pricing is one of the key areas under review, because of four main reasons: first, the incorrect application of the arm's length principle may result in double non-taxation; second, even when income is taxed it may still be taxed in the wrong country; third, the arm's length principle as such may result in outcomes that are considered incorrect; fourth, the guidance on the application of the arm's length principle needs clarification as the interpretation of this principle may vary from one country to another, thereby creating a risk of double taxation. For all these reasons, transfer pricing is an essential element of the BEPS project.

*Introduction to Transfer Pricing* has a twofold purpose. First, it intends to provide a general introduction to the fundamentals of transfer pricing. The book does not take the perspective of a particular country or group of country, and instead focuses on the general principles that apply, albeit to various extents, in most countries.[5] Although the majority of these principles is provided by the OECD, the views of other international organisations, in particular the UN and the European Union, are also taken into account in the book. Given the breadth and the complexity of this discipline, as well as the pedagogical aim of this book, only the key principles necessary to understand transfer pricing are dealt with. Also, the connection between transfer pricing and other areas of tax law is outside the scope of this book.[6] Second, *Introduction to Transfer Pricing* intends to illustrate the fundamentals of transfer pricing by concrete examples, together with the tax planning or risk mitigating aspects that may be considered by multinational enterprises and that need to be monitored by tax administrations, in order to strengthen the pedagogical objective of this book.

The book is divided into the following chapters:

Chapter 1 The key to understanding transfer pricing: the arm's length principle.
Chapter 2 The transfer pricing methods recognised by the OECD Guidelines.
Chapter 3 Transfer pricing models.
Chapter 4 Cross-border business restructurings.
Chapter 5 The substance requirement from a transfer pricing perspective.
Chapter 6 The attribution of profits to permanent establishments.
Chapter 7 The prevention and the resolution of transfer pricing disputes.

territoriality in international tax law, by reinforcing the connection between the right to tax and the presence of a given substance in the territory of a State.

5. Although domestic laws and the wordings of various tax treaties are outside the scope of this book, references to such sources are made occasionally. The purpose of such references is to illustrate certain differences with the recommendations of the OECD or of other international organisations.
6. In particular corporate income taxation, value-added taxation and customs duties, although connected to transfer pricing, are outside the scope of this book. As an illustration of the connections between transfer pricing and customs duties, in particular their reliance on the arm's length principle, see the case *Refrescos y Envasados S.A. v. Administración General del Estado*, Supreme Court of Spain (*Tribunal Supremo*) (30 November 2009, case number 3582/2003); see also Anuschka Bakker and Belema Obuoforibo (eds), *Transfer Pricing and Customs Valuation – Two Worlds to Tax as One* (IBFD, 2009).



# CHAPTER 1
# The Key to Understanding Transfer Pricing: The Arm's Length Principle

'Transfer pricing is a "zero sum game" – a situation in which the "gain" of taxable profits by one jurisdiction must be matched by a "loss" by the other jurisdiction'.[1]

## 1.1 INTRODUCTION

When companies do business abroad they may choose to do so by cooperating with *independent enterprises*, i.e., companies with which there are no legal or economic connections. In such cases, the prices of transactions are normally determined by *market forces*, i.e., supply and demand.[2] Although the taxable income of each party to the transaction – and thus also the corporate income tax paid by each party – will be directly influenced by the prices of the transactions, from a fiscal perspective the tax administrations of the countries concerned have no strong reasons to worry about the prices of the transactions because the parties are independent from each other. Each party is assumed to be business minded and to act in its own interest by trying to maximise its profits. In contrast, when companies do business abroad through dealing with *associated enterprises*,[3] it is quite possible that no such market forces apply given

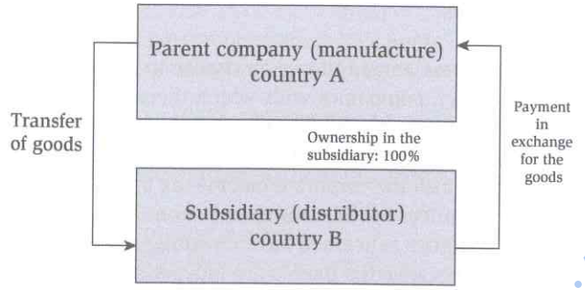
1. UN, *Practical Manual on Transfer Pricing for Developing Countries*, para. 1.7.16 (2013).
2. For a definition of market forces see the *Oxford English Dictionary* (online version): 'The economic factors affecting the price of, demand for, and availability of a commodity'.
3. The notion of associated enterprises refers to companies that belong to the same group. Whether or not enterprises are associated is often defined in a broad manner in the transfer pricing context, in order to cover both legal and economic relations between group companies. The notion of associated enterprises is defined in many countries' domestic tax laws. Domestic definitions are often inspired by Art. 9 of the OECD Model Tax Convention, which states that enterprises are associated when 'an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State' (this is typically the case when a parent company owns shares in a subsidiary), or when 'the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State' (this is typically the case when two sister companies are owned by the same parent company). The notion of 'associated

the legal or economic connections between the parties to the transaction.[4] As a result, the price of transactions between associated enterprises may deviate from what would have been agreed between independent companies because of the lack of market forces. From a fiscal perspective, the problem is that deviations from the prices that would result from market forces affect the level of taxable income of associated enterprises, and thus the amount of corporate income tax they pay in each country.

The area of tax law that is dedicated to the tax consequences of the pricing of cross-border intercompany transactions is usually referred to as *transfer pricing*, since this area of tax law is concerned by the prices of goods or services that are sold, or 'transferred', between associated enterprises. The figure below (figure 1.1) gives an example of the transfer of goods from a parent company that manufactures goods to a subsidiary of the parent company that distributes such goods.[5]

*Example: a parent company (company A) resident in country A manufactures goods. Its wholly owned subsidiary (company B) is resident in country B and purchases the goods to distribute them in country B.*

*Figure 1.1 Payment in Exchange for Goods*




enterprises' is debated in the literature; for an overview see Ramon S.J. Dwarkasing, *The Concept of Associated Enterprises*, vol. 41, issue 8/9, 412–429 (Intertax, 2013). On the definition of an 'enterprise' see Kees van Raad, *'Enterprise' and 'Enterprise of a Contracting State': Towards a Century of Confusion Regarding the Term 'Enterprise' in the Model Double Taxation Conventions*, in *The Meaning of 'Enterprise', 'Business' and 'Business Profits' under Tax Treaties and EU Tax Law*, Guglielmo Maisto (ed.), vol. 7, 61–83 (IBFD, EC and International Tax Law Series, 2011); see also Jacques Sasseville, *'Enterprise', 'Business' and 'Business Profits': From the League of Nations to the Current OECD Model Tax Convention*, in *The Meaning of 'Enterprise', 'Business' and 'Business Profits' under Tax Treaties and EU Tax Law*, Guglielmo Maisto (ed.), vol. 7, 41–58 (IBFD, EC and International Tax Law Series, 2011).

4. For example, the legal or economic connections between associated enterprises may result in a company that needs to purchase a good, not to call for tenders from potential business partners, but to purchase the good directly from a supplier that belongs to the same group without negotiating the price of the good with the intention to maximise its own profit.
5. Multinational enterprises may enter into many other types of intercompany transactions, involving e.g., research and development, financial services, or sales of assets between associated enterprises. Examples of intercompany transactions are provided at s. 3.4 of this book.





In many cases transfer pricing may not be an issue if the parent company and the subsidiary were resident in the same country, as long as tax equalisation mechanisms apply.[6] Transfer pricing may not be an issue in a cross-border context and between independent companies either, because the price of the goods would normally be determined by supply and demand, i.e., the price would be influenced by market forces. However, in the above example, the manufacturer owns 100% of the shares in the distributor, i.e., the enterprises are associated. Such an ownership indeed makes it possible for the shareholder to influence the decisions made by the subsidiary, so the price of the goods may be set at a higher or lower level than the market price, thanks to the relationship existing between the two companies.[7] In addition, company A and company B are resident in different countries. Accordingly, a deviation from the market price will have consequences for the taxes paid in countries A and B as compared to if market prices were applied, because the taxable income of each company is influenced by the transfer prices; if the goods are sold at a price that is higher than the market price, the income of the seller (company A) will be higher than if the goods are sold to a non-related party. At the same time, the income of the buyer (company B) will be lower than if the goods are purchased from a non-related seller, because the price paid will exceed the market price. Consequently, assuming that both companies are profit-making and that company A sells a good to company B over the market price,[8] country A will get more taxes than if the transaction takes place between independent parties, while country B will get less.

The impact of transfer pricing on the taxable profits (and thus on the taxes paid) in each country where a multinational enterprise enters into intercompany transactions is illustrated by the two examples below (table 1.1 and table 1.2). In both examples, a multinational enterprise has a total taxable profit of 150. It is also assumed that the



6. For example, if company A and company B are resident in the same country, and assuming that this country allows the transfer of profits or losses between associated enterprises or the consolidation and taxation of profits at the level of one of the companies, it may not matter for the group and for the tax administration of this country how the tax base is allocated between company A and company B because the group will anyway be taxed on its net profit. Therefore, although the prices of the transactions between company A and company B will influence the profits of these companies at first sight, there is no need from a tax perspective to monitor the prices of the transactions between company A and company B. For a discussion on the issues of principle related to the taxation of corporate groups on their net profit, see Bertil Wiman, *Equalising the Tax Burden in a Group of Companies*, in *International Studies in Taxation: Law and Economics, Liber Amicorum Leif Mutén*, Gustaf Lindencrona, Sven-Olof Lodin and Bertil Wiman (eds), 363–378 (Kluwer Law International, 1999).
7. However, it should not be assumed that all transactions between associated enterprises are able, or intended to depart from market forces simply because they take place between companies that are related to each other. For example, it is quite possible that associated enterprises need to negotiate with each other and maximise their own profits as independent enterprises. That would be the case when two companies belong to the same corporate group but to different business units: it is well possible that the management of each business unit needs to meet certain profitability objectives (the managers of each business unit may even be remunerated based on the profits of the business unit), which would result in each company having an incentive to maximise its own profits.
8. The levels of transfer prices are also relevant for companies that are loss-making, because the pricing of an intercompany transaction affects the losses that may be carried back or carried forward.

corporate income tax rate in country A amounts to 30% (country A is described as a high-tax country), while it amounts to 10% in country B (country B is described as a low-tax country). The purpose of this example is to compute the corporate income taxes paid in country A and in country B, as well as the total tax burden of the whole group.[9]

In table 1.1 a multinational enterprise has a total taxable profit of 150, of which 100 is attributable to a manufacturer (resident in country A) and 50 is attributable to a distributor (resident in country B). Thus, the group earns a high profit in a high-tax country.

*Table 1.1 High Profit in a High-Tax Country*

| | |
|---|---|
| Taxable profit in country A | 100 |
| Tax rate of country A | 30% |
| Taxes paid in country A | 100 × 30% = 30 |
| Taxable profit in country B | 50 |
| Tax rate of country B | 10% |
| Taxes paid in country B | 50 × 10% = 5 |
| Total taxable profits of the group | 100 + 50 = 150 |
| Total tax burden of the group | 30 + 5 = 35 |

In the above example (table 1.1), the total tax burden of a multinational enterprise is 35, given that corporate income taxes paid in country A amount to 30, while corporate income taxes paid in country B amount to 5. However, as countries A and B have different corporate income tax rates, the total tax burden of this multinational enterprise would not be the same with other transfer prices, as the taxable profit in each country would be higher or lower than in the first example. In other words, the group would have a different total tax burden with different transfer prices. This is illustrated by the second example below (table 1.2), where the multinational enterprise has the same total taxable profits (150), but the taxable profit in country A is lower (50) while the taxable profit in country B is higher (100). Thus, the group earns a high profit in a low-tax country.

*Table 1.2 High Profit in a Low-Tax Country*

| | |
|---|---|
| Taxable profit in country A | 50 |
| Tax rate of country A | 30% |
| Taxes paid in country A | 50 × 30% = 15 |
| Taxable profit in country B | 100 |

9. The total tax burden of the whole group is computed as the sum of the corporate income taxes paid in country A and in country B.





| | |
|---|---|
| Tax rate of country B | 10% |
| Taxes paid in country B | 100 × 10% = 10 |
| Total taxable profits of the group | 50 + 100 = 150 |
| Total tax burden of the group | 15 + 10 = 25 |

As a consequence of the group earning more profits in a country with a lower corporate income tax rate (country B) and less profits in a country with a higher corporate income tax rate (country A), the total tax burden of the group in the second example (25, table 1.2) is lower than in the first example (35, table 1.1), although the total profits of the group remain unchanged (150 in both cases). Since it is assumed that these two companies have entered into intercompany transactions, the issue of transfer pricing becomes relevant for the multinational enterprise and the tax administrations of countries A and B. On the one hand, the setting of transfer prices may be of interest for the multinational enterprise as it may enable tax savings, or trigger risks of *double taxation*[10] at the group level. On the other hand, if the tax administration of country A or B suspects transfer prices not to have been correct, it would normally consider that its tax base has been illegitimately eroded (i.e., too little tax has been paid) and would seek to revise the transfer prices for taxation purposes, thus also creating a risk of double taxation for the multinational enterprise. Accordingly, it is necessary to strike a balance between the interests of multinational enterprises and tax administrations with regard to the setting of transfer prices, something that is normally done through applying the *arm's length principle*.

## 1.2 POSSIBLE METHODS FOR SHARING THE PROFITS OF MULTINATIONAL ENTERPRISES: FORMULARY APPORTIONMENT OR THE ARM'S LENGTH PRINCIPLE?

### 1.2.1 The Objectives of a Method for Sharing the Profits of Multinational Enterprises

The aim of transfer pricing, from a tax perspective, is to share the taxable base of a group – i.e., the profits or losses – arising from cross-border intercompany transactions. This goal can hardly be reached in a satisfactory manner by countries taking individual and uncoordinated initiatives: such initiatives would probably result in different principles being applied, multinational enterprises would have no foreseeability and may be subject to double taxation, differences in legislations could lead to stateless income (i.e., double non-taxation), and countries would have troubles ensuring that

10. The risk of double taxation exists when a tax administration rejects the transfer prices applied to a given intercompany transaction to increase the taxable profits earned by a resident company. When the taxable profits of the counterpart to the intercompany transaction remain unchanged, the group may be subject to double taxation as the same profits are subject to tax in two countries. For an example of double taxation created by a transfer pricing reassessment, see below at s. 7.1 of this book.

they levy the right amount of taxes. It is therefore necessary to agree at an international level on a way to share the taxable base of multinational enterprises when they enter into cross-border intercompany transactions.

An essential starting point, when designing a principle to share the profits or losses incurred by the members of a group of companies and arising from cross-border intercompany transactions, is to ensure that this principle is fair[11] to multinational enterprises, their competitors, and the countries in which they are doing business. The need to achieve fairness in international taxation has been strongly emphasised by many countries and international organisations in the recent years, especially the G20 countries and the OECD as part of the BEPS project, together with the UN, the IMF and various stakeholders such as non-governmental organizations. Achieving fairness in the international allocation of taxing rights is one of the main objectives of the BEPS project.[12] It is not only a technical issue, but also a political one. The aim of achieving fairness in the international allocation of taxing rights through designing tax rules is reflected in most parts of the BEPS project, including the work on transfer pricing, although it is expressed in different manners. Yet, fairness is not defined in the material published by the OECD or by other international organisations working with tax policy; the content of this concept seems nevertheless close to the objective of designing an international tax framework that ensures a correct connection between the substance – i.e., the reality – of a transaction or a structure, and the taxes eventually levied on the basis of this transaction or structure.

Having regard to the objective to achieve fairness in international taxation, two main methods can be contemplated to share the profits or losses incurred by the members of a group of companies and arising from cross-border intercompany transactions: formulary apportionment and the arm's length principle.[13]

11. On the need to achieve fairness in the protection of the interests of tax administrations and multinational enterprises, see particularly paras 4 and 18 of the preface to the OECD Guidelines. See also OECD, *Report on the Attribution of Profits to Permanent Establishments*, part I, para. 3 (17 July 2008). More generally, for a discussion on fairness in international tax law, see João Dácio Rolim, *Proportionality and Fair Taxation* (Kluwer Law International, Series on International Taxation, 2014); see also Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 145–203 (Law & Policy in International Business, 1998).
12. See e.g., OECD, *Addressing Base Erosion and Profit Shifting*, 36 (2013): 'In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, questions are being raised as to whether the current rules ensure a fair allocation of taxing rights on business profits.'
13. For a general discussion on the two main alternatives to sharing the taxable base of multinational enterprises see Michael C. Durst, *Beyond BEPS: A Tax Policy Agenda for Developing Countries*, 12–13 (ICTD Working Paper 18, June 2014); Reuven S. Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, 3–18 (World Tax Journal, February 2010); Reuven S. Avi-Yonah, Kimberly A. Clausing and Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, vol. 9, 497–553 (Florida Tax Review, 2009); H. David Rosenbloom, *Angels on a Pin: Arm's Length in the World*, 523–530 (Tax Notes International, 9 May 2005). Formulary apportionment and the arm's length principle may also be considered as possible methods to share final losses between the Member States of the European Union as an alternative to the solution found by the European Court of Justice in the *Marks & Spencer* case (*Marks & Spencer plc v. David Halsey (Her Majesty' s Inspector of Taxes)*, CJEU, 13 December 2005, case number C-446/03), consisting in





### 1.2.2 Formulary Apportionment

One method for sharing the profit of multinational enterprises would be to start from the income earned by each group member and consolidate such income before sharing it between the different members of the group on the basis of an *allocation key*. This method is usually referred to as *formulary apportionment*. The income originally earned by each group member would eventually have no importance as each country would be allocated a certain portion of the consolidated profits or losses. The apportionment would be based on the presence of the elements of a formula in the territory of each country where the group has set up a company. Such a formula may include, for example, the number of persons employed by a group in a given country, the sales achieved there, and/or the assets located in the territory of this country. A group's consolidated income would be shared between different countries on the basis of the proportion of the elements of the formula that are physically present in each country. Lastly, each country would tax the share of the consolidated income that it has been attributed with its own tax rate. For taxation purposes, the pricing of transactions between group members would ultimately play no role, as taxes are levied on the basis of the portion of the consolidated profits or losses allocated to each country, not on the income initially incurred by each group company.

The below example (tables 1.3 and 1.4) shows how the income of a multinational enterprise could be shared between different countries on the basis of formulary apportionment. Let us first assume the following facts: a multinational group has three companies A, B, and C, that are resident in countries A, B, and C. Each company reports turnover, profits, and employs personnel as summarised below. It is also assumed that the three companies enter into intercompany transactions (table 1.3).

*Table 1.3 A Multinational Group Carries on Business through Three Companies Set Up in Three Countries*

| | *Company* | *Country* | *Turnover* | *Number of Employees* | *Profits* |
|---|---|---|---|---|---|
| | A | A | 200 | 25 | 10 |
| | B | B | 500 | 40 | 30 |
| | C | C | 300 | 12 | 60 |
| **Total** | **N/A** | **N/A** | **1000** | **77** | **100** |

At first sight, from an accounting perspective country A gets to tax 10, country B gets to tax 30, and country C gets to tax 60. However, since the companies belong to the same group and enter into intercompany transactions, there is a need to make sure that the profit initially attributed to each country is also a correct one, or a fair one. Indeed,

deducting the final foreign losses in the country of the parent company: see Jérôme Monsenego, *Taxation of Foreign Business Income within the European Internal Market*, 327–337 (IBFD Doctoral Series, 2012).

companies A, B, and C could report different turnovers and profits by solely pricing the intercompany transactions differently. If countries A, B, and C intend to choose formulary apportionment as the method to share the total income of the group and tax the income eventually allocated to each territory, they would need to apply the following methodology: (i) agree on a certain formula, (ii) consolidate the income, (iii) compute the relative part of each element of the formula that is located in each country, and (iv) determine the share of the consolidated income that is attributable to each country. For the purpose of this example, let us assume that countries A, B, and C have chosen to use the turnover and the number of employees as the elements of the formula. It is also assumed that the turnover and the number of employees are attributed the same weight in the formula.[14] Consequently, the share of each country will be computed according to the following formula, where T stands for turnover and E stands for employees:

Share for each country = consolidated profit × [(share of T/consolidated T)/2 + (share of E/total number of E)/2]

The table below (table 1.4) illustrates the application of the formula to the facts described above.

*Table 1.4 The Income of a Multinational Enterprise Is Consolidated and Apportioned between the Three Countries in Which the Group Is Doing Business*

| | *Turnover* | *Number of Employees* | *Weithed Total Share* | *Profits Attributed To Each Country* |
|---|---|---|---|---|
| Share attributed to country A | 200/1000 = 20% | 25/77 = 32% | (20%/2) + (32%/2) = 26.2% | 26.2% × 100 = 26.2 |
| Share attributed to country B | 500/1000 = 50% | 40/77 = 52% | (50%/2) + (52%/2) = 51% | 51% × 100 = 51 |
| Share attributed to country C | 300/1000 = 30% | 12/77 = 16% | (30%/2) + (16%/2) = 22.8% | 22.8% × 100 = 22.8 |
| **Total** | **100%** | **100%** | **100%** | **100** |

The fist column shows the share of the turnover attributable to each country, and the second column shows the share of the number of employees attributable to each country. Since the formula includes two elements (i.e., the turnover and the number of employees), and given that it is assumed that these two elements are attributed the same weight, the relative presence of each element of the formula in the territory of a given country will directly determine the profits attributed to this country. In this example, the application of formulary apportionment has a clear influence on the

14. The three countries could, instead of giving the same weight to each element of the formula, decide to attribute more weight to one element of the formula and less weight to another element. For example, sales could weigh one-third of the consolidated income, whereas the number of employees could weigh two-thirds of the consolidated income.





profits eventually attributed to each country, since such profits are completely different from those that were initially incurred: countries A and B, where the profits initially incurred were respectively of 10 and 30 (see table 1.3), are now attributed profits that amount to 26.2 and 51 after application of the formulary apportionment (see table 1.4). In contrast, while profits of 60 were initially incurred in country C, this country is only allocated 22.8 after apportionment of the consolidated income.

The main advantages and drawbacks of formulary apportionment seem obvious. On the one hand, formulary apportionment may be relatively foreseeable and easy to apply, which may mitigate the risks of disagreements between tax administrations and multinational enterprises. On the other hand, only the elements of the formula attract income that will be shared between the respective countries, which means that other aspects are wholly disregarded from the apportionment mechanism. In certain cases a country may consider that it has a strong connection with a group of companies, whereas the formula attributes only little profits to this country. A typical example is intangible assets, which often contribute to a significant part of a group's profits,[15] but that are difficult to take into account as an element of an allocation key when sharing corporate profits on the basis of formulary apportionment.[16] The assumption of risks is also disregarded for the purpose of relying on formulary apportionment.[17]

Formulary apportionment is applied internally in certain federal States to divide the tax base at a national level, and is being considered by the European Union as part of the project for a common consolidated corporate tax base (often referred to as the CCCTB).[18] However, the application of formulary apportionment at an international

15. See Toshio Miyatake, General Report, Cahiers de droit fiscal international, *Transfer Pricing and Intangibles*, vol. 92a, 19 (2007); see also Isabel Verlinden and Yoko Mondelaers, *Transfer Pricing Aspects of Intangibles: At the Crossroads between Legal, Valuation and Transfer Pricing Issues*, 49 (International Transfer Pricing Journal, January/February 2010).
16. Several reasons may explain why intangible assets are not suitable to be taken into account in an allocation key under a formulary apportionment system, such as the difficulty to locate intangible assets and determine their ownership, the ease with which intangible assets can be moved, or the controversies as to how to value intangible assets. It has nevertheless been argued that ignoring intangible assets is not an issue as such assets would be the result of the activities of the whole group, rather than the result of just certain companies that would be developing the intangibles: see Reuven S. Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, 11 (World Tax Journal, February 2010), footnote 25: 'Any formula that "ignores" intangibles in fact assigns their value to the entire MNE (divided based on the other factors used in the formula), and we believe this result more accurately reflects the nature of intangibles.'
17. See Wolfgang Schön, *International Taxation of Risk*, 287 (Bulletin for International Taxation, July/August 2014).
18. The European Commission has put forward a proposal to tax European companies on the basis of an apportionment of their consolidated income: see *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)* (16 March 2011, COM(2011) 121/4). For a particular analysis of the apportionment mechanism of the CCCTB, see *CCCTB: possible elements of the sharing mechanism* (13 November 2007, CCCTB/WP060\ doc); see also Stefan Mayer, *Formulary Apportionment for the Internal Market* (IBFD, Doctoral Series, 2009). The proposal for a common consolidated corporate tax base did not reach consensus among the Member States. The European Commission has, therefore, informed that it will work on a strategy to re-launch this project, taking into account the comments made on the first draft directive as well as the developments that took place since the first proposal, in particular with respect to preventing tax

level has so far been rejected by most countries as well as by the OECD and the UN.[19] There are several reasons to such a rejection, the most important one being that some countries would be 'losing' part of the tax base if important elements of the formula are lacking on their territory or if certain factors that attract the corporate tax base under the arm's length principle are not taken into account under formulary apportionment; this is, e.g., the case for countries with a small market (i.e., few potential consumers, thereby mitigating the sales factor if it were included in the formula) that invest heavily in higher education: since higher education may contribute to the creation of valuable intangible property, and assuming that intangible property is not part of the formula, the profits of a group that are incurred, thanks to the intangible property would not be attributed to the country(ies) where such intangible property originated. Therefore, it would be very difficult for countries to agree on applying formulary apportionment at an international level, although regional initiatives like the common consolidated corporate tax base may be implemented in the future.

### 1.2.3 The Arm's Length Principle

Instead of applying formulary apportionment, the member countries of the OECD and most non-OECD countries (as particularly emphasised in the UN Model Tax Convention) prefer sharing the profits or losses incurred by the members of a group, and arising from cross-border intercompany transactions, on the basis of the pricing of comparable transactions between independent companies. Accordingly, the international standard for sharing the income of multinational enterprises arising from intercompany transactions consists in favouring intercompany pricing that is in line with the market price, i.e., the so-called *arm's length principle*.[20] Contrary to a tax system implementing formulary apportionment, where the income originally earned by each group company is in principle always adjusted before being shared between the group members, under the arm's length principle the income originally earned by each group company does not need to be adjusted per se. It needs first to be tested against the arm's length principle. If it is concluded that the pricing of intercompany transactions matches the pricing of comparable transactions between independent companies, the income will remain as it was and no changes in the taxes levied will

avoidance and ensuring a fair allocation of the tax base (see *Commission prepares an Action Plan for fairer and more growth-friendly tax systems in Europe*, Brussels (27 May 2015, press release IP/15/5044)).

19. See paras 1.16–1.32 of the OECD Guidelines; UN, *Practical Manual on Transfer Pricing for Developing Countries*, para. 3.2.3 (2013); OECD, *Action Plan on Base Erosion and Profit Shifting*, 14 (2013). See also Masatsugu Asakawa, *Transfer Pricing in the New Global Landscape: The OECD's Engagement beyond Its Borders*, 213 (Tax Notes International, 17 October 2011). However, some proposals have been made in the doctrine to replace the arm's length principle by formulary apportionment: see e.g., Yariv Brauner, *Formula Based Transfer Pricing*, vol. 42, issue 10, 615–631 (Intertax, 2014); Reuven Reuven S. Avi-Yonah and Ilan Benshalom, *Formulary Apportionment – Myths and Prospects – Promoting Better International Tax Policies by Utilizing the Misunderstood and Under-Theorized Formulary Alternative*, 371–398 (World Tax Journal, October 2011).
20. See para. 1.32 of the OECD Guidelines.





need to take place. In contrast, if it is demonstrated that the intercompany prices differ from those applied to comparable transactions between independent companies, the multinational enterprise should adjust its transfer prices in order to implement the arm's length principle. Tax administrations may, according to most domestic tax laws and tax treaties, have the right to reassess the taxable income of the company that is under scrutiny if the arm's length principle is not complied with. Given the right of tax administrations to reassess the income of multinational enterprises that deviates from the arm's length principle, and the risk to face double taxation when the same item of income is taxed in two countries, multinational enterprises have a strong incentive to enforce the arm's length principle while entering into intercompany transactions, i.e., before the pricing of such transactions is tested by tax administrations.

Certain key differences between arm's length pricing and formulary apportionment appear immediately: whereas formulary apportionment lies on a pre-determined formula that offers foreseeability but may not be suitable to take into account the special features of different types of business activities, arm's length pricing is quite the opposite as it implies a case-by-case analysis that is adapted to each situation – thereby being closer to the reality of each transaction. The arm's length principle may also be in a better position to capture the value created by the parties to an intercompany transaction. At the same time, the arm's length principle brings no foreseeability and may easily give rise to controversies.[21] At the end of the day, the choice between formulary apportionment and the arm's length principle boils down to a matter of priority. Should priority be given to allocating the tax base according to certain features of a group of companies that are measurable and that may be determined in advance? Should priority be given to foreseeability and certainty, possibly to the detriment of the correctness of the allocation of income between different countries? Or should priority be given to the search for a well-motivated allocation of income, at the cost of creating complexity and increasing risks of double taxation and disputes? So far, priority is clearly given to the arm's length principle and to the search for a theoretically correct allocation of the income of multinational enterprises.[22] However, the arm's length



21. Of course, disputes may arise and do arise in the countries that apply formulary apportionment at the domestic level. Issues would also arise between the Member States of the European Union if a common consolidated corporate tax base would be implemented. However, the existence of a pre-determined formula limits controversies to issues other than the very formula. In contrast, as the arm's length principle is only a principle, virtually any aspect of its application may give rise to controversies. Therefore, the arm's length principle seems more likely to give rise to disagreements between tax administrations and multinational enterprises than formulary apportionment, at least from a quantitative perspective (i.e., the number of disputes).
22. It is nevertheless important to emphasise that the arm's length principle is erroded in various ways. An example is the 'special measures' that may deviate from the arm's length principle and that are under consideration by the OECD as part of the BEPS project, when such measures are deemed necessary to ensure that transfer pricing outcomes are in line with the creation of value: see OECD, *BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)*, 38–43 (December 2014).

| *Post in the Income Statement* | *Buy/Sell Distributor* | *Contract Manufacturer* | *Contract R&D* | *Entrepreneur* |
|---|---|---|---|---|
| Operating expenses | 20 | 10 | 20 | 72 |
| **Net margin** | **55** | **3.5** | **2** | **79.5** |
| Net margin % | Not relevant | Not relevant | Not relevant | 35.3% |
| Full cost mark-up | Not relevant | 5.0% | 10.0% | Not relevant |
| **Assumptions** | | | | |
| External sales | | 300 | | |
| Targeted gross margin of the distributor | | 25% | | |
| Cost of production of the goods | | 60 | | |
| Operating expenses contract manufacturer | | 10 | | |
| Targeted FCM of contract manufacturer | | 5% | | |
| Operating expenses contract R&D | | 20 | | |
| Targeted FCM of contract R&D | | 10% | | |

Table 3.6 shows that the great increase in the sales benefits essentially the entrepreneur, who now earns a net margin of 79.5. The manufacturer and the researcher are not impacted by this increase, as they support the same costs and earn the same profits as in the past. The distributor earns a higher net margin, as it is remunerated on the basis of a targeted gross margin and supports similar operating expenses.[106]

106. As indicated above this example is simplified; the distributor would often incur higher operating expenses as the sales increase.





CHAPTER 4

# Cross-Border Business Restructurings

This chapter provides an introduction to the topic of cross-border business restructurings from a transfer pricing perspective (section 4.1), a presentation of some frequent types of cross-border business restructurings implying a centralisation of functions, risks and/or assets (section 4.2), and a discussion about situations where a business restructuring may give rise to the payment of compensation between the restructured entities (section 4.3).

## 4.1 INTRODUCTION

Transfer pricing issues often arise when multinational enterprises modify their value chain across borders, i.e., when functions, risks, and/or assets are moved from one group company situated in one country to another group company situated in another country. Such modifications of the value chain are described, for transfer pricing purposes, as 'business restructurings'.

A cross-border business restructuring is defined in the OECD Guidelines as a 'cross-border redeployment by a multinational enterprise of functions, assets, and/or risks'.[1] As with any intercompany transaction, cross-border business restructurings must be priced in accordance with the arm's length principle. This supposes that a restructuring transaction is priced at arm's length, and that it is the best option realistically available to each party.[2] In addition, as with any transfer pricing issue,

1. See para. 9.1 of the OECD Guidelines.
2. Indeed, associated enterprises are expected to enter into a transaction only 'if it does not make them worse off than their next best option' (see para. 9.59 of the OECD Guidelines). This requirement applies to each company, as opposed to several companies taken together. For an analysis of the concept 'options realistically available' see Danny Oosterhoff and Bo Wingerter, *The New OECD Guidelines: The Good, the Bad and the Ugly*, 110 (International Transfer Pricing Journal, March/April 2011).

restructuring transactions have to be supported by sufficient substance.[3] Let us illustrate the definition of a cross-border business restructuring according to the OECD Guidelines by an example where a group outsources a manufacturing function to a subsidiary in a country where the cost of labour is lower. This example illustrates also the need for the countries concerned by the restructuring to ensure that it has been carried out at arm's length.

*Example: a group outsources a manufacturing function to a subsidiary in a country where the cost of labour is lower*

Company A (resident in State A) manufactures trucks in State A. To decrease its manufacturing costs, the group decides to outsource the manufacturing of trucks to subsidiary B (resident in State B), where the cost of labour is lower. The fact that the manufacturing function is no longer performed by company A but by company B is a business restructuring, as at least one function (i.e., the manufacturing of trucks) has been transferred from company A to company B. In addition, other functions, risks, and/or assets may also have been transferred. As a result, States A and B need to ensure that the restructuring does not illegitimately erode their tax base.

Multinational enterprises need to constantly adapt themselves to the international context of their business activities. Accordingly, a business restructuring implying the transformation of the value chain may have different purposes[4] and be driven e.g., by cost reductions,[5] tax savings,[6] the willingness to reach new markets,[7] or the need to centralise the control of the value chain.[8] A reorganisation or a reconsideration of the value chain may also be relevant following a merger or acquisition process, since two different business models may have to be adapted to one another.[9]

3. On the application of the substance requirement to cross-border business restructurings, see s. 5.3 of this book.
4. See Heinz-Klaus Kroppen and José Carlos Silva, General Report, Cahiers de droit fiscal international, *Cross-Border Business Restructuring*, vol. 96a (2011).
5. In particular, it should be emphasised that competition often presses prices down. This creates a need to face competition through different means such as reducing costs.
6. A business restructuring is often accompanied by a reallocation of profits within a group, thus potentially implying a reallocation of the corporate income taxes paid by a multinational enterprise.
7. For example a group may be willing to move its manufacturing or warehousing activities closer to the new markets it wishes to reach.
8. For example a group may wish to concentrate control over its worldwide manufacturing at the level of a single entity, to achieve similar standards of quality.
9. Such a restructuring may be relevant if, for example, a multinational enterprise acquires an independent manufacturer that has developed and owns valuable product and process intangibles. Given the development and the ownership of such product and process intangibles, the manufacturer may be qualified as a fully fledged manufacturer. However, after the acquisition, the multinational enterprise may be willing to integrate the acquired manufacturer to its value chain and convert it to a contract manufacturer, for example if the group has implemented a centralised entrepreneur model. Also, the group may wish to let other group companies use the product and process intangibles; therefore, the group may consider moving the intangibles owned by the acquired company to a central location in the group, for example the entrepreneur or an IP company.





Cross-border business restructurings often give rise to complex transfer pricing issues, as such transactions do not imply the sole sale of a good or a service, but rather the transfer of an activity: a business restructuring may imply the transfer of a combination of goods (e.g., an inventory), intangible assets (e.g., patents and know-how), functions (e.g., the right to make strategic decisions), risks (e.g., the need to provide funding), and persons (e.g., people qualified for a certain task). Although in most cases it will be virtually impossible to find a comparable uncontrolled transaction, business restructurings still need to abide by the arm's length principle. Therefore, multinational enterprises and tax administrations need to analyse the restructuring at hand and figure out a methodology to arrive at the terms (often including the payment of compensation) that independent parties would have agreed on for a comparable uncontrolled transaction.

It should also be emphasised that the transfer pricing issues raised by business restructurings have a strong connection with the operations within multinational enterprises, something that may result in a conflict between tax and operational considerations.[10] Changes to the value chain may happen as a consequence of a management decision that intends to modify the operations, in which case the transfer pricing policy within the group will have to adapt to the operational changes. In such situations, the tax and transfer pricing issues triggered by the business restructuring may be perceived as secondary by the management of the group, whereas the tax administrations of the countries concerned will be keen on ensuring that the operational changes have been carried out at arm's length. In other cases a business restructuring may be tax driven, which would require that the operations are amended accordingly in order for the restructuring to be acceptable to the tax administrations of the countries concerned.[11] In certain cases, a change to the value chain may be considered together from a tax and operational perspective; however, it may be difficult to fully satisfy the two perspectives, as what is optimal from an operational point of view may trigger tax risks or an increased tax burden, whereas what mitigates tax risks and decreases the tax burden may be inefficient, difficult to implement in practice, or too costly. Therefore, a conflict may appear between the tax and operational considerations relating to changes to the value chain.

Last, a key question when it comes to cross-border business restructurings is the tax savings that may be achieved. Business restructurings may indeed result in the tax base being moved as a consequence of the shift of functions, risks, and/or assets; when functions, risks, and/or assets are moved to a country with a lower corporate income tax rate, or a country where a favourable tax regime is available, the total tax burden may decrease. Conversely, moving functions, risks or assets to a country where the corporate income tax rate is higher may increase the total tax burden. Also, the implementation of the centralised entrepreneur model may decrease the total tax burden by letting the group be taxed on the net income incurred throughout the value

10. See s. 3.1. of this book for a presentation of the interactions between taxes and the operations within a multinational enterprise.
11. See Chapter 5 of this book for a presentation of the notion of substance.

chain.[12] The OECD Guidelines consider this issue in a twofold manner.[13] On the one hand, it is clearly stated that tax savings may be achieved and should be accepted by tax administrations, even if decreasing the tax burden is the purpose of a business restructuring.[14] On the other hand, tax savings should be accepted only when a business restructuring has been carried out at arm's length,[15] something that supposes that the restructuring is supported by the right substance.

## 4.2 FREQUENT TYPES OF CROSS-BORDER BUSINESS RESTRUCTURINGS

As transfer pricing issues may arise upon any modification of the value chain across the borders implying a redeployment by a multinational enterprise of functions, assets, and/or risks, each business restructuring is unique and has to be considered according to the facts and circumstances of the case. There may be different types of business restructurings; for example, certain groups may consider centralising functions, risks, and/or assets in order to achieve the effects of the centralised entrepreneur model or make synergies from an operational point of view, while other groups may be willing to spread important functions in order to move decision centres close to their customers. Another example is the case where there is a need to open or close a factory, or to move a warehouse to a strategic region.

The very existence of a business restructuring, i.e., the recognition of the restructuring as a transaction that may have transfer pricing consequences, is not always obvious. For example, there may be cases where the tasks performed by one company are taken over by another company, or cases where an employee keeps being employed by a multinational enterprise but moves to another country from where he/she continues to work, which could easily trigger disagreements between multinational enterprises and tax administrations, the former arguing that no restructuring has taken place and the latter stating the opposite. On the other hand, there may be situations where a restructuring is claimed, without this being necessarily true; an example would be the situation where a group claims the shift of a group company from being highly exposed to risks to having only a limited risk exposure, whereas the functions necessary for the management and control of the risks have not been moved accordingly.

Despite the potential diversity of cross-border business restructurings, certain types of restructurings are frequently carried out by multinational enterprises, in particular in order to implement the centralised entrepreneur model. Such a business restructuring may be motivated not only by tax savings, but also by purely operational reasons such as the need to concentrate the most important activities in a central

12. For a description of the centralised entrepreneur model, see above at s. 3.4.7 of this book.
13. For a discussion on the tax arbitrage effect that may result from transfer pricing, see above at s. 1.5 of this book.
14. See para. 9.181 of the OECD Guidelines.
15. See para. 9.182 of the OECD Guidelines.





location.[16] The three pillars of the value chain of numerous multinational enterprises, namely research and development, manufacturing, and distribution, may be subject to business restructurings carried out with the objective of implementing the centralised entrepreneur model. Accordingly, a fully-fledged researcher may be converted to a contract R&D, a fully-fledged manufacturer may be converted to a contract manufacturer or a toll-manufacturer, and a fully-fledged distributor may be converted to a buy/sell distributor or a commissionaire. These three types of cross-border business restructurings are described below.

The conversion of a fully-fledged researcher to a contract R&D implies that intangible property will, in most cases, not be developed by the converted company after the business restructuring, but by the company that took over the strategic functions and risk assumptions, i.e., the entrepreneur. An example of conversion of a fully-fledged researcher to a contract R&D is the situation where a company, active only in one country, has developed a successful intangible property that has the potential to sell in various countries. The management of the company may not have expected such a success and may, accordingly, be willing to locate the principal role – and thus also the residual profits – in another jurisdiction. In such a case, it will be utterly important to ensure that the company that takes over the principal role has the right substance. This may become a particularly complex issue if no people have moved from the former fully-fledged researcher to the entrepreneur: the multinational enterprise may argue that the strategic functions are performed by the entrepreneur, whereas the tax administration of the country of departure may argue that since no people moved, the functions are in reality still performed in this country.

In order to convert a fully-fledged manufacturer to a contract manufacturer or a toll-manufacturer, the important functions and risks formerly assumed by the fully-fledged manufacturer will be taken over by the entrepreneur, who will also be attributed the residual income generated by the manufacturing function. In addition to the functions and risks being moved to the entrepreneur, the ownership of the inventory of raw material, semi-finished goods and finished products may also need to be moved to the entrepreneur, which would typically be the case upon the conversion to a toll manufacturer.[17] An example of such a conversion is the case where a multinational enterprise has acquired a competitor that owns a manufacturing intangible that would be useful to the products manufactured by the buyer: the intangible property owned by the former fully-fledged manufacturer would typically be transferred to the entrepreneur who would then own the old intangible property and the newly developed intangible property, the combination of which could be used in other parts of the buyer's business activities. Together with the intangible property, the functions, risks, and tangible assets that should not be attributed to the contract manufacturer or a toll-manufacturer would also be transferred to the entrepreneur. The

16. In this respect, see above at 3.4.7 for a presentation of the centralised entrepreneur model.
17. This is because a toll manufacturer shall not own raw materials or stocks of (semi-) finished goods. The transfer of the ownership of raw material, semi-finished and finished goods, which does not need to imply a physical transfer of goods as the legal transfer of ownership implies a shift in risks and costs, consists in a sale of tangible assets that needs to be carried out at market value. The evaluation of tangible assets is out of the scope of this book.

substance supporting the functions performed and risks assumed by the entrepreneur will be a critical issue, e.g., with respect to the technical competence of the personnel employed by the entrepreneur with matters such as the purchase of raw materials, manufacturing know-how, production and stock planning, or logistics.

The conversion of a fully-fledged distributor to a buy/sell distributor or a commissionaire implies, similarly to the examples above, a significant change to the functional profile of the distributor through a shift in the exposure to the economic outcome of the distribution activity to the entrepreneur. Here it may be particularly critical to analyse the possible existence of marketing intangibles such as trade names or lists of clients (which will need to be sold to the entrepreneur, thereby possibly giving rise to capital gains taxation in the country of the former fully-fledged distributor), and the transfer of risks such as inventory risk or credit risk.

The business restructurings described above, as other types of business restructurings, may imply operational changes that affect positively or negatively the profitability of a multinational enterprise as a whole. For example, *synergies* may be achieved, thanks to the increased purchasing power of a centralised purchasing function, or *location savings* may be derived, thanks to, e.g., moving manufacturing activities to a place where labour costs are lower. In both cases, the operational changes (i.e., centralising the purchasing function or moving the manufacturing activities) may have an impact on the global profitability of the group. This raises the question of whether or not the positive or negative effects of a business restructuring such as synergies or locations savings should be shared among the members of a group, and if so, how and to what extent. No single answer to this question is provided by the OECD Guidelines, the recommendation being to apply the arm's length principle to business restructurings in the same way as for other types of intercompany transactions.[18] The draft work on BEPS proposes the same answer, but suggests more guidance with respect to location savings[19] and group synergies.[20] The issue of the

18. See para. 9.9 of the OECD Guidelines.
19. See OECD, *Guidance on Transfer Pricing Aspects of Intangibles*, 13, para. 1.82 (September 2014), where it is indicated that 'in determining how location savings are to be shared between two or more associated enterprises, it is necessary to consider (i) whether location savings exist; (ii) the amount of any location savings; (iii) the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and (iv) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings'. This means that once location savings exist, comparability adjustments for location savings may be needed; however, the discussion draft rightfully emphasises at para. 1.83 that when the comparability analysis has identified comparable companies or transactions in the local market, no adjustments may be needed since the financial information of the comparables already takes into account the existence of the location savings.
20. See OECD, *Guidance on Transfer Pricing Aspects of Intangibles*, 19, para. 1.103 (September 2014), where it is recommended to take into account for transfer pricing purposes certain synergistic benefits that arise because of deliberate concerted group actions, by sharing the benefits of the synergies in proportion to the contributions of the group members to the achievement of the synergies. This means that synergies are not, per se, considered as intangible property for transfer pricing purposes, since they may not be owned or controlled by a given company (see para. 6.30 of the same discussion draft). In this respect, it has been argued that 'Synergies are *consequences* which may (or may not) be derived from the use of several assets





positive or negative effects achieved, thanks to operational changes, is also important from the perspective of developing countries, as these countries may provide the opportunity to increase the global profitability (e.g., thanks to lower production costs) without being able to tax such an increased profitability, because the application of the OECD Guidelines may allocate the gains to the high risk-taking entities that have developed intangibles (especially when intangibles are defined according to the 2010 OECD Guidelines, i.e. before the revision of chapter 6 of the Guidelines) such as entrepreneurs, which may not be located in a developing country.[21] Therefore, location savings are an issue where there may typically be differences of views between developed and developing countries.[22]

Last, it should be emphasised that cross-border business restructurings may raise other issues than transfer pricing ones, in particular with regard to the possible existence of a permanent establishment of the transferee in the country of the transferor.[23] The risk indeed exists that the functions performed and risks assumed by the converted entity are considered as creating a permanent establishment for the transferee, as the transferor will – from the time of the business restructuring – act on behalf of the transferor. This issue is not specific to business restructurings, i.e., it may also arise when an entity is given a certain functional profile as from its set-up, but the issue becomes exacerbated upon business restructurings as a business restructuring may be driven by aggressive tax planning considerations that rely on an extensive interpretation of legal concepts such as the permanent establishment threshold.[24] Also, the operational aspects of the restructuring may not be fully implemented at the time of the restructuring. A typical example is a fully-fledged distributor that has been converted to a commissionaire, but that still concludes contracts on behalf of the



in combination' (see Caroline Silberztein, Mary C. Bennett and Gregg D. Lemein, *The OECD Discussion Draft on the Transfer of Intangibles (Revision of Chapter VI of the OECD Transfer Pricing Guidelines) – Main Comments*, vol. 41, issue 2, 60–65, 61 (Intertax, 2013).
21. See *Spillovers in International Corporate Taxation*, IMF Policy Paper, 33, para. 52 (9 May 2014).
22. See e.g., UN, *Practical Manual on Transfer Pricing for Developing Countries*, 2013, para. 10.4.7.1: 'It is the view of the Indian transfer pricing administration that the concept of "location savings" – which refer to cost savings in a low-cost jurisdiction such as India – should be one of the major aspects to be considered while carrying out comparability analysis during transfer pricing audits'; for the perspective of India, see also Pankaj Jain and Vikram Chand, *Location Savings: International and Indian Perspective*, vol. 43, issue 2, 192–198 (Intertax, 2015). For a concrete example of how location savings may be taken into consideration, see the description of the computation of the profit mark-up for a contract R&D in China: Glenn DeSouza, *What the UN Manual Really Means for China?*, vol. 41, Issue 5, 331 (Intertax, 2013), where it is explained that the median full cost mark-up may be increased by 50% in order to account for a location saving of 50%.
23. Examples of corporate tax issues that may arise as a consequence of a business restructuring are the existence of a permanent establishment, the levy of taxes on the basis of the legislation on controlled foreign companies, or the levy of withholding taxes as a result of new flows of income. Apart from an illustration of the possible existence of a permanent establishment, such issues are not in the scope of this book.
24. For example, the permanent establishment threshold may be avoided by relying on the list of exceptions provided by tax treaties drafted on the basis of Art. 5(4) of the OECD and UN Model Tax Conventions.

CHAPTER 7

# The Prevention and the Resolution of Transfer Pricing Disputes



## 7.1 INTRODUCTION

Although multinational enterprises and tax administrations are encouraged by the OECD Guidelines and the UN practical manual on transfer pricing to apply the arm's length principle when dealing with transfer pricing issues, they may have different views on how a given intercompany transaction should be priced. Also, even if a multinational enterprise complies with transfer pricing documentation requirements, disputes may still arise as the transfer prices, despite being well documented, may not necessarily comply with the arm's length principle. Consequently, the setting of transfer prices may result in disputes between multinational enterprises and tax administrations, as well as between the competent authorities[1] of different countries.[2] Indeed, when a tax administration believes that the transfer prices applied between associated enterprises are not at arm's length, it may reassess such prices to arrive at – what the tax administration considers being – an arm's length transfer price or profit margin.[3] Such a reassessment is likely to increase the taxable base of the company that is subject to the reassessment. However, profits gained from the intercompany transaction may have already been taxed in the country of the counterpart to the

1. Competent authorities refer to the representatives of a country's government that deal with matters relating to the interpretation and the application of tax treaties.
2. On this topic see Caroline Silberztein, *Transfer Pricing Disputes and Their Causes*, 439–446 (Asia-Pacific Tax Bulletin, November/December 2010).
3. See para. 2 of the commentary to Art. 9 of the OECD Model Tax Convention: 'the taxation authorities of a Contracting State may, for the purpose of calculating tax liabilities of associated enterprises, re-write the accounts of the enterprises if, as a result of the special relations between the enterprises, the accounts do not show the true taxable profits arising in that State'. In most countries, it is the tax administration that has the burden of proof that the arm's length principle has not been upheld; for an illustration see e.g., the case *Cap Gemini*, French Supreme Administrative Court (*Conseil d'État*), cases number 266436 and 266438 (7 November 2005).

transaction, something that would result in a double taxation of such profits. Let us illustrate this with an example.

*Example: tax reassessment resulting in double taxation*

Assume that company A (resident in country A) purchases goods manufactured by the associated company B (resident in country B). Countries A and B have a 30% corporate income tax rate. Company A purchases goods for 80, i.e., the COGS of company A is 80 while the turnover of company B is 80. It is assumed that the income statements of companies A and B are, before tax reassessment, as follows (table 7.1).

*Table 7.1 Situation before Tax Reassessment*

| *Company A – Country A* | | *Company B – Country B* | |
|---|---|---|---|
| Turnover | 100 | Turnover | 80 |
| COGS | 80 | COGS | 65 |
| **Gross margin** | **20** | **Gross margin** | **15** |
| OPEX | 15 | OPEX | 7 |
| **Operating margin** | **5** | **Operating margin** | **8** |
| Other costs | 2 | Other costs | 3 |
| **Net profit** | **3** | **Net profit** | **5** |
| Corporate tax | 0.9 | Corporate tax | 1.5 |
| **Total tax burden** | 2.4 | | |

It is then assumed that the tax administration of country A considers that the purchase price paid by company A (80) is not at arm's length and should, instead, amount to 75. Consequently, the tax administration of country A reassesses the income of company A and decreases the purchase price (i.e., the COGS) accepted as a deductible expense, from 80 to 75. The income statements of companies A and B, after the reassessment, are as follows (table 7.2).

*Table 7.2 Situation after Tax Reassessment (Double Taxation)*

| *Company A – Country A* | | *Company B – Country B* | |
|---|---|---|---|
| Turnover | 100 | Turnover | 80 |
| COGS | 75 | COGS | 65 |
| **Gross margin** | **25** | **Gross margin** | **15** |
| OPEX | 15 | OPEX | 7 |
| **Operating margin** | **10** | **Operating margin** | **8** |
| Other costs | 2 | Other costs | 3 |
| **Net profit** | **8** | **Net profit** | **5** |





| *Company A – Country A* | | *Company B – Country B* | |
|---|---|---|---|
| Corporate tax | 2.4 | Corporate tax | 1.5 |
| **Total tax burden** | 3.9 | | |

As evidenced by table 7.2, the consequence of the tax reassessment in country A is that the group is subject to double taxation since a part of the group's profits has been subject to tax in both countries. This is because the turnover of company B is still 80, while the COGS of company A that is accepted as a deductible expense in country A has been decreased to 75. Accordingly, double taxation arises on the difference between the purchasing price deducted in country A (75) and the selling price accounted for in country B (80), i.e., an amount of 5 is subject to double taxation. While the total net profits subject to tax amounted to 8 in table 7.1 (3 + 5 = 8), the total net profits subject to tax in this second example amount to 13 (8 + 5 = 13). Accordingly, the total tax burden now amounts to 3.9 while it amounted to 2.4 before the tax reassessment. The difference between these two tax burdens (3.9–2.4 = 1.5) corresponds to the corporate income tax rate (30%) applied to the income that has been taxed twice (5 × 30% = 1.5).

There may be several methods to eliminate such a double taxation. The claim of country A could be challenged before a court in country A, but situations of double taxation relating to transfer pricing are not always suitable to be solved in courts as they are highly relying on facts.[4] In addition, the claim of country A may very well be justified, something that a court in country A would not amend even if this claim leads to double taxation at the level of the whole group. As an alternative to court proceedings, mutual agreement procedures between competent authorities provide the two countries a framework to discuss the issue and, hopefully, find a way to eliminate the double taxation. Assuming that the claim of country A in the example above is justified (i.e., it is correct that the transfer price of goods between companies A and B should amount to 75, not to 80), a mutual agreement procedure could result in country B recognising the correctness of the adjustment made by country A. In this case, country B could tax company B on the basis of a turnover decreased from 80 to 75, in order to take into account the lower price for the goods sold to company A. Such an elimination of the double taxation is illustrated below in table 7.3.

*Table 7.3 Situation after Tax Reassessment (Double Taxation Eliminated)*

| *Company A – Country A* | | *Company B – Country B* | |
|---|---|---|---|
| Turnover | 100 | Turnover | 75 |
| COGS | 75 | COGS | 65 |

4. For an example where the factual nature of transfer pricing prevented a court from fully assessing a case, see *Amazon.com, Inc. & Subsidiaries v. the Commissioner of Internal Revenue*, United States Tax Court, Tax Court Memo 2014-149 (28 July 2014, case number 31197-12), where the court found that there were 'genuine disputes of material fact that preclude partial summary judgment'.

| *Company A – Country A* | | *Company B – Country B* | |
|---|---|---|---|
| **Gross margin** | **25** | **Gross margin** | **10** |
| OPEX | 15 | OPEX | 7 |
| **Operating margin** | **10** | **Operating margin** | **3** |
| Other costs | 2 | Other costs | 3 |
| **Net profit** | **8** | **Net profit** | **0** |
| Corporate tax | 2.4 | Corporate tax | 0 |
| **Total tax burden** | 2.4 | | |

In table 7.3 it is observed that, as in table 7.1, the COGS of company A is the same as the turnover of company B (75 in both cases). The net profits subject to tax amount to 8 and are the same as in table 7.1, i.e., the double taxation is eliminated. However, the difference between the two tables consists in the shift of part of the tax base (amounting to 5), as a consequence of the reassessment in country A and the corresponding adjustment in country B. This shift has an impact on the fiscal revenues of countries A and B, but not on the total tax burden supported by the group.

The above example illustrates the risk of double taxation in relation to the pricing of intercompany transactions. In order to avoid or at least mitigate double taxation – and assuming that countries apply the arm's length principle,[5] multinational enterprises are encouraged to set transfer prices at arm's length and explain such a pricing in their transfer pricing documentation. However, tax administrations may conduct a tax audit and find, or at least claim, that the transfer prices are not at arm's length. Tax administrations may then reassess the transfer prices applied within a multinational enterprise, even though such prices have been properly documented. Since double taxation is considered to be a hindrance to the development of international trade,[6] the OECD has been encouraging countries to adopt tools to prevent disputes or to eliminate double taxation.[7] Accordingly, several tools may be available to multinational enterprises to prevent, eliminate or mitigate double taxation in relation to transfer pricing. First, disputes may be prevented in advance through concluding advance pricing arrangements (7.2). Second, when a group is subject to double taxation as a result of a transfer pricing reassessment, such a double taxation may be mitigated or eliminated on the basis of a mutual agreement procedure (7.3). Last, when double taxation

5. When countries deviate from the arm's length principle the elimination of double taxation may become impossible, as the application of two different taxation principles is likely to result in double taxation. For a discussion from the perspective of Brazil and the US, see Daniel Hora do Paço and H. David Rosenbloom, *Thoughts on the Brazil-U.S. Tax Treaty Negotiations*, 520 (Tax Notes International, 16 November 2009).
6. See para. 1 of the Introduction to the 2014 OECD Model Tax Convention.
7. It may be observed that the European Union has also been active in the implementation of tools to eliminate risks of double taxation with respect to transfer pricing cases. This has particularly been done through the enactment of the European arbitration convention (see below at 7.4.3) as well as the work of the Joint Transfer Pricing Forum, part of which has been endorsed by the European Commission and the Council of the European Union.





remains despite a mutual agreement procedure, it may be possible to eliminate or mitigate such a double taxation on the basis of an arbitration procedure (7.4).

## 7.2 ADVANCE PRICING ARRANGEMENTS

After discussing the purpose of advance pricing arrangements (7.2.1), the different types of advance pricing arrangements (7.2.2) as well as the procedure to apply for an advance pricing arrangement (7.2.3) are presented.

### 7.2.1 The Purpose of Advance Pricing Arrangements

Advance pricing arrangements (often referred to as APAs) are agreements concluded between the competent authorities of two or more countries, or an agreement concluded between a taxpayer and the competent authority or the tax administration of a given country, with regard to the transfer pricing methodology applied to future transactions between associated enterprises.[8] An APA is normally intended to implement the arm's length principle with respect to a given intercompany transaction, but in practice it cannot be excluded that the parties (i.e., the competent authorities of the countries involved in an APA, or a company and a State) depart from the arm's length principle.

The OECD Guidelines define an APA as 'an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g., method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time'.[9] Accordingly, the purpose of an APA is to agree on the methodology to determine transfer prices over a certain period of time, i.e., it is normally not agreed on transfer prices or profit margins as such.[10] Indeed, it may not be possible to agree on

8. For a thorough study on APAs, see Michelle Markham, *Advance Pricing Agreements: Past, Present and Future* (Kluwer Law International, 2012). Certain countries publish annual reports providing an overview of the content of the APAs that they have entered into. For example, see the annual report for the United States published by the IRS in relation to the year 2014: *Announcement and Report Concerning Advance Pricing Agreements*, IRS, 30 March 2015. This report indicates, among other things, the number of APAs finalised and renewed, the industry to which these APAs relate, the countries with which the United States has concluded the APAs, the types of transactions covered, the transfer pricing methods and profit level indicators used, the sources relied on for the benchmarking studies, the nature of the comparability adjustments that have been performed, the length of the APAs, or the time needed to complete an APA.
9. See para 4.123 of the OECD Guidelines. In addition, para. 9 of the annex to Chapter 4 of the OECD Guidelines indicates that 'the objectives of an APA process are to facilitate principled, practical and co-operative negotiations, to resolve transfer pricing issues expeditiously and prospectively, to use the resources of the taxpayer and the tax administration more efficiently, and to provide a measure of predictability for the taxpayer'.
10. This view is clearly expressed in the guidelines for APAs in the European union: 'The APA should not agree precisely the actual profit which should be taxed in the future' (see *Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee on the work of the EU joint transfer pricing forum in the field of dispute avoidance and resolution procedures and on guidelines for advance pricing agreements within the European Union* (26 February 2007, COM(2007) 71 final), Annex, para. 3).

what constitutes future arm's length prices, since the facts and circumstances that are relevant to pricing an intercompany transaction may evolve over the period of time that is covered by the APA.[11] Rather, the OECD Guidelines encourage the use of comparables, adjustments to such comparables, or profit ranges (e.g., a range of profit mark-up applied with the cost plus method) in order to enhance the reliability of assumptions about future transactions. However, in certain cases an APA may apply to values (i.e., not only a methodology), particularly with regard to transactions that occur only once. For example, an APA may include a value if it is concluded for the sale of an intangible.

The conclusion of an APA is not compulsory, be it for the competent authorities or for multinational enterprises. Competent authorities that conclude an APA accept the application of a transfer pricing methodology for a certain period of time, on the condition that the content of the APA is enforced by the companies benefiting from the agreement and that certain conditions are fulfilled.[12] In addition, although APAs in most cases apply only to future tax years, certain countries accept that previous years are also covered by an APA, so as to avoid or solve previous disputes.[13] Accordingly, APAs can help avoid situations of double taxation and provide certainty, both for tax administrations and for multinational enterprises. APAs may also be an efficient way for the competent authorities to verify that intercompany transactions are conducted at arm's length, thus ensuring that a correct amount of a multinational enterprise's profits (or losses) are attributable to a given company. At the same time APAs have also drawbacks, such as the fact that the procedure to obtain an APA is often highly time-consuming,[14] the risk that the information provided to the competent authorities is not kept secret, or the lack of guarantee that an agreement will be reached. Therefore, while certain countries have been enthusiastic about implementing APA programmes and have entered into numerous APAs,[15] other countries may feel reluctant about enacting an APA programme or giving priority to this issue over other issues. In addition, despite the availability of APAs, multinational enterprises are not always willing to apply for an APA.

Last, it is important to emphasise that both the OECD and the European Union are considering the implementation of the spontaneous exchange of information relating to advance tax rulings concerning cross-border tax issues, something that is likely to

11. See paras 4.124–4.126 of the OECD Guidelines.
12. See para. 4.135 of the OECD Guidelines. See also paras 43–50, para. 67, as well as paras 74–85 of the annex to Chapter 4 of the OECD Guidelines.
13. See para. 4.136 of the OECD Guidelines, and para. 69 of the annex to Chapter 4 of the OECD Guidelines. The retroactive application of an APA is sometimes referred to as a 'roll-back'.
14. This may discourage developing countries from launching an APA programme, in order to focus their resources on other issues: UN, *Practical Manual on Transfer Pricing for Developing Countries*, para. 3.10.3 (2013).
15. For example, the United States is a country that has entered into numerous APAs, although it was not the first country to launch an APA programme. Between 1991 and 2014, the United States has entered into 'over fourteen hundred agreements': see *Announcement and Report Concerning Advance Pricing Agreements*, IRS, 30 March 2015, p. 2. It is indicated at p. 3 of this document that by the end of 2014 a total number of 1964 APAs had been filed.





include APAs.[16] If such initiatives were to be enforced, not only the existence of an APA but also the content of such an APA may have to be communicated by the country(ies) that issued the APA to the other countries that are likely to be impacted by the pricing of the transaction; within the European Union, under the proposed directive the European Commission would also be a recipient of the information exchanged. The purpose of the spontaneous exchange of information relating to advance tax rulings is, similarly to the introduction of country-by-country reporting, the need to increase transparency about the tax positions of multinational enterprises in the countries where they are established. Exchanging information about the content of APAs would reveal the context of, and the transfer pricing methodology applied to the intercompany transactions that are in the scope of such APAs, something that would provide an indication as to whether or not the arm's length principle has been upheld in such APAs. Sharing the content of APAs would also serve in order to assess the existence of harmful tax practices, and within the European Union the exchange of information between the Member States and with the European Commission would help assess the possible existence of illegal State aid.

### 7.2.2 The Different Types of Advance Pricing Arrangements

There are three types of APAs: unilateral, bilateral, and multilateral APAs.

*Unilateral APAs* are agreements that are concluded between a company and the competent authority (or a tax administration) of a given State. The legal basis for concluding a unilateral APA is the country's domestic law. A unilateral APA is comparable to an advance tax ruling, as in both cases a decision is given by an official body in a country on the tax consequences of a transaction or a series of transactions, before such a (series of) transaction takes place. By definition, a unilateral APA will give certainty as to the method to compute transfer prices or profit margins upon a (series of) intercompany transactions only in the country that issued the unilateral APA. Accordingly, the main advantage of concluding a unilateral APA is the relative simplicity of the procedure to obtain such an APA, compared to bilateral and multilateral APAs; the main drawback is that since only one country is bound by a unilateral APA, double taxation may still occur as the tax administration of the counterpart to the intercompany transaction is not involved in such an APA. Moreover, the methodology agreed in a unilateral APA may be problematic in two respects. The first issue is related to the fact that the country that grants a unilateral APA may expect

16. For the suggestions made by the OECD see OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*, pp. 35–50 (September 2014). For the suggestions made by the European Union, see *Proposal for a Council Directive amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation* (18 March 2015, COM(2015) 135 final). The two proposals share some similarities, but are also different in several respects. In particular, the proposal of the OECD targets only rulings related to 'preferential regimes', whereas the proposal of the European Commission does not take into account the method used to determine the tax base, or the tax rate applied to a given tax base, in order to determine whether or not information about an advance tax ruling or an APA would need to be transferred to the other Member States and to the European Commission.

higher than arm's length prices or profit margins, in order to accept to be bound by an agreement.[17] Even in the lack of an overpriced intercompany transaction, the country of the counterpart to the transaction may suspect the country that granted the unilateral APA to tax more than an arm's length income in order to accept the conclusion of a unilateral APA. The result is an increased risk of double taxation, if the second country does not accept the terms of the unilateral APA concluded with the first country. The second issue is that if the methodology agreed in the unilateral APA results in transfer prices that are below arm's length prices, the country that granted the unilateral APA may be accused of harmful tax practices. In the context of the European Union, the country that issued a unilateral APA may also be found to have granted illegal State aid.[18] Consequently, although unilateral APAs provide certainty in the countries that grant them, and may be relatively simple to obtain, there are shortcomings or risks that may deter multinational enterprises from applying to unilateral APAs.

*Bilateral APAs* are concluded between the competent authorities of the two countries where the companies that are party to a transaction are resident. Therefore, bilateral APAs offer a completely different foreseeability and certainty than unilateral APAs, since the two countries will be bound by the agreement: both multinational enterprises and tax administrations will know what transfer pricing methodology will be applied to a given intercompany transaction during the time of the bilateral APA. The risk of harmful tax practices or illegal State aid is lower, as each country would normally negotiate in its own interest in order to ensure that the transfer pricing methodology is at arm's length. The legal basis for concluding a bilateral APA is the mutual agreement article in the tax treaty between the countries at hand,[19] although domestic rules may provide a more complete legal framework. Therefore, it is not compulsory, for a bilateral APA to be concluded, that the countries at hand have implemented domestic rules on APAs. Examples of areas that may be covered by domestic laws are the period covered by a bilateral APA, the fee that may have to be paid by multinational enterprises to apply for an APA, the information that has to be provided to the competent authorities when applying for an APA, as well as the different steps of the procedure.[20] The main advantage of concluding a bilateral APA is

17. For example, if a company applying for a unilateral APA is characterised as a contract manufacturer that should in principle earn a full cost mark-up of 10%, the country where the unilateral APA is sought may require a full cost mark-up of 15%, in order to accept the request.
18. Granting illegal State aid would normally result in an obligation for the Member State to recover the taxes that have not been levied up to a period of ten years: see Council Regulation no 659/1999, OJ L 83 (27 March 1999), Arts 14 and 15. The aid to be recovered includes interest from the date on which the unlawful aid was at the disposal of the beneficiary until the date of its recovery.
19. See paras 4.139 and 4.141 of the OECD Guidelines. The mutual agreement article is often drafted on the basis of Art. 25 of the OECD Model Tax Convention, which provides a legal framework for discussions as well as agreements between the competent authorities of the contracting States. Paragraph 7 of the annex to Chapter 4 of the OECD Guidelines observes, however, that 'in some cases where a bilateral APA has been sought and the treaty is not appropriate, or where a treaty is not applicable, the competent authorities of some countries may nevertheless conclude an arrangement using the executive power conferred on the heads of tax authorities'.
20. Not all countries have implemented rules on APAs, and, for those who do, the content of the domestic rules on APAs may vary from one country to another. However, domestic rules on APAs usually share similar purposes.





that the two competent authorities (and the two tax administrations) are bound by the APA, so in principle no double taxation may occur with respect to the relevant intercompany transaction as long as the agreement is properly enforced by the parties.[21] The two countries will also obtain certainty as to the enforcement of the arm's length principle over the period covered by the APA. The main drawback of concluding a bilateral APA is the length and costs of the procedure to obtain or renew such an APA, as well as the lack of flexibility for the multinational enterprise in case it needs to make changes to the organisation of the value chain within the group. Another drawback concerns situations where the intercompany transactions entered into as part of the value chain involve more than two countries, as the risk of double taxation remains despite a bilateral APA. This is illustrated with the below example.

*Example: risk of double taxation where the value chain implies a chain of intercompany transactions that involve more than two countries*

Assume that goods are manufactured in country A and sold to a wholesaler in country B for an amount of 80. The goods are then re-sold to a retailer in country C for an amount of 100. Even if an APA is concluded between countries B and C for the sale of goods between the wholesaler and the retailer, such an APA does not preclude a situation of double taxation between countries A and B in relation to the sale of goods from the manufacturer to the wholesaler; the tax administration of country B could consider that the arm's length price for the goods purchased from the manufacturer should be 75, not 80. Accordingly, even if country B has concluded an APA for the sale of goods between the wholesaler and the retailer, it may still challenge the purchase price of the goods by the wholesaler from the manufacturer. To eliminate the risk of double taxation for the whole value chain, it would be necessary for countries A and B, and countries B and C to conclude two bilateral APAs that are consistent with each other, i.e., a multilateral APA.[22]

*Multilateral APAs* refer to a series of bilateral APAs that are concluded by the competent authorities of more than two countries. Concluding a multilateral APA is, in theory, the most secure means to agree on intercompany transfer prices in a consistent manner across a value chain that is fragmented between several countries. Also, considering at the same time all – or at least several of – the intercompany transactions that contribute to the same value chain offers an opportunity for understanding how

21. For example, the functional analysis and the characterisation of the associated enterprises should not change during the period covered by the bilateral APA, as such changes may affect the remuneration of the intercompany transactions.
22. With respect to triangular transfer pricing disputes see *Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the work of the EU Joint Transfer Pricing Forum in the period April 2009 to June 2010 and related proposals 1. Guidelines on low value adding intra-group services and 2. Potential approaches to non-EU triangular cases* (25 January 2011, COM(2011) 16 final); see also Hugo Vollebregt, *Triangular Double Taxation: A Fresh Approach*, 103–106 (International Transfer Pricing Journal, March/April 2012).