tax notes international

Volume 68, Number 1 ■ October 1, 2012



# Transfer Pricing Timing Issues Revisited

by Jens Wittendorff

Reprinted from *Tax Notes Int'l*, October 1, 2012, p. 87

# Transfer Pricing Timing Issues Revisited

by Jens Wittendorff

Jens Wittendorff is an international tax partner with Deloitte Copenhagen and an honorary professor with the Department of Business Law of Aarhus School of Business and Social Sciences, Aarhus University, Denmark.



The OECD addresses timing issues concerning transfer pricing in a draft of June 6, 2012.[1] Some of the same issues were considered in 2006,[2] and the results were incorporated into the OECD guidelines in 2010.[3] Reconsideration of the timing issues has been prompted by the OECD's intangibles project, which, among other things, promotes income-based methods at the expense of traditional methods in another draft also published on June 6, 2012.[4] However, the draft on timing issues points out that some countries are less willing to accept income-based methods if the guidelines take a restrictive view of the information that may be used to test the reasonableness of the projections or of the ability of tax administrations to impute renegotiation clauses or other risk-sharing mechanisms to address the uncertainty of the valuation. In this way the two projects interact with each other. The deadline for submission of public comments lapsed on September 14, but both projects will be discussed at an OECD conference November 12-14.

[1]Draft on Timing Issues Relating to Transfer Pricing, OECD, June 6, 2012.

[2]Multiple Year Data, *Comparability*: *Public Invitation to Comment on a Series of Draft Issues Notes*, OECD, 2006. *See* http://www.oecd.org/tax/transferpricing/36651642.pdf.

[3]Paras. 3.67-3.79 of the OECD guidelines.

[4]''Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD transfer pricing guidelines and Related Provisions, 6 June to 14 September 2012,'' OECD, June 6, 2012. *See* Jens Wittendorff, '''Shadowlands': The OECD on Intangibles,'' *Tax Notes Int'l*, Sept. 3, 2012, p. 935, *Doc 2012-16522*, or *2012 WTD 171-15*.

The specific issues addressed by the new draft on timing issues include:

- timing of the arm's-length test;
- timing of data; and
- taxpayer-initiated adjustments (year-end adjustments).

## I. Timing of Arm's-Length Test

### A. Empirical Test

An arm's-length test is often based on empirical evidence of third-party pricing or profitability. This is the preferred approach of the United States[5] and the OECD.[6] An empirical arm's-length test may be made at the time of the controlled transaction (price-setting approach or at a later stage such as at the time of the tax return filing (outcome testing approach). The price-setting approach has traditionally been favored in Germany,[7] whereas outcome testing is relied upon in the United States.[8]

The key differences between the two approaches concern whether data on the controlled taxpayer are based on budget or actual numbers and whether data

[5]Treas. reg. section 1.482-1(c)(2).

[6]Paras. 1.13, 1.33-1.37, and 2.3 of the OECD guidelines.

[7]*See, e.g.*, Federal Fiscal Court's decision of Feb. 17, 1993, I R 3/92 (BStBl II 1993, 457).

[8]Treas. reg. section 1.482-1(b)(1).

**Table 1. Price-Setting vs. Outcome Testing Approach**

| Party | Nature of Data | | Timing of Data | | Timing of Test | | Pricing and Test | |
|---|---|---|---|---|---|---|---|---|
| | Price-Setting | Outcome Testing | Price-Setting | Outcome Testing | Price-Setting | Outcome Testing | Price-Setting | Outcome Testing |
| Controlled taxpayer | Budget | Actual | NA | Contempo-raneous | Controlled transaction | Tax return | Integrated process | Separate processes |
| Comparables | Actual | Actual | Historic | Contempo-raneous | | | | |

on the comparables are historic or contemporaneous.[9] Since the price-setting approach makes use of both third-party evidence and internal budgets, it may be characterized as a hybrid between an empirical and hypothetical arm's-length test. A practical difference is that the determination of transfer prices and the arm's-length test thereof is an integrated process under the price-setting approach and are separate processes under outcome testing. The two approaches are compared in Table 1.

The arm's-length principle does not govern the choice between the two approaches, and the OECD guidelines do not express a preference.[10] The arm's-length principle is thus concerned with the allocation of business profits between associated enterprises rather than pricing methods or processes. However, just as the choice of transfer pricing method is governed by a best method rule,[11] the choice between the price-setting and outcome testing approaches must also be made on the facts of each case. Tax authorities are not bound by the approach applied by a taxpayer. If the facts of a case demonstrate that outcome testing will produce a more reliable arm's-length result vis-à-vis a price-setting approach applied by the taxpayer, the arm's-length principle of article 9(1) will not prevent the tax authorities from relying on outcome testing. Ultimately, a dispute over the most reliable approach must be settled by the courts or the competent authorities under a mutual agreement procedure.

In contrast with this view, paragraph 2.128 of the OECD guidelines provides the following statement regarding the profit-split method:

> When a tax administration examines the application of the method used *ex ante* to evaluate whether the method has reliably approximated arm's length transfer pricing, it is critical for the tax administration to acknowledge that the taxpayer could not have known what the actual profit experience of the business activity would be at the time that the conditions of the controlled transaction were established. Without such an acknowledgement, the application of the transactional profit split method could penalize or reward a taxpayer by focusing on circumstances that the taxpayer could not reasonably have foreseen. *Such an application would be contrary to the arm's length principle, because independent enterprises in similar circumstances could only have relied upon projections and could not have known the actual profit experience*. See also paragraph 3.74. [Emphasis added.]

Here the OECD seems to suggest that it would be contrary to the arm's-length principle for the tax authorities not to accept a price-setting approach applied by a taxpayer. If this is a correct reading of the guidelines, the position of the OECD must be rejected because it mixes up the issues of use of hindsight and the choice of the most reliable arm's-length approach. Hindsight in transfer pricing is thus a relative concept that depends on whether an empirical or hypothetical arm's-length test is made. (See sections II.A and II.B.1 of this article.)

The draft on timing issues does not change the OECD's neutral position regarding the choice between the two approaches. However, the public is invited to provide comments on practical issues associated with the application of the approaches.

A key problem with the application of the price-setting approach is that it may cause the profits of the tested taxpayer to vary considerably from year to year. That variation may arise because transfer prices are determined on the basis of budget numbers for the taxpayer. For example, the budget of a controlled distributor may be based on an expected turnover of 1,000 (sale of 100 items at a price of 10 per item), and sales, general, and administrative costs (SG&A) of 300. A benchmark study indicates that comparable uncontrolled distributors earn an operating margin (OM) of 5 percent. On this basis, transfer prices for goods purchased from an affiliated manufacturer are fixed at 650 because this will leave the distributor with expected

[9]Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Kluwer Law International, 2010), p. 388 et seq.

[10]Para. 3.71 of the OECD guidelines.

[11]Para. 2.2 of the OECD guidelines.

profits of 50 equal to an OM of 5 percent. If the actual sale price turns out to be only 8 per item, and the actual SG&A turns out to be 350, the actual result of the distributor will, all else being equal, be a loss of 200 instead of a profit of 50. The example is presented in Table 2.

**Table 2. Budget vs. Actual Profit Under Price-Setting Approach**

| | Budget | Actual |
|---|---|---|
| Turnover | 1,000 | 800 |
| COGS | (650) | (650) |
| Gross profit | 350 | 150 |
| SG&A | (300) | (350) |
| Operating profit/(loss) | 50 | (200) |

The budget component may easily become a separate tax audit issue. Hence, if a taxpayer reports losses for several years, the tax authorities may question whether the losses are because of market conditions or unreliable budgets. In the example, it could be questioned whether the transfer prices should have been 410 since that would have left the distributor with profits of 40 equal to an OM of 5 percent. An application of the price-setting approach is thus vulnerable to tax authority scrutiny even though a taxpayer has taken every possible step to comply with the arm's-length principle. To mitigate this problem it may be necessary to closely monitor the financial results throughout the year with a view to adjusting transfer prices if the actual deviates from the budget. Other issues caused by the budget component are discussed below. (See Section II.B of this article.) Another problem with the price-setting approach is that data on the comparables are historic rather than contemporaneous. However, in practice the use of multiple-year analysis under the comparable profit method and the transactional net margin method (TNMM) will often mitigate this issue.

A key problem with the application of the outcome testing approach is that it must provide taxpayers with the right to make year-end adjustments. However, the tax laws of most countries do not directly address year-end adjustments, which causes uncertainty and risk of double taxation. (See Section III of this article.) Sometimes prospective price adjustments are made during the year in order to avoid year-end adjustments. Another problem is that tax authorities may argue that settlement of year-end adjustments should include an interest component. Year-end adjustments may cause separate issues regarding customs and VAT because retroactive price adjustments are not always possible in those areas or subject to strict deadlines.

### B. Hypothetical Test

An arm's-length test may also be based on the hypothetical prices (or profits) to which it is assumed that independent parties would agree on transactions that have not actually taken place. Germany has a tradition of the application of hypothetical arm's-length tests, and this approach was codified in 2007.[12] An income-based method is an example of a hypothetical test because it does not rely on third-party evidence. A hypothetical test is a variant of the price-setting approach because transfer prices are determined at the time of the controlled transaction. The lack of comparable uncontrolled transactions, especially regarding intangibles, mean that hypothetical arm's-length tests are gaining importance, as evidenced by the 2012 OECD discussion draft on intangibles[13] and the investor model and income method introduced by the U.S. cost-sharing regulations.[14]

## II. Timing of Data

### A. Empirical Test

An empirical arm's-length test must ideally be based on third-party transactions undertaken or carried out during the same period of time as the controlled transaction (''contemporaneous transactions'').[15] In this context the ban on the use of hindsight[16] in transfer pricing means that no regard can be made of third-party transactions undertaken after the time of the controlled transaction, that is, *ex ante* valuation must be made. The application of contemporaneous transactions thus does not constitute hindsight even though the information was not available to the taxpayer at the time of the controlled transaction. For example, an application of the outcome testing approach based on the CPM/TNMM does not constitute use of hindsight even though the taxpayer does not have information on the profits of the comparables at the time of the controlled transactions. This ''unfairness'' is the exact reason why taxpayers should be entitled to make year-end adjustments. (See sections I.A and III.)

### B. Hypothetical Test

*1. Timing of Data*

A hypothetical arm's-length test, and the budget component of the price-setting approach, must be

[12]Section 1(3), fifth sentence, of the German Foreign Tax Act. See Wittendorff, *supra* note 9, at 309.

[13]Wittendorff, *supra* note 4.

[14]Treas. reg. section 1.482-7(g)(2)(ii)(A) and 1.482-7(g)(4).

[15]Paras. 1.12 and 3.68 of the OECD guidelines. See also para. 29 on timing issues in comparability, *supra* note 2.

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

based on information that was reasonably available to the taxpayer at the time of the controlled transaction (''contemporaneous information''), that is, *ex ante* valuation.[17] The *ex ante* requirement is a key principle of the investor model underlying the U.S. cost-sharing regulations.[18] The 2012 OECD draft emphasizes that taxpayers should also be looking forward under the price-setting approach:[19]

> Pricing determination should be based on information that was known or *reasonably foreseeable* by the associated enterprises at the time the transaction was entered into. [Emphasis added.]

The draft elaborates on the ''reasonably foreseeable'' element as follows:[20]

> Such information includes not only information on comparable transactions from previous years, but also information on economic and market changes likely to occur after the time the transaction was undertaken, that could have reasonably been anticipated at the time the transaction was undertaken and that would have affected the pricing that would have been agreed between independent enterprises in similar circumstances.

In the context of a hypothetical test, hindsight means information that was not available to the taxpayer at the time of the controlled transaction. The definition of hindsight thus slightly differs depending on whether an empirical or hypothetical arm's-length test is made. Arguably the tax authorities may bypass the *ex ante* requirement by applying the outcome testing approach since this will allow the use of information on contemporaneous transactions that was not available to the taxpayer at the time of the controlled transaction. However, this will require that the tax authorities have access to empirical evidence of arm's-length prices or profits.

*2. Subjective vs. Objective Standard*

A problem concerning hypothetical arm's-length tests, and the budget component of the price-setting approach, is whether the data should be those that are actually available to the taxpayer in question or those assumed to be generally available in the industry.

This problem was addressed by proposed U.S. regulations issued in 1992 that would introduce a ''sound business judgment'' standard:[21]

> In determining whether controlled taxpayers have dealt with each other at arm's length, the general principle to follow is whether uncontrolled taxpayers, each exercising sound business judgment on the basis of reasonable levels of experience (or, if greater, the actual experience of the controlled taxpayer) within the relevant industry and with full knowledge of the relevant facts.

This was an objective standard as it turned on the general level of experience and knowledge in the relevant industry rather than the taxpayer's actual experience and knowledge.

The OECD opined against the ''sound business judgment'' standard because it was held to be far too strict and postulated a level of knowledge that would often not exist in the real world.[22] The OECD recommended that the standard was refined to include:

> only the facts which were known to the taxpayer (for example a trade secret) and also any other facts which were in existence at the time and which could reasonably be expected to be known by the taxpayer, even if he maintains to the contrary.

The OECD thus argued for a subjective standard based on the facts known or reasonably known by the taxpayer in question.

The ''sound business judgment'' standard was not included in the final regulations from 1994. By contrast, the final regulations provide that the comparability test must consider the actual business experience of the taxpayer.[23] Moreover, in 2006 a ''business judgment'' rule was adopted under which a service cannot be covered by the services cost method unless:[24]

> in their business judgment, the taxpayer reasonably concludes that the service does not contribute significantly to key competitive advantages, core capabilities, or the fundamental risks of success or failure in one or more trades or businesses of the controlled group.

This is a business judgment that is preeminently within the taxpayer's own expertise and knowledge.[25]

In Germany, transfer prices are evaluated through the concept of a ''sound and prudent business manager.''[26] This is an objective standard, so that in principle the subjective factors are not ascribed any importance. However, management's experience, knowledge,

[17]Para. 3.69 of the OECD guidelines.

[18]Treas. reg. section 1.482-7(g)(2)(ii)(A).

[19]Para. 3.69 of the OECD draft.

[20]*Id*.

[21]Prop. reg. section 1.482-1(b)(1), INTL-372-88, and INTL-401-88 (IRB 1992-8).

[22]Paras. 3.59-3.62 of Tax Aspects of Transfer Pricing within Multinational Enterprises: The United States Proposed Regulations, OECD, 1993.

[23]Treas. reg. section 1.482-5(c)(2)(iii), according to which the comparability analysis under the CPM should take account of differences in management efficiency.

[24]Treas. reg. section 1.482-9(b)(5).

[25]Preamble, ''Explanation of Provisions, 1. Services Cost Method,'' TD 9278 (IRB 2006-34); and section 3.04(3) of Notice 2007-5 (IRB 2007-3).

[26]Federal Fiscal Court's decision of Mar. 16, 1967, I R 261/63 (BStBl III 1967, 626).

and so forth can be included in assessing causality between a departure from the standard and the community of interest.[27] In 2007 this standard was codified together with a new transparency clause (unofficial translation):[28]

> For the application of the arm's length principle, it is to be assumed that unrelated parties are aware of all the essential circumstances of the business transaction and act on the principles of a sound and prudent business manager.

The transparency clause is also an objective standard that resembles the ''sound business judgment'' standard. This provision has been criticized for conflicting with the arm's-length principle.[29]

The OECD guidelines state that the relevant information is that which was reasonably available to the *taxpayers*.[30] This is confirmed by the amendment proposed by the 2012 draft, which refers to the information reasonably foreseeable by the *associated enterprises*.[31] Hence, the OECD guidelines are premised on a subjective standard.

*3. Group Information Symmetry vs. Asymmetry*

Another problem is whether associated enterprises should be assumed to have access to the same information, that is, information symmetry. The transparency clause of the German Foreign Tax Act requires total transparency, in which both parties are assumed to be aware of their own and the other party's circumstances.[32] This provision is thus based on an assumption of information symmetry between associated enterprises. The provision has been criticized because it does not reflect market conditions where information asymmetry reigns.[33] However, since economies of integration must generally be recognized under the arm's-length principle, the application of an assumption of group information symmetry can hardly be criticized.[34] Neither the OECD guidelines nor the draft on timing issues address this issue.

## C. Commensurate With Income Standard

An *ex ante* valuation may, in particular, be problematic for tax authorities because of information asymmetry vis-à-vis taxpayers. For example, if the actual profits attributable to an intangible exceed the profit expectation that influenced the valuation of the intangible, this may give rise to doubts on the part of tax authorities about whether the discrepancy was caused by unforeseen circumstances or by an abuse of the information asymmetry. This problem is relevant for both empirical and hypothetical arm's-length tests.

In 1986 the United States added a commensurate with income (CWI) standard to IRC section 482,[35] and in 1994 this standard was implemented through rules on periodic adjustment.[36] The purpose of the CWI standard was to address information asymmetry.

In 1993 the OECD strongly objected to the proposed rules on periodic adjustments because they were considered to fundamentally contravene the arm's-length principle.[37] It would seem almost impossible for the OECD to accept a CWI standard while conforming to the *ex ante* requirement. However, the OECD claims to have cut the Gordian knot by arguing that an *ex ante* adjustment is made to the form of payment, and that the adjusted form of payment is simply applied to the facts of the case. The OECD is thus authorizing an *ex ante* adjustment of the payment form for an intangible in situations in which valuation is highly uncertain.[38] Under this approach a fixed-price clause may be replaced by a price adjustment clause if that clause would have been agreed between independent parties. The OECD guidelines do not refer to a CWI standard (but the draft OECD guidelines directly used the U.S. concept of ''periodic adjustments'').[39] Hence, this would clearly infringe on the requirement of an *ex ante* valuation under the arm's-length principle. This was confirmed in court cases decided upon the 1968 U.S. regulations.[40] However, the fact remains that the arm's-length test in this situation is based on an *ex post* perspective, and on conditions that differ from those of the actual transaction, causing a recharacterization contrary to the arm's-length principle of article 9(1) of the

[27]Wittendorff, *supra* note 9, at 308.

[28]Section 1(1), second sentence, of the German Foreign Tax Act.

[29]*E.g.*, F. Wassermeyer, *Der Betrieb* (2007), p. 535; M. Greinert, in: H. Schaumburg and T. Rödder (eds.), *Unternehmenssteuerreform* 2008, (2009), p. 546; and A. Eigelshoven, in: K. Vogel and M. Lehner (eds.), *DBA Doppelbesteuerungsabkommen* (2008), Artikel 9, m.no. 23.

[30]Para. 3.69 of the OECD guidelines.

[31]Para. 3.69 of the OECD draft.

[32]Para. 3.2 of the circular on the Relocation of Functions of 13 October 2010, IV B5 — S 1341/08/10003, issued by the German tax authorities.

[33]*E.g.,* Eigelshoven, *supra* note 29; and A. Reichl, *Internationales Steuerrecht* (2009), pp. 680, 682.

[34]M. Naumann, in: J. Lüdicke (ed.), *Besteuerung von Unternehmen in Wandel* (2007), pp. 167, 175.

[35]The Tax Reform Act of 1986 (P.L. 99-514). A CWI standard was also added to IRC sections 367(d) and 936(h).

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

[37]Paras. 3.6 and 3.63-3.71, *supra* note 22; and paras. 2.5 and 2.23-2.33 of the OECD Task Force Report on Intercompany Transfer Pricing Regulations under U.S. Section 482 Temporary and Proposed Regulations, OECD, 1993.

[38]Paras. 1.65, 3.73, 6.28, 6.32, 9.87, and 9.88 of the OECD guidelines. See also paras. 171-178, *supra* note 4.

[39]Paras. 33-41 of *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations: Discussion Draft Part II (Applications)*, OECD, 1995.

[40]*R.T. French Co. v. Commissioner*, 60 T.C. 836 (1973); and *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525, 593 (1989), *aff'd,* 933 F.2d 1084 (2d Cir. 1991).

OECD model tax convention. Authority for the OECD-style CWI standard cannot be found in article 9(1).

In 1998 Canada enacted subsection 247(2)(b) of the Income Tax Act to authorize the recharacterization of transactions in accordance with the OECD guidelines.[41] The recharacterization rule supplements the traditional arm's-length rule in subsection 247(2)(a) and allows for the application of a CWI standard in Canadian tax law.[42] In 2007 Germany also introduced a CWI standard in section 1(3) of the Foreign Tax Act. By contrast, it is highly uncertain whether the domestic tax laws of other countries authorize the application of a CWI standard. For example, the U.K. comptroller and auditor general recently expressed doubt regarding the authority of the Inland Revenue to apply the recharacterization rules of the OECD guidelines.[43]

The CWI standard of the United States has been applied very rarely by the IRS in litigation.[44] This may be one of the reasons why the OECD draft contains the following statement:

> Specifically, questions arise regarding the circumstances, *if any*, involving situations of transfers of intangibles of highly uncertain valuation . . . in which tax administrations should be permitted to assume the existence of a renegotiation, price adjustment clause, milestone payment, or other risk sharing mechanism within an agreement between controlled parties which does [not] expressly contain such a mechanism. [Emphasis added.]

This statement raises doubt about whether the CWI approach of the OECD guidelines is legitimate and appropriate, and whether there is a consensus among the member countries about this approach. This may also be the reason why the draft states that some member countries would be less willing to accept income-based methods if the OECD guidelines take a restrictive view of the ability of tax authorities to impute renegotiation clauses or other risk-sharing mechanisms to address uncertainty of the valuation.

The OECD sought to abandon the CWI approach because it is not authorized by article 9(1) and because the approach's effectiveness is limited. One of the problems with CWI standards is that it may be impossible to identify and measure the return on an intangible reliably in the years following a controlled transaction in which it is transferred. In the meantime, the intangible might have been enhanced, been subdivided into multiple rights, been sold in whole or in part, and so forth. Further, the transferee will normally use the transferred intangible together with other production factors, and this will necessitate a segmentation of the total return, which will often be an arbitrary exercise. From a tax policy perspective it is also unacceptable that multinational enterprises are precluded from adopting a simple fixed-price transfer of ownership of intangibles. In essence, a CWI standard thus imposes a joint venture arrangement between the seller and buyer in which the intangible profits must be shared between the parties for a long period of time. A CWI standard can thus have the same effect as a proposal voiced by some OECD member countries in 1975 that an internal sale of an intangible should simply be disregarded for transfer pricing purposes.[45]

Information asymmetry between taxpayers and tax authorities can instead be addressed by other means. For example, it is surprising that the OECD discussion draft on intangibles does not introduce specific documentation requirements regarding the transfer of intangibles. Existing documentation rules are thus designed to address the transfer of goods and services. It would be appropriate to establish special documentation rules regarding the input parameters and other particular issues associated with the application of income-based methods. Special burden-of-proof rules may also be introduced on a domestic level regarding the transfer of intangibles.[46] Furthermore, CFC taxation may efficiently address unacceptable tax planning.

## III. Taxpayer-Initiated Adjustments

The application of domestic transfer pricing rules is normally the prerogative of the tax authorities. For example, this is the situation in the United States,[47] Germany,[48] and Denmark.[49] At the same time, noncompliance with the arm's-length principle is often sanctioned by harsh penalties. From a taxpayer perspective, this cocktail is far from satisfactory if it prevents taxpayers from adjusting the prices of controlled transactions that

---

[41]N. Boidman, in: *IBFD Transfer Pricing Database*, Canada, para. 2.1.2.5.3.

[42]Paras. 150-151 of the Income Tax Information Circular No. 87-2R (Canada Revenue Agency, Sept. 27, 1999).

[43]''Settling large tax disputes,'' Report by the Comptroller and Auditor General, HC 188, session 2012-13, June 14, 2012, National Audit Office.

[44]Joseph L. Andrus, ''Transfer pricing and intangibles,'' *Cahiers de droit fiscal international*, Vol. 92a (2007), pp. 629, 647. Reportedly, the IRS has used the CWI standard in at least one case, according to an IRS spokesman. *See* 19 *Tax Management Transfer Pricing Report* (Dec. 10, 2010), p. 883.

[45]Draft Report on Tax Avoidance through the Improper Use and Abuse of Tax Conventions, May 21, 1975, CFA/WP1(75)3, p. 23.

[46]Wittendorff, ''Valuation of Intangibles under Income-Based Methods — Part II,'' 17 *International Transfer Pricing Journal* 6 (2010), pp. 383, 397.

[47]Treas. reg. section 1.482-1(a)(3).

[48]Para. 3.4.12.8 of the German 2005 transfer pricing circular, IV B 4 — S 1341 — 1/05.

[49]TfS 2010.664 (SKM 2010.455.VLR).

are found to contradict the arm's-length principle before the tax return for the year in question is filed. This is a problem especially concerning the outcome testing approach. (See Section I.A of this article.)[50]

To address this unfairness, the U.S. regulations provide:[51]

> If necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed U.S. tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged.

Accordingly, if transfer prices differ from arm's-length prices, U.S. taxpayers may themselves make an upward or downward price adjustment in a duly filed tax return in order to get the transfer prices right.[52] In a tax return that is not filed in due time, taxpayers are solely entitled to report an upward price adjustment.[53]

The right of taxpayers to make year-end adjustments is a formal issue that is not addressed by the arm's-length principle. Surprisingly, the United States is one of the very few countries that have adopted specific rules on year-end adjustments.[54] For example, a recent survey shows that only one EU member state (Bulgaria) has specific legislation dealing with year-end adjustments.[55] However, year-end adjustments are accepted on an administrative level by most EU member states. This informal and uncoordinated European approach suffers from the following defects:

- uncertainty regarding the conditions and consequences of year-end adjustments;
- lack of international consensus; and
- uncertainty regarding the authority for the administrative practice.

The case of Denmark demonstrates that the administrative approach does not provide taxpayers with sufficient certainty and protection against double taxation. The 2006 transfer pricing guidelines of the Danish tax authorities state that taxpayers are entitled to make year-end adjustments if it is done before the tax return for the income year in question is filed, and that the adjusted transfer prices are on an arm's-length basis.[56] However, when transfer pricing cases are presented before the courts, the message to taxpayers is that retroactive agreements, including price adjustments, are generally not valid for Danish tax purposes unless a legal basis exists that links the price adjustment with the original transaction. That instrument may be a written contract calling for a price adjustment in specific situations. Two recent cases demonstrate the uncertainty associated with year-end adjustments in Denmark.

In *Swiss Re* it was undisputed that a loan transaction between a U.S. parent company and its Danish subsidiary was made on June 30, 1999, and that compensation was not agreed to in writing before October 15, 1999.[57] The issue concerned the moment in time at which an agreement requiring the subsidiary to compensate its parent company for the loan was made. According to the Supreme Court, the evidence of the case did not support the taxpayer's contention that a final, binding agreement was made before October 15. The agreement concluded on October 15 was thus held not to be effective for the period June 30 to October 19.

In *ACC Invest* controlled taxpayers reached an agreement on January 2, 2002, to reduce transfer prices paid in 2001 because they exceeded arm's-length prices.[58] A similar agreement was reached on January 29, 2003, regarding transfer prices paid in 2002. It was undisputed that the adjusted transfer prices corresponded to arm's-length prices. The court held that a waiver giving up the right to income does not have effect for tax purposes, even though the adjusted transfer prices were on an arm's-length basis. At the time of the price adjustment in 2002, the parties also agreed in writing that future transfer prices should be of a preliminary nature and that year-end adjustments should be made to ensure compliance with the arm's-length principle. The agreement stated that year-end adjustments should be made in view of ''the competitive situation and other market conditions.'' In spite of this agreement, the court decided that a year-end adjustment made in 2003 should not be accepted because the wording of the agreement was considered too imprecise.

Based on the court cases, the 2006 administrative guidelines do not represent current Danish law. Taxpayers should thus be careful not to rely on them too

[50]Several aspects of the provision are considered to be unclear by H. David Rosenbloom, ''Self-Initiated Transfer Pricing Adjustments,'' *Tax Notes Int'l*, June 4, 2007, p. 1019, *Doc 2007-12382*, or *2007 WTD 111-6*. The U.S. Court of Federal Claims in *Intersport Fashions West Inc. v. United States*, Fed. Cir. No. 2012-5080, refused a taxpayer's refund claim based on a self-initiated adjustment made after the due date for a duly filed tax return. *See* K. Chung, C. Hustad, and A. Shapiro, ''Intersport Fashions: U.S. Claims Court Limits Taxpayer's Ability to Make Post-Return Adjustments,'' 21 *Tax Management Transfer Pricing Report* (May 3, 2012), p. 55.

[51]Treas. reg. section 1.482-1(a)(3). *See* para. 4.38 of the OECD guidelines.

[52]A taxpayer's use of IRC section 482 should comply with IRC section 1059A, which provides that the tax value of imported goods may not exceed the customs value.

[53]Rev. Proc. 99-32, 1999-2 C.B. 296.

[54]Para. 4.39 of the OECD guidelines.

[55]Member states' responses to questionnaire on compensating adjustments/year end adjustments, Meeting of 26 October 2011, Doc: JTPF/019/REV1/2011/EN.

[56]Para. 5.4.1 of *Transfer pricing; Kontrollerede transaktioner; Dokumentationspligt*, Feb. 6, 2006.

[57]TfS 2012.151 (SKM 2012.92.HR). *See* Wittendorff, ''Darkness Descends on Danish Tax Law: Supreme Court Decision in *Swiss Re*,'' 19 *International Transfer Pricing Journal* 3 (2012), p. 217.

[58]TfS 2010.664 (SKM 2010.455.VLR).

heavily because the tax authorities may adopt a litigation position that differs from the administrative guidelines.

The uncertain state of law in Denmark regarding year-end adjustments may also be present in other countries that lack specific legislation in this field.

The OECD guidelines primarily address the issue by a statement that competent authorities are encouraged to use their best efforts to resolve double taxation issues that arise from different country approaches to year-end adjustments.[59] As there is a need for international harmonization in this field, the OECD should consider drafting guidelines regarding year-end adjustments initiated by taxpayers. Those guidelines will normally not be effective unless adopted in domestic tax law. It is thus up to the OECD member countries to draft legislation that ensures that taxpayers are entitled to make year-end adjustments.

## IV. Conclusion

The 2012 OECD draft on timing issues addresses a number of important aspects of the arm's-length principle and the application thereof.

The neutral position regarding the choice between the application of the price-setting and outcome testing approaches is maintained. This reflects the fact that it is beyond the scope of the arm's-length principle. The choice between the two approaches must be made on the basis of the facts of each case with a view of producing the most reliable arm's-length result. For this reason the OECD should consider modifying the language of paragraph 2.128 of the guidelines since it seems to suggest that the tax authorities are bound by an election of a taxpayer to apply the price-setting approach.

The key issue of the draft concerns the timing of the data that may be applied in an arm's-length test. The OECD should elaborate more on the contemporaneous requirement and the ban on the use of hindsight. In this context a distinction should be made between empirical and hypothetical arm's-length tests. The OECD rightfully maintains that transfer pricing adjustments cannot be made on the basis of information that was not available to the taxpayer in question under a hypothetical arm's-length test. A relevant issue not addressed is whether information symmetry should be assumed to exist between affiliated companies. That assumption arguably would be consistent with the arm's-length principle. The draft also raises the very relevant question whether the OECD-style CWI standard should be maintained in order to cope with information asymmetry between taxpayers and tax authorities. Since this standard conflicts with the arm's-length principle it would be welcome if it was rejected by the OECD.

Finally, it would be appropriate for the OECD to further elaborate on year-end adjustments since this is a procedure that is applied by most multinational enterprises but is subject to specific legislation in only a few countries. The current situation thus involves great uncertainty and risk of double taxation. ◆

[59]Para. 3.71 of the OECD guidelines. *See also* paras. 4.38 and 4.39 of the OECD guidelines.