the OECD Model, the relationship between Art. 9(1) and domestic tax law, and the adjustments that come under Art. 9(1). The article concludes that Art. 9(1) is concerned only with genuine transfer pricing adjustments and that transactional adjustments are outside its scope.

1. Introduction

Following the publication of the OECD Transfer Pricing Guidelines in 1995,[1] an overwhelming number of articles has been devoted to the difficult question of how to determine an arm's length price pursuant to Art. 9(1) of the OECD Model Tax Convention. The other fundamental aspects of Art. 9(1), however, have received less attention, which is surprising considering the uncertainties about the precise meaning of Art. 9[2] and the magnitude of cross-border transfers of goods and services between members of multinational corporations (MNCs), effectively making Art. 9(1) one of the most important provisions of the OECD Model.

Among the pillars of the international taxation of MNCs is the arm's length principle in Arts. 7(2) and 9(1) of the OECD Model, the separate entity approach in Art. 5(7), and the permanent establishment (PE) concept in Art. 5.[3] Since their adoption by the League of Nations, these principles have been endorsed by most countries to protect MNCs against double taxation and to secure an equitable inter-nation tax base allocation. These principles should also be viewed in light of the principal purpose of the OECD Model and tax treaties to facilitate international trade and investment.[4] The globalization of the world economy, the mobilization of the production factors, tax competition, etc., have forced tax administrators and legislators to seek new sources of revenue. This has resulted in anti-avoidance rules and an intensified inter-nation struggle for the tax revenues of MNCs. In this connection, the PE concept has been broadened, resulting in a trend towards a pure source-state taxation of business profits,[5] and the separate entity approach has been challenged by the introduction of controlled foreign company (CFC) rules.[6] The quest for revenue has not insulated the arm's length principle from inquiries into its ability to generate tax revenues and protect the domestic tax base. Thus, the OECD has advanced an interpretation of Art. 9(1) to cover adjustments based on thin capitalization rules and the "commensurate with income" (CWI) standard. In both respects, the inquiry has shifted from the price of a transaction to the transaction itself (transactional adjustment). In recent years, the tax authorities of some countries have claimed to have lost (net) tax revenues due to business restructurings relocating high-value-added functions, risks and assets as well as associated profit potentials to low-tax countries. Common fact patterns include the transformation of a full-fledged manufacturer into a contract manufacturer or a toll manufacturer, the conversion of a full-fledged distributor into a limited-risk distributor or a commissionaire, the rationalization or specialization of operations, and the transfer of intangibles to a central entity. In 2007, business restructurings led the German government to amend the transfer pricing provision in Sec. 1 of the Foreign Tax Act in order to secure an appropriate exit taxation of the functions, risks and assets shifted out of Germany.[7] In 2005, the OECD launched a project to analyse the tax consequences of business restructurings with an emphasis on transfer pricing and PE issues and, on 19 September 2008, the OECD released its *Discussion Draft on Transfer Pricing Aspects of Business Restructurings* (hereafter "2008 Discussion Draft" or "Discussion Draft") for public comment. The Discussion Draft takes another step towards a conceptual change to Art. 9(1) by supplementing the traditional narrow arm's length principle with a broader arm's length principle and a substance-over-form principle. The recent changes to the OECD Model and Commentary regarding the taxation of business profits would, in general, justify critical reviews since the changes run counter to the original

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1. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995) (hereafter "OECD Transfer Pricing Guidelines" or "OECD Guidelines").
2. Baker, Philip, *Double Taxation Conventions* (London, loose-leaf), No. 9B.01.
3. OECD Transfer Pricing Guidelines, Preface, Para. 9.
4. Para. 7 of the Commentary on Art. 1 of the OECD Model; Art. 1 of the Convention on the Organisation for Economic Co-operation and Development, Paris, 14 December 1960.
5. Skaar, Arvid A., in *Skatterett* (2003), at 129.
6. CFC rules have been legitimized by the OECD Model in Para. 23 of the Commentary on Art. 1, Para. 13 of the Commentary on Art. 7, and Para. 37 of the Commentary on Art. 10.
7. Unternehmensteuerreformgesetzes of 14 August 2007 (*BStBl* I 2007, 1912).

intent of the relevant provisions and the principal purpose of the OECD Model.

This article summarizes the historical development of Art. 9(1) (see 2.), analyses the purpose of the provision (see 3.), and examines the relationship between Art. 9(1) and the other articles of the OECD Model (see 4.) and the relationship between Art. 9(1) and domestic tax law (see 5.). The article also analyses the types of adjustments authorized by Art. 9(1) and challenges the OECD position on transactional adjustments (see 6.).

2. Historical Development

2.1. Art. 9(1)

In 1928, the League of Nations published four model tax conventions dealing with the prevention of double taxation, succession duties, administrative assistance, and assistance in the collection of taxes.[8] The double taxation of business income should be prevented by allocating the taxing rights between the contracting states with the PE concept as the focal point. If an enterprise had PEs in both contracting states, each state was entitled to tax the portion of the income generated in its territory. Art. 5 of the 1927 Draft Model had advanced the method of separate accounting as the primary method for allocating income between two PEs.[9] The 1928 Model, however, intentionally did not address the income allocation issue due to time constraints.[10] Hence, it was left to the competent authorities to reach an arrangement regarding income allocation. This applied to both PEs and affiliated companies that were treated as separate entities for tax purposes under the 1928 Model.[11] In 1930, the Fiscal Committee resolved to make a detailed survey of the domestic rules on income allocation in a number of countries.[12] The inquiry was entrusted to Mitchell B. Carroll who examined the taxation of business income in 35 jurisdictions, culminating in the 1933 report entitled *Taxation of Foreign and National Enterprises*.[13] The report categorized the methods of income allocation as follows: (1) method of separate accounting, (2) empirical methods, and (3) method of fractional apportionment.[14] Carroll recommended that the method of separate accounting be used as the primary method and that empirical methods be used as secondary methods.[15] The separate accounting of branches and affiliated companies should be recognized for tax purposes unless profits had been diverted to other parts of the enterprise. If they had, the profits could be adjusted in accordance with the arm's length principle.[16]

Carroll's report formed the basis for the Draft Convention on the Allocation of Business Income between States for the Purposes of Taxation, published in 1933.[17] The purpose of the 1933 Model was limited to the problem of double taxation. Art. 3 on income allocation between a head office and its PE contained the following reference to the arm's length principle:

> ... The fiscal authorities of the contracting States shall, when necessary, in execution of the preceding paragraph, rectify the accounts produced, notably to correct errors or omissions, or to re-establish the prices or remunerations entered in the books at the value which would prevail between independent persons dealing at arm's length.

Art. 5 of the 1933 Model addressed income allocation between affiliated enterprises:

> When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and as the result of such situation there exists, in their commercial or financial relations, conditions different from those which would have been made between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in the manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the law of the State of such enterprise.

Arts. 3 and 5 provided the arm's length principle with a solid basis in international tax law. The genesis of Art. 5 was Art. IV of the United States–France tax treaty negotiated in 1930 and signed in 1932.[18] The treaty was designed to resolve a dispute between the two countries which arose because of accusations by the French tax authorities that US parent companies systematically overcharged French subsidiaries, causing artificial income shifting to the United States.[19] Art. IV was the first tax treaty article addressing the allocation of income between associated enterprises.[20] Art. IV was based on the principles of Sec. 45 of the US Revenue Act of 1928 pursuant to which profits diverted to affiliated enterprises could be reinstated on basis of the arm's length

8. League of Nations, *Double Taxation and Evasion – Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, League of Nations Documents C.562.M.178.1928.11 (October 1928).
9. League of Nations, *Double Taxation and Evasion – Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, League of Nations Document C.216.M.85.1927.11 (April 1927).
10. League of Nations, Fiscal Committee, *Report to the Council on the Work of the Fourth Session of the Committee*, League of Nations Document C.399.M.204.1933.II.A (26 June 1933).
11. See Carroll, Mitchell B., General Report: Taxation of Enterprises with International Interests, in *Cahiers de droit fiscal international*, Vol. I (1939), at 234, 252; and Herndon, John G., *Relief from International Income Taxation* (Chicago, 1932), at 197 et seq. The 1927 Draft Model treated affiliated companies as PEs. The 1928 Model therefore caused the failure of the German attempt to internationalize the "*Filialtheorie*"; see Bühler, Ottmar, *Prinzipien des Internationalen Steuerrechts* (Amsterdam, 1964), at 101 et seq.
12. League of Nations, Fiscal Committee, *Report to the Council on the Work of the Second Session of the Committee*, League of Nations Document C.340.M.140.1930.II (31 May 1930).
13. *Taxation of Foreign and National Enterprises*; Vol. I, League of Nations Document No. C.73.M.38.1932.II.A; Vol. II, League of Nations Document No. C.425.M.217.1933.II.A; Vol. III, League of Nations Document No. C.425(a).M.217(a).1933.II.A; Vol. IV: *Methods of Allocating Taxable Income*, League of Nations Document No. C.425(b).M.217(b).1933.II.A; and Vol. V: *Allocation Accounting for the Taxable Income of Industrial Enterprises*, League of Nations Document No.C.425(c).M.217(c).1933.II.A.
14. Id., Vol. IV, Para. 120.
15. Id., Paras. 670-674.
16. Id., Paras. 627-629.
17. League of Nations, Fiscal Committee, supra note 10.
18. Carroll, Mitchell B., *Global Perspectives of an International Tax Lawyer* (New York, 1978), at 38 et seq.
19. Id. at 35 et seq.; Carroll, Mitchell B., in *International Lawyer* (1968), at 129.
20. Avery Jones, John F. et al., "The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States", *Bulletin for International Taxation* 6 (2006), at 220.

principle.[21] Accordingly, Sec. 45 is the origin of both Art. 9(1) of the OECD Model and Sec. 482 of the US Internal Revenue Code (IRC).

Arts. 3 and 5 were untouched in the 1935 revised Draft Convention on the Allocation of Business Income, although they were renumbered Arts. III and VI.[22] Subsequently, Art. VII of the protocols to the Mexico Model (1943) and London Model (1946) were phrased in terms almost identical to Art. 5 of the 1933 Model.[23] Art. 5 of the 1933 Model eventually found its way to Art. 9 of the OECD Model in 1963. The Fiscal Committee made some linguistic clarifications to Art. 9, but did not intend to make any substantive changes.[24] The wording of Art. 9(1) has not been changed since 1963; Art. 9(2) was introduced in 1977.

2.2. Commentary on Art. 9(1)

The 1963 Commentary on Art. 9 was remarkably brief, concluding that the provision seemed to call for very little comment. The 1977 update of the OECD Model made no substantive change to the Commentary except for some comments on new Art. 9(2). The Commentary on the 1992 update was amended to take into account the conclusions of three OECD reports issued after 1979.[25] The most important change to the Commentary on Art. 9 was a statement that Art. 9(1) is relevant in determining not only whether the rate of interest in a loan contract is an arm's length rate, but also whether a loan can prima facie be regarded as a loan or whether it should be regarded as some other kind of payment, in particular a contribution to equity capital. Since 1992, no substantive changes have been made to the Commentary on Art. 9(1), which consists of only four paragraphs. The modest scope of the Commentary, however, should be seen in light of the OECD transfer pricing reports. In 1979, the OECD published *Transfer Pricing and Multinational Enterprises* ("1979 OECD Report"), which examined the rules and methods that could be used to establish an arm's length price. In 1992, a direct link was established between the 1979 OECD Report and the Commentary on Art. 9, making the report an integral part of the Commentary.[26] The 1995 OECD Transfer Pricing Guidelines subsequently replaced the 1979 OECD Report. Both reports are structured very similarly to the 1968 and 1994 IRC Sec. 482 regulations, addressing the same issues and reaching the same conclusion in most instances. The convergence of the OECD reports and the Sec. 482 regulations is no coincidence; rather, it is the consequence of a long-standing US tax policy to export the Sec. 482 regulations to other countries with a view to creating an international consensus on the application of the arm's length principle.[27]

3. Purpose of Art. 9(1)

The wording of Art. 9(1) and the Commentary do not reveal the purpose of Art. 9. Para. 11 of the Commentary on Art. 25, however, indicates that the reason for inserting a provision like Art. 9(1) in a treaty is to have economic double taxation covered by the treaty. The position of Art. 9(1) among the distributive articles of the OECD Model and the relationship to Arts. 7(1) and 8 (see 4.) also suggest that the primary purpose of Art. 9(1) is to prevent double taxation. This is also the purpose of the OECD Model, but it has the additional purpose of preventing tax evasion and avoidance.[28] These two goals have coexisted since 1922, when tax evasion was added to the work programme of the League of Nations leading up to the 1928 Model. The article on the allocation of the right to tax business income was incorporated into the Model on the Prevention of Double Taxation rather than the Model on Administrative Assistance drafted to prevent tax evasion. The purpose of both the 1933 and 1935 Models was to prevent double taxation. The Mexico and London Models incorporated the rules on the allocation of business income in the Model on the Prevention of Double Taxation. Hence, the history clearly suggests that the purpose of Art. 9(1) is to prevent double taxation. This author concurs with the prevailing opinion that the primary purpose of Art. 9(1) is to prevent international economic double taxation.[29] This makes Art. 9(1) a pro-

21. Carroll, supra note 18, at 40; Carroll, supra note 19, at 129. Sec. 45 can be traced to Regulation 41, Arts. 77 and 78 of the War Revenue Act of 1917.

22. League of Nations, Fiscal Committee, *Report to the Council on the Work of the Fifth Session of the Committee*, League of Nations Document No. C.252.M.124.1935.II.A (Geneva, 1935).

23. League of Nations, Fiscal Committee, *Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion*, Second Regional Tax Conference, Mexico, D.F., July 1943, League of Nations Document No. C.2.M.2.1945.II.A (Geneva, 1945); League of Nations, Fiscal Committee, *Report on the Work of the Tenth Session of the Committee held in London from March 20th to March 26th, 1946*, League of Nations Document No. C.37.M.37.1946.II.A (Geneva, 1946).

24. OEEC Fiscal Committee, *The Elimination of Double Taxation, Third Report* (Paris, 1960), Para. 18.

25. *Transfer Pricing and Multinational Enterprises, Three Taxation Issues* (Paris: OECD, 1984); *International Tax Avoidance and Evasion, Four Related Studies* (Paris: OECD, 1987); *Thin Capitalization and Taxation of Entertainers, Artistes and Sportsmen* (Paris: OECD, 1987) (hereafter "OECD Thin Capitalization Report").

26. Para. 3 of the 1992 Commentary on Art. 9.

27. See Surrey, Stanley S., "Secretary Surrey reports on developments in Treasury's foreign tax position", 24 *Journal of Taxation* 54 (1966), at 56: "For it is clear that this must be the ultimate goal, an internationally acceptable set of rational rules to govern the allocation of international income arising through these transactions. The United States believes that the OECD Fiscal Committee is the proper body to undertake the task of establishing the allocation standards to guide countries in reaching accommodations with each other. The OECD Fiscal Committee appointed a Working Party for this purpose. We intend, as a measure of assistance to that Working Party, to lay before it our proposed section 482 regulations as they are developed. It is quite likely that these regulations may represent a more structurally developed and detailed framework of allocation rules than has been formulated elsewhere, and hence may prove helpful as a starting point and as a way of focusing attention on a wide range of issues". See also Guttentag, Joseph H., in Andersson, Krister et al. (eds.), *Liber Amicorum Sven-Olof Lodin* (Stockholm, The Hague and New York, 2001), at 119 et seq.

28. Para. 41 of the Introduction to the OECD Model; Para. 7 of the Commentary on Art. 1. Before the 2003 update of the OECD Model, the Commentary on Art. 1 did not refer to the prevention of *tax avoidance* as an aim of the Model, although Para. 7 of the Commentary on Art. 1 mentioned that tax treaties should not help tax avoidance. See Arnold, Brian J., "Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model", *Bulletin for International Fiscal Documentation* 6 (2004), at 244; and van Weeghel, Stef, *The Improper Use of Tax Treaties* (London, The Hague and Boston, 1998), at 34 et seq.

29. See Carroll, supra note 19; Debatin, Helmut, in *Der Betrieb* (1972), at 2030; Vogel, Klaus, in *Steuer und Wirtschaft* (1974), at 193; Pöllath, Reinhard and Albert J. Rädler, *Der Betrieb* (1982), at 561 and 617; Eigelshoven, Axel, in Vogel, Klaus and M. Lehner, *Doppelbesteuerungsabkommen* (Munich, 5th ed., 2008), Art. 9, marginal number 6; Wassermeyer, Franz, in Debatin, H. and

vision sui generis since the general purpose of the OECD Model is to prevent international juridical double taxation.[30] A secondary purpose of Art. 9(1) is to achieve an equitable inter-nation allocation of taxing rights.[31]

Although it has also been argued that the purpose of Art. 9(1) is to prevent tax avoidance, this interpretation must be rejected for the reasons mentioned above.[32] Moreover, tax treaties usually only *restrict* the taxing rights of the contracting states – they do not expand such rights.[33] In any case, such a purpose would be superfluous in a treaty provision authorizing transfer pricing adjustments since, in the absence of Art. 9(1), the contracting states would be free to levy tax on residents according to their domestic tax law as long as the non-discrimination provision in Art. 24 is observed.[34] Accordingly, in a transfer pricing context, the prevention of tax avoidance is entrusted to domestic tax law.

4. Relationship between Art. 9(1) and Other Articles of the OECD Model

Art. 9(1) is placed among the distributive articles in the OECD Model despite the fact that it does not govern the allocation of the taxing rights of the contracting states over a specific income category. Instead, Art. 9(1) provides for a quantification of income between associated enterprises to which the contracting states are ascribed taxing rights according to the genuine distributive articles.[35] Another particularity of Art. 9(1) is that it governs the taxation in two residence states, whereas the distributive articles govern the taxation in a residence state and a source state.

Art. 9(1) is concerned with the taxation of profits. The distributive articles allocating the taxing rights over profits are Arts. 7(1) and 8. For this reason, Art. 9(1) functions as a *supplement* to Arts. 7(1) and 8 (the discussion below refers only to Art. 7(1)).[36] Accordingly, Art. 9(1) determines the amount of business profits from transactions between associated enterprises which is covered by the exclusive taxing rights of the two residence states pursuant to Art. 7(1). Helmut Becker, on the other hand, has argued that Art. 9(1) operates as an *exception* to the exclusive taxing rights of the residence state according to Art. 7(1) in the same manner as the PE exception.[37] This alluring interpretation of Art. 9(1) must be rejected, however. Art. 9(1) governs the taxation of an item of income between two taxpayers, whereas Art. 7(1) governs the taxation of an item of income of one taxpayer. A transfer pricing adjustment does not interfere with the exclusive taxing rights of the residence state since none of the associated enterprises becomes subject to tax in both contracting states. The question whether Art. 9(1) serves as a supplement or exception to Art. 7(1) may seem immaterial, but as Becker pointed out, the distinction has further consequences because Art. 9(1) restricts domestic tax law to a greater extent if it is an exception to Art. 7(1); see 5.2.2.[38]

5. Relationship between Art. 9(1) and Domestic Tax Law

5.1. Does Art. 9(1) broaden the taxing rights under domestic tax law?

Contracting states must rely on domestic tax law as the *authority* to levy tax because tax treaties generally do not broaden taxing rights.[39] This fundamental principle on the relationship between tax treaties and domestic tax law has been referred to as the "golden rule".[40] There are no indications in the wording or context of Art. 9(1) to suggest that the "golden rule" should not apply to Art. 9. This would also conflict with the purpose of Art. 9(1) to prevent double taxation (see 4.). The author concurs with the prevailing opinion that Art. 9(1) does not broaden the taxation authorized by domestic tax law.[41]

F. Wassermeyer, *Doppelbesteurung Kommentar* (Munich, loose-leaf), Art. 9, marginal number 1; Becker, Helmut, in Gosch, D., H.K. Kroppen and S. Grotherr, *DBA-Kommentar* (Herne and Berlin, loose-leaf), Sec. 2, Art. 9, marginal numbers 1 and 8 et seq.; Schaumburg, Harald, *Internationales Steuerrecht* (Cologne, 2nd ed., 1998), marginal number 16.288; Kluge, Volker, *Das Internationales Steuerrecht* (Munich, 4th ed., 2000), at 120; Baumhoff, Hubertus, in Flick, H., F. Wassermeyer and M. Kempermann, *Doppelbesteuerungsabkommen Deutschland–Schweiz* (Cologne, loose-leaf), Art. 9, marginal number 5; Andresen, Ulf, *Konzernverrechnungspreise für multinationale Unternehmen* (Wiesbaden, 1999), at 63; Lang, Michael, *Einführung in das Recht der Doppelbesteuerungsabkommen* (Vienna, 2nd ed., 2002), marginal number 508; Dahlberg, Mattias, *Internationell beskattning* (Lund, 2005), at 171; and Rotondaro, Carmine, "The Notion of 'Associated Enterprise': Treaty Issues and Domestic Interpretation – An Overview", *International Transfer Pricing Journal* 1 (2000), at 2.

30. Paras. 1 and 3 of the Introduction to the OECD Model; Para. 7 of the Commentary on Art. 1.

31. OECD Transfer Pricing Guidelines, Preface, Para. 7.

32. Sundgren, Peter, in *Svensk Skattetidning* (1991), at 399, and in *Svensk Skattetidning* (1992), at 284; Lindencrona, Gustaf, in *Svensk Skattetidning* (1992), at 125, and in *Dubbelbeskattningsavtalsrätt* (Stockholm, 1994), at 101; Weber, Ernst, *Institut Finanzen und Steuern, Brief No. 204* (Bonn, 1981).

33. Vogel, in Vogel and Lehner, supra note 29, Einleitung (Introduction), marginal numbers 43 and 68 et seq.

34. See e.g. the decision of the German Federal Tax Court of 9 November 2005, I R 27/03 (*BStBl* II 2006, 564) in which a German subsidiary of an Italian parent company was subject to tax pursuant to a German domestic tax law that was potentially in conflict with the arm's length principle. However, since the 1925 Germany–Italy tax treaty did not contain a provision similar to Art. 9(1), the Court ruled that the German tax authorities were not precluded from applying the German domestic tax law.

35. Surrey, Stanley S., in *Law and Policy in International Business* (1978), at 409.

36. Baker, supra note 2, No. 9B.14; Wassermeyer, supra note 29, Art. 9, marginal number 2; Hemmelrath, in Vogel and Lehner, supra note 29, Art. 7, marginal number 7; Andresen, supra note 29, at 2 et seq.

37. Becker, supra note 29, Art. 9, marginal number 60.

38. An analysis of the relationship between Art. 9(1) and the arm's length provisions in Arts. 11(6) and 12(4) and the other provisions of the OECD Model is beyond the scope of this article.

39. Para. 9.2 of the Commentary on Art. 1 says that tax treaty provisions, in some rare cases, may broaden taxing rights pursuant to domestic tax law. Thus, in the absence of constitutional hindrances, a tax treaty may in principle broaden taxing rights compared to domestic tax law. See Baker, supra note 2, No. 9B.05; Lang, supra note 29, marginal number 48; and Pedersen, Jan, *Transfer Pricing* (Copenhagen, 1998), at 168.

40. Lindencrona, in *Dubbelbeskattningsavtalsrätt*, supra note 32, at 24, and in *Svensk Skattetidning*, supra note 32, at 125.

41. Michelsen, Aage, *International skatteret* (Copenhagen, 3rd ed., 2003), at 399; Winther-Sørensen, Niels, *Beskatning af international erhvervsindkomst* (Copenhagen, 2000), at 200; Bundgaard, Jakob, in Bundgaard, J. and J. Wittendorff, *Armslængdeprincippet & Transfer Pricing* (Copenhagen, 2001), at 83; Vogel, supra note 29; Eigelshoven, supra note 29, Art. 9, marginal numbers 3 and 19; Wassermeyer, supra note 29, Art. 9, marginal numbers 4 and 76; Vögele, Alexander et al., in Vögele, A., T. Borstell and G. Engler, *Handbuch der Verrechnungspreise* (Munich, 2nd ed., 2004), at 115; Jacobs, Otto H., *Internationale*

Thus, in order to exploit the right to make adjustments pursuant to Art. 9(1), a contracting state relies on the authority provided by domestic tax law. This understanding has been confirmed by the German Federal Tax Court.[42] The OECD seems to be of the same opinion since the report on harmful tax competition did not take the position that Art. 9(1) contains a treaty obligation to invoke and apply the arm's length principle.[43] Another interpretation previously advanced in German theory[44] which considered Art. 9(1) to imply a treaty obligation (*Gebot*) on the contracting states to make adjustments was rejected by the Federal Tax Court. In Swedish theory, it has also been argued that Art. 9(1) may provide taxing authority not present in domestic tax law because the scope of the "golden rule" is considered to be confined to the genuine distributive articles and to cases of juridical double taxation and because the purpose of Art. 9(1) is considered to be the prevention of tax avoidance.[45] For the reasons previously discussed, however, this view must be rejected.

5.2. Does Art. 9(1) restrict the taxing rights under domestic tax law?

Tax treaties generally function by *restricting* the taxing rights under domestic tax law.[46] Para. 4 of the Commentary on Art. 9, however, claims that there is no consensus among the OECD countries regarding the fundamental question of whether Art. 9(1) is of a restrictive or an illustrative nature:[47]

> A number of countries interpret the Article in such a way that it by no means bars the adjustment of profits under national law under conditions that differ from those of the Article and that it has the function of raising the arm's length principle at treaty level.

It is unclear which "conditions" Para. 4 addresses, and thus the precise nature of the purported disagreement among the OECD countries. The OECD Thin Capitalization Report, however, reveals that the disagreement concerns the allocation norm.[48] The following sections analyse the issue with respect to both the allocation norm and the personal scope of Art. 9(1).

5.2.1. Allocation norm

In 1992, the IFA Congress addressed the question whether Art. 9(1) restricts the application of allocation norms in domestic tax law which deviate from the arm's length principle. According to the General Reporter Guglielmo Maisto, Art. 9(1) is of a restrictive nature, although he noted that most Branch Reporters considered Art. 9(1) to be of an illustrative nature.[49] Reading the Branch Reports, however, it is not easy to arrive at this conclusion. Most Branch Reporters said that Art. 9(1) has a restrictive nature or that it conforms to domestic tax law, or they did not answer the question. Moreover, there may have been some uncertainty among the Branch Reporters whether they should address the application of transfer pricing methods other than the traditional methods or allocation norms except the arm's length principle. The General Reporter highlighted the United States and Germany as prominent examples of countries supporting the illustrative approach. As shown below, this conclusion is not convincing.

There were doubts regarding the US treaty policy due to Art. 9(3) of the 1977 US Model[50] and the US reservation on Art. 9(1) of the 1977 OECD Model.[51] Some authors have construed the US treaty policy to mean that the contracting states are not obliged to follow the arm's length principle.[52] However, the purpose of Art. 9(3) and the reservation was to ensure congruity between IRC Sec. 482 and the US tax treaties. During the drafting of the US Model, uncertainty arose as to whether the scope

Unternehmensbesteuerung (Munich, 5th ed., 2002), at 687; Kluge, supra note 29, at 121; Schaumburg, supra note 29, marginal number 16.289; Becker, Helmut, in *Deutsches Steuerrecht* (1972), at 359, and in Gosch, Kroppen and Grotherr, supra note 29, Art. 9, marginal numbers 66-67; Debatin, Helmut, General Report on Subject I: The recognition of services and licence of incorporeal rights between parent companies and their foreign subsidiaries. Avoidance of double taxation in case of non-recognition by tax administrations, in *Cahiers de droit fiscal international*, Vol. 54a (1969), at 1, 14; Debatin, Helmut, in *Deutsche Steuer-Zeitung* (1971), Ausgabe A, at 385; Baumhoff, supra note 29, Art. 9, marginal number 15; Lang, supra note 29, marginal number 509; Baker, supra note 2, No. 9B.14; Lindencrona, in *Dubbelbeskattningsavtalsrätt*, supra note 32, at 100 et seq.; Arvidsson, Richard, *Dolda vinstöverföringar* (Stockholm, 1990), at 184.

42. Federal Tax Court decisions of 3 March 1980, I R 186/76 (*BStBl* 1980 II, 531), and 21 January 1981, I R 153/77 (*BStBl* 1981 II, 517).

43. OECD, *Harmful Tax Competition: An Emerging Global Issue* (OECD: Paris, 1998), Para. 71.

44. See Bellstedt, C., *Die Besteuerung international verflochtener Gesellschaften* (Cologne-Marienburg, 3rd ed., 1973), at 430 et seq.; Schmitz, R.C.A., *Kommentar zum internationalen Steuerrecht der Bundesrepublik Deutschland* (Dusseldorf, 1957), at 473; Menck, Thomas, in *Deutsche Steuer-Zeitung* (1972), Ausgabe A, at 65; and Strobl, Jakob, National Report for Germany on Subject II: Criteria for the allocation of items of income and expense between related corporations in different states, whether or not parties to tax conventions, in *Cahiers de droit fiscal international*, Vol. 56b (1971), at II/1, II/32.

45. Sundgren, in *Svensk Skattetidning* (1991) and in *Svensk Skattetidning* (1992), both supra note 32.

46. Vogel, in Vogel and Lehner, supra note 29, Einleitung (Introduction), marginal numbers 43 and 68 et seq.

47. Para. 4 of the Commentary on Art. 9 was added in 1992 on basis of Paras. 30-32 in "Double Taxation Conventions and the Use of Base Companies", in *International Tax Avoidance and Evasion, Four Related Studies*, supra note 25 (hereafter "OECD Base Companies Report"). Para. 30 added the following to the statement set out in the Commentary: "... thus enabling the Contracting States to deal with it under mutual agreement procedures and to give rise to corresponding adjustments. This is a topic dealt with in the 1984 OECD report on transfer pricing ... and which might be reconsidered again by the Committee on Fiscal Affairs at some later date."

48. OECD Thin Capitalization Report, supra note 25, Para. 50.

49. Maisto, Guglielmo, General Report on Subject I: Transfer pricing in the absence of comparable market prices, in *Cahiers de droit fiscal international*, Vol. 77a (1992), at 19, 60 et seq. (46th Congress of the International Fiscal Association, Cancún, 1992).

50. Art. 9(3) of the 1977 US Model provided: "The provisions of Para. 1 shall not limit any provisions of the law of either Contracting State which permit the distribution, apportionment, or allocation of income, deductions, credits, or allowances between persons, whether or not residents of a Contracting State, owned or controlled directly or indirectly by the same interests when necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons."

51. The US reservation, in Para. 12 of the 1977 Commentary on Art. 9, provided: "The *United States* believes that this Article should apply to all related persons, not just an enterprise of one Contracting State and a related enterprise of the other Contracting State, and that it should apply to 'income, deductions, credits or allowances', not just to 'profits'."

52. Maisto, supra note 49, at 60 et seq.; Pedersen, supra note 39, at 168; Lindencrona, in *Dubbelbeskattningsavtalsrätt*, supra note 32, at 101 et seq.; de Hosson, Fred C. et al., "Treaty aspects of the 'thin capitalisation' issue – A review of the OECD Report", *Intertax* (1989), at 476.

of Art. 9(1) of the OECD Model was narrower than the scope of IRC Sec. 482.[53] The solution adopted was to bridge the potential gap between the two provisions by Art. 9(3), which was not intended to address the allocation norm. This interpretation is supported by the 1988 White Paper which characterized the arm's length principle as a "treaty obligation"[54] and which stated that Art. 9(3) merely clarified that the term "profits" in Art. 9(1) of the OECD Model did not preclude the adjustment of "deductions, credits, or other allowances".[55] In 1992, the US reservation on Art. 9 of the OECD Model was deleted and, in 1996, Art. 9(3) of the US Model was deleted. According to the Technical Explanation of the 1996 US Model, Art. 9(3) was deleted because it had proved to be confusing since it did not grant authority not otherwise present. The Technical Explanation also emphasized that transfer pricing adjustments should adhere to the arm's length principle. The US authorities have also described the arm's length principle as a treaty obligation on other occasions.[56] Finally, the United States Supreme Court has stated that the United States is required to adopt "some form of 'arm's length' analysis in taxing the domestic income of multinational enterprises" pursuant to its tax treaties.[57] There seems to be little doubt that the arm's length principle is considered to be a treaty obligation according to the official US treaty policy.[58]

With respect to German tax law, the General Reporter referred to Helmut Debatin, who has ascribed an illustrative nature to Art. 9.[59] Debatin, however, made a distinction between transactions within and outside the scope of Art. 9. For transactions within the scope of Art. 9, Debatin made it clear that Art. 9 restricts the right of the contracting states to apply allocation norms other than the arm's length principle in order to protect taxpayers against arbitrary adjustments.[60] In line with this view, the German Branch Reporter stated that the tax authorities were of the opinion that tax treaties did not prevent the use of alternative methods, provided the arm's length principle was observed.[61] The regulations issued by the German tax authorities in 1974, 1994 and 2005 suggest that adjustments based on domestic tax law should observe the arm's length principle in Art. 9(1), although this is not specifically stated in the 1983 regulations.[62] Moreover, none of the regulations suggests that Art. 9(1) allows the application of domestic allocation norms that conflict with the arm's length principle. Hence, the German tax authorities seem – at least nowadays – to consider Art. 9(1) to be restrictive in terms of the allocation norm. This is in line with the prevailing opinion in German theory[63] and a decision of the Tax Court of Cologne.[64]

On basis of the Branch Reports, it is difficult to point to any country that definitely considers Art. 9(1) to have an illustrative nature.

An interpretation based on the wording of Art. 9(1) supports the position that the arm's length principle is a treaty obligation. Hence, both the legal condition and effect of Art. 9(1) are described in terms of the arm's length principle. This clearly suggests that the provision is based on a specific allocation norm. The use of the word "may" should not lead to a different conclusion since the change in 1963 from the word "shall" was not intended to result in a substantive change (see 2.1.). The vague terminology does not deprive Art. 9(1) of its nature as a treaty obligation.[65] Moreover, in any event, the term "shall" was less appropriate since the purpose of Art. 9(1) is to prevent double taxation.

Because of this purpose, Art. 9(1) would be less effective if it did not restrict the taxing rights according to domestic tax law by imposing an obligation on the contracting states to apply a specific allocation norm.[66] Moreover, Art. 9(1) would be superfluous if it was merely illustrative since the provision is not necessary with a treaty article authorizing the residence state to make a transfer pricing adjustment regarding a resident (see 3.). In this respect, it should also be noted that the purpose of Art. 9(1) cannot be explained by Art. 9(2) since the latter provision was not added to the OECD Model until 1977.

The context of Art. 9(1) consists especially of Art. 7 because both articles address the taxation of business profits (see 4.). The history of Art. 9(1) shows that the legal effect of Arts. 7(2) and 9(1) is the same. Since Art. 7(2) requires the contracting states to adhere to the arm's length principle, the legal effect of Art. 9(1) must be the same.[67]

53. Patrick, Jr., Robert J., in *Law and Policy in International Business* (1978), at 613.
54. US Department of the Treasury and Internal Revenue Service, *Study of intercompany pricing under section 482 of the Code* (18 October 1988), Notice 88-123, 1988-2 C.B. 485 (White Paper), Chap. 7A.
55. Id., footnote 155.
56. US Internal Revenue Service, *Report on the Application and Administration of Section 482* (21 April 1999), Chap. 5.II; GAO, *Problems Persist in Determining Tax Effect of Intercompany Prices* (June 1992) (GAO/GGD-92-89), at 60 and 94.
57. *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983).
58. The US Branch Report in *Cahiers de droit international*, supra note 49, at 657, did not address the issue. Regarding the impact of the saving clause in Art. 1(4) of the US Model on the interpretation of Art. 9(1), see Lepard, Brian D., "Is the United States Obligated to Drive on the Right?", 10 *Duke Journal of Comparative & International Law* 43 (2000), 145 et seq.
59. Debatin, in *Deutsches Steuer-Zeitung*, supra note 41; Debatin, in *Der Betrieb*, supra note 29.
60. Pöllath and Rädler, supra note 29.
61. Moebus, Ulrich, Branch Report on Germany on Subject I: Transfer pricing in the absence of comparable market prices, in *Cahiers de droit fiscal international*, supra note 49, at 403, 421.
62. Para. 1.14.1 of the Verwaltungsgrundsätze of 11 July 1974 (*BStBl* I 1974, 442); Paras. 1.2.1 and 1.2.2 of the Verwaltungsgrundsätze of 23 February 1983 (*BStBl* I 1983, 218); Para. 64 of the Verwaltungsgrundsätze of 15 December 1994 (*BStBl* I 1995, 25); Para. 6.1.1 of the Verwaltungsgrundsätze-Verfahren of 12 April 2005 (*BStBl* I 2005, 569). See Kluge, supra note 29, at 121.
63. See the authors mentioned in note 71, infra.
64. Decision of the Tax Court of Cologne of 22 August 2007, 13 K 647/03 (*EFG* 2008, 161). See Baumhoff, Hubertus et al., in *Internationales Steuerrecht* (2008), at 353.
65. Lehner, Moris, *Möglichkeiten zur Verbesserung des Verständigungsverfahrens auf der Grundlage des EWG-Vertrages* (Munich, 1992), at 39 et seq. Lepard, supra note 58, however, characterized the arm's length principle in Art. 9(1) as a persuasive obligation rather than a binding obligation.
66. The principle of effective interpretation is considered to be embodied in the requirement of Art. 31(1) of the Vienna Convention on the Law of Treaties that a treaty be interpreted in good faith and in light of the its object and purpose. See Para. 6 of the Commentary on Art. 27, in *Yearbook of the International Law Commission, 1966* (New York: United Nations, 1967), Vol. II at 220.
67. Para. 1 of the Commentary on Art. 7 indicates that the legal effect of Art. 7(2) and that of Art. 9(1) are identical.

The Commentary leaves no doubt that Art. 9 is based on the arm's length principle. Since 1963, the Commentary has provided that transfer pricing adjustments may not be made if transactions between associated enterprises took place on normal open market commercial terms.[68] This was clarified in 1977 to mean on an arm's length basis. Moreover, the OECD Transfer Pricing Guidelines (Part G-1) make it clear that the arm's length principle is the international standard agreed upon by the OECD countries to be used to determine transfer prices for tax purposes. The OECD Thin Capitalization Report determined that thin capitalization rules should usually not produce adjustments causing the profits of the debtor company to exceed an arm's length profit.[69] This also implies that Art. 9(1) has a restrictive nature.[70] The only conflicting evidence is Para. 4 of the Commentary on Art. 9 indicating a disagreement among the OECD countries (see 5.2.).

Based on the above, the author concurs with the prevailing opinion that Art. 9(1) is of a restrictive nature, i.e. the arm's length principle is a treaty obligation.[71] The OECD should amend Para. 4 of Commentary on Art. 9 to clarify this understanding of Art. 9. An OECD country disagreeing with this opinion would have the option of entering an observation on the Commentary.

5.2.2. Personal scope

The OECD Model does not specifically address the right of the contracting states to make transfer pricing adjustments regarding transactions outside the personal scope of Art. 9(1). An analysis of this issue is particularly relevant when the personal scope of domestic tax law is broader than Art. 9(1).

Helmut Debatin was the originator of the interpretation of Art. 9 that tax treaties do not restrict the right to make transfer pricing adjustments according to domestic tax law regarding transactions outside the personal scope of Art. 9.[72] This was explained by the fact that Art. 9 exceeds the normal boundaries of tax treaties by governing the right of the residence state to levy tax on its residents. Tax treaties usually do not impose any tax restrictions on the residence state. According to Debatin, the purpose of tax treaties cannot be to protect taxpayers against appropriate transfer pricing adjustments. Since Art. 9 does not require the contracting states to make transfer pricing adjustments, it is argued that Art. 9 cannot exclude appropriate transfer pricing adjustments. The German tax authorities concur with this interpretation.[73] Debatin's opinion is shared by several other authors, although there is no consensus in German theory.[74]

Helmut Becker has been the proponent of a different interpretation according to which the contracting states are generally precluded from making transfer pricing adjustments outside the personal scope of Art. 9(1).[75] According to Becker, the taxation of business profits was carefully addressed in the OECD Model, and the articles dealing with business profits were considered to be complete and to restrict taxation according to domestic tax law since the articles would otherwise be superfluous. It was argued that when a tax treaty acknowledged taxation in some situations, taxation in other situations could not take place. Becker subsequently modified his opinion in that the restricting effect of Art. 9(1) only applies to transactions between enterprises.[76] Regarding enterprises, it is said that the restricting effect results from Art. 9(1) being an exception to Art. 7(1) and that Art. 9(1) as an exception should be interpreted restrictively.[77] Accordingly, if the conditions for a transfer pricing adjustment in Art. 9(1) are not satisfied, the residence state retains the exclusive right to tax the profits of an enterprise carried on by a resident. As mentioned above (see 4.), this author thinks that this interpretation of the relationship between Arts. 9(1) and 7(1) must be rejected. Moris Lehner has also argued that the right to make transfer pricing adjustments regarding transactions outside the scope of Art. 9(1) is restricted since tax

68. Para. 1 of the Commentary on Art. 9 from 1963 to 1977; Para. 2 of the Commentary on Art. 9 since then.
69. OECD Thin Capitalization Report, supra note 25, Para. 50.
70. Maisto, supra note 49, at 60 et seq.
71. Pedersen, supra note 39, at 168; Sandström, K.G.A., *Svenska dubbelbeskattningsavtal* (Stockholm, 1949), at 292; Arvidsson, supra note 41, at 184; Wiman, Bertil, *Prissättning inom multinationella koncerner* (Uppsala, 1987), at 341; Zimmer, Frederik, *Internasjonal inntektsskatterett* (Oslo, 3rd ed., 2003), at 181; Skaar, Arvid A. et al., *Norsk skatteavtalerett* (Oslo, 2006), at 338 et seq.; Lindencrona, in *Dubbelbeskattningsavtalsrätt*, supra note 32, at 99; Vogel, supra note 29; Eigelshoven, supra note 29, Art. 9, marginal number 18 et seq.; Wassermeyer, supra note 29, Art. 9, marginal numbers 22, 76, 77 and 77a; Baumhoff, supra note 29, Art. 9, marginal number 7; Jacobs, supra note 41, at 696; Kluge, supra note 29, at 121; Pöllath and Rädler, supra note 29, at 561 and 617; Andresen, supra note 29, at 3; Brezing, Klaus, in *Finanz-Rundschau* (1973), at 485; Schaumburg, supra note 29, marginal number 16.290; Knobbe-Keuk, Brigitte, *Bilanz- und Unternehmenssteuerrecht* (Cologne, 9th ed., 1993), at 695; Gosch, Dietmar, in Lang, Michael, *Festschrift für Klaus Korn* (Bonn, 2005), at 391; Lang, supra note 29, marginal number 508; Baker, supra note 2, No. 9B.14; Maisto, supra note 49, at 60; Rotondaro, supra note 29; Messere, Ken, "OECD Reports on Transfer Pricing and Multinational Enterprises", *Intertax* (1979), at 288; de Hosson et al., supra note 52; Calderón, Jose, "The OECD Transfer Pricing Guidelines as a Source of Tax Law: Is Globalization Reaching the Tax Law?", *Intertax* (2007), at 4; Hay, Diane et al., "Past and Present Work in the OECD on Transfer Pricing and Selected Issues", *Intertax* (1994), at 423; Morrison, Philip D., "US Transfer Pricing Policy: Prospects for Continuing Controversy", *Intertax* (1993), at 62; Turro, John, "Treasury Continues to Champion Worldwide Arm's Length Standard", 66 *Tax Notes* 316 (1995); Avi-Yonah, Reuven, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation", 15 *Virginia Tax Review* 89 (1995).
72. Debatin, in *Deutsche Steuer-Zeitung*, supra note 41; in *Der Betrieb*, supra note 29; and in *Recht der Internationalen Wirtschaft* (1975), at 596.
73. Para. 1.2.1 of the Verwaltungsgrundsätze of 23 February 1983 (*BStBl* I 1983, 218). Para. 7 of the protocol to the 1989 United States–Germany tax treaty clarifies this interpretation: "Either State may apply the rules of its national law that permit the distribution, apportionment, or allocation of income, deductions, credits, or allowances between related persons with a view to apportioning or allocating such deductions, credits, or allowances in accordance with the general principles of para. 1 of Article 9. Article 9 shall not be construed to limit either Contracting State in allocating income between persons that are related other than by direct or indirect participation within the meaning of para. 1, such as by commercial or contractual relationships resulting in controlling influence, so long as such allocation is otherwise in accordance with the general principles of para. 1 of Article 9."
74. Wassermeyer, supra note 29, Art. 9, marginal notes 2, 22, 78 and 79; Pöllath and Rädler, supra note 29; Kluge, supra note 29, at 121; Chebounov, Anton, in *Internationales Steuerrecht* (2002), at 586; Baumhoff, supra note 29, Art. 9, marginal numbers 8 and 10 et seq.; Gosch, supra note 71; Schaumburg, supra note 29, marginal number 16.291.
75. Becker, in *Deutsches Steuerrecht*, supra note 41. See Vogel, Horst, in *Der Betriebs-Berater* (1971), at 1185; and Vögele et al., supra note 41, at 115 et seq.
76. Becker, supra note 29, Art. 9, marginal number 71 et seq. For the same opinion, see Eigelshoven, supra note 29, Art. 9, marginal number 34.
77. Becker, id., Art. 9, marginal number 57 et seq.

treaties function by confining the taxing rights according to domestic tax law.[78] Axel Eigelshoven has argued that the purpose of Art. 9(1) is generally to eliminate the barriers to cross-border trade in the form of double taxation.[79] It has been argued that the protection according to Art. 9(1) may be extended to transactions between independent enterprises. The issue has also been discussed in Swedish theory; some authors have argued that Art. 9(1) restricts domestic tax law regarding transactions outside the personal scope of the provision,[80] but others have supported the opposite view.[81]

On the basis of the above, this author's opinion is that Art. 9(1) does not restrict the right of the contracting states to make transfer pricing adjustments according to domestic tax law regarding transactions outside the personal scope of Art. 9(1). This follows from the principle that a tax treaty does not generally restrict the taxing rights of the residence state. Accordingly, the restrictive effect of tax treaties is usually directed at the source state. Any exceptional restrictions on the taxing rights of the residence state should be specifically set out in the tax treaty. Such restrictions can be found in Art. 7(2) regarding PEs and in Art. 9(1) regarding associated enterprises. In other situations, the OECD Model does not restrict the right of the residence state to make transfer pricing adjustments; thus, the contracting states are free to apply domestic tax law. Art. 9(1) therefore differs from the genuine distributive articles of the OECD Model pursuant to which income not governed by a specific article is caught by Art. 21 (Other income).[82] Accordingly, in the absence of a general provision on income allocation, there is no treaty protection against international economic double taxation for transactions outside the scope of Art. 9(1).

6. Adjustments Covered by Art. 9(1)

International double taxation may be defined as the imposition of comparable taxes in two or more states in respect of the same income for identical periods.[83] Identity with respect to the taxpayer gives rise to juridical double taxation. Art. 7 of the OECD Model governs international juridical double taxation of business profits. In the absence of taxpayer identity, double taxation is of an economic nature.[84] Art. 9 of the OECD Model governs international economic double taxation. Income distortions between associated enterprises may take different forms, which is reflected in the means available to the tax authorities to adjust distortions. The discussion below analyses whether Art. 9(1) addresses the economic double taxation caused by a transfer pricing adjustment, by an assignment of income adjustment and by a transactional adjustment.

6.1. Transfer pricing adjustments

A transfer pricing adjustment is characterized by the recognition for tax purposes of the actual transaction and the assignment of income among associated enterprises. The transfer price of the transaction, however, is adjusted by including the profits of one enterprise in the profits of an associated enterprise. A transfer pricing adjustment involves a pure redistribution of profits among the taxpayers, i.e. an increase in the profits of one taxpayer is balanced by a decrease in the profits of the other. A transfer pricing adjustment will result either in income being *imputed* if the transfer price is below the arm's length price or in income being *reduced* if the transfer price exceeds the arm's length price. It goes without saying that Art. 9 is concerned with the economic double taxation caused by transfer pricing adjustments. The basis for such double taxation may be of a legal or factual nature. *Legally* caused economic double taxation may be due to the application of different allocation norms in the domestic tax laws of the contracting states. For example, one state may apply the arm's length principle and the other may apply formulary apportionment. The purpose of Art. 9(1) is to protect taxpayers against primary adjustments that conflict with the arm's length principle. The purpose of Art. 9(2) is to provide taxpayers a corresponding adjustment that accords with the arm's length principle.[85] Thus, the purpose of both Arts. 9(1) and (2) is to prevent legally caused economic double taxation.[86]

Factually caused economic double taxation may arise because the contracting states disagree on the facts applicable with respect to a specific allocation norm applied by both states. The disagreement may, for instance, involve the question whether the transfer price adheres to the arm's length principle. If it does, a state may refuse to make a corresponding adjustment because the state considers the transfer price to observe the arm's length principle.[87] Factually caused economic double taxation at the treaty level may be resolved by the mutual agreement procedure in Art. 25.[88] If the competent authorities reach an agreement, Art. 9 provides the legal basis at the treaty level for avoiding economic double taxation. If the primary adjustment proves to be in conflict with the arm's length principle, Art. 9(1) will require the primary adjustment to be nullified. If, on the other hand, the outcome is that the primary adjustment adheres to the arm's length principle, Art. 9(2) will require a corresponding adjustment to be made. The OECD Transfer Pricing Guidelines aim at preventing factually caused economic double taxation by providing

78. Lehner, supra note 65, at 36 et seq.
79. Eigelshoven, supra 29, Art. 9, marginal number 39.
80. Arvidsson, supra note 41, at 184 et seq.; Lindencrona, in *Svensk Skattetidning*, supra note 32, and in *Dubbelbeskattningsavtalsrätt*, supra note 32, at 101.
81. Sundgren, in *Svensk Skattetidning* (1991) and in *Svensk Skattetidning* (1992), both supra note 32; Sandström, supra note 71, at 288 et seq.
82. Lang, supra note 29, at 32 et seq. The prohibition against discrimination in Art. 24 may, however, impose restrictions on domestic tax law.
83. Para. 1 of the Introduction to the OECD Model; Para. 1 of the Commentary on Art. 23.
84. Para. 5 of the Commentary on Art. 9; Para. 2 of the Commentary on Art. 23.
85. Paras. 5 and 6 of the Commentary on Art. 9.
86. Wassermeyer, supra note 29, Art. 9, marginal number 77.
87. Para. 6 of the Commentary on Art. 9.
88. Para. 11 of the Commentary on Art. 9; Paras. 9-12 of the Commentary on Art. 25.

detailed rules and methods for a common application of the arm's length principle.[89]

International economic double taxation will not arise if the profits are tax exempt in one or both of the contracting states or if one or both taxpayers are tax exempt. Treaty protection under Art. 9(1) does not depend on the tax position of the taxpayers, i.e. the protection applies to both actual and virtual double taxation. In contrast, a corresponding adjustment under Art. 9(2) is available only in respect of actual double taxation.[90]

6.2. Assignment of income adjustment

An assignment of income adjustment is characterized by the recognition for tax purposes of the existence, form and transfer price of a transaction. The assignment of the income (or expenses) relating to the transaction, however, is disregarded for tax purposes. An assignment of income adjustment may trigger economic double taxation when the same income is taxed in the hands of two taxpayers.[91] This may be caused by the application of conflicting norms of domestic tax law (legal basis) or disputes arising from the application of the same norm (factual basis). The OECD Model does not generally govern issues regarding the proper assignment of income among taxpayers.[92] In this respect, Art. 9(1) is not different from the general pattern of the OECD Model and, for this reason, conflicts on the assignment of income among associated enterprises are not governed by Art. 9(1). This implies, for instance, that economic double taxation caused by the application of conflicting domestic norms for identifying the ownership of intangibles for tax purposes is outside the scope of Art. 9(1). The distinction between transfer pricing adjustments and assignment of income adjustments may, in practice, be blurred. Thus, according to the OECD, a stock option offered by a parent company to the employees of its subsidiaries may constitute a service under Art. 9(1).[93] Hence, a transaction that may be addressed by an assignment of income adjustment arguably qualifies as "commercial or financial relations", making Art. 9(1) applicable.[94] The two types of adjustments may cause different monetary results, assuming that a transfer pricing adjustment will be on a profit basis whereas an assignment of income adjustment will be on a cost-only basis.

6.3. Transactional adjustments

The relationship between transactional adjustments and Art. 9(1) of the OECD Model is analysed generally in 6.3.1. Transactional adjustments are examined in the context of thin capitalization, the "commensurate with income" (CWI) standard, and business restructurings in 6.3.2, 6.3.3. and 6.3.4.

6.3.1. In general

A transactional adjustment usually implies that a valid private law transaction is disregarded for tax purposes. A distinction may be made between the following types of transactional adjustments:

(a) the existence of a transaction as such is disregarded for tax purposes, e.g. the transfer of assets to an associated enterprise is disregarded;
(b) the existence of a transaction as such is recognized, but its form is recharacterized for tax purposes ("full recharacterization"), e.g. the financing of a company is recharacterized from debt to equity; and
(c) the existence and form of a transaction are recognized, but price-sensitive terms are recharacterized for tax purposes ("partial recharacterization"), e.g. the payment form is changed from a fixed-price term to a contingent-price term.

The domestic legal basis for transactional adjustments may be general income tax provisions, statute-based anti-avoidance rules, or court-based doctrines on substance-over-form, economic substance, business purpose, etc.[95] The discussion below demonstrates that an interpretation of Art. 9(1) of the OECD Model based on the Vienna Convention on the Law on Treaties ("Vienna Convention") leads to the conclusion that transactional adjustments are not governed by the arm's length principle in Art. 9.

First, pursuant to the wording of Art. 9(1), the provision should be applied based on "*their* [the two enterprises'] commercial or financial relations" (emphasis added). Accordingly, an objective interpretation based on the ordinary meaning of the terms in Art. 9(1) shows that the fixed point for the arm's length test is the actual transac-

89. Para. 1 of the Commentary on Art. 9; OECD Transfer Pricing Guidelines, Preface, Para. 15.
90. Eigelshoven, supra note 29, Art. 9, marginal number 163; Schaumburg, supra note 29, marginal number 16.316; Grotherr, Siegfried, in Gosch, Kroppen and Grotherr, supra note 29, Grundlagen (The basics), marginal number 28; Wassermeyer, supra note 29, Art. 9, marginal number 369.
91. Vogel, in Vogel and Lehner, supra note 29, Einleitung (Introduction), marginal numbers 4 and 181a et seq.
92. Para. 22.1 of the Commentary on Art. 1; OECD Base Companies Report, supra note 47, Paras. 38-40. See Wheeler, Joanna, General Report on Subject 2; Conflicts in the attribution of income to a person, in *Cahiers de droit fiscal international*, Vol. 92b (2007), at 17 (61st Congress of the International Fiscal Association, Kyoto, 2007); Wheeler, Joanna, "The Attribution of Income to a Person for Tax Treaty Purposes", *Bulletin for International Fiscal Documentation* 11 (2005), at 477; Arnold, supra note 28; Danon, Robert J., "Conflicts of Attribution of Income Involving Trusts under the OECD Model Convention: The Possible Impact of the OECD Partnership Report", 32 *Intertax* 210 (2004); Lang, supra note 29, marginal number 93; Lang, Michael, "CFC Regulations and Double Taxation Treaties", *Bulletin for International Fiscal Documentation* 2 (2003), at 51; Ault, Hugh J., "Issues Related to the Identification and Characteristics of the Taxpayer", *Bulletin for International Fiscal Documentation* 6 (2002), at 263; Winther-Sørensen, supra note 41, at 115; Wassermeyer, Franz, in *Recht der Internationalen Wirtschaft* (1983), at 352; and (various authors) "Interpretation of Tax Treaties", *Bulletin for International Fiscal Documentation* 2 (1986), at 75, 79 (Kees van Raad).
Tax treaties may contain special provisions aimed at conflicts on the assignment of income. For instance, Art. 45(1) of the 1995 Denmark–Germany tax treaty contains a special rule on double taxation relief ("switch-over clause") which may be applied e.g. when the contracting states have assigned income to different taxpayers and the income is subject to double non-taxation or reduced taxation due to the conflicting assignment.
93. *Report on Employee Stock Option Plans: Impact on Transfer Pricing* (Paris: OECD, 2004), Paras. 35 and 151. The report should be seen in light of the decision of the UK Special Commissioners in *Waterloo Plc v. Inland Revenue Commissioner*, 2002 (SpC 301).
94. The term "commercial or financial relations" in Art. 9(1) should be interpreted on the basis of domestic tax law. See 6.3.1.
95. See Zimmer, Frederik, General Report on Subject I: Form and substance in tax law, in *Cahiers de droit fiscal international*, Vol. 87a (2002), at 19 (56th Congress of the International Fiscal Association, Oslo, 2002).

tion. The object for an adjustment pursuant to Art. 9(1) cannot therefore be the transaction itself. This understanding is reinforced by the two references in Art. 9(1) to "those conditions" showing that the object of the provision is the actual conditions of the transaction.[96] The use of the word "conditions" was recently interpreted by the OECD to mean that any conditions of a transaction may be subject to an adjustment.[97] This would mean, however, that Art. 9(1) is not applied on the basis of the actual transaction. A proper application of Art. 9(1) would imply that all price-sensitive conditions of an independent transaction are adjusted to match the conditions of the controlled transaction. Any price difference emerging between the transactions could form the basis for a transfer pricing adjustment. This approach is explicitly set forth in the US Sec. 482 regulations.[98]

Second, the wording of Art. 9(1) defines the scope as "commercial or financial relations". This term is not defined in Art. 9(1) or elsewhere in the OECD Model. A contextual interpretation of Art. 9(1) should, in particular, take Art. 7(1) into account since Art. 9(1) determines the amount of business profits from transactions between associated enterprises which is covered by the exclusive taxing rights of the two residence states according to Art. 7(1) (see 4.).[99] Thus, there is an overlap between income covered by Art. 7 and income covered by Art. 9. The profits from commercial or financial relations governed by Art. 9(1) are therefore identical to the business profits governed by Art. 7(1). The term "business profits" is not defined in the OECD Model, but should generally be given a broad meaning to include all income derived from carrying on an enterprise.[100] The Commentary on Art. 3 dealing with the definition of the terms "enterprise" and "business", however, is important in this respect. According to the Commentary (Paras. 4 and 10.2), both terms should be interpreted based on domestic tax law; thus, Art. 3(2) and the context require that the term "business profits" in Art. 7 be defined on the basis of domestic tax law.[101] Since "business profits" are the result of "commercial or financial relations", the latter term should, for the same reasons, also be interpreted on the basis of domestic tax law. Accordingly, the existence, form and contents of a transaction pursuant to Art. 9(1) should be determined on the basis of domestic tax law. The object qualification of domestic tax law must therefore be made a priori to the application of Art. 9(1).[102]

Third, Arts. 9(1) and 7(2) should be interpreted in light of each other since both provisions govern the income allocation of a unified business which is carried on, in the case of Art. 7(2), by one enterprise and, in the case of Art. 9(1), by two separate enterprises under common control.[103] The arm's length principle in the two provisions is identical despite the different phrasing, which is confirmed by the Commentary.[104] The more precise wording of Art. 7(2) requires that the hypothetical separate enterprise which is the basis for the arm's length test should be "... engaged in the same or similar activities under the same or similar conditions ...". Accordingly, Art. 7(2) clearly requires that the actual transaction undertaken by the enterprise be recognized for purposes of the arm's length test. Due to the convergence of the arm's length principle in the two provisions, the actual transaction should also be recognized under Art. 9(1).[105]

Fourth, the wording of Art. 3 of the 1933 Model dealing with PEs explicitly authorized an adjustment of "... the prices or remunerations entered in the books at the value ..." (see 2.1.).[106] The same wording was used in the 1935 Model and the Mexico and London Models. This suggests that Art. 9(1) only authorizes transfer pricing adjustments since the arm's length principle is identical in the two provisions and has remained unchanged since the 1933 Model. This understanding is reinforced by the OEEC report outlining proposed Art. XVI (now Art. 9(1)) pursuant to which:[107] "Rules are also needed for calculating the profits of an enterprise of a Contracting State dealing with an enterprise of the other Contracting State." The use of the phrase "calculating the profits" suggests that Art. 9(1) governs the pricing of transactions. The historical setting of Art. 9(1) therefore supports the conclusion that Art. 9(1) is concerned only with the prices of transactions and is not concerned with the transactions themselves.

Fifth, it follows explicitly from the wording of the special arm's length rules in Art. 11(6) on interest and Art. 12(4) on royalties of the OECD Model that an adjustment may be directed only at the price of a transaction.[108] There is no evidence indicating that the arm's length principle in the special rules and in Art. 9(1) should be different. Arts. 11(6) and 12(4) therefore also suggest that Art. 9(1) is concerned only with transfer pricing adjustments.

Sixth, according to the Commentary, substance-over-form and similar doctrines as well as general anti-avoidance rules are part of the basic domestic tax law provisions which determine the facts giving rise to a tax liability, and such doctrines and rules are generally not

96. Becker, supra note 29, Art. 9, marginal number 106.
97. 2008 Discussion Draft, Para. 198; OECD Transfer Pricing Guidelines, Paras. 1.37-1.38.
98. US Treas. Reg. § 1.482-1(d)(2): "Generally, such adjustments [of material differences between the controlled and uncontrolled transactions] must be made to the results of the uncontrolled comparable ...."
99. The context of a treaty within the meaning of Art. 31(1) of the Vienna Convention consists of the treaty as a whole. See Para. 12 of the Commentary on Art. 27 in *Yearbook of the International Law Commission, 1966*, supra note 66, Vol. II at 221.
100. Para. 59 of the Commentary on Art. 7.
101. Arnold, Brian J., "Fearful Symmetry: The Attribution of Profits 'in Each Contracting State'", *Bulletin for International Taxation* 8 (2007), at 312; Avery Jones, John F. et al., in Arnold, Brian J. et al., *The Taxation of Business Profits under Tax Treaties* (Toronto, 2003), at 25, 28; Hemmelrath, supra note 29, Art. 7, marginal number 21; Winther-Sørensen, supra note 41, at 130 et seq. See *Discussion Draft on the Attribution of Profits to Permanent Establishments* (Paris: OECD, 2004), Para. 46.
102. This may cause qualification conflicts which cannot be resolved by Art. 23 (Elimination of double taxation) since Art. 9(1) involves economic double taxation and is applied by two residence states. See Arnold, id.
103. Kluge, supra note 29, at 121; Wassermeyer, supra note 29, marginal number 2.
104. Para. 14 of the Commentary on Art. 7.
105. Reimer, Ekkehart, *Der Ort des Underlassens* (Munich, 2004), at 226 et seq.
106. In addition, it was possible to correct mere errors or omissions.
107. OEEC Fiscal Committee, supra note 24, Para. 17.
108. Para. 35 of the Commentary on Art. 11; Para. 22 of the Commentary on Art. 12.

addressed in tax treaties and are therefore not affected by them.[109] There is widespread support for this understanding of the relationship between domestic anti-avoidance rules and tax treaties.[110] The Commentary, however, has been criticized for not taking account of domestic anti-avoidance rules based on an interpretative approach.[111] The Commentary specifically states that to the extent the application of substance-over-form rules results in a recharacterization of income or a redetermination of the taxpayer who is considered to derive such income, the articles of the OECD Model will be applied taking these changes into account.[112] The interpretation in the Commentary is of a general nature and affects all the articles of the OECD Model, including Art. 9(1).[113] Hence, the Commentary supports the position that Art. 9(1) does not incorporate a substance-over-form rule and that transactional adjustments based on domestic substance-over-form considerations are not affected by Art. 9(1).

Seventh, case law has rejected transactional adjustments based on treaty and domestic tax provisions incorporating an arm's length principle similar to that in Art. 9(1). This has been the outcome of the cases dealing with the risk allocation between associated enterprises, realistic alternatives to the actual transaction, unusual transactions, the form of payment for intangibles, and the form of financing. Some of the cases are briefly discussed below.

Since the sources of law mentioned above clearly establish that the scope of Art. 9(1) does not include transactional adjustments, one would expect the Commentary to reach the same conclusion. The Commentary on the 1963 and 1977 OECD Models did not address transactional adjustments. The 1979 OECD Report (Para. 23) contained the following statement regarding the scope of Art. 9(1): "The aim in short is, for tax purposes, to adjust the price for the actual transaction to an arm's length price." This echoes the wording of the PE articles from 1933 to 1963 (see above). The 1979 OECD Report (Para. 15) also determined that the tax authorities should normally recognize the actual transaction. At the same time, the 1979 OECD Report (Para. 23) acknowledged that the actual transaction could be disregarded in exceptional cases in order, for example, to recharacterize a loan into equity. The 1979 OECD Report did not, however, pretend that a recharacterization was within the scope of Art. 9(1). The 1979 OECD Report recognized that Art. 9(1) did not restrict the application of domestic substance-over-form rules, which is in line with the interpretation later adopted in the Commentary (see above). The OECD Base Companies Report expressed a similar understanding of the adjustments authorized by Art. 9(1): "Therefore, transfer prices which differ from those which would be agreed upon between unrelated parties may be adjusted under that provision."[114] The OECD interpretation of Art. 9(1) underwent a fundamental *change* in the OECD Thin Capitalization Report because it was concluded that Art. 9(1) was relevant in determining whether a loan transaction could be recharacterized into equity capital.[115] Hence, in the view of the OECD, a transactional adjustment of the financing form was within the scope of Art. 9(1). In 1992, the new interpretation was incorporated into the Commentary on Arts. 9, 10, 11, 23 B and 25.[116] In 1995, the OECD Transfer Pricing Guidelines (Para. 1.36) reiterated that the tax authorities should normally recognize the actual transaction. The OECD Guidelines (Para. 1.37) also stated that there are two exceptional circumstances in which it is both appropriate and legitimate for the tax authorities to disregard the actual transaction: (1) where the economic substance of a transaction differs from its form; and (2) where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction viewed in their totality differ from those that would have been made by independent enterprises behaving in a commercially rational manner, and the actual structure practically impedes the tax authorities from determining an appropriate transfer price. In these circumstances, the OECD Guidelines (Para. 1.38) provide that the totality of the terms was the result of a condition that would not have been made in arm's length dealings for which Art. 9(1) would allow an adjustment. The second circumstance was new and arguably adopted in order to legitimize a CWI standard.[117] In 2008, the Discussion Draft took another step towards broadening and justifying transactional adjustments in an Art. 9(1) context.

The interpretation of Art. 9(1) advanced by the Commentary since 1992 must be rejected because it does not reconcile with the ordinary meaning of the terms in Art. 9(1) in its context and in view of its object and purpose. The sources of law referred to above clearly demonstrate

109. Paras. 9.1, 9.2 and 22-22.2 of the Commentary on Art. 1; Para. 21.1 of the Commentary on Art. 11.
110. Vogel, in Vogel and Lehner, supra note 29, Einleitung (Introduction), marginal numbers 188-192; Prokisch, Rainer, in Vogel and Lehner, supra note 29, Art. 1, marginal numbers 103-118; Ward, David A., in Alpert, Herbert H. et al., *Essays on International Taxation* (Deventer, the Netherlands and Boston, 1993), at 397; Martín Jiménez, Adolfo J., "The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A Case for the Declining Effect of the OECD Commentaries?", *Bulletin for International Fiscal Documentation* 1 (2004), at 17; Martín Jiménez, Adolfo J., "Domestic Anti-Abuse Rules and Double Taxation Treaties: a Spanish Perspective – Part I", *Bulletin for International Fiscal Documentation* 11 (2002), at 542, 620 et seq.; Arnold, supra note 28; Zimmer, Frederik, "Domestic Anti-Avoidance Rules and Tax Treaties – Comment on Brian Arnold's Article", *Bulletin for International Fiscal Documentation* 1 (2005), at 25. According to a majority of the Branch Reports at the 2002 IFA Congress, domestic anti-avoidance rules are not restricted by tax treaties. See Zimmer, supra note 95, at 60.
111. Arnold, supra note 28; Zimmer, in *Bulletin for International Fiscal Documentation*, id.; Zimmer, Frederik, in Ståhl, Kristina et al., *Festskrift til Nils Mattsson* (Halmstad, 2005), at 563.
112. Para. 22.1 of the Commentary on Art. 1.
113. The 2008 Discussion Draft attempts to modify the Commentary on Art. 1 by suggesting that transactional adjustments are covered by Art. 9(1). See 6.3.4.
114. OECD Base Companies Report, supra note 47, Para. 27.
115. OECD Thin Capitalization Report, supra note 25, Para. 48.
116. Para. 2 of the Commentary on Art. 9; Para. 25 of the Commentary on Art. 10; Para. 19 of the Commentary on Art. 11; Paras. 67-68 of the Commentary on Art. 23 B; Paras. 56 and 58 of the Commentary on Art. 24; Paras. 8 and 34 of the Commentary on Art. 25.
117. Eigelshoven, supra note 29, Art. 9, marginal number 52; Canada Revenue Agency, *Income Tax Information Circular No. 87-2R* (27 September 1999), Para. 150.

that the OECD is, in essence, revising Art. 9(1) rather than interpreting it.[118] As a result, in this author's view, the OECD interpretation should not be taken into account when interpreting tax treaties regardless of whether the treaty in question was concluded before or after the 1992 Commentary and the OECD Transfer Pricing Guidelines.[119] Hence, it must be maintained that the scope of Art. 9(1) does not cover transactional adjustments and that Art. 9(1) does not contain a substance-over-form principle.[120] As explained in 6.3.2., 6.3.3. and 6.3.4., the change must be ascribed to tax policy considerations rather than the application of traditional means of treaty interpretation. In this respect, the OECD Transfer Pricing Guidelines pose a problem because the OECD countries are not given the possibility of entering observations as they are with respect to the Commentary.[121] Thus, regarding controversial issues such as the CWI standard, the OECD countries cannot point out that they disagree with the interpretation in the OECD Guidelines.[122] Further, this makes it difficult, if not impossible, for the public to ascertain whether the tax authorities of a particular OECD country adhere to the existing law of that country in an OECD context. This creates a democratic vacuum and arguably causes the OECD Guidelines to lose value as a primary means of interpretation according to Art. 31(1) of the Vienna Convention.[123]

Although transactional adjustments are outside the scope of Art. 9(1), it is important to determine the relationship between domestic anti-avoidance rules and Art. 9(1). There may be a tension between the object qualification according to domestic law and the treaty requirement to recognize the actual transaction for purposes of applying Art. 9(1). The issue may seem circular since the actual transaction does not appear out of the blue, but comes into existence based on the domestic object qualification taking into account substance-over-form rules. Art. 9(1) would normally not restrict domestic substance-over-form rules (see above);[124] thus, transactional adjustments based on domestic substance-over-form rules must be made a priori to the application of Art. 9(1). As an example, in the *Statoil Angola* case, the Norwegian Supreme Court decided that the domestic transfer pricing provision could not be invoked regarding an interest-free loan because the debt was recharacterized as surrogate equity for tax purposes.[125] Art. 9(1) may, however, restrict a transactional adjustment based on domestic anti-avoidance rules if there are no substance-over-form conflicts.[126] Art. 9(1) would, for instance, restrict a transactional adjustment which 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. The Norwegian Supreme Court emphasized this in the *Schlumberger* case in which the Court noted that the domestic transfer pricing provision implied that actual transactions between associated enterprises must be treated for tax purposes as if the transactions had been entered into by independent enterprises and that the fact that the prices may have been affected by the affiliation provided a legal basis only to adjust the price charged, not to disregard the transaction.[127] In this author's view, Art. 9(1) may also constitute a barrier to the application of domestic anti-avoidance rules specifically aimed at controlled transactions if there are no substance-over-form issues or a clearly abusive situation.[128] 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.[129] Art. 9(1) could, for instance, be a barrier to the application of

118. See Para. 6 of the Commentary on Art. 27 in *Yearbook of the International Law Commission, 1966*, supra note 66, Vol. II at 221.
119. Ward, David A. et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentary on the OECD Model* (Amsterdam, 2005), at 35; Waters, Mike, in Lang, Michael et al., *Festschrift für Helmut Loukota* (Vienna, 2005), at 671; Barenfeld, Jesper, *Taxation of Cross-Border Partnerships* (Amsterdam, 2005), at 38.
120. Wassermeyer, supra note 29, Art. 9, marginal numbers 22, 46 and 76; Eigelshoven, supra note 29, Art. 9, marginal number 28; Gosch, supra note 71, at 397 and 403; Becker, supra note 29, Art. 9, marginal numbers 104-109; Andresen, supra note 29, at 76, 81, 85, 110 and 141; Baumhoff, Hubertus, in Flick, H., F. Wassermeyer and H. Baumhoff, *Außensteuerrecht* (Cologne, loose-leaf), Sec. 1, marginal number 269; Chebounov, supra note 74, at 586; Knobbe-Keuk, supra note 71, at 695. Contra: Nilausen, Karin Skov, *Løsning af internationale skattetvister* (Copenhagen, 2005), at 52 et seq.; and Bullen, Andreas, in *Skatterett* (2008), at 110, 112, arguing that Art. 9(1) also governs transactional adjustments.
121. Miyatake, Toshio, General Report on Subject 1: Transfer pricing and intangibles, in *Cahiers de droit fiscal international*, Vol. 92a (2007), at 17, 21 (61st Congress of the International Fiscal Association, Kyoto, 2007).
122. See 6.3.3. on the use of the phase "OECD consensus position" regarding the CWI standard incorporated into the OECD Guidelines.
123. The OECD Commentary may, in particular, qualify as a primary means of interpretation by providing the "ordinary meaning" of treaty terms under Art. 31(1) or the "special meaning" according to Art. 31(4) of the Vienna Convention.
124. Wassermeyer, supra note 29, Art. 9, marginal numbers 46, 76, 77 and 77a; Schaumburg, Harald, *Internationale Verrechnungspreise zwischen Kapitalgesellschaften* (Cologne, 1994), at 7; Becker, supra note 29, Art. 9, marginal numbers 124-126; Becker, Helmut, in Kroppen, H.K., *Handbuch Internationale Verrechnungspreise*, Vol. II: *Internationale Vorschriften* (loose-leaf), Sec. 1.37; Eigelshoven, supra note 29, Art. 9, marginal number 51; Sieker, Klaus, in Debatin and Wassermeyer, supra note 29, Art. 9, marginal number 146; Michielse, Geerten M.M., National Report for the Netherlands on Subject II: International Aspects of Thin Capitalization, in *Cahiers de droit fiscal international*, Vol. LXXXIb (1996), at 583, 599 (50th Congress of the International Fiscal Association, Geneva, 1996).
125. *Norsk Retstidende* 2007/1025 (*Statoil Angola*). The decision accords with German case law based on Sec. 1 of the pre-2003 Foreign Tax Act. In its decision of 29 November 2000, I R 85/99 (*BStBl* II 2002, 720), the Federal Tax Court rejected a transfer pricing adjustment of a parent company that had provided a financial guarantee to a thinly capitalized subsidiary free of charge since the guarantee replaced an injection of the equity needed by the subsidiary to perform its functions. 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. Sec. 1 was amended in 2003 and now applies to any private law relation that does not qualify as a company law agreement; see Steuervergünstigungsabbaugesetz of 16 May 2003 (*BStBl* I 2003, 660).
126. Baumhoff, supra note 29, Sec. 1, marginal number 269; Eigelshoven, supra note 29, Art. 9, marginal number 51; Becker, in Kroppen, supra note 124, Sec. 1.37. A different opinion is expressed in Norwegian theory in Skaar et al., supra note 71, at 383, and in Bullen, supra note 120, at 110, 112.
127. *Norsk Retstidende* 1995/124 (*Schlumberger*).
128. In this respect, it should not be lightly assumed that a taxpayer entered into a transaction that constitutes an abuse of tax treaty provisions. See Paras. 9.3, 9.4 and 22.2 of the Commentary on Art. 1.
129. Arnold, supra note 28, at 250. The European Court of Justice has held that broad domestic anti-avoidance rules applicable to all cross-border transactions meeting certain standard conditions violate the freedom of establishment of Art. 41 of the EC Treaty. See e.g. Para. 57 of Case C-324/00 (*Lankhorst-Hohorst*), Para. 52 of Case C-347/04 (*Rewe Zentralfinanz*) and Paras. 72 and 74 of Case C-524/04 (*Test Claimants in the Thin Cap Group Litigation*).

a CWI standard in domestic tax law adopted to overcome the problems associated with the valuation of intangibles under the arm's length principle. In this author's view, the requirement to recognize the actual transaction therefore imposes limits on the object qualification pursuant to domestic law not to erode the treaty obligations under Art. 9(1).[130]

6.3.2. Thin capitalization

The OECD position is that Art. 9(1) is relevant in determining whether a company's debt may be recharacterized as equity for tax purposes.[131] The Commentary dealing with thin capitalization was added in 1992 without any change to the wording of Art. 9(1). This would normally indicate that the Commentary is relevant to the interpretation and application of existing tax treaties.[132] The background to the Commentary was the OECD Thin Capitalization Report which concluded that Art. 9(1) was relevant for purposes of determining both the rate of interest and whether a loan could be recharacterized as equity capital.[133] The following analysis formed basis for the new interpretation of Art. 9(1). Para. 49 of the OECD Thin Capitalization Report provided:

> The basis for this view is as follows. Article 9(1) allows the tax authority of a Contracting State to adjust the taxable profit of an enterprise of that State to include profits which have not accrued to it in its accounts but which would have accrued to it in the arm's length situation. Thus, if profits have not accrued to the enterprise in its accounts because it has paid what it has described as interest to an associated enterprise and this payment has been deducted in arriving at the profits shown in the accounts but, in the arm's length situation, the payment would not have been deductible, then, in adjusting the taxable profits of the enterprise to include the payment, the tax authority would be acting in conformity with Article 9(1). Provided therefore that the re-categorisation of interest as a distribution of profit under domestic thin capitalisation rules has the effect of including in the profits of a domestic enterprise only profit which would have accrued to it in the arm's length situation there is nothing in Article 9 to prevent operation of those rules.

The reasoning of this analysis suffers from a number of weaknesses. First, it does not take into account the cause for the income shifting. As mentioned above, Art. 9(1) applies only in the case of income shifting caused by transfer prices. Income shifting in a thin capitalization case is caused by the form of the transaction rather than the transfer price. Art. 9(1) requires the form of the transaction to be recognized. Second, the analysis confuses the issues whether a payment may be recharacterized from interest to a dividend and whether a payment is tax deductible. As a result, the substantive tax treatment of interest and dividends under domestic tax law becomes the crucial point for purposes of determining whether Art. 9(1) is applicable. This reasoning must be rejected because Art. 9(1) does not address the substantive tax treatment of controlled transactions. Third, domestic tax law may grant a deduction for dividends, but treat interest expenses as non-deductible.

For the above reasons, many authors have rejected the OECD interpretation regarding thin capitalization.[134] There is no consensus, however, and some authors have supported the OECD position, although sometimes without any independent analysis.[135] In 2003, the controversy was addressed in the French *Andritz* case dealing with the compatibility of the French thin capitalization rules with the 1959 France–Austria tax treaty. The Supreme Administrative Court of France ruled, inter alia, that neither the domestic transfer pricing provision (Art. 57 of the General Tax Code of France) nor Art. 6(5) of the treaty (similar to Art. 9(1) of the OECD Model) provided authority for a thin capitalization adjustment.[136] According to the Supreme Administrative Court, the 1992 Commentary did not affect the interpretation since it was introduced after the treaty was concluded. Hence, the Commentary on thin capitalization

130. According to Art. 27 of the Vienna Convention, a party may not invoke the provisions of its internal law as a justification for its failure to perform its treaty obligations.

131. Para. 3 of the Commentary on Art. 9; OECD Transfer Pricing Guidelines, Para. 1.37.

132. Para. 35 of the Introduction to the OECD Model.

133. OECD Thin Capitalization Report, supra note 25, Paras. 48-49.

134. De Hosson, et al., supra note 52; Michielse, G.M.M., "Thin Capitalization – the IFA Congress Resolution", *Bulletin for International Fiscal Documentation* 10 (1996), at 463; Michielse, supra note 124, at 598 et seq.; Michielse, G.M.M., "Treaty Aspects of Thin Capitalization", *Bulletin for International Fiscal Documentation* 12 (1997), at 565; Becker, Helmut, "Once again: Thin capitalisation and treaty overriding", *Intertax* (1990), at 52; Becker, supra note 29, Art. 9, marginal numbers 104-109; Gosch, supra note 71, at 391; Knobbe-Keuk, supra note 71, at 695; Knobbe-Keuk, Brigitte, in *Der Betrieb* (1993), at 60; Sommerhalder, Ruud A., "Approaches to Thin Capitalization", *European Taxation* 3 (1996), at 82; Arvidsson, Richard, in *Svensk Skattetidning* (1999), at 195; Erasmie, Anders, Branch Report for Sweden on Subject 1: Non-discrimination at the crossroads of international taxation, in *Cahiers de droit fiscal international*, Vol. 93a (2008), at 567 (62nd Congress of the International Fiscal Association, Brussels, 2008).

Regarding Art. 4 of the EU Arbitration Convention, which is worded like Art. 9(1) of the OECD Model, the following have rejected that thin capitalization is covered by Art. 9(1): Terra, Ben J.M. and Peter J. Wattel, *European Tax Law* (Alphen aan den Rijn, 5th ed., 2008), at 574; Hinnekens, Luc, "The Tax Arbitration Convention. Its Significance for the EC Based Enterprise, the EC Itself, and for Belgian and International Tax Law", *EC Tax Review* (1992), at 70; and Schelpe, Dirk, "The Arbitration Convention: Its Origin, Its Opportunities and its Weaknesses", *EC Tax Review* (1995), at 68, 76 et seq. According to Para. 1.6 of the Consolidated Document on Suggestions Received for the JTPF 2007-2008 Work Programme, June 2007 (Doc: JTPF/009/BACK/2007/EN), thin capitalization has so far not been addressed by the Joint Transfer Pricing Forum since the topic is considered to be outside the scope of Art. 4 of the EU Arbitration Convention.

135. Helminen, Marjaana, *The Dividend Concept in International Tax Law* (London, 1999), at 334 et seq.; Nilausen, supra note 120, at 52 et seq.; Gäverth, Leif, *Skatteplanering och kapitaliseringsfrågor* (Uppsala, 1999), at 50; Avery Jones, John F. et al., "The Non-Discrimination Article in Tax Treaties", *European Taxation* 10 (1991), at 310; Lüthi, Daniel, "Thin capitalisation of companies in international tax law", *Intertax* (1991), at 446, 451; Zimmer, supra note 71, at 181; Adonnino, Pietro, "Some Thoughts on the EC Arbitration Convention", *European Taxation* 11 (2003), at 403; Calderón, Jose, supra note 71; Piltz, Detlev J., General Report on Subject II: International aspects of thin capitalization, in *Cahiers de droit fiscal international*, supra note 124, at 19, 78 et seq.; Jensen, Søren Næsborg, *EU-selskabsskatteret* (Copenhagen, 1997), at 352 et seq.; Pedersen, supra note 39, at 248 et seq.; Skaar et al., supra note 71, at 486. In 1996, IFA adopted a resolution to the effect that thin capitalization was within the scope of Art. 9(1); see *IFA Yearbook* (1996), at 72. However, Art. 9(1) was not considered to be a practical yardstick for thin capitalization cases. See Michielse, "Thin Capitalization – the IFA Congress Resolution", supra note 134.

136. Conseil d'Etat, 30 December 2003, No. 233894, *RJF* 3/04, No. 238. The decision was analysed in Douvier, Pierre-Jean et al., "France: Recent Case Law Developments Regarding Thin Capitalization", *International Transfer Pricing Journal* 3 (2004), at 132; Baker, Philip, "Review of Recent Treaty Cases – *NatWest II*, *NEC* and *SA Andritz*", *Bulletin for International Fiscal Documentation* 5 (2004), at 205; and Gouthiére, Bruno, "A Comparative Study of the Thin Capitalization Rules ...." (France), *European Taxation* 9/10 (2005), at 389.

was considered to imply a fundamental new interpretation of Art. 9(1) which could not be reconciled with the wording of the provision.

The interpretation of Art. 9(1) advanced by the OECD may have been influenced by tax policy considerations rather than internationally accepted rules of treaty interpretation. The 1979 OECD Report had already concluded that the OECD countries could disregard the actual transaction in order to recharacterize debt as equity on the basis of a substance-over-form analysis. So why was this all of a sudden not sufficient? The answer probably lies in the fact that several OECD countries wanted to retain or introduce thin capitalization rules applicable only in cross-border cases. This was problematic due to the non-discrimination provision in tax treaties similar to Art. 24 of the OECD Model. Domestic thin capitalization rules would be compatible with the non-discrimination provision in Art. 24(5) (now Art. 24(4)) if two conditions were satisfied: (a) an adjustment would be covered by Art. 9(1) or 11(6), and (b) Art. 24(6) (now Art. 24(5)) would not be applicable. According to the wording of Art. 11(6), the provision only addresses the interest rate. For this reason, it was convenient for these OECD countries that the OECD determined that thin capitalization was within the scope of Art. 9(1) and that Art. 24(6) should give way to Art. 24(5).[137] That made the pieces of the puzzles fit together, and the OECD countries were free to adopt thin capitalization rules incorporating an arm's length safe harbour.

6.3.3. CWI standard

A CWI standard was added to IRC Sec. 482 by the 1986 Tax Reform Act, requiring the payment for an intangible to be adjusted over time to reflect changes in the income attributable to the intangible. In 1994, the Sec. 482 regulations were amended to implement the CWI standard.[138] The rules on periodic adjustment mandate an ex post perspective which takes into account the actual profit experience.[139] The purpose of the CWI standard was twofold: (1) to deal with the lack of comparables for high-profit intangibles that were often valued on the basis of normal-profit intangibles; and (2) to negate the case law suggesting that the arm's length test for intangibles was limited to the question whether the compensation was appropriate based on an ex ante perspective considering only the facts in existence at the time of the transaction. The latter concern resulted from *R.T. French Co. v. Commissioner*, 60 T.C. 836 (1973), in which the Tax Court decided that the US Internal Revenue Service (IRS) was not authorized to adjust a fixed royalty rate simply because the intangible lost its value at the end of the licence period: "The Commissioner does not seriously contend that the 1946 agreement was not representative of an arm's-length bargain .... What later transpired in no way detracted from the reasonableness of the agreement when it was made."

The Tax Court applied an ex ante perspective which did not allow the actual profit experience to influence the arm's length test. This interpretation of IRC Sec. 482 was later confirmed in *Bausch & Lomb, Inc. v. Commissioner*, 933 F.2d 1984 (2d Cir. 1991):

> Unlike both respondent and petitioners' experts, we find little relevance in B&L Ireland's actual results of operations during 1981 and 1982. Such information would not have been available in 1980 to a potential licensee negotiating a license agreement which was entered on January 1, 1981. The arm's length nature of an agreement is determined by reference only to facts in existence at the time of the agreement.

Hence, US case law has firmly rejected the application of a CWI standard based solely on the arm's length principle in the 1968 Sec. 482 regulations; thus, it was necessary to amend IRC Sec. 482 to satisfy the tax policy goal of safeguarding the tax base. In 1998, Canada enacted Sec. 247(2)(b) of its Income Tax Act to authorize a recharacterization of transactions in accordance with the OECD Transfer Pricing Guidelines.[140] The recharacterization rule supplements the traditional arm's length rule in Sec. 247(2)(a) and accommodates the application of a CWI standard in Canadian tax law.[141] In 2007, Germany also introduced a CWI standard in Sec. 1(3) of the Foreign Tax Act. The necessity for the CWI standard was explained by the high uncertainty associated with a hypothetical arm's length test and by the fact that taxpayers often based valuations on wrong assumptions.[142]

According to the OECD Guidelines, the arm's length principle allows an adjustment to be made of the payment form for intangibles if the valuation is highly uncertain at the time of the transaction and independent enterprises would have insisted on a price-adjustment clause.[143] In such cases, according to the OECD Guidelines, the tax authorities should be permitted to determine the pricing on the basis of an imputed price-adjustment clause. Similarly, if independent enterprises would have considered unforeseeable subsequent developments so fundamental that their occurrence would have led to a prospective renegotiation of the pricing of a transaction, such developments should also lead to a modification of the transfer price of a controlled transaction. The OECD Guidelines would deny associated enterprises the option of a simple straightforward sale of an intangible and impose a sort of joint venture relationship between the parties for an undefined number of years. Although couched in arm's length jargon, the OECD Guidelines in reality attempt to incorporate a CWI standard into the arm's length principle in Art. 9(1) of the OECD Model.

137. The solution to the conflict between Arts. 24(5) and 24(6) was criticized in Detlev, supra note 135, at 134; Avery Jones et al., supra note 135, at 343 et seq.; and Lüthi, supra note 135, at 452. Moreover, the *Andritz* case was decided on basis of a treaty provision similar to Art. 24(5) of the OECD Model. In connection with the 2008 update, the OECD has maintained that Art. 24(5) is usually not relevant to thin capitalization; see Para. 79 of the Commentary on Art. 24.
138. US Treas. Reg. § 1.482-4(f)(2).
139. Subject to certain exceptions set out in US Treas. Reg. § 1.482-4(f)(2)(ii).
140. See Boidman, Nathan, in *IBFD Transfer Pricing Database*, Canada, Para. 2.1.2.5.3. (2008).
141. Canada Revenue Agency, supra note 117, Paras. 150-151.
142. See the comments on Sec. 1 of the AStG, in *Gesetzentwurf Bundesregierung* (30 March 2007), *BR-Drucksache* 20/07.
143. OECD Transfer Pricing Guidelines, Paras. 6.34 and AN-15 et seq.

The common denominator of the CWI standards in the domestic US and German tax laws and the OECD Guidelines is that they cause a partial recharacterization of the actual transaction, where the arm's length test is made on the basis of conditions deviating from the actual conditions of the transaction. As previously mentioned, transactional adjustments are outside the scope of the arm's length principle in Art. 9(1) of the OECD Model. Moreover, the arm's length principle in Art. 9(1) should be applied on an ex ante basis.[144] International case law has confirmed this fundamental aspect of the arm's length principle on numerous occasions. It also follows from the preamble to the proposed US cost-sharing regulations addressing the valuation of intangibles according to the investor model:[145] "The ex ante perspective is fundamental to achieving arm's length results." The OECD Guidelines emphasize the ex ante perspective by stating that the use of hindsight contradicts the arm's length principle.[146] In 1992 and 1993, the OECD Task Force criticized the proposed US rules on periodic adjustments as follows:[147]

> To the extent that a commensurate with income approach involves the application of hindsight, there is a danger of a fundamental contradiction between the arm's length standard which depends on evaluating transactions at the time they take place and the commensurate with income concept to the extent that it involves a year-by-year retrospective reappraisal based on profits.

Thus, the arm's length principle in Art. 9(1) of the OECD Model should be applied based on all the information reasonably available at the time of the transaction.[148] It would therefore seem almost impossible to apply a CWI standard in conformity with the ex ante requirement, as the OECD rightfully emphasized in 1992 and 1993. The OECD, however, pretends to have solved the Gordian knot by arguing that the adjustment is made ex ante to the form of payment and that the imputed payment form is simply applied based on the ex post information. *Keine hexerei, nur Behändigkeit!* [No witchcraft, simply ingenuity!] Notwithstanding the technical makeover to which the CWI standard in the OECD Guidelines was subject from the discussion draft issued on 1 March 1995 using the term "periodic adjustments"[149] to the final report adopted on 27 June 1995, the result remains that the arm's length test is based on an ex post perspective and on conditions other than those of the actual transaction, causing a partial recharacterization.

Moreover, the CWI approach adopted by the OECD also fails the causality test in Art. 9(1). The underlying assumption of the OECD is that the actual value of an intangible turns out to be above the expected value at the time of the transaction. But the actual value may ultimately turn out to be below the expected value. Hence, if a price-adjustment clause had been agreed, this could have caused a reduction in the seller's profits. The reason is, of course, that what determines whether the actual value of the intangible will be at, below or above the expected value is a myriad of post-transaction circumstances assuming that the valuation was made in good faith and on the basis of all reasonably available information.[150] Thus, the basic requirement of Art. 9(1) that a decrease in profit should be attributable to the conditions of the transaction is not met. For these reasons, the CWI standard in the OECD Guidelines is not compatible with the arm's length principle in Art. 9(1) of the OECD Model.[151] This has been confirmed by the above-mentioned US case law. In the Norwegian *Kronos Titan* case, the court noted that the tax authorities were hardly authorized to adjust a fixed royalty rate simply because the market value of the licence agreement after the transaction increased or decreased.[152] Moreover, to this author's knowledge, it is not possible to point to any court cases that acknowledged an adjustment applying a CWI standard based on a domestic transfer pricing provision worded like Art. 9(1) of the OECD Model.[153]

It is therefore well founded that separate legal authority has been established in US, German and Canadian tax law for applying a CWI standard. Only two countries may be pointed to where the tax authorities definitely consider that they are authorized to apply a CWI standard based on traditional arm's length provisions.[154] Thus, the 2008 Discussion Draft (Para. 88) seems to exaggerate when it elevates the CWI standard to the "OECD consensus position". Against this backdrop, the

144. OECD Transfer Pricing Guidelines, Paras. 1.11, 1.30, 1.66, 2.11, 3.12 and 3.14.
145. REG-144615-02 (IRB 2005-40), Preamble, Explanation of Provisions, A. Overview. The cost-sharing regulations were issued in temporary form on 31 December 2008; see REG-144615-02, TD 9441, *Federal Register*, Vol. 74, No. 2 (5 January 2009), at 340.
146. OECD Transfer Pricing Guidelines, Paras. 1.51, 3.14, 5.20, 6.32, 8.20, AN-16 (Para. 4), AN-37 (Para. 49) and AN-38 (Para. 52).
147. *Tax Aspects of Transfer Pricing within Multinational Enterprises – the United States Proposed Regulations* (Paris: OECD, 1993), Paras. 3.6 and 3.63-3.71; *OECD Task Force Report on Intercompany Transfer Pricing Regulations under Section 482 temporary and proposed regulations* (Paris: OECD, 1993), Paras. 2.5 and 2.23-2.33.
148. OECD Transfer Pricing Guidelines, Para. 6.33.
149. Id., Part II: Applications, Paras. 33-41.
150. Rödder, Thomas, in Schaumburg, H. and T. Rödder, *Unternehmensteuerreform 2008* (Munich, 2007), at 382 (regarding the German CWI standard).
151. Lodin, Sven-Olof, in Alpert et al., supra note 118, at 265, 271; Maisto, supra note 49, at 55; Becker, in Kroppen, supra note 124, Sec. 1.37; Eigelshoven, supra note 29, Art. 9, marginal number 52; Baumhoff, supra note 120, Sec. 1, marginal numbers 269 and 716; Kroppen, Heinz-Klaus et al., *Internationale Wirtschafts-Briefe* (2007), Fach 3, Gruppe 1, at 2201, 2219 et seq.; Kessler, Wolfgang et al., "Out of Germany: The New Function Shifting Regime", 48 *Tax Notes International* 53 (2007); Andresen, supra note 29, at 85 et seq., 107, 110, 116 et seq. and 141; Dam, Henrik, *Rette indkomstmodtager* (Copenhagen, 2005), at 791l; Pedersen, supra note 39, at 232.
152. *Utvalget: Domme og uttalelser m.v. i skattesakter* 1992/1250 (*Kronos Titan*).
153. The analysis of international case law is based on *Cahiers de droit fiscal international*, Vol. 92a (2007), supra note 121. In a 1988 case (*BNB* 1998/385), the Netherlands Supreme Court recognized that the payment form could be adjusted; the case is mentioned in Doets, Mark and Harmen van Dam, "Transfer Pricing in the Netherlands – The 'Rules of the Road'", *Bulletin for International Taxation* 8/9 (2006), at 344. But the case concerned a domestic transaction and was decided based on the predecessor to the new transfer pricing provision which did not articulate an arm's length principle as set out in Art. 9(1). For this reason, the precedential value of the decision for the interpretation of the arm's length principle in Art. 9(1) is modest.
154. The analysis is based on *Cahiers de droit fiscal international*, id., and the home pages of the OECD countries' tax authorities. The countries are Japan and the Netherlands. According to the Dutch tax authorities, a CWI standard akin to the one in the OECD Transfer Pricing Guidelines may be applied; see Decree of the Underminister of Finance of 21 August 2004, No. IFZ 2004/680M, Para. 5. The decree is presumably based on the 1998 Netherlands Supreme Court decision mentioned in note 153, supra.

sudden U-turn from the OECD Task Force Reports in 1992 and 1993 to the OECD Guidelines in 1995 is surprising and may be ascribed to e.g. the US government's significant influence on the drafting of the OECD Guidelines. This is another example of the OECD interpreting the arm's length principle in Art. 9(1) on the basis of tax policy considerations rather than internationally recognized principles of treaty interpretation.

6.3.4. Business restructurings

The 2008 Discussion Draft addresses business restructurings involving the cross-border redeployment of functions, assets and risks between associated enterprises. The Discussion Draft (Para. 16) contains the reassuring statement that it is based on existing transfer pricing rules and the premise that the arm's length principle and the OECD Transfer Pricing Guidelines do not and should not apply differently to post-restructuring transactions than to transactions that were structured as such from the beginning. The Discussion Draft, however, embarks on a journey aimed at consolidating and providing further authority for the position that transactional adjustments are within the scope of Art. 9(1).[155] The Discussion Draft contains four Issues Notes, analysed below.[156]

6.3.4.1. Risks

In a transfer pricing context, the identification and allocation of risks between affiliated companies are crucial due to the relationship between risk and return. In recent years, business restructurings have often shifted the risk and the associated profit potential from distribution and manufacturing companies to an "entrepreneur" or "principal company" in the group. Pursuant to Issues Note No. 1,[157] the starting point for the arm's length test in Art. 9(1) is the contractual risk allocation. In other words, the actual transaction should be recognized for transfer pricing purposes, but the contractual risk allocation may be disregarded if it lacks economic substance. It is therefore necessary to examine both the contractual terms and the economic substance of a transaction. If the contractual terms differ from the economic substance, the latter should prevail according to the Discussion Draft. As a result, the Discussion Draft could as well have stated that the examination of risk may be reduced to a substance analysis in which the contractual terms are just one of several factors to consider.

According to the Discussion Draft, the following factors should guide the substance analysis and the transfer pricing consequences of a risk allocation: (1) whether the related parties conform to the contractual risk allocation; (2) whether the contractual terms provide for an arm's length risk allocation; (3) whether the risk is economically significant; and (4) the transfer pricing consequences of the risk allocation. These four factors are presumably of a coordinated nature since no order of priority is given. This is in contrast to the existing guidance in the OECD Guidelines in which the actual conduct is given the greatest weight (see below). Moreover, the substance analysis is contrary to the US Sec. 482 regulations which place the greatest weight on the actual conduct of the parties and their respective legal rights for purposes of evaluating the economic substance of contractual terms.[158]

The third and fourth factors are genuine transfer pricing issues covered by the arm's length principle in Art. 9(1). The first factor is relevant for assessing the legal facts of a transaction which may be derived from both the contractual terms and the actual conduct of the parties.[159] The OECD Guidelines refer to the actual conduct as the primary factor for purposes of the substance analysis (see above). The emphasis on the actual conduct should be seen in light of the US case law on round-trip transactions where intangibles were licensed by US parent companies to foreign affiliated manufacturers and all, or nearly all, the goods produced were purchased by the parent companies or affiliated companies without any contractual obligations to do so. The IRS applied the "contract manufacturing" theory according to which the licence transaction and the goods transaction were collapsed and the foreign manufacturer was treated as a low-risk contract manufacturer for purposes of IRC Sec. 482. US case law has rejected this approach since the affiliated companies were under no contractual obligation to purchase the goods. In *Bausch & Lomb, Inc. v. Commissioner*, the US Tax Court noted:

> Respondent's argument would have some merit had we found that B&L was required to purchase B&L Ireland's production of soft contact lenses .... The most that can be said is that B&L Ireland had certain expectations as to the volume and price of lenses it could anticipate selling to B&L or its affiliates. However, such expectations are no different than those which any supplier has with regard to the business of a major customer and do not constitute a guarantee which effectively insulated B&L Ireland from market risks.

The Tax Court rejected the contract manufacturing theory because it disregarded the actual risk allocation.[160] The 1994 Sec. 482 regulations on the actual conduct of the parties were issued to negate the case law. If a written agreement exists and the market risk is allocated to a manufacturing company, the IRS may take the actual conduct into account for purposes of evaluating the economic substance of the risk allocations.[161] Thus, if affiliated companies in fact purchase all the output of the manufacturing company even during a recession, this may potentially result in the risk allocation being deemed to lack economic substance. In the absence of a written agreement, the IRS is authorized to impute a contractual purchase obligation if affiliated companies in fact purchase all the output of a manufacturing com-

155. Domestic anti-avoidance rules are outside the scope of the 2008 Discussion Draft (see Paras. 8 and 195).
156. The genuine transfer pricing aspects of the Discussion Draft are not analysed in this article.
157. 2008 Discussion Draft, Para. 20.
158. US Treas. Reg. § 1.482-1(d)(3)(ii)(B)(1).
159. OECD Transfer Pricing Guidelines, Para. 1.26.
160. *Bausch & Lomb, Inc. v. Commissioner*, 933 F.2d 1984 (2d Cir. 1991); *Sundstrand Corp. v. Commissioner*, 96 T.C. 226 (1991).
161. US Treas. Reg. §§ 1.482-1(d)(3)(ii)(B)(1) and 1.482-1(d)(3)(iii)(B).

pany.[162] Hence, the actual conduct is important for determining the "real deal" of associated enterprises according to the Sec. 482 regulations regardless of whether a written risk allocation exists.

In the context of Art. 9(1) of the OECD Model, however, it must be maintained that domestic tax law rather than Art. 9(1) of a tax treaty prevails for identifying the risk allocation since the notion of commercial or financial relations should be interpreted on the basis of domestic tax law (see 6.3.1.). As a result, Art. 9(1) cannot guarantee that the contracting states will arrive at the same risk allocation. That said, the domestic tax laws of most OECD countries probably recognize that an examination of the conditions of controlled transactions may take the actual conduct into account. An example is the Danish *BP* case[163] which concerned a Danish distribution company that had concluded a long-term supply agreement with a UK sister company pursuant to which the transfer prices of oil products for a certain year were above the spot prices on the Rotterdam market. The tax authorities argued that the conditions for making a transfer pricing adjustment were met. The long-term agreement resulted in transfer prices below the spot prices in some years and in transfer prices above the spot prices in other years. The actual conduct of the taxpayers accorded with the contractual terms during the entire period. The majority of the Danish Supreme Court ruled that the tax authorities had failed to prove that the arm's length principle was not observed.

The second factor is much more troublesome in the context of Art. 9(1). According to the 2008 Discussion Draft, a contractual risk allocation can be recognized under an empirical test or a hypothetical test. A risk allocation should be recognized where reliable empirical data evidences a similar risk allocation in independent transactions.[164] If no such data exists, it is necessary to examine whether the risk allocation is one that independent parties might hypothetically have agreed to under similar circumstances. The OECD considers that two factors should guide the hypothetical examination: (1) the control over the risk, and (2) the financial capacity to bear that risk.[165] These factors also originated from the 1994 Sec. 482 regulations.[166] The analysis in the Discussion Draft is devoted primarily to the control factor, which seems to be given the greatest weight by the OECD.[167] Applying the financial capacity factor in a transfer pricing analysis accords with the arm's length principle because it simply involves recognizing the counterpart risk inherent in any transaction. This, however, is not the same as applying the factor in a substance analysis where it could cause an "all or nothing" result rather than establishing the price of a particular risk.[168] The OECD Transfer Pricing Guidelines (Para. 1.27) refer to the control factor as a secondary factor in a substance analysis next to the actual conduct of the parties. The Discussion Draft states that the notion of control should be understood to mean the capacity to make decisions to take on the risk and decisions on whether and how to manage the risk. Moreover, the Discussion Draft states that this would require the company to have individuals with authority to perform these control functions. But this would not prevent outsourcing the day-to-day monitoring and administration of a risk to a service provider.[169] The control factor could result in a risk allocation being disregarded even though it had been contractually agreed to on an ex ante basis, the parties actually observed the risk allocation, and the risk-taker had the financial capacity to bear the risk.

If one turns to the OECD Report on the attribution of profits to a PE,[170] it is striking to note that the risk allocation between a head office and a PE under the "authorized OECD approach" (AOA) is also based on a factual identification of the significant people functions relevant to the initial acceptance and subsequent management of the risks. The OECD, in essence, attempts to cause the risk allocation to be determined on a factual basis for both associated enterprises governed by Art. 9(1) and PEs governed by Art. 7.[171] It is difficult to believe the assertion in the Discussion Draft (Para. 17) that the guidance on Art. 9(1) was developed independently from the AOA regarding Art. 7. The adoption of the AOA in an Art. 9(1) context is surprising since the OECD has emphasized that distinct rules were necessary for the risk allocation in a PE context because a PE is not legally distinct from the rest of the enterprise of which it is a part in the way that an associated enterprise is legally distinct from other enterprises of the same MNC.[172] The tax policy reason for this move is obvious, however, since a factual allocation of risk between associated enterprises would invalidate the tax planning opportunities provided by the separate entity approach and the recognition of controlled transactions.[173] Hence, adopting the AOA for associated enterprises would prevent a contractual separation of the risks and assets from the functions.[174] The AOA has been adopted precisely to prevent such tax planning.[175] From a *de lege ferenda* perspective,

162. US Treas. Reg. § 1.482-1(d)(3)(ii)(B)(2).
163. *Tidsskrift for Skatteret* 1988, 292.
164. Under the 2006 US services regulations, the risk allocation of a contingent-payment arrangement should *not* be examined on the basis of uncontrolled transactions. See TD 9278 (IRB 2006-34), Explanation of Provisions, 8 – Contingent-Payment Contractual Terms: "That is, whether a particular arrangement entered into by controlled parties has economic substance is not determined by reference to whether it corresponds to arrangements adopted by uncontrolled parties."
165. 2008 Discussion Draft, Para. 28.
166. US Treas. Reg. § 1.482-1(d)(3)(iii)(B).
167. This understanding is reinforced by Para. 199 of the Discussion Draft ("and in particular").
168. Warner, J.P. and H.B. McCawley, 887 T.M., *Transfer Pricing: The Code and the Regulations* (2003), at A-86.
169. Discussion Draft, Paras. 30-33.
170. *Report on the Attribution of Profits to Permanent Establishments (Part I)* (Paris: OECD, 2008), Para. 27.
171. Dali-Ali, Chaïd and Simon Langlois, in 17 *Tax Management Transfer Pricing Report* (11 June 2008), at 543.
172. *Report on the Attribution of Profits to Permanent Establishments (Part I)*, supra note 170, Paras. 16 and 17; 2008 Discussion Draft, Para. 20.
173. Vann, Richard J., in Arnold et al., supra note 101, at 133, 153 et seq.
174. Vann, id. at 143, however, suggested that Art. 9 should be oriented towards Art. 7 in order to mitigate tax planning.
175. *Report on the Attribution of Profits to Permanent Establishments (Part I)*, supra note 170, Para. 21.

this solution cannot be recommended because it would significantly undermine the rule of law due to the immense uncertainty associated with a "highly fact-specific" risk allocation.[176] From a *de lege lata* perspective, the issue is that a substance analysis of the risk allocation is outside the scope of Art. 9(1) since the existence, form and content of commercial or financial relations should be determined under domestic tax law a priori the application of Art. 9(1) (see 6.3.1.). Thus, as long as an arm's length price was paid for a contractual assumption of risk that is recognized by domestic tax law, further considerations about which company in the group effectively controls the risk is irrelevant in the context of Art. 9(1).[177]

In this author's view, the control factor is unlikely to be given particular weight for purposes of the object qualification under domestic tax law. Thus, in an integrated, centrally managed MNC, all major decisions may, in substance, be taken by the parent company, including decisions regarding the business of the subsidiaries. This organizational approach was explicitly recognized by the US Court of Claims in *Merck & Co. v. United States*, 24 Cl.Ct. 73 (1991):

> To assure that operations in the Group comply with policies established and decisions made by Merck's executive officers, the posts on the boards of directors and officers in the wholly owned affiliates, for the most part, are filled by senior management personnel located at Merck's headquarters at Rahway, New Jersey. This method of staffing, which results in many individuals having multiple titles and overlapping duties in numerous corporate entities throughout the Group, is a type of business organization and management customarily employed in a group of controlled corporations, and it in itself is not illegal or challenged by the IRS. As a consequence of this method of staffing, notwithstanding the formality that the affiliates legally are corporations with separate identities, the business of the Merck Group was controlled through the supervision and coordination by Merck's executive officers from the Rahway headquarters.

The organizational structure of MNCs often requires that the management and administration of particular risks be centralized to minimize the costs and risks for the benefit of all the group companies. There is no reason to assume that the management of a risk is less efficient because it is done by an affiliated company. The OECD seems to have forgotten that affiliated companies face commercial circumstances different from independent companies.[178] Hence, economies of integration and the opportunity to execute controlled transactions in a manner different from uncontrolled transactions are the raison d'être of MNCs. It would be a contradiction in terms and contrary to the OECD Guidelines to require affiliated companies to conduct business as if they were independent companies. Art. 9(1) requires only that associated enterprises price controlled transactions in accordance with the arm's length principle.

The control factor was addressed in the Danish *Larsen Rejser* case[179] which concerned an agreement between a travel company and a retail company pursuant to which the retail company was to sell package tours on behalf of the travel company for a commission of DKK 75 per tour. The retail company guaranteed a certain minimum sale. If the minimum sale was not met and the travel company suffered a loss of at least DKK 10 million, the retail company was liable for damages of DKK 800 per tour below the minimum threshold and the commission would be annulled. If, on the other hand, the travel company's profit exceeded DKK 10 million, 50% of the profit was to be allocated between the two companies. Thus, the market risk was partly transferred from the travel company to the retail company. Due to falling sales, the retail company became liable for damages of DKK 9.4 million and was not entitled to the commission. The tax authorities took the position that the arrangement failed the arm's length test and that the retail company was subject to tax on imputed commission income; they also disallowed a deduction for the damages payment. The tax authorities argued, inter alia, that the risk allocation was particularly onerous for the retail company since it did not control the number of tours, destinations, tour programme, prices, marketing and other factors that influenced the sales. The taxpayer argued that the conditions were at arm's length because the arrangement was expected to result in an influx of potential customers to the retail stores. The High Court relied on the taxpayer's testimony that the arrangement was at arm's length due to the prospect of attracting new customers. The tax authorities had not substantiated that the arrangement violated the arm's length principle. The High Court respected the contractual risk allocation even though the retail company did not control the marketing and other factors that influenced the sales.

6.3.4.2. Arm's length compensation for the restructuring itself

A business restructuring involves the transfer between affiliated companies of functions, risks, assets and the associated profit potentials. Issues Note No. 2 is concerned with the arm's length compensation for a restructuring itself and touches on transactional adjustments in three instances.

First, the termination of a short-term contractual arrangement where a company has performed market development activities may, according to the Discussion Draft, "be indicative of a longer-term arrangement, and hence greater rights than those indicated by the legal contractual arrangement".[180] This should presumably authorize the tax authorities to disregard the short-term contractual terms and impute the longer-term contractual terms under Art. 9(1). The tax authorities would be able to claim that a compensation should be paid for the premature termination of a long-term agreement. The origin of this approach is once again the Sec. 482 regulations dealing with economic substance.[181] The Sec. 482

176. Id., Para. 98.
177. The management of risks for an affiliated company may, of course, qualify as commercial or financial relations according to Art. 9(1), which would require the payment of an arm's length service fee.
178. OECD Transfer Pricing Guidelines, Para. 1.10.
179. *Tidsskrift for Skatter og Afgifter* 1999, 730.
180. 2008 Discussion Draft, Para. 51; see also Paras. 107 and 200.
181. US Treas. Reg. §§ 1.482-1(d)(3)(ii)(B)(1) and 1.482-1T(f)(2)(ii)(A).

regulations authorize the IRS to impute contractual terms providing compensation for the termination of an imputed long-term, exclusive distribution agreement where a US subsidiary has undertaken incremental marketing activities causing low returns in the early years and a subsequent above-normal return is attributed to a foreign parent company.[182] In the context of Art. 9(1) of the OECD Model, however, disregarding the short-term contractual terms involves a partial recharacterization which is outside the scope of Art. 9(1); for this reason, the guidance in the Discussion Draft lacks a legal basis. Applying Art. 9(1) properly would require that the arm's length test be directed at the transfer prices during the early years, recognizing both the incremental marketing activities and the contractual terms, including the risk of an early termination. The Discussion Draft (Para. 111) is aware of this more proper approach, which is advanced in an example regarding a contract manufacturing arrangement. But the Discussion Draft implicitly expresses a clear preference for the restructuring approach over the transfer pricing approach. This may be explained by the following advantages offered to the tax authorities by the restructuring approach: (1) a valuation based on the imputed terms rather than the actual terms may be easier, and (2) a transfer pricing adjustment in the early years may be precluded by the statute of limitations.

Second, the Discussion Draft (Sec. A.2) makes several references to the business purpose of a business restructuring. The reason for these comments is not entirely clear. Considering the context of the project, one could fear that the OECD was attempting to incorporate a business purpose test into Art. 9(1), which would clearly be outside its scope because the arm's length principle is an objective standard and a tax avoidance purpose should not influence the application of Art. 9(1).[183] Moreover, the case law of most countries recognizes that taxpayers may pursue legitimate tax minimization strategies.[184] In *Merck and Co. v. United States*, 24 Cl.Ct. 73 (1991), for instance, the IRS argued that a Sec. 482 adjustment was appropriate due to a purported tax evasion purpose. The US Claims Court rejected this argument:

> The fact that Merck's management was diligent and creative, and used sophisticated tax planning to reduce its overall tax liabilities, in itself does not constitute prohibited tax avoidance or evasion .... A taxpayer that does not take the tax laws into consideration when structuring complex transactions not only is naïve but probably is out of business.

The Discussion Draft explicitly recognizes that it can be commercially rational from an Art. 9(1) perspective to restructure in order to obtain a tax saving.[185] Accordingly, in the Discussion Draft (Paras. 57 and 82), the discussion of the business purpose of a restructuring seems to be twofold: (1) the synergy gains and other benefits should be taken into account when applying the arm's length principle; and (2) transfer pricing adjustments may be appropriate even though a business restructuring is based on proper commercial reasons since the arm's length principle should be applied on a separate entity basis. In this author's view, both positions accord with the arm's length principle in Art. 9(1) of the OECD Model.

Third, the Discussion Draft (Para. 88) refers to the CWI standard of the OECD Guidelines in relation to an intangible transferred at a time when it does not have an established value. The conclusion of the OECD Guidelines is repeated that an adjustment of the payment form may be appropriate even though the valuation was made in good faith on the basis of information reasonably available at the time of the transaction if the valuation was so uncertain that unrelated parties would have insisted on such a payment form. As mentioned above, the CWI standard in the OECD Guidelines is contrary to the arm's length principle in Art. 9(1) of the OECD Model (see 6.3.3.).

6.3.4.3. Remuneration of post-restructuring controlled transactions

Issues Note No. 3 addresses the remuneration of post-restructuring controlled transactions without resort to transactional adjustments.

6.3.4.4. Recognition of the actual transactions undertaken

Issues Note No. 4 is the centrepiece of the Discussion Draft since it considers the application of the existing guidance in the OECD Guidelines regarding the exceptional circumstances in which it is considered to be legitimate for the tax authorities to disregard the actual transactions undertaken for transfer pricing purposes. This was reportedly the most difficult Issues Note for the OECD countries on which to reach agreement.[186] Four particular aspects of the Discussion Draft and the examples illustrating the guidance are analysed below.

First, the Discussion Draft (Para. 195) attempts to establish a distinction between transactional adjustments for transfer pricing purposes and for other tax purposes, but it fails to provide any reasoning regarding the legal basis for this distinction. The new interpretation is probably a response to the 2003 Commentary analysing the general relationship between anti-avoidance rules and tax treaties (see 6.3.1.). The OECD is apparently now of the opinion that Art. 9(1) provides authority for transac-

182. US Treas. Reg. § 1.482-1T(d)(3)(ii)(C) (examples 3-4). The examples in the Sec. 482 regulations are mirrored in Para. 113 of the 2008 Discussion Draft.
183. OECD Transfer Pricing Guidelines, Para. 1.2. The OECD previously considered that a tax avoidance motive could invalidate a request for a corresponding adjustment; see Para. 70 of the report on transfer pricing, corresponding adjustments and the mutual agreement procedure in *Transfer Pricing and Multinational Enterprises, Three Taxation Issues*, supra note 25. This interpretation, however, has not been incorporated into the OECD Guidelines. Art. 9(3) of the UN Model, on the other hand, explicitly provides that the contracting states are not obliged to make a corresponding adjustment if one of the enterprises concerned is liable to a penalty for fraud, gross negligence or wilful default.
184. Zimmer, supra note 95, at 47.
185. 2008 Discussion Draft, Paras. 196, 212, 213 and 220.
186. See interview with Mary Bennett in 17 *Tax Management Transfer Pricing Report* (11 June 2007), at 518.

tional adjustments, although the conclusion in the 2003 Commentary was clear: "... these rules [substance-over-form, economic substance and general anti-abuse rules] are not addressed in tax treaties and are therefore not affected by them." If Art. 9(1) incorporates a substance-over-form principle, it is remarkable that this is not mentioned in the 2003 Commentary or in any of the preceding OECD reports leading up to the 2003 Commentary. Hence, the new interpretation set out in the Discussion Draft is not easily reconciled with the 2003 Commentary and must be rejected.

Second, the Discussion Draft (Para. 198) states that adjustments pursuant to Art. 9(1) may be made to the price or other conditions of a transaction. This is the first time that OECD explicitly said that adjustments of conditions other than the price are generally within the scope of Art. 9(1). Adjustments of the payment terms and risk allocations are mentioned as examples. The adjustment of a price-sensitive condition implies a partial recharacterization (see 6.3.1.). According to the Discussion Draft (Para. 201), a partial recharacterization may be made irrespective of substance-over-form considerations. As mentioned above, a partial recharacterization is outside the scope of Art. 9(1) and, for this reason, the interpretation must be rejected.[187]

Third, the Discussion Draft addresses the different types of adjustments considered to be covered by Art. 9(1). The classification adopted by the OECD is set out in Table 1.

Table 1

OECD Model	Object of adjustment	Classification	OECD Guidelines
Art. 9(1)	prices	pricing adjustment[1]	other parts
	other conditions		
	nature of transaction[2]	non-recognition adjustment	Paras. 1.36-1.41

Notes:
(1) 2008 Discussion Draft, Para. 205.
(2) 2008 Discussion Draft, Para. 201.

The Discussion Draft (Para. 205) establishes a priority for pricing adjustments over non-recognition adjustments, but does not point to any legal authority for the priority. Art. 9(1) does not distinguish between various types of adjustments, making the prioritization absurd. The only possible source for this approach is the OECD Guidelines themselves. It seems as if the Discussion Draft overlooks that the OECD Guidelines should accord with Art. 9(1), not the other way around.[188] In addition, the Discussion Draft does not explain why an adjustment of a price-sensitive condition is not classified as a non-recognition adjustment even though such an adjustment means disregarding the actual transaction. The reason for the classification may be that it takes such adjustments out of the "exceptional circumstances" requirement in Para. 1.37 of the OECD Guidelines. Unfortunately, the Discussion Draft is contrary to the OECD Guidelines which provide that adjustments of payment terms are covered by Para. 1.37. Reconciling the two interpretations seems impossible. The Discussion Draft attempts both to broaden the scope of transactional adjustments claimed to be covered by Art. 9(1) and to lower the threshold for making transactional adjustments by removing the "exceptional circumstances" requirement for adjustments involving a partial recharacterization.[189]

Fourth, the Discussion Draft considers three important notions regarding the two exceptional circumstances in which Para. 1.37 of the OECD Guidelines legitimizes transactional adjustments. With respect to the meaning of the word "exceptional", the Discussion Draft (Para. 205) fails to provide any guidance since it simply explains the word as "not the norm but an exception"!

Regarding the second exceptional circumstance in the OECD Guidelines, two cumulative conditions should be satisfied: (1) the transaction practically impedes the tax authorities from determining an appropriate transfer price; and (2) the arrangements made in relation to the transaction, viewed in their totality, differ from those that would have been adopted by independent enterprises behaving in a commercially rational manner.

Regarding the "hard to value" test, the Discussion Draft (Para. 206) emphasizes that a transactional adjustment cannot be made if an appropriate transfer price may be established irrespective of the fact that similar transactions are not encountered by independent enterprises and that the tax authorities might have doubts as to the taxpayer's commercial purpose. Considering that the lack of comparables is one of key issues associated with applying the arm's length principle, the test is anything but operational. This is of particular concern with respect to the valuation of intangibles which depends on the competence, resources and strategies of the individual taxpayer. In most cases, the tax authorities would undoubtedly be able to claim that an appropriate transfer price cannot be established due to the countless number of uncertainties associated with the expected future return of an intangible.

Regarding the "commercially rational behaviour" test, the Discussion Draft (Para. 208) recognizes that the OECD Guidelines lack guidance. What may be inferred from the Discussion Draft (Paras. 207-213) are that:

187. The impetus for the OECD may have been the recent amendment to Sec. 1(1) of the German Foreign Tax Act according to which the arm's length test should be based on the conditions, and "in particular the prices", of the transaction. It is unclear whether the amendment should be understood to mean that adjustments may generally be made of conditions other than prices, or whether the intention is solely to ensure that the new CWI standard in Sec. 1(3) may be applied. See Wassermeyer, Franz, in *Der Betrieb* (2007), at 535; and Eigelshoven, supra note 29, marginal number 51.
188. Para. 1 of the Commentary on Art. 9; OECD Transfer Pricing Guidelines, Para. 1.6.
189. Dali-Ali and Langlois, supra note 171.

(1) a large majority of the OECD countries considers that the test is not intended solely to deal with transactions that do not have a non-tax business purpose;
(2) the test should apply only in exceptional circumstances;
(3) the fact that a similar arrangement such as a global business model is not found between independent enterprises does not in itself mean that the test is met;[190]
(4) a business restructuring carried out in order to obtain a tax saving may be commercially rational;
(5) the test should be applied on a separate entity basis; and
(6) the realistic alternatives available to a taxpayer should be taken into account for purposes of examining the test.

On this basis, it would seem that the "commercially rational behaviour" test should be based primarily on the realistic alternatives for each taxpayer. In this respect, the Discussion Draft (Para. 209) becomes circular because the question whether a better alternative is available depends on the price of the transaction actually undertaken, i.e. it boils down to a valuation issue. This was the outcome in *Claymont Investments, Inc. v. Commissioner*, 90 T.C.M. 462 (2005), dealing with a Sec. 482 adjustment based on an examination of the realistic alternatives and the economic substance of the contractual terms.[191] The US Tax Court ruled in the taxpayer's favour: "While respondent was not authorized to restructure the transaction as if petitioners had adopted his proposed alternative, he could have adjusted the terms of the CIC/CIHI transaction (e.g., reduced the interest rate)."

It follows from this decision that if the objection to a transaction is the price, the IRS is usually only authorized to make a transfer pricing adjustment. Moreover, a realistic alternative cannot in itself establish a lack of economic substance. The notion of realistic alternatives is also taken from the IRS, which has applied the notion to disregard controlled transactions for purposes of IRC Sec. 482. In *Bausch & Lomb, Inc. v. Commissioner*, 933 F.2d 1984 (2d Cir. 1991), the approach was advanced as one of several reasons supporting a transfer pricing adjustment of a US parent company which licensed valuable intangibles regarding soft contact lenses to a newly formed Irish subsidiary and which purchased back a substantial part of the output. The parent company paid USD 7.50 per unit to the Irish subsidiary and presented evidence of uncontrolled sales of the same product by third parties at prices at or above USD 7.50. Acknowledging that this would provide a strong defence for the taxpayer, the IRS also advanced a realistic alternative argument:

> Finally, respondent urges that it is inconceivable that at arm's length B&L, which possessed the technology and present ability to manufacture contact lenses at a cost far below that achievable by any of its competitors, would go into the open market and pay $7.50 per lens for a product it could produce itself for approximately $1.50 even though other distributors without this capability would consider the $7.50 a market price.

The Tax Court ruled that the use of the comparable uncontrolled price method was mandatory and that the third-party transactions identified by the taxpayer provided ample evidence that USD 7.50 was equal to or below the market price for contact lenses. The outcome of the case depended on the IRS's realistic alternative argument. The Tax Court rejected it (emphasis in original):

> Finally, respondent argues that B&L *could have* produced the contact lenses purchased from B&L Ireland itself at lesser cost. However, B&L *did not* produce the lenses itself. The mere power to determine who in a controlled group will earn income cannot justify a section 482 allocation of the income from the entity who actually earned the income.

According to the Tax Court, IRC Sec. 482 does not provide authority to disregard the actual transaction on the basis of realistic alternatives.[192] The US courts have rejected similar considerations in a number of other cases.[193] The IRS's reaction has been to incorporate the realistic alternative approach into the 1994 Sec. 482 regulations authorizing the tax authorities to consider the alternatives available to the taxpayer for purposes of determining both an arm's length price[194] and comparability.[195] Regarding a price determination, the aim of the rules is to incorporate a "make/buy" analysis into the arm's length test.[196] As a result, IRC Sec. 482 has been turned into a two-step test, i.e. an empirical arm's length test and a hypothetical test of the realistic alternatives. The US courts have not yet had an opportunity to determine whether the rules on realistic alternatives conform with IRC Sec. 482.[197] The use of realistic alternatives is appropriate for examining the comparability of transactions because it provides information on the relative bargaining power of the parties. It would be inappropriate, however, to use realistic alternatives as a separate means for establishing arm's length prices according to Art. 9(1) of the OECD Model because the arm's length test should

190. In the Danish *TT Meditrade* case, the Supreme Court recognized the unusual terms of a transaction whereby a company rented out a holiday home to the sole shareholder on a full-year basis; see *Tidsskrift for Skatter og Afgifter* 2004, 903. The Supreme Court specifically stated that rent for a full year was assumed to be unusual and that no information was available regarding the market price of such a condition. But this did mean that the Supreme Court disregarded the conditions of the transaction. Instead, the arm's length price of the actual transaction was estimated on the basis of a realistic alternative to the company.
191. See US Treas. Reg. §§ 1.482-1(d)(3)(ii)(B) and 1.482-1(f)(2)(ii).
192. See Rosenbloom, H. David, "Angels on a Pin: Arm's Length in the World", 38 *Tax Notes International* 523 (2005), arguing with reference to *Bausch & Lomb, Inc. v. Commissioner* that the inquiry should focus on the transaction itself, not just the price.
193. See *Merck & Co. v. United States*, 24 Cl.Ct. 73 (1991); and *Hospital Corp. of America, Inc. v. Commissioner*, 81 T.C. 520 (1983). For the earlier US case law rejecting the realistic alternative analysis in Sec. 482 cases, see Schrotenboer, Ronald B., in 17 *Tax Management Transfer Pricing Report* (25 September 2008), at 430.
194. US Treas. Reg. §§ 1.482-1T(f)(2)(ii)(A), 1.482-3(e)(1), 1.482-4(d)(1), 1.482-7T(g)(2)(iii) and 1.482-9T(h).
195. US Treas. Reg. §§ 1.482-1(d)(3)(iv)(H) and 1.482-3(b)(2)(B)(8).
196. See TD 8470 (IRB 1993-10), Preamble: Explanation of Provisions, § 1.482-1T(d)(3)(iii).
197. Andrus, Joseph L., Branch Report for the United States on Subject 1: Transfer pricing and intangibles, in *Cahiers de droit fiscal international*, supra note 121, at 629, 641.

take into account the perspective of both parties[198] and be based on a profit maximization assumption.[199] In a 1993 case, the German Federal Tax Court ruled that a taxpayer could not escape a transfer pricing adjustment regarding a services transaction made on a cost-only basis by referring to the buyer's realistic alternative of performing the activity itself without incurring a mark-up.[200] The realistic alternative did not take into account the perspective of the seller who would ordinarily require a mark-up on costs. For this reason, it is disturbing that the Discussion Draft (Para. 58) states that realistic alternatives are relevant to both the comparability and pricing of a transaction. The OECD Guidelines (Para. 1.15) mention realistic alternatives only regarding the comparability analysis. It is unclear whether the Discussion Draft attempts to diverge from the OECD Guidelines.

The Discussion Draft concludes with three examples regarding the recognition of the actual transaction. Example A involves the sale of "crown jewel" intangibles for a lump-sum payment.[201] If the restructuring is commercially rational for the MNC (alignment of the acquired company with the rest of the group), the transaction should be recognized. Some OECD countries, however, have taken the position that the sale of "crown jewel" intangibles should not be recognized for transfer pricing purposes if the seller remains in business, i.e. continues to perform the functions albeit in a different legal/economic context. A similar fact pattern was considered by the Swedish Supreme Administrative Court in the *Findus* case[202] in which a Swedish manufacturing company in the Nestlé group transferred the ownership of valuable trademarks and other intangibles to an affiliated Swiss company free of charge. The two companies subsequently concluded a licence agreement pursuant to which the Swedish company had to pay a royalty for the right to use the intangibles. The statute of limitations prevented the tax authorities from making a transfer pricing adjustment regarding the transfer of the ownership of the intangibles. Instead, a deduction for the royalty payments was disallowed on the ground that an independent Swedish company would not have accepted the arrangement in its totality. The size of the royalty, however, was not called into question. The Supreme Administrative Court decided that separate arm's length tests should be applied to the transfer of the ownership and to the licence agreement. Since the tax authorities had not questioned the royalty payments, the tax authorities' decision was nullified. The US case law on round-trip transactions would also seem to reject the minority view. In *Eli Lilly & Co. v. Commissioner*, for example, the IRS argued that a transfer of the legal title to "crown jewel" intangibles from a US parent company to a Puerto Rican subsidiary should be disregarded for purposes of Sec. 482. The Tax Court rejected this argument:[203]

> We find that both the form and substance of petitioner's transfer of assets to Lilly P.R. comported with economic reality .... Respondent's case actually is based upon his belief that because petitioner could have retained the ownership of the patents and know-how and realized all the income attributable thereto, petitioner's transfer of the ownership of the patents and know-how can be ignored for income tax purposes. That argument was rejected by this Court 40 years ago.

Example B involves the transfer of valuable brand names to a shell company for a lump-sum payment.[204] From the facts in the example, it is not possible to identify any reliable evidence of comparable uncontrolled transactions. The shell company is managed by a trust company and does not have employees with the authority to control the risks associated with the brand strategy; the shell company does not have the financial and economic capability to bear these risks; all strategic decisions of the shell company are formally taken by high-ranking officials of the parent company once a year at a meeting in the country of the shell company; and the development, maintenance and execution of the marketing strategy continue to be performed by the employees of the parent company. Most of the OECD countries are of the opinion that, in this case, the transfer of the intangibles should be totally disregarded for tax purposes. If the majority view accorded with the arm's length principle in the US Sec. 482 regulations, the US temporary cost-sharing regulations would be superfluous in many cases because the inclusion of a foreign "cash box" company in a cost-sharing arrangement could simply be disregarded for transfer pricing purposes.[205] Hence, the IRS must presumably be of the opinion that "cash box" companies cannot be disregarded on the basis of economic substance considerations. Moreover, the majority view is not consistent with the Danish *Dandy* case,[206] which concerned a group of companies that was in the business of manufacturing and selling chewing gum. The Danish shareholder of the group and two of the Danish group companies transferred the contractual rights under the licence agreements with independent licensees to an affiliated Swiss company. The Swiss company did not have any offices or employees, and the rights under the licence were administered by one of the Danish companies on a service basis. In addition, the licensees

198. The dual-perspective requirement is acknowledged in Para. 61 of the Discussion Draft. See Warner and McCawley, supra note 168, at A-90.
199. *OECD Task Force Report on Intercompany Transfer Pricing Regulations under Section 482 temporary and proposed regulations*, supra note 147, Paras. 3.14-3.16.
200. German Federal Tax Court decision of 23 June 1993, I R 72/92 (*BStBl* II 1993, 801).
201. 2008 Discussion Draft, Paras. 214-216.
202. *Regeringsrättens årsbok* 1979 1:98 (*Findus*).
203. *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996 (1985); 856 F.2d 855 (7th Cir. 1988). This part of the Tax Court's decision was affirmed by the Court of Appeals.
204. 2008 Discussion Draft, Paras. 217-219.
205. The IRS has described a typical cost-sharing arrangement (CSA) as follows: "The typical initial buy-in fact pattern involves an established U.S. group with significant self-developed intangibles. The U.S. group has a R&D capability consisting of fixed assets, an experienced workforce, and a record of successful products or technologies. The U.S. group and its CFC enter into a CSA to further develop the U.S. group's platform intangibles .... In such cases, the CFC's assets at the outset of cost sharing consist of only the cash required to pay the CSA buy-in and to fund its proportional share of the intangible development costs under the CSA." See *Coordinated Issue Paper, Section 482 CSA Buy-In Adjustments*, LMSB-04-0907-62 (27 September 2007), Sec. II.A.
206. *Tidsskrift for Skatteret* 1989, 650. See Winther-Sørensen, supra note 41, at 459 et seq.; and Dam, supra note 151, at 412 et seq.

had accepted the transfer of the rights for a guarantee from one of the Danish companies. The National Tax Tribunal recognized that the Swiss company was the owner of the rights under the licence and that the royalties should be attributed to the Swiss company.[207]

The facts in Example C[208] are the same as in Example B except that employees of the parent company are actually transferred to the subsidiary to carry out the development, maintenance and execution of the marketing strategy, and the employees have the authority to perform, and actually perform, the control functions in relation to the risks associated with the strategic development of the brand names. The main reason for the restructuring is to benefit from a favourable tax regime. The vast majority of the OECD countries concurs that the transaction should be recognized for tax purposes. The fact that the intangibles are transferred for a lump-sum payment does not mean that an adjustment of the payment form should be made.

7. Conclusion

This article has addressed the scope of Art. 9(1) of the OECD Model with special emphasis on transactional adjustments. It concludes that Art. 9(1) is concerned only with genuine transfer pricing adjustments and that transactional adjustments are outside the scope of the provision. One of the distinctive features of the arm's length principle is that the actual transaction undertaken should be recognized for tax purposes. The recognition should encompass the controlled transaction as such, its form, all of its conditions other than the price, and the circumstances of the transaction. In addition, the object qualification for purposes of Art. 9(1) should be based on domestic tax law.

Art. 9(1) is under tax policy pressure from the tax authorities to supplement the traditional narrow arm's length principle with a broader arm's length principle as well as a substance-over-form principle. The departure from the arm's length principle may be explained by issues associated with the application of the arm's length principle, such as the absence of comparables, information asymmetry, economies of integration, etc. The OECD countries may consider that the arm's length principle is not sufficiently robust to properly safeguard against income shifting in a globalized economy. The first step was taken in 1992 when Para. 4 was added to the Commentary on Art. 9(1) stating that thin capitalization issues are within the scope of Art. 9(1). The second step was taken in 1995 when Para. 1.37 of the OECD Transfer Pricing Guidelines legitimized transactional adjustments based on substance-over-form considerations and a CWI standard. The third step is found in the 2008 Discussion Draft on business restructurings which takes transactional adjustments a step further in the direction of – and in certain respects beyond – the US Sec. 482 regulations. The most troublesome novelty is the attempt to impose the AOA, which was developed for purposes of the risk allocation between a head office and a PE in an Art. 7(2) context, on associated enterprises and in an Art. 9(1) context. Other issues in the Discussion Draft include the inconclusive discussion of realistic alternatives; the view that, in certain cases, short-term contracts may be disregarded and replaced by imputed long-term contracts; and the position that Art. 9(1) authorizes adjustments of both prices and other conditions. The new shades of transactional adjustments, per definition, mean that the actual transaction is disregarded; for this reason, they are contrary to the arm's length principle in Art. 9(1) and the requirement that the object qualification be made under domestic tax law.

This development must be ascribed to the US Sec. 482 regulations that authorize transactional adjustments, the influence of the US government on the work of the OECD, the endeavour of the OECD to maintain an international consensus regarding the meaning of the arm's length principle, and a desire of the OECD countries' tax authorities to broaden the scope of Art. 9(1). The shift away from Art. 9(1) may potentially also be explained by an ignorance of the basic differences in the legal basis of the arm's length principle in Art. 9(1) of the OECD Model and IRC Sec. 482. A distinctive feature of IRC Sec. 482 is the vague description of the allocation norm, as a result of which the provision has been described as "a goulash of imprecise concepts".[209] This leaves considerable authority for the IRS to interpret IRC Sec. 482 and gives the Sec. 482 regulations a quasi-legislative nature.[210] Thus, the Sec. 482 regulations need not comply with a narrow arm's length principle such as that found in Art. 9(1) of the OECD Model. The arm's length principle in the Sec. 482 regulations has been incisively described as follows: "when I use the words 'arm's length', it means just what I choose it to mean – neither more nor less."[211] The OECD Committee on Fiscal Affairs, on the other hand, is bound by the arm's length principle in Art. 9(1); thus, the Commentary, including the OECD Guidelines, should be consistent with Art. 9(1). The authority of the OECD Committee on Fiscal Affairs is considerably more limited than that of the IRS.

The attempt to supplement the traditional arm's length principle with a broader arm's length principle and a substance-over-form principle is in line with the general trend of the OECD and the OECD countries to shift the focus in the international tax arena from the prevention of double taxation to the prevention of tax avoidance.[212] The OECD Model and Commentary are increasingly

207. The transfer of the intangibles was not addressed in the Supreme Court's final decision in the case.
208. 2008 Discussion Draft, Paras. 220-221.
209. Bittker, B. and J. Eustice, *Federal Income Taxation of Corporations and Shareholders* (New York, loose-leaf), Para. 13.20[1][b].
210. Warner and McCawley, supra note 168, at A-1.
211. Schrotenboer, Ronald B., "Arm's Length in Wonderland", 102 *Tax Notes* 265 (2004). This statement was recently echoed by Edward Kleinbard, Chief of Staff of the Joint Committee on Taxation: "We can simply interpret arm's length to mean what we think it should mean, and if we say it correctly, that's what it means"; quoted in Sheppard, Lee A., "Reflections on the Death of Transfer Pricing", 51 *Tax Notes International* 970 (2008), at 971.
212. Martín Jiménez, in *Bulletin for International Fiscal Documentation* (2004), supra note 110.

used as an instrument to justify domestic anti-avoidance rules. The OECD may be criticized for seeking to accomplish a fundamental reform of the arm's length principle by changing the Commentary and the OECD Guidelines without amending the wording of Art. 9(1). This is bound to cause considerable uncertainty regarding the meaning of Art. 9(1), the domestic transfer pricing provisions relying on Art. 9(1), and Art. 4(1) of the EU Arbitration Convention.[213] Since there is case law rejecting transactional adjustments based on transfer pricing provisions, the departure from the arm's length principle in Art. 9(1) is likely to be litigated. Recent cases such as the Australian *Roche* case[214] and the Canadian *Glaxosmithkline* case[215] suggest that the courts undertake a critical review of the OECD Guidelines and that non-US courts are not inclined to accept the US approach to transfer pricing adopted by the OECD Guidelines. Moreover, the position that Art. 9(1) and domestic transfer pricing provisions relying on the arm's length principle in Art. 9(1) already include a substance-over-form principle is not recognized in the heated debate on the adoption of a general anti-avoidance rule in many countries and will probably be new to many tax professionals outside the transfer pricing area.

A less far-reaching but perhaps more appropriate response would be for the OECD to adopt new transfer pricing rules within the framework of Art. 9(1). In fact, the new German rules on business restructurings and the US cost-sharing rules seem to rely more on the traditional transfer pricing approach than the substance-over-form approach in the 2008 Discussion Draft. It is striking, for instance, that the OECD Guidelines do not contain rules on the income method, which is the most commonly applied valuation method for intangibles. The income method is now addressed in the domestic tax laws of the United States and Germany. The OECD should also consider expanding the Commentary on Art. 9 to clarify and elaborate on the distinct features of the arm's length principle, the terms used in Art. 9, and the relationship between Art. 9 and other treaty articles as well as domestic tax law. It is noteworthy that the Commentary on Art. 9 is one of shortest Commentaries on the articles of the OECD Model. The time has come to get the fundamentals of the arm's length principle right in the Commentary on Art. 9 and expel the transactional ghost of Art. 9(1).

213. The EU Arbitration Convention was concluded in 1990, i.e. before the 1992 Commentary and the 1995 OECD Transfer Pricing Guidelines. The arm's length principle in Art. 4(1) of the Convention is phrased like Art. 9(1) of the OECD Model. The arm's length principle in Art. 4(1) should be interpreted on the basis of the tax treaty between the states concerned; see Art. 3(2) of the Convention.
214. *Roche Products Pty. Ltd. v. Commissioner*, Administrative Appeals Tribunal 639 (2008).
215. *Glaxosmithkline Inc. v. The Queen*, 2008 TCC 324 (2008).