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**TRANSFER PRICING GUIDELINES
FOR MULTINATIONAL ENTERPRISES
AND TAX ADMINISTRATIONS
(DRAFT TEXT OF PART II)**

THE COMMITTEE ON FISCAL AFFAIRS

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Paris 1995

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FOREWORD

The attached draft of Part II of the revised OECD Transfer Pricing Guidelines is derestricted under the responsibility of the Secretary-General to facilitate discussions between Member governments and the business community. The document will be discussed in April by Working Party No. 6 and it is hoped that Parts I and II of the Report can be finalised by the Committee on Fiscal Affairs in June 1995.

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**TRANSFER PRICING GUIDELINES
FOR MULTINATIONAL ENTERPRISES
AND TAX ADMINISTRATIONS**

**PART II: APPLICATIONS
(Draft text as of 1st March 1995)**

**ORGANISATION FOR
ECONOMIC CO-OPERATION AND DEVELOPMENT
PARIS**

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CHAPTER IV

SPECIAL CONSIDERATIONS FOR INTANGIBLE PROPERTY

A. Introduction

1. This Chapter discusses special considerations that arise in seeking to establish whether the conditions made or imposed in transactions between associated enterprises involving intangible property reflect arm's length dealings. Particular attention to intangible property transactions is appropriate because the transactions are often difficult to evaluate for tax purposes. The Chapter discusses the application of appropriate methods under the arm's length principle for establishing transfer pricing for transactions involving intangible property used in production and marketing activities. It also discusses specific difficulties that arise when the enterprises conducting marketing activities are not the legal owners of marketing intangibles such as trademarks and tradenames. Cost contribution arrangements among associated enterprises for research and development expenditures that may result in intangible property are discussed in Chapter VI.

2. For the purposes of this Chapter, the term "intangible property" includes rights to use industrial assets such as patents, trademarks, trade names, designs or models, literary and artistic property rights, and intellectual property such as know-how and trade secrets.. This Chapter concentrates on industrial rights, that is intangible property associated with the two categories of production and marketing as representative of the intangible property that is most relevant to the taxation of MNEs. These intangibles are assets that may have considerable value even though they may have no book value in the company's balance sheet. There also may be considerable risks associated with them (e.g., contract or product liability and environmental damages).

B. Production and marketing intangibles

(i) *In general*

3. Production intangibles include patents, know-how, designs, and models that are used for the production of a good or the provision of a service (e.g., installation or repair of a computer). Production intangibles often are created through risky and costly research and development (R&D) activities, and the developer generally tries to recover the expenditures on these activities and obtain a return thereon through product sales, service contracts, or licence agreements. Production intangibles may be developed by any member of an MNE group, to be used by itself and/or other group members. The developer may perform the research activity in its own name, i.e. with the intention of having legal and economic ownership of any resulting production intangible, or on behalf of one or more other group members under an arrangement of contract research where the beneficiary has legal and economic ownership of the intangible. Reciprocal licensing (cross-licensing) is not uncommon, and there may be other more complicated arrangements as well.

4. Marketing intangibles include trademarks and tradenames that aid in the commercial exploitation of a product or service, customer lists, distribution channels, and unique names, symbols, or pictures that have an important promotional value for the product concerned. Some marketing intangibles (e.g., trademarks)

may be protected by the law of the country concerned and used only with the owner's permission for the relevant product or services. The value of marketing intangibles depends upon many factors, including the reputation and credibility of the tradename or the trademark fostered by the quality of the goods and services provided under the name or the mark in the past, the degree of quality control and ongoing R & D, distribution and availability of the goods or services being marketed, the extent and success of the promotional expenditures incurred in order to familiarize potential customers with the goods or services (in particular advertising and marketing expenditures incurred in order to develop a network of supporting relationships with distributors, agents, or other facilitating agencies), the value of the market to which the marketing intangibles will provide access, and the nature of any right created in the intangible under the law.

5. Intellectual property such as know-how and trade secrets can be production intangibles or marketing intangibles. Know-how and trade secrets are proprietary information or knowledge that assists or improves a commercial activity, but that is not registered for protection in the manner of a patent or trademark. The term know-how is perhaps a less precise concept. Paragraph 11 of the Commentary on Article 12 of the OECD Model Convention gives the following definition: "Know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; in as much as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique." Know-how thus may include secret processes or formulae or other secret information concerning industrial, commercial or scientific experience that is not covered by patent. Any disclosure of know-how or a trade secret could substantially reduce the value of the property. Know-how and trade secrets frequently play a significant role in the commercial activities of MNE groups.

6. Care should be taken in determining whether or when a production or marketing intangible exists. For example, not all research and development expenditures produce a valuable production intangible, and not all marketing activities result in the creation of a marketing intangible. It can be difficult to evaluate the degree to which any particular expenditure has successfully resulted in a business asset and to calculate the economic effect of that asset for a given year.

7. For example, marketing activities may encompass a wide range of business activities, such as market research, designing or planning products suitable to market needs, sales strategies, public relations, sales, service, and quality control. Some of these activities may not have an impact beyond the year in which they are performed, and so would properly be treated as current expenses rather than as capitalisable expenditures contributing to the value of an intangible asset. Other activities may have both short-term and long-term effect. In certain cases marketing activities and, with respect to production intangibles, research and development expenditures, should be taken into account as functions relevant to the determination of comparability, rather than as an expenditure creating intangible property that must be valued.

(ii) Examples: patents and trademarks

8. The differences between production and marketing intangibles can be seen in a comparison of patents and trademarks. Patents are basically concerned with the production of goods (which may be sold or used in connection with the provision of services) while trademarks are used in promoting the sale of goods or services. A patent gives an exclusive right to its owner to use a given invention for a limited period of time. A trademark may continue indefinitely; its protection will disappear only under special circumstances (voluntary renunciation, no renewal in due time, cancellation or annulment following a judicial decision, etc.). A trademark is a unique name, symbol or picture that the owner or licensee may use to identify special products or services of a particular manufacturer or dealer and, as a corollary, to prohibit their use by other parties for similar purposes under the protection of domestic law. Trademarks may confer a valuable market status on the goods or services to which they are attached, whether or not those goods or services are otherwise unique. Patents may create a monopoly in certain products or services whereas

trademarks alone do not, because competitors may be able to sell the same or similar products so long as they use different distinctive signs.

9. Patents are usually the result of risky and costly research and development and the developer will try to recover its costs through the sale of products covered by the patent, licencing others to use the invention (often a product or process), or through the outright sale of the patent. The legal creation of a new trademark (or one newly introduced to a given market) is not an expensive matter. In contrast, it will very often be an expensive business to make it valuable and to ensure that the value is maintained (or increased). Intensive and costly advertising campaigns and other marketing activities will ordinarily be necessary as will expenditure on the control of the quality of the trademarked product. The value and any changes will depend to an extent on how effectively the trademark is promoted in the markets in which it is used. In certain cases, the value for the licensor may increase as the result of efforts and expenditure by the licensee. In some cases patents, because of their outstanding quality, may also have a very strong marketing effect similar to that of a pure trademark and payments for the right to use such patents may have to be looked at in much the same light as payments for the right to use a trademark. See, e.g., Section C of this Chapter.

10. Trademarks may be established for goods, either for specific products or for a line of products. They are perhaps most familiar at the consumer market level, but they are likely to be encountered at all market levels. Trademarks may also be acquired for services. The ownership of a trademark would normally be vested in one person, for example, a legally independent company. A trade name (often the name of an enterprise) may have the same force of penetration as a trademark and may indeed be registered in some specific form as a trademark. The names of certain multinational enterprises in pharmaceutical or electronic industries, for example, have an excellent sales promotion value, and they may be used for the marketing of a variety of goods or services. The names of well-known persons, designers, sports figures, actors, people working in show business, etc., may also be associated with trade names and trademarks, and they have often been very successful marketing instruments.

11. A trademark may be sold, licensed, or otherwise transferred by one person to another. Various kinds of license contracts are concluded in practice. A dealer could be allowed to use the trademark without a licence agreement in selling products manufactured by the owner of the trademark, but trademark licencing also has become a common practice, particularly in international trade. Thus, the owner of a trademark may grant a licence to the trademark to another enterprise to use for goods that it produces itself or buys from other sources (or from the licensor). The terms and conditions of license agreements may vary to a considerable extent.

C. Applying the arm's length principle

(i) In general

12. The general guidance set out in Part I for applying the arm's length principle pertains equally to the determination of transfer pricing between associated enterprises for intangible property. It follows from this that such transactions should not be treated differently for tax purposes from similar transactions between independent parties solely by virtue of the fact that the enterprises are associated. This principle can, however, be difficult to apply to controlled transactions involving intangible property because such property may be unique and because, for wholly legitimate business reasons due to the overall long term relationship between them, associated enterprises might sometimes structure a transfer in a manner that independent enterprises would not contemplate (See Chapter I, paragraph 27).

13. Arm's length pricing for intangible property must take into account the perspective of both the transferor of the property and the transferee. From the perspective of the transferor, the arm's length principle would examine the pricing at which a comparable independent enterprise would be willing to transfer the property. From the perspective of the transferee, a comparable independent enterprise may or may not be prepared to pay such a price, depending on the value and usefulness of the intangible property

to the transferee in its business. In considering the value of any benefit that has accrued to an enterprise from entering into a licencing arrangement, regard must be given to whether the fee allows the licensee to obtain an arm's length return from the functions it performs.

14. This analysis is important to ensure that an associated enterprise is not required to pay for intangible property valued based on its highest or most productive use when the property is of more limited usefulness to the associated enterprisers given its business operations. In such a case, it is possible that the price a comparable independent transferee would pay would be lower than the price that a comparable independent transferor would accept. On the other hand, the transferee may have or develop the capacity to make full use of the intangible property (or rights therein) being transferred, in which case examining the range of prices that independent transferors would charge would be sufficient to the analysis. Both perspectives must be considered in establishing arm's length pricing. This discussion highlights the importance of comparability of enterprises when determining the arm's length pricing for intangible property.

(ii) Identifying arrangements made for the transfer of intangible property

15. The conditions for transferring intangible property may be those of an outright sale of the intangible or, more commonly, a royalty under a licensing arrangement for rights in the intangible property. A royalty would ordinarily be a recurrent payment based on the user's output, sales, or in some circumstances, profits. When the royalty is based on the licensee's output or sales, a payment computed on a digressive basis (e.g., a decreasing percentage as output increases) may be common. In arm's length situations cases arise where the payment made to the licensor varies according to the turnover of the licensee (see the example of stepped royalties in paragraph 34). Variations in rates may be justified also according to the extent to which the intangible property concerned has already been used by the licensee in production.

16. In some cases, the value of intangible property will be embedded in the transfer pricing for goods (or services) that incorporate (or make use of) the intangible property. In principle, the transfer of goods (or services) with an embedded intangible should not be considered a transfer of the intangible itself if the associated purchaser does not acquire any right to exploit the intangible, other than rights relating to the resale of the good under normal commercial practices. However, in case the transfer of the good or service conveys to the associated purchaser a right to exploit an embedded production or marketing intangible, it may be necessary to determine whether the transfer pricing for the good or service includes a charge for the intangible property. For example, an enterprise may sell unfinished goods to an associated enterprise and at the same time make available its technical expertise for further processing of these products. The transfer price may be a package price, i.e., for the goods and for the intangible property, in which case, depending on the facts and circumstances, an additional payment for royalties may not be needed for the provision of technical expertise. This type of package pricing may need to be disaggregated to calculate a separate arm's length royalty in countries that impose royalty withholding taxes.

17. In some cases, intangible property will be bundled in a package contract including rights to patents, trademarks, trade secrets, and know-how. For example, an enterprise may grant a license in all the industrial and intellectual properties it owns. The package may need to be disaggregated for purposes of establishing transfer pricing for tax purposes. It also is important to take into account the value of services such as technical assistance and training of employees that the developer may render in connection with the transfer. Similarly, benefits provided by the licensee to the licensor by way of improvements to products or processes may need to be taken into account. These services should be evaluated by applying the arm's length principle, taking into account the special considerations for services described in Chapter V. It may be important in this respect to distinguish between the various means of making know-how available. Guidance on these issues is provided by paragraph 11 of the Commentary to Article 12 of the OECD Model Convention (September 1992).

18. A know-how contract and a service contract may be dealt with differently in a particular country according to its internal tax legislation or to the tax treaties it has concluded with other countries. For

example, whether or not a withholding tax is levied on payments made to non-residents may depend on the way the contract is viewed. If the payment is seen as service fees, it is usually not taxed in the country of origin unless the receiving enterprise carries on business in that country through a permanent establishment situated therein and the fee is attributable to the permanent establishment. On the other hand, royalties paid for the use of intangible property are subject to a withholding tax in some countries.

(iii) Calculation of an arm's length consideration

19. In applying the arm's length principle to controlled transactions involving intangible property, some special factors affecting comparability between the controlled and uncontrolled transactions should be considered. These factors include the expected profits from the intangible property (possibly determined through a net present value calculation), any limitations on the geographic area in which rights may be exercised; export restrictions on goods produced by virtue of any rights transferred; the exclusive or non-exclusive character of any rights transferred; the capital investment (to construct new plants or to buy special machines), the start-up expenses and the development work required in the market; the possibility of sub-licensing, the licensee's distribution network, and whether the licensee has the right to participate in further developments of the property by the licensor.

20. When the intangible property involved is a patent, the analysis of comparability should take into account the nature of the patent (e.g. product or process patent) and the degree and duration of protection afforded under the patent laws of the relevant countries, bearing in mind that new patents may be developed speedily on the basis of old ones, so that the effective protection of the intangible property may be prolonged considerably. An entirely new and distinctive "breakthrough" patent may make existing patents rapidly obsolete and will command a higher price than one either designed to improve a process already governed by an existing patent or one for which substitutes are readily available.

21. Other factors for patents include the length of the period during which patents are likely to maintain their value, the process of production for which the property is used, and the value that the process contributes to the final product. For example, where a patented invention covered only one component of a device, it could be inappropriate to calculate the royalty for the invention by reference to the selling price for the complete product. In such a case, a royalty based on a proportion of the selling price would have to take into account the relative value of the component to the other components of the product. Also, in analysing functions performed (including assets used and risks assumed) for transactions involving intangible property, the risks considered should include product and environmental liability, which have become increasingly important.

22. In establishing arm's length pricing in the case of a sale or licence of intangible property, it may be possible to use the CUP method where the same owner has transferred or licensed comparable intangible property under comparable circumstances to independent enterprises. The amount of consideration charged in comparable transactions between independent enterprises in the same industry may also be a guide, where this information is available, and a range of pricing may be appropriate. Offers to unrelated parties or genuine bids of competing licensees also may be taken into account. If the associated enterprise sub-licenses the property to third parties, it may also be possible to use some form of the resale price method to analyse the terms of the controlled transaction.

23. In the sale of goods incorporating intangible property such as a trademark, it may also be possible to use the CUP or resale price method following the principles in Chapter II. When a trademark is involved, the analysis of comparability should consider the value added by the trademark, taking into account consumer acceptability, geographical significance, market shares, sales volume, and other relevant factors..

24. For example, it may be the case that a branded athletic shoe transferred in a controlled transaction is comparable to an athletic shoe transferred under a different brand name in an uncontrolled transaction

both in terms of the quality and specification of the shoe itself and also in terms of the consumer acceptability and other characteristics of the brand name in that market. Where such a comparison is not possible, some help also may be found, if adequate evidence is available, by comparing the volume of sales and the prices chargeable and profits realised for trademarked goods with those for similar goods that do not carry the trademark. It therefore may be possible to use sales of unbranded products as comparable transactions to sales of identical branded products, but only to the extent that adjustments can be reliably made to account for any value added by the trademark. For example, if it is established that the brand name of an athletic shoe with a comparable market acceptance attracts a 10 percent premium in the open market, then it may be possible to use the information in determining the price of an otherwise comparable but unbranded athletic shoe. However, adjustments may be particularly difficult where a trademarked product has a dominant market position such that the generic product is in essence trading in a different market, particularly where sophisticated products are involved.

25. In cases involving highly valuable intangible property, it may be difficult to find transactions between independent enterprises that are sufficiently close in their transactional features to the controlled transaction to achieve adequate comparability for the transaction-based methods. Indeed, transactions between independent enterprises involving highly valuable intangible property are infrequent. As a consequence, comparable transactions may not often exist; even where they do exist, neither the taxpayer nor the tax administration may be able to uncover or obtain information about them, due in part to business concerns over secrecy and confidentiality. Where the foregoing difficulties arise, it may be useful as a last resort to take account of evidence provided by profit methods as discussed in Chapter III. However, it may not be necessary to value the intangible property or find comparables for it where it is possible to determine under a transactions-based method the appropriate return to the licensee from the functions it is performing. This approach could be combined with a residual profit split method (see Part I, paragraph 146). It may be difficult to identify reliable data to apply the comparable profits method unless the associated enterprise to which the method is applied does not own valuable intangible property or unique assets that distinguish it from potential comparable enterprises (see Part I, paragraph 169).

26. In assessing whether the conditions of a transaction involving intangible property reflect arm's length dealings, the costs incurred in developing or maintaining the intangible property might be examined as an aid to determining comparability or possibly relative value, particularly where a profit split method is used. However, there is no necessary link between costs and value. In particular, the actual fair market value of intangible property is frequently not measurable in relation to the costs involved in developing and maintaining the property. One reason is that intangible property, such as patents and know-how, may be the result of long-lasting and expensive R&D. The actual size of R&D budgets depends on a variety of factors, including the policy of competitors or potential competitors, the expected profitability of the research activity, and the trend of profits; or considerations based on some relation to turnover, or an assessment of the yield from R & D activity in the past as a basis for fixing future expenditure levels.

27. Basic research can be of great importance to a wide range of production intangibles. There have been many instances where private groups have helped to advance the limits of scientific knowledge as a result of basic research sometimes undertaken with only the broadest commercial objective in view. As to applied research, such activities will be oriented to the solution of fairly immediate and well-defined problems whose commercial potential is perceived by the enterprise that undertakes it. [From paragraph 24] Another reason is that intangible property may require ongoing R&D and quality control that may benefit a range of products.

28. It is important to distinguish between the value of intangible property, to which costs have no necessary link, and the success of R&D activities, which may be measured by reference to costs. For example, where the actual or reasonably expected future revenue (through licencing or the sale of products) or the proceeds of sale of the production intangible exceed the cost of its development, research can be successful in the sense that the desired production process was produced, but such an outcome does not make the product or process valuable. On one view, it could be said that any research which resulted in

some revenue being received from the commercial exploitation of a production intangible is successful, but it might be the case that the costs associated with the development of that production intangible may never be recovered. This does not mean that the production intangible concerned has no value. It may be that it has quite a high value, but its earning capacity may not cover the cost of its development. It is only failed research that does not lead to a generation of any revenue.

29. The fair market value of a production intangible may be able to be determined using a discounted cash flow technique or some other valuation technique but such techniques are unlikely to be based on the cost of development of the production intangible.

30. The commercial exploitation of production intangibles arising from research will need to cover the costs associated with their development as well as the costs associated with failed research. Where an examination of costs is being undertaken, it will often be difficult to determine the costs connected with the development of a particular production intangible or to identify research with a particular project when research is performed in a group on a large scale and for various purposes or where there is a pooling of R&D efforts or where basic research contributes to multiple products. Any reference to cost can be hazardous because of the uncertainties attendant on the eventual return on expenditures on research and development, the length of time during which technology will prove to be commercially useful, and any monopoly element that may be present.

31. In some multinational enterprises R & D is undertaken by one or more members in their own name, the results being made available to the other members mainly by way of licensing contracts; in such a case, R & D expenditures will not be recouped until such time as any intangible property is developed. For instance, R & D expenditures may be recovered in part from the sales of the goods which derive from the results of the R&D, and in part from the sale and licensing of items of intangible property to associated or independent enterprises. In both cases, taxable profits accrue to the entities using the results of their R & D against which the costs involved can be offset.

32. Other MNEs find it convenient to adopt varying forms of cost contribution arrangements for allocating R & D expenses (and sometimes other expenses like services and overheads) among the different members participating in the agreement; in such cases, R & D expenditures can be funded before any production intangible is developed. It may also occur that research is performed by an enterprise on a contract basis at the specific request of an associated enterprise to whom any resulting production intangibles will be assigned (contract research). Such arrangements may often be regarded simply as a service being rendered by the enterprise undertaking the research and, if so, the payments made for the research may be more appropriately treated as fees for the provision of intra-group services as discussed in Chapter V. Tax administrations should be aware of the developments regarding the manner in which expenditures on R & D are recovered and take them into account when examining the conditions of controlled transactions involving production intangibles.

(iv) Periodic adjustments

33. Tax administrations can face particular difficulties in determining the arm's length consideration when intangible property is transferred between associated enterprises for a lump sum fixed price, or licensed for a multiple year term at a fixed royalty rate established at the beginning of the term and applicable for the entire term. These difficulties arise largely because of the potential problems in valuing the intangible property at the time the property is transferred. They raise the issue of when it is appropriate for a tax administration to adjust a lump sum transfer price or royalty rate established in such an arrangement, particularly in years after the year of the transfer.

34. The value of an intangible, which is always an important comparability factor in cases involving the transfer of intangibles, can be difficult to determine. Difficulty in valuing intangible property at the time it is transferred can give rise to several fundamental problems for determining arm's length transfer prices.

One problem is that a tax administration may have difficulty obtaining sufficient information to evaluate what profits were anticipated by the parties at the time of the transaction. Subsequent developments may be helpful in such cases in evaluating the reasonableness of the parties' valuation, as discussed in paragraph 40.

35. A second problem is that where the value of intangible property is uncertain the potential lack of tension between the interests of the associated enterprises could lead to results that are inconsistent with the arm's length principle. Thus, where the value of an intangible is highly uncertain independent enterprises might in some cases prefer to enter into shorter term licences or licences with price adjustment or renegotiation provisions or would not transfer it at all (indeed, there are very few arm's length transfers of the most valuable intangibles). Associated enterprises may enter into such lump sum sales or fixed royalty rate arrangements because they are not worried about surrendering the profits to a separate economic interest. Moreover, this lack of tension in interests means that associated enterprises may choose to terminate an arrangement that results in an undesirable allocation of profits whether or not independent enterprises would have done so. Similarly, associated enterprises may choose not to disturb the lopsided results obtained under an agreement, even though independent enterprises might have renegotiated the agreement under similar circumstances, even in the absence of contractual terms providing for such renegotiation. For example, such renegotiation could occur at arm's length if a royalty rate that turned out to be excessive removed the incentive of the licensee to use the intangible property at all. In addition, renegotiation could occur at arm's length because such a lopsided result might threaten the basis of a mutually beneficial long-term relationship between the parties or because of the possibility of a breach of the agreement that could only be remedied through prolonged, costly litigation with an uncertain outcome.

36. On the other hand, as indicated in paragraph 27 of Part I, it cannot be automatically assumed that independent enterprises would transfer intangible property for a fixed amount or at a fixed rate only when the property can be valued with certainty. Paragraph 27 states: "[T]here is always a risk that the intangible is not as valuable as it seems to be. Therefore, an independent enterprise has to make the choice between selling the intangible and so diminishing the risk and safeguarding the profit, and exploiting the intangible and taking the risk that the profit will vary from the profit which could be gained by selling the intangible." Further, tax administrations should also take into account the fact that independent enterprises do not always strike the best deal, and at times must suffer the consequences of having made a poor business decision. They do not necessarily break contracts if the terms have become unfavourable to them

37. In view of these difficulties associated with the valuation of intangible property, tax administrations may find it necessary to review transfers of intangible property between associated enterprises. Such a review may need to address two distinct issues: 1) whether the consideration established at the time of transfer is consistent with the arm's length principle and 2) whether to adjust the amount of consideration with respect to a subsequent year. Such adjustments in subsequent years are sometimes referred to as "periodic adjustments."

38. As to the first of these issues, Part B provides relevant guidance. In addition, tax administrations may find it necessary to consider whether the transactions should be restructured under the principles set forth in paragraphs 52-57 of Chapter I. For example, a tax administration might consider whether to restructure a lump sum sale as a royalty arrangement, or to convert a long-term royalty arrangement into a series of shorter-term arrangements. For example, if associated enterprises have entered into a fixed rate royalty agreement for a 50-year term, the tax administration might question the substance of the transaction and whether comparable independent enterprises would have been willing to set a term of that duration or would rather have, for example, structured the transaction as a series of 5-year royalty arrangements (with a fixed royalty rate being established at the outset of each 5-year term).

39. The more difficult question for tax administrations will be whether to adjust the amount of consideration with respect to a subsequent year based upon subsequent developments. In determining whether such future adjustments may be appropriate, the following principles should be observed. First,

no such adjustment should be made if comparable independent enterprises would have agreed to comparable fixed amount or fixed rate arrangements with respect to the sale or licence of intangible property presenting a comparable level of uncertainty in valuation (and would not have agreed to a subsequent modification of the terms of the agreement). Second, a future adjustment would be appropriate only if the tax administration has no other recourse to determine an appropriate transfer price. This standard could be met only where it is not possible to determine what the value of the intangible property was on the date the arrangements were made. Third, where intangible property has been transferred at a fixed sales price or a fixed royalty rate, tax administrations should make every effort to establish an arm's length amount that requires no future adjustment, using all information that is available with the guidance in Part I.

40. Thus, future adjustments will be limited to those exceptional cases in which associated enterprises have sold or licensed intangible property under fixed terms for multiple years where comparable independent enterprises would have insisted on bonus payments, a price adjustment clause, or would have been able to achieve a renegotiation of the contract. In determining whether independent enterprises would have maintained fixed terms for a transfer, one consideration that tax administrations may take into account is whether actual profit experience has been inconsistent with that anticipated by the associated enterprises in the projections made at the time of the initial transfer. The existence of such an inconsistency would not by itself be sufficient to justify an adjustment by the tax administration. Rather, the question to be asked is whether the variation in actual profit experience is attributable to factors that could not reasonably have anticipated. Where profit experience has been affected by such unanticipated factors, an adjustment to future consideration would not generally be appropriate, since parties at arm's length would not have considered those factors in determining whether to adopt fixed terms for the agreement.

41. When a tax administration seeks to adjust the consideration for the use of an intangible in a year subsequent to the initial transfer, it will of course need to respect applicable time limits for adjustments under the relevant provisions of national law. This consideration may be particularly important when a lump sum fixed sales price has been established for a transfer of intangible property. In any event, by definition a future years adjustment cannot be retractive, in the sense that it should not be applied until the period in which a price adjustment clause would reasonably have come into effect, had such a clause been included in the contract.

[IT IS ANTICIPATED THAT EXAMPLES WILL BE ADDED]

D. Marketing activities undertaken by enterprises not owning trademarks or tradenames

42. Difficult transfer pricing problems are presented when marketing activities are undertaken by enterprises that do not own the trademarks or tradenames that they are promoting (such as a licensee or distributor of branded goods). One difficulty arises in attempting to identify the return that is attributable to marketing activities. A marketing intangible may obtain value as a consequence of advertising and other promotional expenditures, which can be important to maintain the value of the trademark. However, it can be difficult to determine what these expenditures have contributed to the success of a product. For instance, it can be difficult to determine what advertising and marketing expenditures have contributed to the production or revenue, and to what degree. It is also possible that a new trademark or one newly introduced into a particular market may have no value or little value in that market and its value may change over the years as it makes an impression on the market (or perhaps loses its impact). A dominant market share may to some extent be attributable to marketing efforts of a distributor. The value and any changes will depend to an extent on how effectively the trademark is promoted in the particular market. More fundamentally, in many cases higher returns derived from the sale of trademarked products may be due as much to the unique characteristics of the product or its high quality as to the success of advertising and other promotional expenditures. The actual conduct of the parties over a period of years should be

given significant weight in evaluating the return attributable to marketing activities. See paragraphs 65-67 of Part I (multiple year data).

43. A second difficulty arises in determining the capacity in which a distributor or licensee has undertaken advertising or other promotional expenditures and therefore how it might be compensated at arm's length for those activities. In particular, difficulties may arise in determining the extent to which these activities should be viewed as being undertaken for the distributor's or licensee's own benefit at its own risk or rather as a service to the owner of the trademark or tradename. This type of problem as a general rule is solved based on the functions that each party performs, taking into account all the obligations implied by the licensing arrangement and the likely costs to be incurred or saved by both parties. As with production intangibles, the analysis must consider both the costs to the transferor and the benefit to the transferee. This analysis requires an assessment of the obligations implied by the licence agreement and the likely costs to be incurred or saved by both parties.

44. For example, it would not always be appropriate to attribute greater profitability from a branded product relative to an unbranded product entirely to the owner of the brand. Where such profits are attributable to a distributor's promotional activities, the appropriate allocation of those profits will depend on the capacity in which the distributor undertook the activities. Where the distributor actually bears the cost of its promotional expenditures (i.e., there is no arrangement for the owner to reimburse the expenditures) and where the distributor has the ability to obtain the benefits of successful promotional activities in the future, then in arm's length dealings the distributor would ordinarily be entitled to some additional profits if these activities were successful. In general, a party that is not the legal owner of a marketing intangible should obtain an arm's length share in the income generated in the MNE from marketing activities to promote that intangible where the facts and circumstances reasonably indicate that such an allocation would be made were the parties independent. In making this determination, it would be appropriate to consider the promotional expenditures that would have been made by an independent enterprise with similar legal rights. To the extent that the associated enterprise incurs greater expenditures than an independent enterprise would have incurred in comparable circumstances, appropriate compensation should be received.

45. Where the distributor does not bear the costs of the promotional expenditures, because it is reimbursed for those costs, it usually would be inappropriate for the distributor to obtain more than a margin appropriate for its distribution activities alone. In such a case, the distributor may be treated as performing promotional services for the owner of the intangible, and may be entitled to be compensated for those services according to the principles in the foregoing Chapters and Chapter V (special considerations for intra-group services).

46. Where the distributor does bear the costs of the promotional expenditures, the tax administration should determine the extent to which the distributor is able to share in the potential benefits from those activities, for example in the transfer pricing agreement for the product. In general, in arm's length dealings the ability of a party that is not the legal owner of a marketing intangible to obtain the future benefits of promotional activities that increase the value of that intangible will depend on the substance of the economic rights of that party. For example, a distributor would have the ability to obtain the future benefits from investments in developing the value of a trademark to the extent that it had a long-term contract of sole distribution rights for the trademarked product, although in some cases the nature of the risk may require a higher margin.

CHAPTER V

SPECIAL CONSIDERATIONS FOR INTRA-GROUP SERVICES

A. Introduction

47. This Chapter discusses issues that arise in determining for transfer pricing purposes whether services have been provided by one member of an MNE group to other members of that group and, if so, in establishing arm's length pricing for those intra-group services. The Chapter does not address except incidentally whether services have been provided in a cost contribution arrangement, and if so the appropriate arm's length pricing, i.e., where members of an MNE group jointly acquire, produce or provide goods, services, and/or intangible property, allocating the costs for such activity amongst the members participating in the arrangement. Cost contribution arrangements are the subject of Chapter VI.

48. Nearly every MNE group must arrange for a wide scope of services to be available to its members, in particular administrative, technical, financial and commercial services. Such services may include management, coordination and control functions for the whole group. The cost of providing such services may be borne initially by the parent, by a specially designated group member ("a group service centre"), or by another group member. An independent enterprise in need of a service may acquire the services from a service provider who specialises in that type of service or may perform the service for itself (i.e., in house). In a similar way, a member of an MNE group in need of a service may acquire it directly or indirectly from independent enterprises, or from one or more associated enterprises in the same MNE group (i.e., intra-group), or may perform the service for itself. Intra-group services often include those that are typically available externally from independent enterprises (such as legal and accounting services), in addition to those that are ordinarily performed internally (e.g., by an enterprise for itself, such as central auditing, financing advice, or training of personnel).

49. Intra-group arrangements for rendering services are sometimes linked to arrangements for transferring goods or intangible property (or the licensing thereof). In some cases, such as with know-how contracts containing a service element, it may be very difficult to determine where the exact border lies between the transfer or licensing of property and the transfer of services. Ancillary services are frequently associated with the transfer of technology. It may therefore be necessary to consider the principles for aggregation and segregation of transactions in Chapter I where a mixed transfer of services and property is involved.

50. Intra-group service activities may vary considerably among MNE groups, as does the extent to which those activities provide a benefit, or expected benefit, to one or more group members. Each case is dependent upon its own facts and circumstances and the arrangements within the group. For example, in a decentralised group, the parent may limit its intra-group activity to monitoring its investments in its subsidiaries in its capacity as a shareholder. In contrast, in a centralised or integrated group, the Board of Directors and senior management of the parent company may make all important decisions concerning the affairs of its subsidiaries and the parent company may carry out all marketing, training and treasury functions.

B. Main Issues

51. There are two issues in the analysis of transfer pricing for intra-group services. One issue is whether intra-group services have in fact been provided. The other issue is what the intra-group charge for such services should be for tax purposes in accordance with the arm's length principle. Each of these issues is discussed below.

(i) Determining whether intra-group services have been rendered

52. Under the arm's length principle, the question whether an intra-group service has been rendered when an activity is performed for one or more group members by another group member should depend on whether a comparable independent enterprise would have concluded that the activity would provide economic or commercial value to enhance its commercial position. This can be determined by considering whether the independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself. If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle.

53. The analysis described above quite clearly depends on the actual facts and circumstances, and it is not possible in the abstract to set forth categorically the activities that do or do not constitute the rendering of intra-group services. However, some guidance may be given to elucidate how the analysis would be applied for some common types of activities undertaken in MNE groups.

54. Some intra-group services are performed by one member of an MNE group to meet an identified need of one or more specific members of the group. In such a case, it is relatively straightforward to determine whether a service has been provided. Ordinarily an independent enterprise in comparable circumstances would have satisfied the identified need either by performing the activity in-house or by having the activity performed by a third party. Thus, in such a case, an intra-group service ordinarily would be found to exist. For example, an intra-group service would normally be found where an associated enterprise repairs equipment used in manufacture by another member of the MNE group.

55. More difficult cases are presented where an associated enterprise undertakes activities that relate to more than one member of the group or to the group as a whole. In a narrow range of cases, an intra-group activity may be performed relating to group members even though those group members do not need the activity (and would not be willing to pay for it were they independent enterprises). Such an activity would be one that a group member (usually the parent company or a regional headquarters company) performs solely because of its ownership interest in one or more other group members, i.e. in its capacity as shareholder. This type of activity would not justify a charge to the recipient companies. It may be referred to as a "shareholder activity", distinguishable from the broader term "stewardship activity" used in the 1979 Guidelines. Stewardship activities covered a range of activities by a shareholder that may include the provision of services to other group members, for example services that would be provided by a coordinating centre. These latter types of non-shareholder activities could include detailed planning services for particular operations, emergency management or technical advice (trouble shooting), or in some cases assistance in day-to-day management or internal audit as far as required for coordination purposes.

56. Shareholder activities could include the following:

- a) activities relating to the juridical structure of the shareholding company itself, such as meetings of shareholders of the shareholding company, issuing of shares in the shareholding company;
- b) activities to satisfy statutory reporting requirements of the shareholding company including the consolidation of reports; and
- c) raising funds for the acquisition of new group members.

The foregoing categories are intended to be illustrative rather than determinative. The determination whether an activity is an intra-group service should be made not according to whether the activity falls within one of the categories but rather according to whether under comparable facts and circumstances the activity is one that an independent enterprise would have been willing to pay for or to perform for itself.

57. In general, no intra-group service should be found for activities undertaken by one group member that merely duplicate a service that another group member is performing for itself, or that is being performed for such other group member by a third party. An exception may be where the duplication of services is only temporary, for example, where an MNE group is reorganizing to centralize its management functions.

58. There are some cases where an intra-group service performed by a group member such as a shareholder or coordinating centre relates only to some group members but incidentally provides benefits to other group members. Examples could be taking a decision to reorganise the group, to acquire new members, or to terminate a division. These activities could constitute intra-group services to the particular group members involved, for example those members who will make the acquisition or terminate one of their divisions, but they may also produce economic benefits for other group members not involved in the object of the decision by increasing efficiencies, economies of scale, or other synergies. The incidental benefits ordinarily would not cause these other group members to be treated as receiving an intra-group service because the activities producing the benefits would not be ones for which an independent enterprise ordinarily would be willing to pay. Similarly, an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed. For example, no service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member, or where the enterprise benefitted from active marketing of the group's reputation. In this respect, passive association should be distinguished from active promotion of the MNE group's attributes that positively enhances the profit-making potential of particular members of the group. Each case must be determined according to its own facts and circumstances.

59. Other activities that may relate to the group as a whole are those centralised in the parent company or a group service centre, (such as a regional headquarters company) and made available to the group (or multiple members thereof). The activities that are centralised depend on the kind of business and on the organisational structure of the group, but in general they may include administrative services such as planning, coordination, budgetary control, financial advice, accounting, auditing, legal, factoring, computer services; financial services such as supervision of cash flows and solvency, capital increases, loan contracts, intercompany swapping and hedging, and refinancing; assistance in the fields of production, buying, distribution and marketing; and services in staff matters such as recruitment and training. Group service centres also often carry out research and development or administer and protect intangible property for all or part of the MNE group.

60. These type of activities ordinarily will be considered intra-group services because they are the type of activities that independent enterprises would have been willing to pay for or to perform for themselves

(assuming that commercial circumstances did not dictate to the contrary). The extent of the benefit will affect the amount of an arm's length charge for the service. In considering whether a charge for the provision of some of the listed services would be made between independent enterprises, it would also be relevant to consider the form that an arm's length consideration would take had the transaction occurred between independent enterprises dealing at arm's length. For example, in respect of financial services such as loans, foreign exchange and hedging, the appropriate form of remuneration is built into the spread and it would not be appropriate to expect a further service fee to be charged if such were the case.

61. Another issue arises with respect to services provided "on call". The question is whether the availability of such services is itself a separate service for which an arm's length charge (in addition to any charge of services actually rendered) should be determined. A parent company or a group service centre may be on hand to provide services such as financial, managerial, technical, legal or tax advice and assistance to members of the group at any time. In that case, a service may be rendered to associated enterprises by having staff, equipment, etc., available. An intra-group service may exist to the extent that it would be reasonable to expect an independent enterprise in comparable circumstances to incur "standby" charges to ensure the availability of the services when the need for them arises. It is not unknown, for example, for an independent enterprise to pay an annual "retainer" fee to a firm of lawyers to ensure entitlement to legal advice and representation if litigation is brought. Another example is a service contract for priority computer network repair in the event of a breakdown.

62. These services may be available on call and they may vary in amount and importance from year to year. It is unlikely that an independent enterprise would incur stand-by charges where the potential need for the service was remote, where the advantage of having services on-call was negligible, or where the on-call services could be obtained promptly and readily from other sources without the need for stand-by arrangements. Thus, the benefit conferred on a group company by the on-call arrangements should be considered, perhaps by looking at the extent to which the services have been used over a period of several years rather than solely for the year in which a charge is to be made, before determining that an intra-group service is being provided.

63. The fact that a payment was made to an associated enterprise for purported services can be useful in determining whether services were in fact provided, but the mere description of a payment as, for example, "management fees" should not be expected to be treated as prima facie evidence that such services have been rendered. At the same time, the absence of payments or contractual agreements does not automatically lead to the conclusion that no intra-group services have been rendered.

(ii) *Determining an arm's length charge*

(a) In general

64. Once it is determined that an intra-group service has been rendered, it is necessary, as for other types of intra-group transfers, to determine whether the amount of the charge, if any, is in accordance with the arm's length principle. This means that the charge for intra-group services should be that which would have been made between independent enterprises in comparable circumstances. Consequently, such transactions should not be treated differently for tax purposes from comparable transactions between independent enterprises, simply because the transactions are between enterprises that happen to be associated.

(b) Identifying actual arrangements for charging for intra-group services

65. To identify the amount, if any, that has actually been charged for services, a tax administration will need to identify what arrangements, if any, have actually been put in place between the associated enterprises to facilitate charges being made for the provision of services between them. In certain cases, the arrangements made for charging for intra-group services can be readily identified. These cases are where

the MNE group uses a direct-charge method, i.e., where the associated enterprises are charged for specific services. In general, the direct-charge method is of great practical convenience to tax administrations because it allows the service performed and the basis for the payment to be clearly identified. Thus, the direct-charge method facilitates the determination whether the charge is consistent with the arm's length principle.

66. An MNE group should often be able to adopt direct charging arrangements, particularly where services similar to those rendered to associated enterprises are also rendered to independent parties. If specific services are provided not only to associated enterprises but also to independent enterprises in a comparable manner and as a significant part of its business, it could be presumed that the MNE has the ability to demonstrate a separate basis for the charge (e.g., by recording the work done and costs expended in fulfilling its third party contracts). As a result, MNEs in such a case are encouraged to adopt the direct-charge method in relation to their transactions with associated enterprises. It is accepted, however, that this approach may not always be appropriate if, for example, the services to third parties are merely occasional or marginal.

67. A direct-charge method for charging for intra-group services is so difficult to apply in practice in many cases for MNE groups that such groups have developed other methods for charging for services provided by parent companies or group service centres. In these cases, the practice of MNE groups for charging for intra-group services is often to make arrangements that are either (a) readily identifiable but not based on a direct-charge method; or (b) not readily identifiable and either incorporated into the charge for other transfers, allocated amongst group members on some basis, or in some cases not allocated amongst group members at all. It is important that the practice chosen allows a determination whether the transfer pricing is consistent with the arm's length principle.

68. In such cases, MNE groups may find they have few alternatives but to use cost allocation and apportionment methods which often necessitate some degree of estimation or approximation. Such methods are generally referred to as indirect-charge methods and should be allowable provided sufficient regard has been given to the value of the services to recipients and the extent to which comparable services are provided between independent enterprises. These methods of calculating charges would generally not be acceptable where specific services that form a main business activity of the enterprise are provided not only to associated enterprises but also to third parties. While every attempt should be made to charge fairly for the service provided, any charging has to be supported by an identifiable and reasonably foreseeable benefit. Any indirect charge method needs to be applied to the facts and circumstances of the case, contain safeguards against manipulation, and be capable of producing charges or allocations of costs that are in proportion to the actual or reasonably expected benefits to the recipient of the service.

69. In some cases, an indirect charge method may be necessary due to the nature of the service being provided. One example is where the proportion of the value of the services rendered to the various relevant entities cannot be quantified except on an approximate or estimated basis. This problem may occur, for example, where sales promotion activities carried on centrally (e.g. at international fairs, in the international press, or through other centralised advertising campaigns) may affect the quantity of goods manufactured or sold by a number of affiliates. Another case is where a separate recording and analysis of the relevant service activities for each beneficiary would involve a burden of administrative work that would be disproportionately heavy in relation to the activities themselves. In such cases, the charge could be determined by allocating among all potential beneficiaries the costs that cannot be allocated directly, i.e., costs that cannot be specifically assigned to the actual beneficiaries of the various services. To satisfy the arm's length principle, the allocation method chosen must be consistent with what comparable independent enterprises would have arranged.

70. The allocation might be based on turnover, or staff employed, or some other basis. Whether the allocation method is appropriate will depend on the nature and usage of the service. For example, the usage or provision of payroll services may be more related to the number of staff than to turnover. The need for

accounting and auditing services may be more dependent on geographical location (e.g. complexity of requirements in the jurisdiction) than to turnover.

71. The compensation for services rendered to an associated enterprise may be included in the price for other transfers. For instance, the price for licencing a patent or know-how may include a payment for technical assistance services or centralised services performed for the licensee or for managerial advice on the marketing of the goods produced under the licence. In such cases, the tax administration would have to check that there is no additional service fee charged and that there is no double deduction.

72. When an indirect charge method is used, the relationship between the charge and the services provided is obscured and it may become difficult to evaluate the benefit provided. Indeed, it may mean that the enterprise being charged for a service itself has not related the charge to the service. Consequently, there is an increased risk of double taxation because it may be more difficult to determine a deduction for costs incurred on behalf of group members if compensation cannot be readily identified, or for the recipient of the service to establish a deduction for any amount paid if it is unable to demonstrate that services have been provided.

73. In cost contribution arrangements, discussed in Chapter VI, services are jointly acquired or funded, where the actual costs incurred in providing the services are allocated in the manner that most reasonably reflects the benefits received or expected to be derived therefrom. Such cost contribution arrangements may be preferred by highly-integrated groups of companies, since the benefit of the central activities which are peculiar to such companies often cannot be precisely related to individual group members.

74. In relation to any retainer charge for the provision of "on call" services, an arm's length price for the retainer charge might depend on the actual use of the services, and the basis for charging for those actual services (for example, whether any charge for actual use of services is not made until such time as the level of usage exceeds a predetermined level). A better guide to the reasonableness of the retainer charge, in an arm's length situation, is whether the arrangement is maintained or not, although a group member may not have that choice. CUPs may also be available to determine whether the retainer charge is reasonable or not.

(c) Calculating the arm's length consideration

75. In trying to determine the arm's length price in relation to intra-group service, the matter should be considered both from the perspective of the service provider and also from the perspective of the recipient of the service. In this respect, relevant considerations include the value of the service to the recipient and how much a comparable independent enterprise would be prepared to pay for that service in comparable circumstances, as well as the costs to the service provider.

76. For example, from the perspective of an independent enterprise seeking a service, the service providers in that market may or may not be willing or able to supply the service at a price that the independent enterprise is prepared to pay. If the service providers can supply the wanted service within a range of prices that the independent enterprise would be prepared to pay, then a deal will be struck. From the point of view of the service provider, a price below which it would not supply the service and the cost to it are relevant considerations to address, but they are not necessarily determinative of the outcome in every case.

77. The method to be used to determine arm's length transfer pricing for intra-group services should be determined according to the guidelines in Part I. Often, the application of these guidelines will lead to use of the CUP or cost plus method for pricing intra-group services. A CUP method is likely to be used where there is a high degree of comparability between the intra-group service being provided and a comparable service that is provided between independent enterprises in the recipient's market, or between the associated enterprise providing the service and an independent enterprise. For example, this might be the case where

accounting, auditing, legal, or computer services are being provided. A cost plus method might be used in the absence of a CUP where the nature of the intra-group services are comparable to services being provided between independent enterprises. This method may be used often because information on the "plus" margin of comparable independent enterprises will frequently be available. As indicated in Chapter II, in applying the cost plus method, the determination of the costs usually includes not only direct but also indirect costs. Direct costs are those identifiable with a particular service including, for example, costs attributable to employees directly engaged in performing such services, and expenses for material and supplies directly consumed in rendering such services. Indirect costs are those that cannot be identified as incurred in relation to a particular activity but which, nevertheless, are related to the direct costs, such as heat, lighting, and other overhead burdens and reasonably allocable general and administrative expenses.

78. Under the Part I guidelines, profit methods would not often be needed to establish the transfer pricing of intra-group services that do not belong to the core business of the associated enterprise performing those services, because the cost plus method will frequently be available. Where this is not the case and if a profit method is being applied as a last resort, great care must be taken so that the profits being examined relate as closely as possible to the services themselves. This may be a difficult task unless the intra-group services are of a particular importance within the group.

79. It may be helpful to perform a functional analysis of the various members of the group and analyze their performances and profits (perhaps over several years) to establish the relationship between the relevant services and the member's activities and performance. In addition, it may be necessary to consider not only the immediate impact of a service, but also its long-term effect. For example, expenditure on preparations for a marketing operation might prima facie be too heavy to be borne by a member in the light of its current resources, but, taking into account the profit expectations from the operation, a charge for such services may nevertheless be regarded as an arm's length charge. The taxpayer should be prepared to demonstrate the reasonableness of its charges to members in such cases.

80. Depending on the method being used to establish an arm's length charge for intra-group services, the issue may arise whether it is necessary that the charge include an element of profit for the service provider. In an arm's length transaction, an independent enterprise normally would charge for services in such a way as to capture an element of profit, rather than providing the services merely at cost. However, there are circumstances in which an independent enterprise may not realize a profit from the performance of service activities, for example where a supplier's costs (anticipated or actual) exceed market price but the supplier agrees to provide the service to get market share or to complement its range of activities. Therefore, it need not always be the case that an arm's length price will result in a profit for an associated enterprise that is performing an intra-group service.

81. For example, it may be the case that the value of intra-group services to the recipient is not greater than the costs incurred by the service provider. This could occur where, for example, the service is not an ordinary or recurrent activity of the service provider but is offered incidentally as a convenience to the MNE group. In such a case, an independent enterprise engaged in providing the service to third parties may not be comparable to the intra-group service provider because the intra-group provider does not have a particular expertise or qualification for rendering the service, and as a result its costs may be higher. The comparison of costs can be relevant in assessing comparability to determine whether the services are providing the same value for the charge as what could be obtained from an independent enterprise. An MNE group may still determine to provide the service intra-group rather than using a third party, so long as the costs incurred do not exceed what the third party would charge in comparable circumstances. To require a profit element in such a case could cause an associated enterprise to pay more for a service than, for example, what the arm's length price would be determined under the CUP method. It would not be appropriate in such a case to increase the price above what would be established by the CUP method just to make sure the associated enterprise makes a profit. Such a result would be contrary to the arm's length principle.

82. Where the cost plus method is being used (which assumes the CUP method is not considered appropriate in the case), there may similarly be situations in which the arm's length price would not produce a profit element for the associated service provider, taking into account what mark-up a comparable independent enterprise would have been willing to pay for a comparable service given the cost structure. Since a CUP presumably is not available, this analysis would require examining whether the costs incurred by the group service provider are arm's length costs or rather need some adjustment to make the comparison with independent enterprises valid. In some cases, the costs that would be incurred by the recipient were it to perform the service for itself may be instructive on the type of arrangement an independent recipient would be prepared to accept for the service in dealing at arm's length. It may be necessary, for example, to adjust the relevant costs (as opposed to the mark-up rate) in applying the cost-plus method to make the respective transactions comparable.

83. When an associated enterprise is acting only as an agent or intermediary in the provision of services, it is important in applying the cost-plus method that the return or mark-up is appropriate for the performance of an agency function rather than for the performance of the services themselves. In such a case, it may not be appropriate to determine arm's length pricing as a mark-up on the cost of the services. For example, an associated enterprise may hire employees to perform services for a second associated enterprise in circumstances where the second associated enterprise would have hired the employees directly had it been independent. This might be the case where, for example, the first associated enterprise is not in the business of providing the type of services at issue but is merely acting as an intermediary for the convenience of the group. In such a case, the first associated enterprise is only entitled to compensation for the agency function that it is performing.

84. Where services are centralised in a separate special purpose company with no other functions, it would be expected that the special purpose company would seek to maximise its profit subject to the range of prices that the market would bear for the function the special purpose company is performing. An independent enterprise comparable to the special purpose company would be prepared to perform the activity only so long as the opportunity to cost to it of so doing did not exceed the expected compensation. If the intra-group charge necessary to yield this expected compensation is higher than the market could bear, i.e., higher than what an independent enterprise would be willing to pay for the same functions, the arm's length price would be uneconomic for the special purpose entity. This result would not justify a charge in excess of an arm's length price, but it could call into question why the special purpose company is remaining in existence. It may be that there is some benefit other than the purported special purpose that the MNE group derives from the existence of that company, and in such a case it must be considered whether the company is receiving an arm's length compensation for providing that separate benefit. Some profit to the special purpose company exceeds an arm's length charge determined in accordance with the foregoing principles and Part I, it could be the case that the cost of the special purpose company do not relate wholly to the activities for which the charge is being determined.

85. It should not be overlooked that there may be simple practical reasons why a tax administration in its discretion might be willing to forego computing and taxing a profit element from service charges in some cases. For instance, a cost-benefit analysis might indicate the additional tax revenue that would be collected does not justify the costs and administrative burdens of determining what an appropriate profit mark-up might be in some cases. This could be particularly true when only an indirect charging method is possible. It may be that the profit element would not be especially significant for the service provider, although this could only be the case when the provision of service is a marginal activity of the service provider. In such cases, charging cost without a profit element may provide a satisfactory result for MNEs and tax administrations. However, a unilateral decision by a tax administration not to insist on an arm's length charge may be of concern to the other jurisdiction involved in the transaction because of the possibility of non-taxation of income. As a result, this issue is best considered in the context of the mutual agreement procedure (where retrospective) or a bilateral APA (where prospective).

C. Some examples of intra-group services

86. This section sets forth several examples of transfer pricing issues in the provision of intra-group services. The examples are provided for illustrative purposes only. When dealing with individual cases, it is necessary to explore the actual facts and circumstances to judge the applicability of any transfer pricing method.

87. One example involves an MNE group engaged in hedging activities. An MNE group that carries on extensive cross border trading could be subject to substantial currency risk. Every member of the group could work to diminish this risk by executing one or more hedge agreements with independent enterprises. These transactions would not raise transfer pricing issues because they are not intra-group. However, an MNE group may decide to reduce its currency risk in a more efficient manner by matching all the assets and liabilities of different group members in the same currency. Only the assets or liabilities that could not be matched would be hedged with independent enterprises. In such a case, it should be considered whether the group member that coordinates this activity has performed an intra-group service and should charge an amount comparable to what independent enterprises would charge. A range of fees may be available in the financial sector.

88. Another example involves factoring activities, where an MNE group decides to centralize the invoicing activities for economic reasons. For example, it may be prudent to centralize the invoicing activities to limit currency and debt risks and to minimize administrative burdens. A factoring centre that takes on this responsibility is performing intra-group services for which a charge should be made. A cost plus method could be appropriate in such a case.

89. Contract manufacturing is another example of an activity that may involve intra-group services. In such cases the producer may get extensive instruction about what to produce, in what quantity and of what quality. The production company bears low risks and may be assured that its entire output will be purchased, assuming quality requirements are met. In such a case the production company could be considered as performing a service, and the cost plus method could be appropriate.

90. Contract research is an example of an intra-group service involving highly skilled personnel that is often crucial to the success of the group. The actual arrangements can take a variety of forms from the undertaking of detailed programmes laid down by the principal party to agreements where the research company has discretion to work within broadly defined categories. In the latter instance, generally involving frontier research, the additional functions of identifying commercially valuable areas and assessing the risk of unsuccessful research can be a critical factor in the performance of the group as a whole. However, the research company itself is often insulated from financial risk since it is normally arranged that all expenses will be reimbursed whether the research was successful or not. In addition, intangible property deriving from research activities is generally owned by the principal company and so risks relating to the commercial exploitation of that property are not assumed by the research company itself. In such a case a cost plus method may be appropriate.

91. Issues may also arise where an MNE group uses a group finance centre. A finance centre may have better access to capital markets than all the separate members of the group would have individually. The finance centre might also be able to borrow against a lower rate of interest than the individual members and provide a better hedge against currency fluctuations. Thus, the finance centre might borrow from the market and lend smaller amounts to group members. A CUP might be available from the transactions of independent banks or financial institutions to determine the arm's length price for the funds supplied to the group members. The difference between this price and the costs incurred by the group finance centre would be expected to allow the centre a margin on those costs without a further charge for that particular service being made. Separate charging would, however, be appropriate for additional services.

92. Another example of intra-group services is the administration of licences. The administration and enforcement of intangible property rights should be distinguished from the exploitation of those rights for this purpose. The control of a license might be handled by a group service centre responsible for monitoring possible license infringements and for enforcing license rights.

CHAPTER VI

COST CONTRIBUTION ARRANGEMENTS

A. Introduction

93. The foregoing chapters have discussed the amount that should be charged (i.e., the transfer pricing) under the arm's length principle in an arrangement where one associated enterprise provides products, intangible property, and/or services to another associated enterprise. This Chapter addresses a different but related type of arrangement that may exist between associated enterprises, namely, a cost contribution arrangement. In a cost contribution arrangement, members of an MNE group acting in concert jointly produce or provide goods, intangible property, and/or services, or jointly acquire goods, intangible property or services from a third party. In a cost contribution arrangement, the costs for the joint activity are allocated amongst the members participating in the arrangement.

94. A cost contribution arrangement will exist only to the extent that the associated enterprises are engaged in a joint activity. It therefore does not itself trigger traditional transfer pricing questions because it does not involve a transfer of property or services among the participants to the arrangement. However, transfer pricing questions may be raised ancillary to the cost contribution arrangement, because the participants to the arrangement may be involved, separately or jointly, in intra-group transfers with the participants or other associated enterprises. For example, a cost contribution arrangement may involve the joint acquisition of services from an associated enterprise, such as from a separate purpose company performing contract research or from a central service center providing administrative, technical, and commercial services. In that case, the participants would be the associated enterprises acquiring the services, and these participants would receive an intra-group transfer from the service provider. The pricing of the services to the cost contribution participants (as a whole) would be resolved under the general principles of these Guidelines as well as the special considerations for services discussed in Chapter V.

95. It should be noted that the service provider in the above example would not be included in the cost contribution arrangement even if it were itself making use of its own advertising services. The nature of the cost contribution arrangement above is the joint acquisition of services, and the service provider could not be treated as participating in that activity, i.e., acquiring its own services, without ignoring the fact that the enterprise is a single entity. In such a case, the enterprise's internal use of its own advertising services would be governed by rules for taxation of permanent establishments.

96. A cost contribution arrangement may often be encountered when associated enterprises act jointly to perform research and development to create intangible property, where economic rights to use the property will be shared in accordance with the interest each participant has in the arrangement. In some cases each participant will be entitled to use the intangible property for its own purposes rather than in a joint activity. In other cases, the cost contribution arrangement may cover not only development of the intangible property but also its joint exploitation, similar to what independent enterprises might do if involved in a joint venture. In either case, the arrangement, if validly made, would eliminate the need for a royalty payment for the use of the intangible property since all the participants share economic ownership of the intangible. [However, it might still be examined whether the R&D activity undertaken by each participant is in proportion to the expected benefit received. If the benefit proportionately exceeds the level of activity by a participant, that participant may have to pay one of the other participants for performing R&D on its

behalf. In such a case, that payment may indicate the performance of contract research services for which an arm's length transfer price must be determined.]

97. As the foregoing paragraphs suggest, cost contribution arrangements can take a variety of forms. While cost contribution arrangements more commonly cover services and R&D, they need not be limited to these categories and could exist for any joint acquisition or provision of products, intangible property, or services.

98. Cost contribution arrangements raise the issue whether the allocation of costs among the participants is appropriate given the respective interests of the parties to the arrangement in the results of the activity. This issue is pertinent in the context of these Guidelines because it must be resolved pursuant to the arm's length principle. In particular, it is necessary to examine whether the arrangement is consistent with what independent enterprises would have accepted, from the perspective of the participants, in comparable circumstances. If the arrangement is not consistent with the arm's length principle, tax administrations ordinarily would adjust the allocation of costs. In rare cases, it may be that the allocation chosen by the parties indicates that no valid cost contribution arrangement was intended, and that in fact the arrangement was intended to disguise the transfer of property or services among the participants. In such cases, the tax administration might conclude that no cost contribution arrangement exists and that the arrangement must be analysed under general transfer pricing rules.

B. Different types of arrangements

99. Two main categories of cost contribution arrangements can be distinguished depending on how the costs are recouped. There is first the cost sharing arrangement. This is an agreement under which members of the group agree to share the actual costs of and the risks associated with the joint activity undertaken for the benefit or expected benefit of each of them. In such case, each participant would bear its fair share of the costs and risks and would in return be entitled to an equitable interest in what is obtained by the activity at issue, e.g., production intangibles developed through joint R&D, the benefits of service acquired jointly. When the acquisition or development of property is involved it may be that only one of the participants is the legal owner of the property, but all the participants would obtain economic ownership rights in the property. These arrangements resemble in some respects joint ventures or partnerships formed by independent enterprises.

100. Secondly, there is the cost funding arrangement. This is an arrangement under which members of the group are required to contribute an amount up-front to the costs of the joint activities of the group. In such a case the contribution to the costs should be a genuine estimate based on the actual costs of past years and budgeted costs for future years. The contribution should be determined with a view to achieving a break-even result and should not produce over time an accumulating fund. The difference between cost sharing and cost funding is the way in which a project is financed and possibly in the timing of deductions (a matter of domestic law).

C. The allocation of costs

101. Under the arm's length principle, the allocation of costs in a cost contribution arrangement should result in each participant bearing a share of costs that is in proportion to its benefit in the result of the joint activity that is the subject of the arrangement. In other words, the allocation should be consistent with the allocation that would be undertaken by independent enterprises dealing with each other at arm's length in a joint arrangement of the same type. In such a case, each participant is paying for its proper share of the activity in proportion to the benefits it receives from the joint activity that are relevant to its own operation and is not receiving a separate benefit from the other participants for which a charge from those participants would be appropriate.

102. To determine an allocation of costs that is arm's length, it is necessary to calculate the amount of the overall costs incurred by the participants in carrying out the joint activity, and then to choose a method of allocation consistent with benefits and burdens. These two steps are discussed below.

(i) The amount of costs

103. Determining the total amount of costs is relatively easy when the participants are jointly acquiring property or services from a third party. In such a case, the cost of the joint activity is the transfer price charged by the third party for the property or service (which would be determined under general transfer pricing principles when the third party is an associated enterprise). It would not be costs to the third party of providing the property or the service, but rather the arm's length transfer price for the property or service that would encompass the costs to the participants in the cost contribution arrangement,

104. When the participants are jointly producing property or providing services, the determination of costs can be more difficult, since each participant may be incurring indirect costs that need to be allocated in part to the joint activity and in part to the company's other business activities. For example, costs of supervisory, clerical, administrative and other overhead activities should be included in accordance with generally accepted accountancy practice. It may, however, be very difficult in practice to determine the amount of such costs precisely attributable to the joint activity.

105. Costs of a capital nature, like expenditure for buildings, machines and other assets may be allocated based on the relative use of the capital asset in the joint activity using [fair market value] [book depreciated value] as the measure of the total cost.

106. In a cost sharing arrangement, in principle only net costs may be subject to allocation. [This means for instance that the any licence receipts or receipts from an ancillary sale of research assets should be deducted from the amount to be allocated among participants.] It would ordinarily not be expected that the arrangement would take into account any subsidies or tax incentives (including tax credits on investments) that a particular participant may be granted by a government in allocating costs, except where the subsidies accrue because of the activity undertaken by the cost contribution group.

107. Whatever the arrangements, it is essential to ensure that costs recovered under the cost contribution arrangement are not also recovered through direct transfers between the enterprise performing the joint activity and the participants.

(ii) Methods of allocation

108. An arm's length allocation of costs is one that is reasonably expected to produce contributions appropriate for the economic enhancement (i.e., benefits) expected to be received and the burdens (e.g., risks) assumed by the participants as a result of the joint activity. There is no formula that could be universally applied as the circumstances may vary considerably. Generally MNEs allocate costs in proportion to the expected benefits of the parties involved. For instance, in some cases, such as dividing R&D costs for developing a production intangible, it might be appropriate to allocate costs in proportion to sales or other measures of income attributable to the use of the product of the joint activity. However, there is not always a reasonable connection between sales and benefit. Other possibilities are to use capital invested, number of employees, production capacity, gross profits, value added or staff time spent as the basis of allocation. Whether any particular allocation method is appropriate depends on the nature of the activity and the relationship between the allocation factors and the benefit or expected benefit to the participants. More than one allocation key may be necessary depending on the sort of joint activity being undertaken.

109. Allocations based on sales projections may have somewhat more merit theoretically, but they leave the problems of how a tax authority is to attempt to verify projected data, and of how to deal with

situations in which projections vary markedly from actual data. In any case, cost allocations should be made based upon the participants' most accurate measure of benefit and burdens.

110. An allocation key essentially based on net returns must be analysed carefully to ensure it is reasonable and does not reward inefficiency. Exchange of information between treaty partners and the mutual agreement procedure may help establish the acceptability of the method of allocation.

111. In assessing whether any particular allocation approach is arm's length, the terms and conditions of the cost contribution arrangements must be carefully examined in each particular case to determine the actual or expected benefit to the participant from the joint activity. In this sense an expected benefit would exist if the relevant party has a genuine and substantial interest in the results of the activity from the point of view of its own operations. In other words, the expectation that the profit making capacity of the participant will be enhanced by the joint activity must be realistic. Whether this is in fact the case seems determinable in part by - for example - whether the R&D being carried out is likely to benefit the participant, and in part by whether each participant has an economic interest in the results of successful R&D which is appropriate for the costs incurred.

112. For the arrangement to be commercially realistic, the joint activities carried out would have to be closely related to the needs and interests of each participant so that each one could benefit from the activity, as discussed above, from the point of view of its own operations. This may mean that some related activities are excluded from the cost contribution arrangement. However, at the same time, to be commercially realistic, the scope of the arrangement cannot be too narrow. If an arrangement excludes some of the resources that a participant must obtain to exploit a jointly developed intangible, this situation is likely to be examined very closely. Where some R&D is included in the arrangement, and some is excluded, there should be sound business reasons for the exclusion in the arrangement. The same scrutiny would be appropriate in the context of service arrangements.

113. The costs of unsuccessful research should still be charged out even though there has been no benefit so long as the participants would have received a benefit had the research been successful. Moreover, it could take quite a lot of time before a benefit is realised. However, if a member of an MNE participating in a cost contribution arrangement has not benefited significantly from substantial contributed expenditure over a longer period of time, this may be an indication, since the R&D budgets of independent enterprises are naturally profit oriented, that the research was not carried out in the interest, and for the benefit, of that particular company. In such circumstances an independent enterprise would not be likely to continue to participate in the arrangement.

114. The tax legislation of most countries does not deal specifically with cost contribution arrangements. However, the tax law of most countries requires that, generally, for costs to be recognized, whether as an immediate deduction, in the amortization of capital outlays, or as a capitalisable amount, they must be related to a business of the taxpayer. An arrangement which does not appear to be one which makes commercial sense would come under close scrutiny. An arrangement whereby a participant could not share in benefits from successful R&D on a basis reflecting its contribution to costs would be most unlikely to reflect commercial reality. Moreover, if it turns out that the nature of a participant's activity precludes a potential benefit from all R&D results, then the cost allocation concept will have to be revised to reflect this fact properly with respect to the current and subsequent years.

D. Verifying cost contribution arrangements

115. A cost contribution arrangement will be most readily verified if it is laid down in a written contract concluded in advance of incurring the costs of the joint activities. Where the arrangement is not in writing, it will be more difficult to determine that a cost contribution arrangement exists and properly allocates benefits and costs, or perhaps even that there was an intention to establish a cost contribution arrangement in the first instance.

116. In a written cost contribution arrangement, the terms and conditions should be as precisely defined as possible. In addition, the participants to the cost contribution arrangement should be able to demonstrate that the terms of the agreement have been or will be carried out in practice. All the evidence needed to prove that - for example - the research has been performed in the interest and for the expected real benefit of a particular entity should have to be produced at the request of the tax authorities concerned. It will be important to look at the substance rather than the form of an arrangement.

117. Although the acceptability of a cost contribution arrangement is ultimately determined by its operation, it would be helpful if tax administrations could indicate to the participants whether the written form of the arrangement (where one exists) is acceptable in principle. In such a case, tax administrations may need further information concerning the participants and the activities in order to interpret the contractual arrangements.

118. It would be easier for tax authorities to accept the cost contribution arrangements of MNEs if they could be set up and applied in a manner which would remove the fear that the arrangements could lead to the shifting of profits. Thus it would help if the following principles were observed:

- a) The method is laid down in clearly formulated and binding contracts, concluded in advance;
- b) These contracts are observed consistently over several years (although giving due regard for the need for flexibility in start-up years);
- c) The contracts apply to those associated enterprises which will benefit, or from an ex ante point of view may be expected to benefit, from the activities;
- d) The costs of the relevant activities is determined on the basis of generally-acceptable accounting principles (such as those underlying the consolidated group's annual report), and details of auditing provision for the calculation of costs and for their allocation;
- e) The group members which share the costs have full access to the activities concerned;
- g) The contracting group members do not pay for the intangibles or services concerned in any other way;
- h) Alterations in the responsibilities and activities of group members which influence their benefit position are taken account of as soon as possible in the contracts (changes in profitability would not normally justify amendment of the contract).
- i) The contracts address the consequences of a participant entering or withdrawing from the cost contribution arrangement.

119. Any commitments entered into in the course of giving guidance in advance would obviously need to be dependant upon the facts and circumstances remaining substantially the same as they were or were expected to be, when the guidance was given. If the contract is acceptable and carried out correctly - especially with regard to condition h) of paragraph 28 - tax authorities should refrain from making an adjustment based on a single fiscal year. In the case of fluctuating volumes of activities, consideration should be given over a period of years as to whether the remuneration adequately reflects the benefits and burdens associated with the activities performed.

E. Other considerations

120. The question arises, when an entity becomes a participant of, or withdraws from, a cost contribution arrangement, whether consideration must be paid to the other participants according to the arm's length principle. These are the so-called buy-in and buy-out rules. Whilst payment might be appropriate in some cases, there are also circumstances where the entrance or withdrawal of a participant would not produce a benefit or detriment to the other participants so that there would be no transfer for which compensation was required. Compensation seems inappropriate, for example, where the arrangement does not involve the joint economic ownership of property (as an R&D arrangement might) but instead involves, e.g., the provision of services. Also compensation may be unnecessary on withdrawal where there is a rough equality between the values of assets jointly owned (economically) at the time of entry and withdrawal. When for bona fide business reasons a member withdraws from a cost contribution arrangement, the remaining members will in fact have to bear a larger share of the costs and risks of the arrangement. Consideration should be required only to the extent that the remaining members derive a measurable benefit from the withdrawal. The question whether an amount of consideration should be paid in any case in which an entity becomes a member of, or withdraws from, a cost contribution arrangement therefore should be examined and decided on a case by case basis according to the arm's length principle. Also, the type of provision for buy-in and buy-out in the arrangement may be relevant in evaluating whether the cost allocation formula is appropriate..

CHAPTER VII

ADMINISTRATIVE APPROACHES TO AVOIDING AND RESOLVING TRANSFER PRICING DISPUTES

A. Introduction

121. This chapter examines various administrative procedures that could be applied to minimise transfer pricing disputes and to help resolve them when they do arise between taxpayers and their tax administrations, and between different tax administrations. Such disputes may arise even though the guidance in this Report is followed in a conscientious effort to apply the arm's length principle. It is possible that taxpayers and tax administrations may reach differing determinations of the arm's length conditions for the controlled transactions under examination given the complexity of some transfer pricing issues and the difficulties in interpreting and evaluating the circumstances of individual cases.

122. Where two or more tax administrations take different positions in determining arm's length conditions, double taxation may occur. Double taxation means the inclusion of the same income in the tax base by more than one tax administration, when either the income is in the hands of different taxpayers (economic double taxation, for associated enterprises) or the income is in the hands of the same juridical entity (juridical double taxation, for permanent establishments). Double taxation is undesirable and should be eliminated whenever possible, because it constitutes a potential barrier to the development of international trade and investment flows. The double inclusion of income in the tax base of more than one jurisdiction does not always mean that the income will actually be taxed twice. For example, although included in the tax base, there may be foreign tax credit provisions that will alleviate the impact of the double inclusion. Further, differing transfer pricing positions will not always result in a double inclusion in the tax base, for example because the income is subject to an exemption in one jurisdiction. Nevertheless, also in these cases the transfer pricing dispute should be solved because the same income should not be accounted for in more than one jurisdiction.

123. This Chapter discusses several administrative approaches to resolving disputes caused by transfer pricing adjustments and for avoiding double taxation. Section B discusses transfer pricing compliance practices by tax administrations, in particular examination practices, the burden of proof, and penalties. Section C discusses corresponding adjustments (Article 9(2) of the OECD Model Tax Convention) and the mutual agreement procedure (Article 25). Section D describes the use of simultaneous tax examinations by two (or more) tax administrations to expedite the identification, processing, and resolution of transfer pricing issues (and other international tax issues). Sections E and F describe some possibilities for minimising transfer pricing disputes between taxpayers and their tax administrations. Section E addresses the possibility of developing safe harbours for certain taxpayers, and Section F deals with the possibility of determining in advance a transfer pricing methodology or conditions for the taxpayer to apply to specified controlled transactions. Section G considers briefly the use of arbitration procedures to resolve transfer pricing disputes between countries.

B. Transfer pricing compliance practices

124. Tax law compliance strategies are developed and implemented in each Member country according to its own domestic legislation and administrative procedures. As a matter of domestic sovereignty and to accommodate the particularities of widely varying tax systems, compliance procedures cannot be dictated on an international level but must remain within the province of each country. However, when a taxpayer under examination in one country is a member of an MNE group, it is possible that the domestic tax compliance rules will be consequential in other tax jurisdictions. This may be particularly the case when cross-border transfer pricing issues are involved, because the transfer pricing has implications for the tax collected in the tax jurisdictions of both of the associated enterprises involved in a controlled transaction. Both tax jurisdictions must accept the same transfer pricing or else the MNE group will be subject to double taxation. Thus, tax administrations should be conscious of the potential implications of their transfer pricing compliance rules for other tax jurisdictions and seek to facilitate both the equitable allocation of taxes between jurisdictions and the prevention of double taxation for taxpayers.

125. This section describes three aspects of transfer pricing compliance that should receive special consideration to help tax jurisdictions administer their transfer pricing rules in a manner that is fair to taxpayers and other jurisdictions. The three aspects are: examination practices, the burden of proof, and penalty systems. The evaluation of these three aspects will necessarily differ depending on the characteristics of the tax system involved, e.g., self-assessment vs. administrative assessment, and so it is not possible to describe a uniform set of principles or issues that will be relevant. Instead, this section seeks to provide general guidance on the types of problems that may arise and reasonable approaches for achieving a balance of the interests of the taxpayers and both tax administrations involved in a transfer pricing inquiry.

(i) Examination practices

126. Examination practices vary widely among OECD Member countries. Differences in procedures may be prompted by such factors as whether the jurisdiction has a self-assessment system, the structure of the tax administration, the geographic size and population of the country, the level of domestic and international trade, and cultural and historical influences. In administrative assessment systems, there might be no formal program of audit but instead procedures for determining which taxpayers should be subject to a more thorough review. In self-assessment systems, tax jurisdictions may develop regular procedures for auditing tax returns and may tailor audit practices to the size and nature of the taxpayer. Some countries provide special audit programs to the largest of their corporate taxpayers, including a practice of annual examination. Self-assessment systems leave the initial interpretation of the law and reporting position up to the taxpayer, and thus may necessitate more sophisticated audit selection techniques and in some cases more detailed scrutiny of the tax return.

127. Transfer pricing cases can present special challenges to the normal audit or examination practices, both for the administration and for the taxpayer. Transfer pricing cases are fact-intensive and may involve difficult evaluations of comparability, markets, and financial or other industry information. Consequently, a number of tax administrations have examiners who specialize in transfer pricing, and transfer pricing examinations themselves may take longer than other examinations and follow separate procedures.

128. Transfer pricing analyses can involve a great deal of subjective judgment, in keeping with the recognition that transfer pricing is not an exact science. It will not always be possible to determine the single correct arm's length price; rather, as Chapter I recognizes, the correct price may have to be estimated within a range of acceptable figures. Also, the choice of methodology for establishing arm's length transfer pricing will not often be unambiguously clear. Taxpayers may experience particular difficulties presented to them when the tax administration is using a profit method to establish the transfer pricing, because profit methods are virtually never used by businesses to set their prices.

129. In a difficult transfer pricing case, because of the complexity of the facts to be evaluated and the subjectivity of the analyses, even the best-intentioned taxpayer can make an honest mistake. Moreover, even the best-intentioned tax examiner may draw the wrong conclusion from the facts. Tax administrations are encouraged to take this observation into account in conducting their transfer pricing examinations. This involves two implications. First, to recognize the subjectivity of the analyses, tax examiners are encouraged to be flexible in their approach and not demand from taxpayers in their transfer pricing a precision that is unrealistic under all the facts and circumstances. Second, tax examiners are encouraged to take into account the taxpayer's commercial judgment about the application of the arm's length principle, so that the transfer pricing analysis is more closely tied to business realities. Recognising that enterprises almost never use profit methods to set transfer prices for business purposes, tax examiners are encouraged to begin their analyses of transfer pricing from the perspective of the method that the taxpayer has chosen in setting its prices.

(ii) *Burden of proof*

130. Like examination practices, the burden of proof rules for tax cases also differ among the Member countries. In most jurisdictions, the tax administration bears the burden of proof both in its own dealings with the taxpayer (e.g., internal appeals) and in litigation. In some of these countries, the burden of proof can be reversed, allowing the tax administration to estimate taxable income, if the taxpayer is found not to have acted in good faith, for example by not cooperating or complying with reasonable documentation requests or by filing false or misleading returns. In other countries, the burden of proof is on the taxpayer.

131. In theory, the rules governing burden of proof have implications for the behaviour of the tax administration and the taxpayer. For example, where as a matter of domestic law the burden of proof is on the tax administration, the taxpayer may not have any legal obligation to prove the correctness of its transfer pricing unless the tax administration makes a prima facie showing that the pricing is inconsistent with the arm's length principle. Even in such a case, of course, the tax administration might still reasonably oblige the taxpayer to produce its records in the controlled transactions that would enable the tax administration to undertake its examination.

132. When transfer pricing issues are present, the divergent rules on burden of proof among the Member countries could present serious problems if the strict legal rights implied by those rules are used as a guide for appropriate behaviour. For example, consider the case where the controlled transaction involves one jurisdiction in which the burden of proof is on the taxpayer and a second jurisdiction in which the burden of proof is on the tax administration. If the burden of proof is guiding behaviour, the tax administration in the first jurisdiction might make an unsubstantiated assertion about the transfer pricing, which the taxpayer might accept, and the tax administration in the second jurisdiction would have the burden of disproving the pricing. It could be that neither the taxpayer nor the tax administration would be making efforts to establish an acceptable arm's length price. This type of behaviour would set the stage for significant conflict as well as double taxation.

133. In practice, neither countries nor taxpayers routinely misuse the burden of proof in the manner described above. Still, because of the difficulties and subjectivity of transfer pricing analyses, it would be appropriate for both taxpayers and tax administrations to take special care and to use restraint in relying on the burden of proof in the course of the examination of a transfer pricing case. More particularly, as a matter of good practice, the burden of proof should not be used by tax administrations or taxpayers as a justification for making groundless or unverifiable assertions about transfer pricing. A tax administration should be prepared to make a good faith showing that its determination of transfer pricing is consistent with the arm's length principle even where the burden of proof is on the taxpayer, and taxpayers similarly should be prepared to make a good faith showing about their transfer pricing regardless where the burden of proof lies.

(iii) *Penalties*

134. Many domestic tax compliance strategies have three main elements: (i) to reduce opportunities for non-compliance (e.g., through withholding taxes and information reporting); (ii) to provide positive assistance for compliance (e.g., through education and published guidance); and (iii) to provide disincentives for non-compliance. It is to this third element that penalties are most often directed, where the compliance may relate to procedural requirements such as providing necessary information or filing returns, or to the substantive determination of tax liability. Penalties are generally designed to make tax underpayments and other types of noncompliance more costly. In the context of a self-assessment system, this effect can be very important so that there is a positive reason for taxpayers to attempt to report the correct tax rather than to wait and see whether they are caught or shown to be in error by the tax administration. The Committee on Fiscal Affairs has recognized that promoting compliance should be the primary objective of civil tax penalties. (OECD publication "Taxpayers' Rights and Obligations").

135. There are many similarities in national practices and policies for the use and design of penalties. Care needs to be taken, however, in comparing these practices and policies with one another. First, any comparison needs to take into account that there are different names used in the various countries for penalties that accomplish the same purposes. Second, national tax compliance strategies depend, as indicated above, on the overall tax system in the country, and they are designed on the basis of domestic need and balance, such as the choice between the use of taxation measures that remove opportunities for non-compliance and the use of monetary deterrents. The nature of tax penalties may also be affected by the judicial system of a country.

136. There a number of different types of penalties that tax jurisdictions have adopted. Penalties can involve either civil or criminal sanctions - criminal penalties are virtually always reserved for cases of very significant fraud, and they usually carry a very high burden of proof for the party asserting the penalty (i.e., the tax administration). Criminal penalties are not the principal means to promote compliance in any of the OECD Member countries. Civil penalties are more common, and they typically involve a monetary sanction (although as discussed above there may be a non-monetary sanction such as a shifting of the burden of proof when, e.g., procedural requirements are not met or the taxpayer is uncooperative).

137. Some civil penalties are directed towards procedural compliance, such as timely filing of returns and information reporting. The amount of such penalties is often small and based on a fixed amount that may be assessed for each day in which, e.g., the failure to file continues. The more significant civil penalties are those directed at the understatement of tax liability.

138. Civil monetary penalties for tax understatement are frequently triggered by one or more of the following: an understatement of tax liability exceeding a threshold amount, negligence of the taxpayer, or wilful intent to evade tax (and also fraud, although fraud can trigger much more serious criminal penalties). Many Member countries impose civil monetary penalties for negligence or wilful intent, while only a few countries penalise "no-fault" understatements of tax liability. This difference may be due in part to the special nature of a self-assessment system of taxation. In a self-assessment system, tax administrations may find it especially difficult to discover the intent of the taxpayer, and indeed those few with an intention to evade tax might be best able to disguise their intent and to avoid a penalty triggered in this manner. "No-fault" penalties can be useful to ensure even-handed application and to encourage best practices by taxpayers, provided they are not excessive.

139. It is difficult to evaluate in the abstract whether the amount of a civil monetary penalty is excessive. Among OECD Member countries, civil monetary penalties for tax understatement are frequently calculated as a percentage of the tax understatement, where the percentage most often ranges from 10 percent to 200 percent. In most OECD Member countries, the rate of the penalty increases as the conditions for imposing the penalty increase. For instance, the higher rate penalties often can be imposed

only by showing a high degree of taxpayer culpability, such as a wilful intent to evade. "No-fault" penalties, where used, tend to be at lower rates than those triggered by taxpayer culpability.

140. Improved compliance in the transfer pricing area is of some concern to Member countries and the appropriate use of penalties can play a role in addressing this concern. However, owing to the nature of transfer pricing problems, care should be taken to ensure that the administration of a penalty system as applied in such cases is fair and not unduly onerous for taxpayers.

141. Because cross-border transfer pricing issues implicate the tax base of two jurisdictions, an overly harsh penalty system in one jurisdiction may give taxpayers an incentive to overstate taxable income in that jurisdiction. If this were to happen, the penalty system would have failed in its primary objective to promote compliance and instead would lead to non-compliance of a different sort -- non-compliance with the arm's length principle and under-reporting in the other jurisdiction. Each tax administration is encouraged to be sensitive to this potential problem and so to strive to ensure that its penalty system is fair.

142. One approach to avoiding excessive or overly harsh penalty systems is to focus on the rate of the penalty. However, this approach is not particularly useful in the international context, because the rate of the penalty can only be evaluated in the context of the overall tax rate, which is itself a matter of domestic sovereignty. It may be, for instance, that in one jurisdiction the base tax rate and the penalty tax rate combined do not exceed the base tax rate in another jurisdiction that has a much lower (or perhaps no) understatement penalty.

143. Perhaps a better approach is to consider the fairness of the penalty system by considering whether the penalties are proportionate to the offence. This would mean, for example, that the severity of a penalty would be balanced against the conditions under which it would be imposed, and that the harsher the penalty the more limited the conditions in which it would apply. It might not be appropriate, for example, for a no-fault penalty to be imposed at a higher rate than the penalty imposed on intentional misstatements of tax liability. Each country will, of course, make its own judgment about whether the proper balance is being achieved, taking into account the particularities of its own system, but it may be helpful in this regard to observe the practice in other countries.

144. When a "no-fault" penalty is applicable, the balance can be somewhat more difficult to attain, since the condition for imposing the penalty is low, i.e., the mere existence of an understatement of a certain amount. Given the inexactness and subjectivity of transfer pricing determinations, the imposition of a sizeable penalty for an accidental understatement may seem unduly harsh, unless there are means to moderate the impact. For example, the penalty rate might be set relatively low. If this cannot be done, there might be an exception for taxpayers who can show that the understatement was accidental and done in good faith (thereby in essence eliminating the "no-fault" nature of the penalty). This could be particularly effective if the standard of good faith behaviour were interpreted in a manner consistent with the principles set forth in these Guidelines. There may be other possibilities as well to moderate the impact of a "no-fault" penalty. Tax administrations are encouraged to take these observations into account in the implementation of their penalty systems.

C. Corresponding adjustments and the mutual agreement procedure: Articles 9 and 25 of the OECD Model Tax Convention

(i) The mutual agreement procedure

145. The mutual agreement procedure is a well-established means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. This procedure, described and authorized by Article 25 of the OECD Model Tax Convention, can be used to eliminate double taxation that could arise from a transfer pricing adjustment.

146. Article 25 sets out three different areas where mutual agreement procedures are generally used. The first area includes instances of "taxation not in accordance with the provisions of the Convention" and is covered in paragraphs 1 and 2 of the Article. Procedures in this area are typically initiated by the taxpayer. The other two areas, which do not necessarily involve the taxpayer, are dealt with in paragraph 3 and involve questions of "interpretation or application of the Convention" and the elimination of double taxation in cases not otherwise provided for in the Convention. Paragraph 9 of the Commentary to Article 25 makes clear that Article 25 is intended to be used by competent authorities in resolving juridical and economic double taxation issues arising from transfer pricing adjustments made pursuant to Article 9, paragraphs 1 and 2.

147. The mutual agreement procedure does not compel competent authorities to reach an agreement and resolve their tax disputes. The competent authorities are only obliged to endeavour to reach an agreement. The competent authorities may be unable to come to an agreement because of conflicting domestic laws or restrictions imposed by domestic law on the tax administration's power of compromise. Some unresolved cases may have recourse to arbitration, although such procedures are new and not universally accepted by all Member countries. The Member States of the European Communities signed on 23 July 1990 their multilateral Arbitration Convention, which entered into force on 1 January 1995.

ii) Corresponding adjustments: Article 9 (2)

148. To eliminate double taxation in transfer pricing cases, tax administrations may consider requests for corresponding adjustments as described in Article 9(2). A corresponding adjustment, which in practice may be undertaken as part of the mutual agreement procedure, can mitigate or eliminate double taxation in cases where one tax administration increases a company's taxable profits (i.e., makes a "primary adjustment") as a result of applying the arm's length principle to transactions involving an associated enterprise in a second tax jurisdiction. The corresponding adjustment in such a case is a downward adjustment to the tax liability of that associated enterprise, made by the tax administration of the second jurisdiction, so that the allocation of profits between the two jurisdictions is consistent with the primary adjustment and no double taxation occurs. It is also possible that the first tax administration will agree to decrease (or eliminate) the primary adjustment as part of the consultative process with the second tax administration, in which case the corresponding adjustment would be smaller (or perhaps unnecessary). It should be noted that a corresponding adjustment is not intended to provide a benefit to the MNE group greater than would have been the case if the controlled transactions had been undertaken at arm's length conditions in the first instance.

149. Article 9(2) specifically recommends that the competent authorities consult each other if necessary to determine corresponding adjustments. This demonstrates that the mutual agreement procedure of Article 25 may be used to consider corresponding adjustment requests. However, the overlap between the two Articles has caused OECD member countries to consider whether the mutual agreement procedure can be used to achieve corresponding adjustments where the bilateral income tax convention between two Contracting States does not include a provision comparable to Article 9(2). Paragraph 10 of the Commentary on Article 25 of the OECD Model Tax Convention now expressly states the view of most Member countries that the mutual agreement procedure is considered to apply to transfer pricing adjustment cases even in the absence of a provision comparable to Article 9(2). Paragraph 10 also notes that those Member countries that do not agree with this view in practice apply domestic laws in most cases to alleviate double taxation of bona fide enterprises .

150. Under Article 9(2), a corresponding adjustment may be made by a treaty partner either by recalculating the profits subject to tax for the associated enterprise in that country using the relevant revised price or by letting the calculation stand and giving the associated enterprise relief against its own tax paid in that State for the additional tax charged to the associated enterprise by the adjusting State as a consequence of the revised transfer price. The former method is by far the more common among OECD Member countries.

151. Corresponding adjustments are not mandatory, mirroring the rule that tax administrations are not required to reach agreement under the mutual agreement procedure. Under Article 9(2), a tax administration should make a corresponding adjustment only insofar as it considers the primary adjustment to be justified both in principle and in amount. The non-mandatory nature of corresponding adjustments is necessary so that one tax administration is not forced to accept the consequences of an arbitrary or capricious adjustment by another State. It also is important to maintaining the fiscal sovereignty of each Member country.

152. Once a tax administration has agreed to make a corresponding adjustment it has to decide whether the adjustment is to be attributed to the year in which the controlled transactions giving rise to the adjustment took place or to an alternative year, such as the year in which the primary adjustment is determined. The first approach is more appropriate because it achieves a matching of income and expenses and better reflects the economic situation as it would have been if the controlled transactions had been at arm's length. However, in cases involving lengthy delays between the year covered by the adjustment and the year of its acceptance by the taxpayer or a final court decision, the tax administration should have the flexibility to agree to make corresponding adjustments for the year of acceptance or decision on the primary adjustment. This approach would need to rely on domestic law for implementation. While not ordinarily preferred, it could be appropriate as an equitable measure in exceptional cases to facilitate implementation and to avoid time limit barriers.

153. Corresponding adjustments can be a very effective means of obtaining relief from double taxation resulting from transfer pricing adjustments. OECD Member countries generally strive in good faith to reach agreement whenever the mutual agreement procedure is invoked. Through the mutual agreement procedure, tax administrations can address issues in a non-adversarial proceeding, often achieving a negotiated settlement in the interests of all parties. It also allows tax administrations to take into account other taxing rights issues, such as withholding taxes.

154. At least one country has a procedure that may avoid the need for primary adjustments by allowing the taxpayer to report a transfer price for tax purposes that is an arm's length price for a controlled transaction, even though this price differs from the amount actually charged between the associated enterprises. This adjustment, sometimes known as a "compensating adjustment", would be made before the tax return is filed. Compensating adjustments may facilitate the reporting of true taxable income by taxpayers, recognizing that information about comparable uncontrolled transactions may not be available at the time associated enterprises establish the prices for their controlled transactions. Thus, if a taxpayer reports an amount on its tax return that is different from its books and records, it would be permitted to make a compensating adjustment by recording the difference between the actual price and the arm's length price as an account payable or receivable between the associated enterprises. However, compensating adjustments are not recognized by most OECD Member countries, on the grounds that the tax return should reflect the actual transactions. If compensating adjustments are permitted in the country of one associated enterprise but not permitted in the country of the other associated enterprise, double taxation may result because corresponding adjustment relief may not be available if no primary adjustment is made. It may be possible to use the mutual agreement procedure to resolve difficulties presented by compensating adjustments.

(iii) Concerns with the procedures

155. While corresponding adjustment and mutual agreement procedures are able to resolve most cases, some concerns have been expressed by taxpayers. For example, because transfer pricing issues are so complex, taxpayers may fear that there are not sufficient safeguards in the procedures against double taxation. These concerns are addressed in the Commentary to Article 25, which discusses the use of advisory opinions from an impartial third party, submission of questions to the Committee on Fiscal Affairs, or arbitration as alternative methods. Moreover, taxpayers should not be precluded from having recourse

to the mutual agreement procedure when they are in the sort of situation outlined in Article 25 of the Model Convention.

156. Taxpayers have also expressed fears that their cases may be settled not on their individual merits but by reference to a balance of the results in other cases. Similarly, there may be a fear of retaliation or offsetting adjustments by the country from which the corresponding adjustment has been requested. It is not the intention of tax administrations to take retaliatory action; the fears of taxpayers may be a result of inadequate communication of this fact. Tax administrations should take steps to assure taxpayers that they need not fear retaliatory action and that, consistent with the arm's length principle, each case is resolved on its own merits.

157. Perhaps the most significant concerns that have been expressed with the mutual agreement procedure, as it affects corresponding adjustments, are the following, which are discussed separately in the sections below:

- (a) time limits under domestic law may make corresponding adjustments unavailable if those limits are not waived in the relevant tax treaty;
- (b) mutual agreement procedures may take too long to complete;
- (c) taxpayer participation may be limited;
- (d) published procedures may not be readily available to instruct taxpayers on how the procedure may be used; and
- (e) there may be no procedures to suspend the collection of tax deficiencies or the accrual of interest pending resolution of the mutual agreement procedure.

(iv) Recommendations to address concerns

a) Time limits

158. Relief under Article 9(2) may be unavailable if the time limit provided by treaty or domestic law for making corresponding adjustments has expired. Article 9(2) does not specify whether there should be a time limit after which corresponding adjustments should not be made. Some countries prefer an open-ended approach so that double taxation may be mitigated. Other countries consider the open-ended approach to be unreasonable for administrative purposes. Thus, relief may depend on whether the applicable treaty overrides domestic time limitations, establishes other time limits, or has no effect on domestic time limits.

159. Time limits for finalizing a taxpayer's tax liability are necessary to provide certainty for taxpayers and tax administrations. In a transfer pricing case a country may be legally unable to make a corresponding adjustment if the time has expired for finalising the tax liability of the relevant associated enterprise. Thus, the existence of such time limits and the fact that they vary from country to country should be considered in order to minimize double taxation.

160. Article 25(2) of the OECD Model Tax Convention addresses the time limit issue by requiring that an agreement reached pursuant to the mutual agreement procedure be implemented regardless of any time limits in the domestic law of the Contracting States. Time limits therefore do not impede the making of corresponding adjustments where a bilateral treaty includes this provision. Some countries, however, may be unwilling or unable to override their domestic time limits in this way and have entered explicit reservations on this point. Member countries therefore are encouraged as far as possible to extend domestic

time limits for the purposes of making corresponding adjustments when mutual agreement procedures have been invoked.

161. Where a bilateral treaty does not override domestic time limits for the purposes of the mutual agreement procedure, tax administrations should be ready to initiate discussions quickly upon the taxpayer's request, well before the expiration of any time limits that would preclude the making of an adjustment. Furthermore, Member countries are encouraged to adopt domestic law that would allow the suspension of time limits on determining tax liability until the discussions have been concluded.

162. The time limit issue might also be addressed through rules governing primary adjustments rather than corresponding adjustments. The problem of time limits on corresponding adjustments is at times due to the fact that the initial assessments for primary adjustments for a taxable year are not made until many years later. Thus, one proposal favoured by some countries is to incorporate in bilateral treaties a provision that would prohibit the issuance of an initial assessment after the expiration of a specified period. Many countries, however, have objected to this approach. Tax administrations may need a long time to make the necessary investigations to establish an adjustment. It would be difficult for many tax administrations to ignore the need for an adjustment, regardless of when it becomes apparent, provided that they were not prevented by their domestic time limits from making the adjustment. While it is not possible at this stage to recommend generally a time limit on initial assessments, tax administrations are encouraged to make these assessments within their own domestic time limits without extension, unless the taxpayer's consent to an extension is truly voluntary. If the complexity of the case or lack of cooperation from the taxpayer necessitates an extension, the extension should be made for a minimum and specified time period. Tax examiners are encouraged to indicate to taxpayers at an early stage their intent to make an assessment based on cross-border transfer pricing, so that the taxpayer can, if it so chooses, inform the tax administration in the other interested state so it can begin considering the issue from the context of a prospective mutual agreement procedure.

163. Another time limit that must be considered is the three year time limit within which a taxpayer must invoke the mutual agreement procedure under Article 25 of the OECD Model Tax Convention. The three year period begins to run from the time the tax administration first notifies the taxpayer of the proposed adjustment, described as the "adjustment action". Although some countries consider three years too short a period for invoking the procedure, other countries consider it too long and have entered reservations on this point. The Commentary to Article 25 indicates that the time limit "must be regarded as a minimum so that Contracting States are left free to agree in their bilateral conventions upon a longer period in the interests of taxpayers".

164. The three year time limit raises an issue about determining the date of the adjustment action. Paragraph 18 of the Commentary to Article 25 states that the three year time period "should be interpreted in the way most favourable to the taxpayer". In addition, it clarifies that "where it is the combination of decisions or actions taken in both Contracting States resulting in taxation not in accordance with the Convention, it begins to run only from the first notification of the most recent decision or action."

165. In order to minimise the possibility that time limits may prevent the mutual agreement procedure from effectively ensuring the relief or avoidance of double taxation, taxpayers should be permitted to avail themselves of the procedure at the earliest possible stage, which is as soon as an adjustment appears likely. If this were done, the process of consultation could be begun before any irrevocable steps were taken by either tax administration, with the prospect that there would be as few procedural obstacles as possible in the way of achieving a mutually acceptable conclusion to the discussions. However, some competent authorities may not like to be involved at such an early stage because a proposed adjustment may not result in final action or may not trigger a claim for a corresponding adjustment. Consequently, too early an invocation of the mutual agreement process may create unnecessary work.

166. Nevertheless, the competent authorities should be prepared to enter into discussions under the mutual agreement procedure relating to transfer pricing issues at as early a stage as is compatible with the economical use of their resources.

b) Duration of mutual agreement proceedings

167. Once discussions under the mutual agreement procedure have commenced, the proceedings may turn out to be lengthy. The complexity of transfer pricing cases may make it difficult for the tax administrations to reach a swift resolution. Distance may make it difficult for the tax administrations to meet frequently, and correspondence is often an unsatisfactory substitute for face-to-face discussions. Difficulties also arise from differences in language, procedures, and legal and accounting systems, and these may lengthen the duration of the process. The process also may be prolonged if the taxpayer delays in providing all the information the tax administrations require for a full understanding of the transfer pricing issue. However, delays do not always occur and, in practice, the consultations often result in a settlement of the problem in a relatively short time.

168. It may be possible to reduce the amount of time involved to conclude a mutual agreement procedure. Reducing the formalities required to operate the procedure may expedite the process. In this regard, personal contacts or conferences by telephone may be useful to establish more quickly whether an adjustment by one country may give rise to difficulty in another country. Such contacts are expensive but in the long run may prove to be more cost-effective than the time-consuming process of just a formal written communication.

169. The procedure could be expedited by delegating the authority to engage in mutual agreement procedure consultations on transfer pricing issues to knowledgeable senior officials below the competent authority itself. The mutual agreement procedure has generally been regarded as requiring that high level officials of the tax administrations be involved and the officer responsible for the development of the primary adjustment should not be in charge but might advise and participate in the proceedings. The reasons for this approach are sound; the fewer officials that are involved, the greater the likelihood of ensuring a consistent approach and the confidentiality of taxpayer information. Indeed, without the supervisory control of experts in a central position, there would be a real danger of inconsistent decisions and, as a result, of failure to achieve equitable results. Any delegation therefore should be limited to a small number of senior officials.

170. A number of countries have found that the delegation of authority can be a useful expedient once a mutual agreement procedure has been initiated between competent authorities. For example, the following procedure has been used successfully between some countries. The competent authorities ask their case officers in the field to prepare a joint report on the case under investigation on, inter alia, the following lines: the case officers establish the facts and co-ordinate their findings so that both countries will base their decisions on the same facts and circumstances; they then specify those questions of law (if any) on which the reporting authorities disagree, and, where problems of evaluation are involved, may set up agreed lower and upper limits for the appropriate price (where possible), thus providing a range within which the competent authorities can reach a decision. In this way both delegation to lower levels and supervisory control by the competent authorities have been satisfactorily achieved. This kind of procedure may not be appropriate in all cases, however. In particular, a joint report of case officers can be administratively burdensome and may even present legal problems for some countries outside the context of a simultaneous examination procedure.

c) Taxpayer participation

171. Paragraph 1 of Article 25 of the OECD Model Convention gives taxpayers the right to submit a request to institute a mutual agreement procedure. Paragraph 23 of the Commentary on Article 25 provides that such requests should not be rejected without good reason.

172. However, although the taxpayer has the right to initiate the procedure, the taxpayer has no specific right to participate in the process. It has been argued that the taxpayer also should have a right to take part in the mutual agreement procedure, including the right at least to present its case to both competent authorities, and to be informed of the progress of the discussions. It should be noted in this respect that implementation of a mutual agreement in practice is subject to the taxpayer's acceptance. Some taxpayer representatives have suggested that the taxpayer also should have a right to be present at face-to-face discussions between the competent authorities. The purpose would be to ensure that there is no misunderstanding by the competent authorities of the facts and arguments that are relevant to the taxpayer's case.

173. The mutual agreement procedure envisaged in Article 25 of the OECD Model Tax Convention and adopted in many bilateral agreements is not a process of litigation. While input from the taxpayer in some cases can be helpful to the procedure, the taxpayer's ability to participate should be subject to the discretion of the competent authorities. If the solution proposed for adoption by tax administrations eliminates double tax, but the MNE group remains unsatisfied, the taxpayer should invoke the domestic appeals systems of one or the other of the States concerned.

174. Outside the context of the actual discussions between the competent authorities, it is essential for the taxpayer to give the competent authorities all the information that is relevant to the issue in a timely manner. Tax administrations have limited resources and taxpayers should make every effort to facilitate the process. Further, because the mutual agreement procedure is fundamentally designed as a means of providing assistance to a taxpayer, the tax administrations should allow taxpayers every reasonable opportunity to present the relevant facts and arguments to them to ensure as far as possible that the matter is not subject to misunderstanding.

175. In practice, the tax administrations of many OECD Member countries routinely give taxpayers such opportunities, keep them informed of the progress of the discussions, and often ask them during the course of the discussions whether they can accept the settlements contemplated by the competent authorities. These practices, already standard procedure in most countries, should be adopted as widely as possible.

d) Publication of applicable procedures

176. It would be helpful to taxpayers if competent authorities were to develop and publicise their own domestic rules or procedures for utilizing the mutual agreement procedure so that taxpayers may more readily understand the process. The development and publication of such rules could also be helpful to tax administrations, especially if they are faced with the possibility of a large or growing number of cases in which mutual agreement with other tax administrations may be necessary or desirable, possibly saving them the need to answer a variety of enquiries or to develop procedures afresh in every case.

177. In publicising such rules and procedures it could be made clear, for example, how the taxpayer may bring a problem to the attention of the competent authority in order to start a discussion with the other country's competent authorities. The publication could indicate the official address to which the problem should be referred, the stage at which the competent authority would be prepared to take the matter up, the nature of the information necessary or helpful to the competent authority in handling the case, and so on. It could be helpful also to give guidance on the policy of the competent authorities regarding questions of transfer pricing and corresponding adjustments. This possibility could be explored unilaterally by competent authorities and, where appropriate, descriptions of their rules and procedures should be given suitable domestic publicity (respecting, however, taxpayer confidentiality).

178. There is no need for the competent authorities to agree to rules or guidelines governing the procedure, since the rules or guidelines would be limited in effect to the competent authority's domestic relationship with its own taxpayers. However, competent authorities should routinely communicate such

unilateral rules or guidelines to the competent authorities of the other countries with which mutual agreement procedures are undertaken.

e) Problems concerning collection of tax deficiencies and accrual of interest

179. When considering a corresponding adjustment, the issue arises of collection of tax deficiencies and the assessment of interest on those deficiencies or overpayment. A first problem is that the assessed deficiency may be collected before the corresponding adjustment proceeding is completed, because of a lack of domestic procedures allowing the collection to be suspended. This may cause the taxpayer to pay the same tax twice until the issues can be resolved. This problem arises not only in the context of the mutual agreement procedure but also for internal appeals. Countries that do not have procedures to suspend collection during a mutual agreement procedure are encouraged to adopt them where permitted by domestic law.

39a. Where the deficiency is not collected, other complications may arise. Because of the lengthy time period for processing many transfer pricing cases, the interest due on a deficiency or, if a corresponding adjustment is allowed, on the overpayment of tax in the other country can equal or exceed the amount of the tax itself. Inconsistent interest rules across the two jurisdictions may result in additional cost for the taxpayer. Therefore, it may be appropriate in certain cases for both competent authorities to agree not to assess interest from the taxpayer or pay interest to the taxpayer in connection with the adjustment at issue, but this may not be possible in the absence of a specific provision addressing this issue in the relevant bilateral treaty. This approach would also reduce administrative complexities. However, as the interest on the deficiency and the interest on the overpayment are attributable to different taxpayers in different jurisdictions, there would be no assurance under such an approach that a proper economic result would be achieved.

(v) Secondary adjustments

180. Corresponding adjustments are not the only adjustments that may be triggered by a primary transfer pricing adjustment. Primary transfer pricing adjustments and their corresponding adjustments change the allocation of taxable profits of an MNE group for tax purposes but they do not alter the fact that the excess profits represented by the adjustment are in the wrong hands. To make the actual allocation of profits consistent with the transfer pricing adjustment, some countries will assert a constructive transaction (a "secondary transaction"), whereby the excess profits resulting from a primary adjustment are treated as having been transferred in some other form and taxed accordingly. Thus, secondary adjustments attempt to account for the difference between taxable profits and booked profits. Ordinarily, the secondary transactions will be constructive dividends, constructive equity contributions, or constructive loans. For example, a country making a primary adjustment to the income of a subsidiary of a foreign parent may treat the excess profits in the hands of the foreign parent as having been transferred as a dividend, in which case withholding tax may apply. It may be that the subsidiary paid an excessive transfer price to the foreign parent as a means of avoiding that withholding tax. Thus, secondary adjustments may serve to prevent tax avoidance. The exact form of a secondary adjustment will depend on the facts of the case and on the tax laws of the country that makes the adjustment.

181. A secondary adjustment may result in double taxation unless a corresponding credit or some other form of relief is provided by the other country for the additional tax liability that may result from a secondary adjustment. Where a secondary adjustment takes the form of a constructive dividend any withholding tax which is then imposed may not be relievable because there may not be a deemed receipt under the domestic legislation of the other country.

182. The commentary on Article 9(2) of the OECD Model Convention notes that the Article does not deal with secondary adjustments, and thus it neither prevents nor requires tax administrations making secondary adjustments. However, many countries do not make secondary adjustments either as a matter of

practice or because their respective domestic provisions do not permit them to do so. These countries might therefore refuse to grant relief in respect of other countries' secondary adjustments.

183. Secondary adjustments are rejected by some countries because of the practical difficulties they present. For example, if a primary adjustment is made between brother-sister companies, the secondary adjustment may involve a hypothetical dividend from one of those companies up a chain to a common parent, followed by constructive equity contributions down another chain of ownership to reach the other company involved in the transaction. Many hypothetical transactions might be created, raising questions whether tax consequences should be triggered in other jurisdictions besides those involved in the transaction for which the primary adjustment was made. This might be avoided if the secondary transaction were a loan, but constructive loans are not used by most countries for this purpose and they carry their own complications because of issues relating to imputed interest.

184. It is also unclear how minority shareholders should be treated, and in particular whether the fiction of a secondary transaction that is a dividend should be carried through to them. The minority shareholders might not be assumed to receive a part of a hypothetical dividend, but this approach is somewhat contrary to the regard for corporate precision that underlies the concept of secondary adjustments. If the minority shareholders are assumed to receive part of the dividend and then contribute it back to capital, they could be subject to inappropriate tax consequences.

185. In light of the foregoing difficulties, tax administrations are encouraged to avoid secondary adjustments where possible, except in cases where the taxpayers behaviour suggests an intent to disguise a dividend for purposes of a withholding tax. Some countries that have adopted secondary adjustments also give the taxpayer another option that allows the taxpayer to avoid the secondary adjustment by repatriating excess profits to conform its accounts to the transfer pricing adjustment. The repatriation could be effected either by setting up an account payable (usually interest-bearing) or by reclassifying other transfers, such as dividend payments where the adjustment is between parent and subsidiary, as a payment of additional transfer price (where the original price was too low) or as a refund of transfer price (where the original price was too high).

186. Where a repatriation involves reclassifying a dividend payment, the amount of the dividend (up to the amount of the primary adjustment) would be excluded from the recipient's gross income (because it would already have been accounted for through the primary adjustment). The consequences would be that the recipient would lose any indirect tax credit (or benefit of a dividend exemption in an exemption system) and a credit for withholding tax that had been allowed on the dividend.

187. When the repatriation involves establishing an account payable, the adjustments to actual cash flow will be made over time, although domestic law may limit the time within which the account can be satisfied. This approach is identical to using a constructive loan as a secondary transaction to account for excess profits in the hands of one of the parties to the controlled transaction. The accrual of interest on the account could have its own tax consequences, however, and this may complicate the process, depending upon when interest begins to accrue under domestic law. Some countries may be willing to waive the interest charge on these accounts as part of a competent authority agreement.

D. Simultaneous tax examinations

(i) Definition and background

188. A simultaneous tax examination is a form of mutual assistance, used in a wide range of international issues, that allows two or more countries to cooperate in tax investigations. Simultaneous tax examinations can be particularly useful where foreign-based information is a key to a tax investigation, since they generally lead to more timely and more effective exchanges of information. Historically, simultaneous tax examinations of transfer pricing issues have focused on cases where the true nature of

transactions was obscured by the interposition of tax havens. However, in complex transfer pricing cases, some members believe that simultaneous examinations could serve a broader role since they may improve the adequacy of data available to the participating tax administrations for transfer pricing analyses. These members also believe that simultaneous examinations could help reduce the possibilities for economic double taxation, reduce the compliance cost to taxpayers and speed-up the resolution of issues.

189. Simultaneous tax examinations are defined in Part A of the OECD Model Agreement for the Undertaking of Simultaneous Tax Examinations. According to this agreement, a simultaneous tax examination means an "arrangement between two or more parties to examine simultaneously and independently, each on its own territory, the tax affairs of (a) taxpayer(s) in which they have a common or related interest with a view to exchanging any relevant information which they so obtain". This form of mutual assistance is not meant to be a substitute for the mutual agreement procedure. Any exchange of information as a result of the simultaneous tax examination continues to be exchanged via the competent authorities, with all the safeguards that are built into such exchanges.

190. While provisions that follow Article 26 of the Model may provide the legal basis for conducting simultaneous examinations, Competent Authorities frequently conclude working arrangements that lay down the objectives of their simultaneous tax examination programs and practical procedures connected with the simultaneous tax examination and exchange of information. Once such an agreement has been reached on the general lines to be followed and specific cases have been selected, tax examiners and inspectors of each state will separately carry out their examination within their own jurisdiction and pursuant to their domestic law and administrative practice.

(ii) *Legal basis for simultaneous tax examinations*

191. Simultaneous tax examinations are within the scope of the exchange of information provision based on Article 26 of the OECD Model Tax Convention. Article 26 provides for cooperation between the competent authorities of the Contracting States in the form of exchanges of information necessary for carrying out the provisions of the Convention or of their domestic laws concerning taxes covered by the Convention. Article 26 and the Commentary do not restrict the possibilities of assistance to the three methods of exchanging information mentioned in the Commentary (exchange on request, spontaneous and automatic exchanges of information).

192. Simultaneous tax examinations are also authorized outside the context of double tax treaties. For example, Article 12 of the Nordic Convention on Mutual Assistance in Tax Matters governs exchange of information and assistance in tax collection between the Nordic countries and provides for the possibility of simultaneous tax examinations. This convention gives common guidelines for the selection of cases and for carrying out such examinations. Article 8 of the joint Council of Europe and OECD Convention on Mutual Administrative Assistance in Tax Matters also provides expressly for the possibility of simultaneous tax examinations.

193. In all cases the information obtained by the tax administration of a state has to be treated as confidential under its domestic legislation and may be used only for certain tax purposes and disclosed only to certain persons and authorities involved in specifically defined tax matters covered by the tax treaty or mutual assistance agreement. Taxpayers are usually notified of the fact that they have been selected for a simultaneous examination and in some countries they may have the right to be informed when the tax administrations are considering a simultaneous tax examination or when information will be transmitted in conformity with the Exchange of Information Article. In such cases, the competent authority should inform its counterpart in the foreign state that such disclosure will occur.

(iii) *Simultaneous tax examinations and transfer pricing*

194. In selecting transfer pricing cases for simultaneous examinations, there may be major obstacles caused by the differences in time limits for conducting examinations or making assessments in different countries and the different tax periods open for examination. However, these problems may be mitigated by an early exchange of examination schedules between the relevant competent authorities to find out in which cases the tax examination periods coincide and to synchronize future examination periods. While at first glance an early exchange of examination schedules would seem beneficial, some countries have found that the chances of a treaty partner accepting a proposal are considerably better when one is able to present issues more comprehensively to justify a simultaneous examination.

195. Once a case is selected for a simultaneous examination it is customary for tax inspectors or examiners to meet, to plan, to coordinate and to follow closely the progress of the simultaneous tax examination. Especially in complex cases, meetings of the tax inspectors or examiners concerned may also be held with taxpayer participation to clarify factual issues.

196. Simultaneous tax examinations may be a useful instrument to determine the correct tax liability of associated enterprises in cases where, for example, costs are shared or charged and profits are allocated between taxpayers in different taxing jurisdictions or more generally where transfer pricing issues are involved. Simultaneous tax examinations may facilitate an exchange of information on multinational business practices, complex transactions, cost contribution arrangements and profit allocation methods in special fields such as global trading and innovative financial transactions. The Committee on Fiscal Affairs is studying separately issues presented by global trading innovative financial transactions, and any conclusions of those studies should be considered in conjunction with these guidelines. As a result, tax administrations may acquire a better understanding of and insight into the overall activities of a multinational enterprise and obtain extended possibilities of comparison and checking international transactions. Simultaneous tax examinations may also support the industry-wide exchange of information, which is aimed at developing knowledge of taxpayer behaviour, practices and trends within an industry, and other information that might be suitable beyond the specific cases examined.

197. One objective of simultaneous tax examinations is to promote compliance with transfer pricing regulations. Obtaining the necessary information and determining the facts and circumstances about such matters as the transfer pricing conditions of controlled transactions between associated enterprises in two or more tax jurisdictions may be difficult for a tax administration, especially in cases where taxpayers do not cooperate or fail to provide the necessary information in due time. The simultaneous tax examination process can help tax administrations to establish these facts faster and more effectively and economically.

198. The process also might allow for the identification of potential transfer pricing disputes at an early stage, thereby minimising litigation with taxpayers. This could happen when, based upon the information obtained in the course of a simultaneous tax examination, the participating tax examiners or inspectors have the opportunity to discuss any differences in opinion with regard to the taxpayer's transfer pricing conditions and are able to reconcile these contentions. When such a process is undertaken, the tax examiners or inspectors concerned should, as far as possible, arrive at concurring statements as to the determination and evaluation of the facts and circumstances of the taxpayer's controlled transactions, stating any disagreements about the evaluation of facts, and any differences with respect to the legal treatment of the taxpayer's transfer pricing conditions. Such statements could then serve as a basis for subsequent mutual agreement procedures and perhaps obviate the problems caused by one country examining the affairs of a taxpayer long after the treaty partner country has finally settled the tax liability of the relevant associated enterprise. For example, such an approach could minimize mutual agreement procedure difficulties due to the lack of relevant information.

199. In some cases the simultaneous tax examination procedure may allow the participating tax administrations will seek to reach an agreement on the transfer pricing conditions of a taxpayer's controlled

transactions. In case of an agreement, corresponding adjustments may be made at an early stage, thus avoiding time-limit impediments and economic double taxation to the extent possible. In addition, if the agreement about the taxpayer's transfer pricing is reached with the taxpayer's consent, time consuming and expensive litigation may be avoided.

200. Even if no agreement between the tax administrations can be reached in the course of a simultaneous tax examination with respect to the taxpayer's transfer pricing, the OECD Model Agreement envisions that the taxpayer may be able to present a request for the opening of a mutual agreement procedure to avoid economic double taxation at an earlier stage than it would have if there were no simultaneous tax examination. If this is the case, then simultaneous tax examinations may significantly reduce the time-span between a tax administration's adjustments made to the taxpayer's tax liability and the implementation of a mutual agreement procedure. Moreover, the OECD Model Agreement envisions that simultaneous tax examinations may facilitate mutual agreement procedures, because tax administrations will be able to build up more complete factual evidence for those tax adjustments for which a mutual agreement procedure may be requested by the taxpayer. Based upon the determination and evaluation of facts and the proposed tax treatment of the transfer pricing issues concerned as set forth in the tax administrations' statements described above, the practical operation of the mutual agreement procedure may be improved significantly, allowing the competent authorities to reach an agreement more easily.

201. The taxpayer may also benefit from simultaneous tax examinations from the savings of time and resources due to the coordination of inquiries from the tax administrations involved and the avoidance of duplication. In addition, the simultaneous involvement of two or more tax administrations in the examination of a taxpayer's transfer pricing may provide the opportunity to take a more active role in resolving its transfer pricing issues. By presenting the relevant facts and arguments to each of the participating tax administrations during the simultaneous tax examination the taxpayer may help avoid misunderstandings and facilitate the tax administrations' concurring determination and evaluation of its transfer pricing conditions. Thus, the taxpayer may obtain certainty with regard to its transfer pricing at an early stage.

(iv) Recommendation on the use of simultaneous tax examinations

202. As a result of the increased use of simultaneous tax examinations among Member countries, the Committee on Fiscal Affairs decided it would be useful to draft the OECD Model Agreement for the Undertaking of Simultaneous Examinations for those countries that are able and wish to engage in this type of cooperation. On 23 July 1992, The Council of the OECD made a recommendation to Member countries to use this Model Agreement, which provides guidelines on the legal and practical aspects of this form of cooperation.

203. With the increasing internationalization of trade and business and the complexity of transactions of MNEs, transfer pricing issues have become more and more important. Simultaneous tax examinations can alleviate the difficulties experienced by both taxpayers and tax administrations connected with the transfer pricing of MNEs. A greater use of simultaneous tax examinations is therefore recommended as a mechanism to identify potential transfer pricing disputes and to facilitate exchange of information and the operation of mutual agreement procedures.

E. Safe Harbours

(i) Introduction

204. Applying the arm's length principle can be a fact-intensive and often judgmental process that presents uncertainty and may impose a heavy administrative burden on taxpayers and tax administrations

that can be exacerbated by both legislative and compliance complexity. These facts have lead OECD Member countries to consider whether safe harbour rules would be appropriate in the transfer pricing area.

(ii) *Definition and concept of safe harbours*

205. The difficulties in applying the arm's length principle may be ameliorated by providing circumstances in which taxpayers could follow a simple set of rules under which transfer prices would be automatically accepted by the national tax administration. Such provisions would be referred to as a "safe harbour" or "safe haven". Formally, in the context of taxation, a safe harbour is a statutory provision that applies to a given category of taxpayers and that relieves eligible taxpayers from certain obligations otherwise imposed by the tax code by substituting exceptional, usually simpler obligations. In the specific instance of transfer pricing, the administrative requirements of a safe harbour may vary from a total relief of targeted taxpayers from the obligation to conform with a country's transfer pricing legislation and regulations to the obligation to comply with various procedural rules as a condition for qualifying for the safe harbour. These rules could, for example, require taxpayers to establish transfer prices or results in a specific way, e.g. by applying a simplified transfer pricing method provided by the tax administrations, or satisfy specific information reporting and record maintenance provisions with regard to controlled transactions. Such an approach requires a more substantial involvement from the tax administration, since the taxpayer's compliance with the procedural rules may need to be monitored.

206. A safe harbour may have two variants regarding the taxpayer's conditions of controlled transactions: certain transactions are excluded from the scope of application of transfer pricing provisions (in particular by setting thresholds), or the rules applying to them are simplified (for example by designating ranges within which prices or profits must fall). Both safe harbour targets may need to be revised and published periodically by the tax authorities. Safe harbours do not include procedures whereby a tax administration and a taxpayer agree on transfer pricing in advance of the controlled transactions ("advance pricing arrangements"), which are discussed in Section E of this chapter. The discussion in this section does not extend to tax provisions designed to prevent "excessive" debt in a foreign subsidiary ("thin capitalization" rules), which are discussed in Chapter X of this Report.

207. The provision of safe harbours raises significant questions about the degree of arbitrariness that would be created in determining transfer prices by eligible taxpayers, tax planning opportunities and the potential for double taxation resulting from the possible incompatibility of the safe harbours with the arm's length principle.

(iii) *Factors supporting use of safe harbours*

208. The basic objectives of safe harbours are as follows: simplifying compliance for eligible taxpayers in determining arm's length conditions for controlled transactions; providing assurance to a category of taxpayers that the price charged or received on controlled transactions will be accepted by the tax administration without further review; and relieving the tax administration from the task of conducting further examination and audits of such taxpayers with respect to their transfer pricing.

a) *Compliance relief*

209. Application of the arm's length principle may require collection and analysis of data that may be difficult to obtain and/or evaluate. In certain cases, such complexity may be disproportionate to the size of the corporation or its level of controlled transactions.

210. Safe harbours could significantly ease compliance by exempting taxpayers from such provisions. Designed as a comfort mechanism, they allow greater flexibility especially in the areas where there are no matching or comparable arm's length prices. Under a safe harbour, taxpayers would know in advance the range of prices or profit rates within which the corporation must fall in order to qualify for the safe harbour. Meeting such conditions would merely require the application of a simplified method, predominantly a measure of profitability, which would spare the taxpayer the search for comparables, thus saving time and resources which would otherwise be devoted to determining transfer prices.

b) Certainty

211. Another advantage provided by a safe harbour would be the certainty that the taxpayer's transfer prices will be accepted by the tax administration. Qualifying taxpayers would have the assurance that they would not be subject to an audit or reassessment in connection with their transfer prices. The tax administration would accept without any further scrutiny any price or result exceeding a minimum threshold or falling within a predetermined range. For that purpose, taxpayers could be provided with relevant parameters which would provide a transfer price or a result deemed appropriate to the tax administration. This could be, for example, a series of sector-specific mark-ups or profit indicators.

c) Administrative simplicity

212. A safe harbour would result in a degree of administrative simplicity for the tax administration. Once the eligibility of certain taxpayers to the safe harbour has been established, those taxpayers would require minimal examination with respect to transfer prices or results of controlled transactions. Tax administrations could then allocate more resources to the examination of other transactions and taxpayers.

(iv) Problems presented by use of safe harbours

213. The availability of safe harbours for a given category of taxpayers would have a number of adverse consequences which must carefully be weighed against its expected benefits by tax administrations. These concerns stem from the facts that:

- a) the implementation of a safe harbour in a given country would not only affect tax calculations within that jurisdiction, but would also impinge on the tax calculations of associated taxpayers in other jurisdictions, and
- b) it is difficult to establish satisfactory criteria for defining safe harbours, and accordingly they can potentially produce prices or results that may not be consistent with the arm's length principle. The issue can be examined from several perspectives.

214. Under a safe harbour, taxpayers may not be required to follow a specific pricing method, or even have a pricing method for tax purposes. Where a safe harbour imposes a simplified transfer pricing method, it would be unlikely to correspond in all cases to the most appropriate method applicable to the facts and circumstances of the taxpayer under the regular transfer pricing provisions. For example, a safe harbour may impose a minimum profit percentage under a profit method when the taxpayer could have used the comparable uncontrolled price method or other transaction-based methods.

215. Such an occurrence could be considered as inconsistent with the arm's length principle, which requires the use of a pricing method that is consistent with the conditions that independent parties engaged in comparable transactions under comparable conditions would have agreed upon in the open market. Some sectors where goods, commodities or services are standard and market prices are widely publicised such as, for example, the oil and mining industries and the financial services sector, could conceivably apply a safe harbour with a higher degree of precision and, thus, a lesser departure from the arm's length principle. But even these industry segments produce a wide range of results which a safe harbour would be unlikely

to be able to accommodate to the satisfaction of the tax administrations. And the existence of published market prices would presumably also facilitate the use of transaction-based methods, in which case there may be no need for a safe harbour.

216. Even assuming that the pricing method imposed under a specific safe harbour is appropriate to the facts and circumstances of particular cases, the application of the safe harbour would nonetheless sacrifice accuracy in the reporting of transfer prices. This is inherent in safe harbours, under which transfer prices are predominantly established by reference to a standard target as opposed to the individual facts and circumstances of the transaction, as under the arm's length principle. It follows that the prices or results that produce compliance with the standard target may not be arm's length prices or results.

217. Safe harbours are likely to be arbitrary since they rarely fit exactly the varying facts and circumstances even of enterprises in the same trade or business. This arbitrariness could be minimized only with great difficulty by devoting a considerable amount of skilled labour in collecting, collating and continuously revising a pool of information about prices and pricing developments. Obtaining relevant information for establishing and monitoring safe harbour parameters may therefore impose administrative burdens on tax administrations, because such information may not be readily available and may be accessible only through in-depth transfer pricing inquiries. Therefore, the extensive research necessary to set the safe harbour parameters accurately enough to satisfy the arm's length principle, would jeopardize one of the purposes of a safe harbour, that of administrative simplicity.

a) Risk of double taxation and mutual agreement procedure difficulties

218. From a practical point of view, the most important concern raised by a safe harbour is its international impact. Safe harbours could affect the pricing strategy of corporations. The existence of safe harbour "targets" may induce taxpayers to modify the prices that they would otherwise have charged to controlled parties, in order to increase profits to meet the targets and thereby avoid transfer pricing scrutiny on audit. The concern of possible overstatement of taxable income in the country providing the safe harbour is greater where that country imposes significant penalties for understatement of tax or failure to meet documentation requirements, with the result that there may be added incentive to ensure that the transfer pricing is accepted without further review.

219. Taxpayers may value the certainty provided by the safe harbour to the point where they would raise the prices charged to associated enterprises for the purpose of qualifying for the safe harbour, notwithstanding the fact that those transfer prices would be above the relevant taxpayer's arm's length prices taking into account its specific circumstances. In that case, the safe harbour would work to the benefit of the tax administration providing the safe harbour, as more taxable income would be reported by such domestic taxpayers. On the other hand, the safe harbour would penalize both the foreign associated enterprises and their tax administrations, since less profits and taxable income would be reported in their respective jurisdictions. This would create an issue with respect to the proper sharing of tax revenue between tax jurisdictions.

220. Indeed, in such cases, the tax administration of the jurisdiction adversely affected may not be in a position to accept the prices charged to their taxpayers in connection with transactions with associated enterprises in the safe harbour country. The prices may differ from those obtained in these jurisdictions by the application of transfer pricing methods consistent with the arm's length principle. It would be expected that foreign tax administrations would challenge prices derived from the application of a safe harbour, with the result that the taxpayer would face the prospect of double taxation.

221. At the outset, one would argue that the possibility of double taxation would nullify the objectives of certainty and simplicity originally pursued by the taxpayer in electing the safe harbour. However, taxpayers may consider that a moderate level of double taxation is an acceptable price to be paid in order to obtain relief from the necessity of complying with complex transfer pricing rules.

222. It follows that double taxation may not, in itself, be a disqualifying factor against safe harbours. One may argue that the taxpayer alone should be required to make its own decision if the possibility of double taxation is acceptable in electing the safe harbour or not. However, in order to ensure that taxpayers make such a decision clearly on the basis of this trade-off, the country offering the safe harbour would need to make it explicit whether or not it would attempt to alleviate any eventual double taxation resulting from the use of the safe harbour. Since the safe harbour provides taxpayers with the privilege of avoiding any subsequent review or audit of their transfer prices resulting from the application of a safe harbour and given the nature of safe harbours, whose prices or results are, by design, only a proxy of those obtained under the arm's length principle, it is only appropriate that the taxpayer should equally be prepared, in electing the safe harbour, to bear any ensuing international double taxation resulting from the non-acceptance by a foreign tax administration of the transfer prices reported under the safe harbour. This would logically imply that taxpayers electing the safe harbour should generally be prohibited from bringing double taxation issues before the competent authorities should the use of the safe harbour result in international double taxation. Tax relief from double taxation attributable to a taxpayer's election of a safe harbour should only be granted in the foreign country if the taxpayer can prove that the results of meeting the safe harbour are consistent with the arm's length principle.

223. However, transfer pricing adjustments of foreign tax administrations will be complicated when the MNE has chosen a safe harbour in another country, because the taxpayer is likely to dispute the adjustment to prevent double taxation. The prospect that competent authorities procedures are generally not available to adjust prices or results downwards that have been set under a safe harbour regime, may therefore have a detrimental effect on the tax administration in the foreign countries.

224. The adoption of safe harbour regimes in one country may require that the other countries' tax administrations examine the transfer pricing policy of all companies associated with enterprises that have elected a safe harbour in order to identify all cases of potential inconsistency with the arm's length principle. Failure to do so could amount to a transfer of tax revenue from those countries to the country providing the safe harbour. Consequently, any administrative simplicity gained by the tax administration of the safe harbour country would be obtained at the expense of other countries, which, in order to protect their own tax base, would have to determine systematically whether the prices or results permitted under the safe harbour are consistent with what would be obtained by the application of their own transfer pricing rules. The administrative burden saved by the country offering the safe harbour would therefore be shifted to the foreign jurisdictions

225. Double taxation possibilities would exist not only where a single country adopts a safe harbour. Adoption of a safe harbour by more than one country would not avoid double taxation if each taxing jurisdiction were to adopt conflicting approaches and methods. The parameters of two countries' safe harbours for specific industry segments are likely to deviate since both countries would want to safeguard their revenues. In theory, international coordination could achieve the degree of harmonization among national systems that would be required to prevent double taxation. However, in practice, it is most unlikely that two jurisdictions could harmonize conflicting safe harbours that would eliminate double taxation.

b) Possibility of opening avenues for tax planning

226. Safe harbours would also provide taxpayers with tax planning opportunities. Enterprises may have an incentive to modify their transfer prices in order to shift taxable income to other jurisdictions. This may

also possibly induce tax avoidance, to the extent that artificial arrangements are entered into for the purpose of exploiting the safe harbour provisions.

227. If a safe harbour were based on an industry average, tax planning opportunities might exist for taxpayers with better than average profitability. For example, a cost-efficient company selling at the arm's length price may be earning a mark-up of 15 percent on controlled sales. This corporation would have an incentive to elect a safe harbour providing for a 10 percent mark-up. The company would, under the safe harbour, be taxed on a scaled-down profits figure, notwithstanding the fact that the underlying transfer prices on controlled transactions would be significantly below the arm's length prices. Consequently, taxable income would be shifted out of the country. When applied on a large scale, this could mean significant revenue lost for the country offering the safe harbour. By design, the tax administration would have no recourse to counter such instances of profit shifting.

228. Safe harbours may potentially result in the international under-taxation of income, to the extent that they result in prices or profits not approximating the arm's length principle and allow taxable income to be shifted to low tax countries or tax havens.

229. Whether a country is prepared possibly to suffer some erosion of its own tax base in implementing a safe harbour is for that country to decide. The basic trade-off in making such a policy decision is between the scope and attractiveness of the safe harbour for taxpayers on the one hand, and tax revenue erosion on the other. The more attractive a safe harbour is for a taxpayer, the more taxpayers will elect to use it, thereby reducing the taxation authority's administrative burden. On the other hand, the more attractive the safe harbour is, the more tax revenue is likely to be lost due to under-reporting of income. However, the magnitude of the respective costs and benefits of such a trade-off is irrelevant if the tax administration is not prepared, as a matter of principle, to surrender any discretionary power with respect to the assessment of any taxpayer's liability.

c) Equity and uniformity issues

230. Finally, safe harbours raise equity and uniformity issues. By implementing a safe harbour, one would create two distinct sets of rules in the transfer pricing area, one requiring conformity of prices with the arm's length principle and another requiring conformity with a different and simplified set of conditions. Since criteria would necessarily be required to differentiate those taxpayers eligible for the safe harbour, similar and possibly competing taxpayers could, in some circumstances, find themselves on the opposite side of the safe harbour threshold, thus resulting in similar taxpayers enjoying different tax treatment: one meeting the safe harbour rules and thus being relieved from regular compliance provisions and the other being obliged to do business exclusively in conformity with the arm's length principle, (either because the enterprise in fact deals at arm's length or because it is subject to transfer pricing legislation that is based on the arm's length principle). Preferential tax treatment under safe harbour regimes for a specific category of taxpayers could entail discrimination and competitive distortions.

(v) Recommendations on use of safe harbours

231. The foregoing analysis suggests that whilst safe harbours could accomplish a number of objectives relating to the compliance and administration of transfer pricing provisions, they raise fundamental problems. They could potentially have perverse effects on the pricing decisions of enterprises engaged in controlled transactions. They may also have a negative impact on the tax revenues of the country implementing the safe harbour as well as on the countries whose associated companies engage in controlled transactions with taxpayers electing a safe harbour. More importantly, safe harbours are generally not compatible with the enforcement of transfer prices consistent with the arm's length principle. These drawbacks must be measured against the expected benefits of safe harbours, certainty and compliance simplicity on the taxpayer's side and relief from administrative burden on the tax administration's side.

232. Under the normal administration of tax laws, certainty cannot be guaranteed for the taxpayer, because taxation administrations must retain the ability to review any aspect of a taxpayer's income tax assessment, including the area of transfer pricing. Fundamentally, the introduction of a safe harbour means that the tax administration surrenders a portion of its discretionary power in favour of automatic rules. Tax administrations may not be prepared to go that far, and may consider it essential to retain the ability to verify the accuracy of a taxpayer's self-assessed tax liability and its basis. Compliance simplicity may also often be subordinated to other tax policy objectives such as reasonable and adequate documentation and reporting and the prevention of tax avoidance.

233. On the other hand, tax administrations have considerable flexibility in administering tax law. They can choose to concentrate more resources on cases involving large taxpayers or an important proportion of controlled transactions and show more tolerance towards smaller taxpayers. While more flexible administrative practices towards smaller taxpayers are not a substitute for a formal safe harbour, they may achieve, to a lesser extent, the same objectives pursued by safe harbours. In view of the above considerations, special statutory derogations for categories of taxpayers in the determination of transfer pricing are not generally considered advisable, and consequently the use of safe harbours is not recommended.

F. Advance Pricing Arrangements

(i) Definition and concept of advance pricing arrangements

234. An advance pricing arrangement ("APA") is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g., method, comparables and appropriate adjustments thereto) for the determination of the transfer pricing for those transactions over a fixed period of time. An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer and one or more tax administrations. APAs are intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues. They may be most useful when traditional methods fail or are difficult to apply.

235. One key issue in the concept of APAs is how specific they can be in prescribing a taxpayer's transfer pricing over a period of years, for example whether only the transfer pricing methodology or more particular results can be fixed in a particular case. In general, great care must be taken if the APA goes beyond the methodology, because more specific conclusions rely on predictions about future events.

236. The reliability of a prediction depends both on the nature of the prediction and the critical assumptions on which the prediction is based. For example, it would not be reasonable to assert that the arm's length short-term borrowing rate for a certain corporation will remain at six percent during the coming three years. It would be more plausible to predict that the rate will be LIBOR + 0,2 percent. The prediction would become even more reliable if an appropriate critical assumption were added regarding the company's credit rating (e.g., the rate will be LIBOR + 0,2 percent if the credit rating remains at AA).

237. As another example, it would not be appropriate to specify a profit split formula between associated enterprises if it is expected that the allocation of functions between the enterprises will be unstable. It would, however, be possible to prescribe a profit split formula if the role of each enterprise were articulated in critical assumptions. In certain very simple cases, it might even be possible to make a reasonable prediction on the appropriateness of an actual profit split ratio if enough assumptions were provided.

238. In deciding how specific an APA can be in a particular case, tax administrations should recognize that predictions of absolute future profit experience seems least plausible. It may be possible to use profit ratios of independent enterprises as comparables, but these also are often volatile and hard to predict. Use

of appropriate critical assumptions and use of ranges may enhance the reliability of predictions. Historical data in the industry in question can also be a guide.

239. In sum, the reliability of a prediction depends on the facts and circumstances each actual case. Taxpayers and tax administrations need to pay close attention to the reliability of a prediction when considering the scope of an APA. Unreliable predictions should not be included in APAs. The appropriateness of a method can usually be predicted with more reliability than future results (price or profit level).

240. Some countries allow for unilateral arrangements where the tax administration and the taxpayer establish an arrangement without the involvement of other interested tax administrations. However, a unilateral APA may affect the tax liability of associated enterprises in other tax jurisdictions. Where unilateral APAs are permitted, the competent authorities of other interested jurisdictions should be informed about the procedure as early as possible to determine whether they are willing and able to consider a bilateral arrangement under the mutual agreement procedure.

241. Because of concerns over double taxation, most countries prefer bilateral or multilateral APAs (i.e., an arrangement in which two or more countries concur), and indeed some countries will not grant a unilateral APA (i.e., an arrangement between the taxpayer and one tax administration) to taxpayers in their jurisdiction. The bilateral (or multilateral) approach is far more likely to ensure that the arrangements will reduce the risk of double taxation, will be equitable to all tax administrations and taxpayers involved, and will provide greater certainty to the taxpayers concerned. It is also the case in some countries that domestic provisions do not permit the tax administrations to enter into binding agreements directly with the taxpayer, so that APAs can only be concluded with the competent authority of a treaty partner under the mutual agreement procedure. For purposes of this discussion, an APA is not intended to include a unilateral arrangement except where specific reference to a unilateral APA is made.

242. Tax administrations may find APAs particularly useful in profit allocation or income attribution issues arising in the context of global securities and commodity trading operations, and also in handling multilateral cost contribution arrangements. The concept of APAs also may be useful in resolving issues raised under Article 7 of the OECD Model Convention relating to permanent establishments and branch operations.

243. APAs, including unilateral ones, differ in some ways from more traditional private rulings that some tax administrations issue to taxpayers. One obvious difference in the case of bilateral or multilateral APAs is the involvement of the competent authorities of one or more other tax administrations. In addition, an APA generally deals with factual issues, whereas more traditional private rulings tend to be limited to addressing questions of a legal nature based on facts presented by a taxpayer. The facts underlying a private ruling request may not be questioned by the tax administration, whereas in an APA the facts are likely to be thoroughly analyzed and investigated. In addition, an APA usually covers several transactions, several types of transactions on a continuing basis, or all of a taxpayer's international transactions for a given period of time. In contrast, a private ruling request typically is binding only for a particular transaction.

244. The associated enterprises' cooperation is vital to a successful APA negotiation. For example, the associated enterprises ordinarily would be expected to provide the tax administrations with the methodology that it considers most reasonable under its particular facts and circumstances. The associated enterprises also should submit documentation supporting the reasonableness of its proposal, which would include, for example, data relating to the industry, markets, and countries to be covered by the agreement. In addition, the associated enterprises may identify uncontrolled businesses that are comparable or similar to the associated enterprises' business in terms of the economic activities performed and the transfer pricing conditions, e.g., economic costs and risks incurred etc., and perform a functional analysis as described in Chapter I of this Report.

245. Typically, taxpayers are allowed to participate fully in the process of obtaining an APA, by presenting the case to and negotiating with the tax administrations concerned, providing necessary information and reaching agreement on a transfer pricing methodology or conditions of the controlled transactions. From the taxpayer's perspective, this may be seen as an advantage over the mutual agreement procedure. However, there may be stages in the process or certain issues that may be best addressed by confidential discussions between the tax administrations, without the presence of taxpayers.

246. At the conclusion of an APA process, the tax administration should provide a confirmation to the taxpayer that no transfer pricing adjustment will be made as long as the taxpayer follows the agreed methodology. There should also be provision in an APA that provides for possible revision or cancellation of the arrangement when business operations change significantly, or when uncontrolled economic circumstances critically affect the reliability of the methodology.

247. An APA may cover all of the transfer pricing issues of a taxpayer (as is preferred by some countries) or may provide the flexibility to the taxpayer to limit its APA request to specified affiliates and intercompany transactions. An APA would apply to prospective years and transactions and the actual term would depend on the industry, products or transactions involved. The taxpayer may limit its request to specified prospective tax years. An APA can provide an opportunity to apply the agreed transfer pricing methodology to resolve similar transfer pricing issues in open prior years. However, this application would require the agreement of the tax administration the taxpayer, and, where appropriate, the treaty partner.

248. The tax administration will naturally wish to monitor the taxpayer's compliance with an APA, and this may be done in two ways. First, it may require a taxpayer that has entered into an APA to file annual reports demonstrating the extent of its compliance with the terms and conditions of the APA. Second, the tax administration may continue to examine the taxpayer as part of the regular audit cycle but without reevaluating the methodology. Instead, the tax administration may limit the examination of the transfer pricing to verifying the initial data relevant to the taxpayer's proposal and determining whether or not the taxpayer has complied with the terms and conditions of the APA. With regard to transfer pricing, the tax administration may also examine the reliability and accuracy of the representations in the APA and annual reports and the accuracy and consistency of how the particular methodology has been applied. All other issues not associated with the APA fall under regular audit jurisdiction.

249. An APA should be subject to cancellation, even retroactively, in the case of fraud or misrepresentation of information during an APA negotiation, or when a taxpayer fails to comply with the terms and conditions of an APA.

(ii) Possible approaches for legal and administrative rules governing advance pricing arrangements

250. APAs involving the competent authority of a treaty partner should be considered within the scope of the mutual agreement procedure in Article 25 of the OECD Model Tax Convention, even though such arrangements are not expressly mentioned there. Paragraph 3 of that Article provides that the competent authorities shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. Although the Commentary paragraph 32 indicates that the matters covered by this paragraph are difficulties of a general nature concerning a category of taxpayers, it specifically acknowledges that the issues may arise in connection with an individual case. APAs typically arise from cases where the application of transfer pricing to a particular category of taxpayer gives rise to doubts and difficulties, for example in global financial trading. Paragraph 3 of Article 25 also indicates that the Competent Authorities may consult together for the elimination of double taxation in cases not provided for in the Convention. Bilateral APAs should fall within this provision because they have as one of their objectives the avoidance of double taxation. Even though the Convention provides for transfer pricing adjustments, it specifies no particular methodologies or procedures other than the arm's length principle as set out in Article 9. Thus, it could be considered that APAs are authorised by paragraph 3 of

Article 25 because the specific transfer pricing cases subject to an APA are not otherwise provided for in the Convention. The exchange of information provision in Article 26 also could facilitate APAs, as it provides for cooperation between competent authorities in the form of exchanges of information.

251. Tax administrations might additionally rely on general domestic authority to administer taxes as the authority for entering into APAs. In some countries tax administrations may be able to issue specific administrative or procedural guidelines to taxpayers describing the appropriate tax treatment of transactions and the appropriate pricing methodology. As mentioned above, the tax codes of some Member countries include provisions that allow taxpayers to obtain specific rulings for different purposes. Even though these rulings were not designed specifically to cover APAs, they may be broad enough to be used to include APAs.

252. Some countries lack the basis in their domestic law to enter into APAs. However, when a tax convention contains a clause regarding the mutual agreement procedure similar to Article 25 of the OECD Model Tax Convention, the competent authorities generally should be allowed to conclude an APA, if transfer pricing issues were otherwise likely to result in double taxation, or would raise difficulties or doubts as to the interpretation or application of the convention. Such an arrangement would be legally binding for both States and would create rights for the taxpayer involved. Inasmuch as double tax treaties take precedence over domestic law, the lack of a basis in domestic law to enter into APAs would not prevent application of APAs on the basis of a mutual agreement procedure.

(iii) Advantages of advance pricing arrangements

253. APAs can provide an opportunity for both tax administrations and taxpayers to consult and cooperate in a non-adversarial spirit and environment. The opportunity to discuss complex tax issues in a less confrontational atmosphere than in a transfer pricing examination can stimulate a free flow of information among all parties involved for the purpose of coming to a legally correct and practicably workable result. The non-adversarial environment may also result in a more objective review of the submitted data and information than may occur in a more adversarial context (e.g. litigation). The close consultation and cooperation required between the tax administrations in an APA program also leads to closer relations with treaty partners on transfer pricing issues.

254. An APA may prevent costly and time-consuming examinations and litigation of major transfer pricing issues for taxpayers and tax administrations. Once an APA has been agreed, less resources may be needed for subsequent examination of the taxpayer's return, because more information is known about the taxpayer. It may still be difficult, however, to monitor the application of the arrangement. The APA process itself may also present time savings for both taxpayers and tax administrations over the time that would be spent in a conventional examination, although in the aggregate there may be no net time savings, for example, in jurisdictions that do not have an audit procedure and where the existence of an APA may not directly affect the amount of resources devoted to compliance.

255. Bilateral and multilateral APAs substantially reduce or eliminate the possibility of juridical or economic double or non taxation since both contracting states participate. By contrast, unilateral APAs do not provide as much certainty in the reduction of double taxation because tax administrations affected by the transactions covered by the APA may consider that the methodology adopted does not give a result consistent with the arm's length principle. In addition, bilateral and multilateral APAs can enhance the mutual agreement procedure by significantly reducing the time needed to reach an agreement since competent authorities are dealing with current data as opposed to prior year data that may be difficult and time-consuming to produce.

256. The disclosure and information aspects of an APA programme as well as the cooperative attitude under which an APA can be negotiated may assist tax administrations in gaining insight into complex international transactions undertaken by MNEs. An APA programme can improve knowledge and understanding of highly technical and factual circumstances in areas such as global trading of MNE transactions and the tax issues involved. The development of specialist skills that focus on particular industries or specific types of transactions will enable tax administrations to give better service to other taxpayers in similar circumstances. Through an APA programme tax administrations have access to useful industry data and analysis of pricing methodologies in a cooperative environment. The data and methodologies can then be readily applied to other taxpayers in similar industries, with due regard to confidentiality (so that business details are not revealed to the potential competitors of the taxpayer).

257. An APA programme can assist taxpayers by eliminating uncertainty through enhancing the predictability of tax treatment in international transactions. Provided the critical assumptions are met, an APA can provide a taxpayer with certainty in the tax treatment of the transfer pricing issues covered by the APA for a specified period of time. In some cases, an APA may also provide an option to extend the period of time to which it applies. When the term of an APA expires, the opportunity may also exist for the relevant tax administrations and taxpayers to renegotiate the APA. Because of the certainty provided by an APA, a taxpayer may be in a better position to predict its tax liabilities, thereby providing a tax environment that is favourable for investment. In some cases, APAs can permit the resolution of transfer pricing issues more promptly and at less cost than under alternative methods of dispute resolution.

(iv) Disadvantages relating to advance pricing arrangements

258. Unilateral APAs may present significant problems for tax administrations and taxpayers alike, most notably because there is a greater level of uncertainty and a greater risk of economic or juridical double taxation. One problem is the possible effect on the taxpayer's behaviour. If the taxpayer accepts an arrangement that over-allocates income to the country making the APA in order to avoid lengthy and expensive transfer pricing enquiries or excessive penalties, the administrative burden shifts from the country providing the APA to other tax jurisdictions. Taxpayers should not feel compelled to enter into APAs for these reasons.

259. Another problem with a unilateral APA is the issue of corresponding adjustments. The flexibility of an APA may lead the taxpayer and the related party to accommodate the results to the range of permissible prices or results by making compensating adjustments. In a unilateral APA, it is critical that this flexibility preserves the arm's length principle since a foreign competent authority is not likely to allow a corresponding adjustment arising out of an APA that is inconsistent with the arm's length principle.

260. Another possible disadvantage would arise if an APA involved an unreliable prediction on changing market conditions without adequate critical assumptions, as discussed above. To avoid the risk of double taxation, it is necessary for an APA program to remain flexible, because a static APA may not satisfactorily reflect arm's length conditions.

261. An APA program may initially place a strain on transfer pricing audit resources, as tax administrations will generally have to divert resources earmarked for other purposes (e.g., examination, advising, litigation, etc.) to the APA programme. Demands may be made on the resources of the tax administration by taxpayers seeking the earliest possible conclusion to an APA request, keeping in mind their business objectives and time scales. These may not coincide with the resource planning of the tax administrations, thereby making it difficult to process efficiently both the APAs and other equally important work. Renewing an APA, however, is likely to be less time consuming than the process of initiating an APA. The renewal process may focus on updating and adjusting facts, business and economic criteria and computations. In the case of bilateral arrangements, the agreement of the Competent Authority of the contracting State is to be obtained on the renewal of an APA to avoid double taxation (or non-taxation).

262. Another potential disadvantage could occur where one tax administration has undertaken a number of bilateral APAs which involve only certain of the associated enterprises within an MNE group. A tendency may exist to harmonise the basis for concluding later APAs in a similar way to those previously concluded without sufficient regard being had to the conditions operating in other markets. Care should therefore be taken with interpreting the results of previously concluded APAs as being representative across all markets.

263. Concerns have also been expressed that, because of the nature of the APA procedure, it will interest taxpayers with a good voluntary compliance history. There is then a serious danger of audit resources and expertise being diverted to these taxpayers and away from the investigation of less compliant taxpayers, where these resources could be better deployed in reducing the risk of losing tax revenue through avoidance or evasion. The balance of compliance resources may be particularly difficult to achieve since an APA programme tends to require highly experienced and often specialised staff. Requests for APAs are often concentrated in particular areas or sectors, e.g. global trading, and this can overstretch the specialist resources already allocated to those areas by the authorities. Tax administrations require time to train experts in specialist fields in order to meet unforeseeable demands from taxpayers for APAs in those areas.

264. In addition to the foregoing concerns, there are a number of pitfalls as described below that could arise if an APA program were improperly administered, and tax administrations who use APAs should make strong efforts to eliminate the occurrence of these problems as APA practice evolves.

265. For example, an APA might seek more detailed industry and taxpayer specific information than would be requested in a transfer pricing examination. In principle, this should not be the case and the documentation required for an APA should not be more onerous than for an examination. In fact, an APA should seek to limit the documentation, as discussed above, and focus the documentation more closely on the issues in light of the taxpayer's business practices. Tax administrations need to recognize that :

- a) publicly available information on competitors and comparables is limited;
- b) not all taxpayers have the capacity to undertake in-depth market analyses; and
- c) only parent companies may be knowledgeable about group pricing policies.

266. Another possible concern is that an APA may allow the tax administration to make a closer study of the transactions at issue than would occur in the context of a transfer pricing examination. The taxpayer must provide detailed information relating to its transfer pricing and satisfy any other requirements imposed for the verification of compliance with the terms and conditions of the APA. At the same time, the taxpayer is not sheltered from normal and routine examinations by the tax administration on other issues. An APA also does not shelter a taxpayer from examination of its transfer pricing activities. The taxpayer may still have to establish that it has complied in good faith with the terms and conditions of the APA, that the material representations in the APA remain valid, that the supporting data used in applying the methodology were correct, that the critical assumptions underlying the APA are still valid and are applied consistently, and that the methodology is applied consistently. Thus, the taxpayer could find its overall burden increased. It is therefore important that APA procedures be no more cumbersome or demanding than examination procedures.

267. Problems could also develop if tax administrations misuse information obtained in an APA in its examination practices. If the taxpayer withdraws from its APA request or if the taxpayer's application is rejected after consideration of all of the facts, the information provided to the tax administrations might be available in examining other years. The tax administration may also be in a stronger position if litigation ensues because of the information elicited through an APA program. To protect taxpayers, tax administrations should not routinely use this information in selecting cases to be examined.

268. Tax administrations also should ensure the confidentiality of trade secrets and other sensitive information and documentation submitted to them in the course of an APA proceeding. Domestic rules against disclosure should be applied where possible. In a bilateral APA the confidentiality requirements on treaty partners would apply, thereby preventing public disclosure of confidential data.

269. APAs might have an effect on competition, insofar as the first taxpayer in an industry reaching an APA may set a standard for its competitors. Depending on the size or importance of the taxpayer this could possibly result in competitive distortions. A widespread use of APAs could also turn the tax administration into a general price regulating force in the economy. This should be avoided.

270. An APA program cannot be used by all taxpayers because the procedure can be expensive and time consuming and small taxpayers generally may not be able to afford it. This is especially true if independent experts are involved. APAs may therefore only assist in resolving mainly large transfer pricing cases. In addition, the resource implications of an APA program may limit the number of requests a tax administration can entertain.

(v) Recommendations

a) In general

271. At present, only a few OECD Member Countries have experience with APAs. Those countries which do have some experience seem to be satisfied so far, so that it can be expected that under the appropriate circumstances the experience with APAs will continue to expand. The success of APA programs will depend on the care taken in determining the proper degree of specificity for the arrangement based on critical assumptions, the proper administration of the program, and the presence of adequate safeguards to avoid the pitfalls described above, in addition to the flexibility and openness with which all parties approach the process.

272. There are some continuing issues regarding the form and scope of APAs that require greater experience for full resolution and agreement among Member countries, such as the question of unilateral APAs. Whilst it is too early to make a final recommendation whether the expansion of such programmes should be encouraged, it seems likely that in certain circumstances they will aid in resolving transfer pricing disputes. The Committee on Fiscal Affairs intends to monitor carefully any expanded use of APAs and to promote greater consistency in practice among those countries who choose to use them.

b) Unilateral versus bilateral (multilateral) arrangements

273. Wherever possible, an APA should be concluded on a bilateral or multilateral basis between competent authorities through the mutual agreement procedure of the relevant treaty. A bilateral APA carries less risk of taxpayers feeling compelled to enter into an APA or to accept a non-arm's length agreement in order to avoid expensive and prolonged enquiries and possible penalties. A bilateral APA also significantly reduces the chance of any profits either escaping tax altogether or of being doubly taxed, particularly where the APA establishes conditions for controlled transactions and not just methodology for determining the transfer price. Moreover, concluding an APA through the mutual agreement procedure may be the only form that can be adopted by a tax administration which lacks domestic legislation to conclude binding agreements directly with the taxpayer. Where, nevertheless, unilateral APAs are concluded, some of their inherent disadvantages can be reduced by keeping the affected treaty partners informed.

c) Equitable access to APAs for all taxpayers

274. As discussed above, the nature of APA proceedings may de facto limit their accessibility to large taxpayers. The restriction of APAs to large taxpayers may raise questions of equality and uniformity, because taxpayers in identical situations might be treated differently. A flexible allocation of examination

resources may alleviate these concerns. Tax administrations also may need to consider the possibility of adopting a stream-lined access for small taxpayers.

d) Developing working agreements between competent authorities and improved procedures

275. Between those countries that use APAs, greater uniformity in APA practices could be beneficial to both tax administrations and taxpayers. Accordingly, the tax administrations of such countries may wish to consider working agreements with the Competent Authorities for the undertaking of APAs. These agreements may set forth general guidelines and understandings for the reaching of mutual agreement in cases where a taxpayer has requested an APA involving transfer pricing issues.

276. In addition, bilateral APAs with treaty partners should conform to certain requirements. For example, the same necessary and pertinent information should be made available to each tax administration at the same time, and the agreed upon methodology should be in accordance with the arm's length principle.

G. Arbitration

277. As trade and investment have taken on an increasingly international character, the tax disputes that such activities involve have likewise become increasingly international. And more particularly, the disputes no longer involve simply controversy between taxpayers and the tax administrations but also concern disagreements between the tax administrations themselves. In many of these situations, the taxpayer is primarily a stake holder and the real parties in interest are the governments involved. Traditionally, problems of this sort have been resolved through the mutual agreement procedures, as discussed in this Chapter. However, relief is not guaranteed under the mutual agreement procedure if the tax administrations, after consultation, can reach no agreement.

278. Similar problems of resolving conflicting governmental views have arisen in other settings. In the context of international trade and investment, the General Agreement on Tariffs and Trade and its successor the World Trade Organization, have developed increasingly sophisticated procedures and institutions to resolve international trade disputes. The basic mechanism has been the use of what is essentially an arbitral panel composed of independent persons who produced a reasoned legal ruling as to the issue in question. Similarly, the U.S.-Canada Free Trade Agreement and the expanded North American Free Trade Agreement provide for an arbitration panel procedure to resolve disputes concerning antidumping or countervailing duty issues. Similar arbitral arrangements are present in the European Energy Charter.

279. In the tax area as well, there has been some interest in the use of arbitration to resolve tax disputes. Most publicized is the European Community Tax Arbitration Convention, which came into force on 1 January 1995, but, in addition, some bilateral tax conventions have provisions for arbitration. Neither the European Community Convention nor these bilateral treaty provisions have yet been applied.

280. The possibility of the use of arbitration in tax disputes has been recognized for some time in the work on the OECD Model Convention. In 1977, the Commentary to Article 25 mentioned the possibility of "independent arbitrators" who could be asked to give "advisory opinions." The current version of the Commentary to Article 25 also refers to the possible "solution" of arbitration and the European Community Arbitration Convention as well as the developments in bilateral conventions concerning arbitration .

281. It is in the context of transfer pricing that arbitration has received the most attention by the OECD. The 1984 Report on Corresponding Adjustments contains a discussion of the use of arbitration procedures to insure that corresponding adjustments would be made on a consistent basis. After discussing some the

advantages and disadvantages of arbitration, the Report concludes that "for the time being" it was not appropriate to recommend an arbitration procedure. However, as indicated above, a number of changes have taken place since the Report was written in 1984. The European Community arbitration procedure was at that time only in draft form, the trade agreement dispute resolution procedures had not been so fully developed, bilateral tax conventions had not begun to adopt arbitration procedures, and the dramatic increase of interest in transfer pricing questions with their attendant potential for tax controversy had not yet occurred. Accordingly, it seems appropriate to analyze again and in more detail whether the introduction of a tax arbitration procedure would be an appropriate addition to international tax relations. Therefore, the Committee on Fiscal Affairs has agreed to undertake a study of this topic and to supplement these Guidelines with the conclusions of that study when it is completed.

CHAPTER VIII

DOCUMENTATION

A. Introduction

282. This Chapter provides general guidance for tax administrations to take into account in developing rules and/or procedures on documentation to be obtained from taxpayers in connection with a transfer pricing inquiry. It also provides guidance to assist taxpayers in identifying documentation that would be most helpful in showing that their controlled transactions satisfy the arm's length principle and hence in resolving transfer pricing issues and facilitating tax examinations.

283. Documentation obligations may be affected by rules governing burden of proof in the relevant jurisdiction. In most jurisdictions, the tax administration bears the burden of proof. Thus, the taxpayer need not prove the correctness of its transfer pricing in such cases unless the tax administration makes a prima facie case showing that the pricing is inconsistent with the arm's length principle. The discussion of documentation in this Chapter is not intended to alter in any manner the domestic rules governing burden of proof in any jurisdiction, or to impose a greater burden on taxpayers than is required by those domestic rules. However, it should be noted that even where the burden of proof is on the tax administration, the tax administration might still reasonably oblige the taxpayer to produce documentation about its transfer pricing, because without adequate information the tax administration would not be able to examine the case properly. In fact, where the taxpayer does not provide adequate documentation, there may be a shifting of burden of proof in some jurisdictions in the manner of a rebuttable presumption in favour of the adjustment proposed by the tax administration. Perhaps more importantly, both the tax administration and the taxpayer should endeavour to make a good faith showing that its determination of transfer pricing is consistent with the arm's length principle regardless where the burden of proof lies. In examination practices the behaviour of the tax administration should not be affected by the knowledge that the taxpayer bears the burden of proof where this is the case. The burden of proof should never be used by either tax administrations or taxpayers as a justification for making groundless or unverifiable assertions about transfer pricing.

B. Guidance on documentation rules and procedures

284. Each taxpayer should endeavour to determine transfer pricing for tax purposes in accordance with the arm's length principle, based upon information reasonably available at the time of the determination. Thus, a taxpayer ordinarily should give consideration to whether its transfer pricing is appropriate for tax purposes before the pricing is established. For example, it would be reasonable for a taxpayer to have made a determination regarding whether comparable data from uncontrolled transactions is available. The taxpayer also could be expected to examine, based on information reasonably available, whether the conditions used to establish transfer pricing in prior years have changed, if those conditions are to be used to determine transfer pricing for the current year.

285. The taxpayer's process of considering whether transfer pricing is appropriate for tax purposes should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. It would be expected that the application of these principles will require the taxpayer to prepare or refer to written materials that could serve as documentation of the efforts undertaken to comply with the arm's

length principle, including the information on which the transfer pricing was based, the factors taken into account, and the method selected. It would be reasonable for tax administrations to expect taxpayers when establishing their transfer pricing for a particular business activity to prepare or to obtain such materials regarding the nature of the activity and the transfer pricing, and to retain such material for production if necessary in the course of a tax examination. Such actions should assist taxpayers in filing correct tax returns. Note, however, that there should be no contemporaneous obligation at the time the pricing is determined or the tax return is filed to produce these types of documents or to prepare them for review by a tax administration. The documents that it would be appropriate to request with the tax return are described in paragraph 247 of this Chapter.

286. Because the tax administration's ultimate interest would be satisfied if the necessary documents were submitted in a timely manner when requested by the tax administration in the course of an examination, the document storage process should be subject to the taxpayer's discretion. For instance, the taxpayer may choose to store relevant documents in the form of unprocessed originals or in a well-compiled book, and in whichever language it might prefer, prior to the time the documents must be provided to the tax administration. The taxpayer should, however, comply with reasonable requests for translation of documents that are made available to the tax administration.

287. In considering whether transfer pricing is appropriate for tax purposes, it may be necessary in applying principles of prudent business management for the taxpayer to prepare or refer to written materials that would not otherwise be prepared or referred to in the absence of tax considerations, including documents from foreign associated enterprises. When requesting submission of these types of documents, the tax administration should take great care to balance its need for the documents against the cost and administrative burden to the taxpayer of creating or obtaining them. For example, the taxpayer should not be expected to incur disproportionately high costs and burdens to obtain documents from foreign associated enterprises or to engage in an exhaustive search for comparable data from uncontrolled transactions if the taxpayer reasonably believes, having regard to the principles in Part I of this Report, either that no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue. Tax administrations should also recognise that they can avail themselves of the Exchange of Information Articles in bilateral double tax conventions to obtain such information, where it can be expected to be produced in a timely and efficient manner.

288. Thus, while some of the documents that might reasonably be used or relied upon in determining arm's length transfer pricing for tax purposes may be of the type that would not have been prepared or obtained other than for tax purposes, the taxpayer should be expected to have prepared or obtained such documents only if they are indispensable for a reasonable assessment of whether the transfer pricing satisfies the arm's length principle and can be obtained or prepared by the taxpayer without a disproportionately high cost being incurred. The taxpayer should not be expected to have prepared or obtained documents beyond the minimum needed to make a reasonable assessment of whether it has complied with the arm's length principle.

289. Consistent with the above guidance, taxpayers should not be obligated to retain documents that were prepared or referred to in connection with transactions occurring in years for which adjustment is time-barred beyond a reasonable period of retention consistent with the body of general domestic law for similar types of documents. In addition, tax administrations ordinarily should not request documents relating to such years, even where the documentation has been retained. However, at times such documents may be relevant to a transfer pricing inquiry for a subsequent year that is not time-barred, for example where taxpayers are voluntarily keeping such records in relation to long-term contracts, or to determine whether comparability standards relating to the application of a transfer pricing method in that subsequent year are satisfied. Tax administrations should bear in mind the difficulties in locating documents for prior years and should restrict such requests to instances where they have good reason in connection with the transaction under examination for reviewing the documents in question.

290. Tax administrations also should limit requests for documents that became available only after the transaction in question occurred to those that are reasonably likely to contain relevant information as determined under principles governing the use of multiple year data in Chapter I or information about the facts that existed at the time the transfer pricing was determined. In considering whether documentation is adequate, a tax administration should have regard to the extent that information reasonably could have been available to the taxpayer at the time transfer pricing was established.

291. Tax administrations further should not require taxpayers to produce documents that are not in the actual possession or control of the taxpayer or otherwise reasonably available, e.g., information that cannot be legally obtained, that is not actually available to the taxpayer because it is confidential to the taxpayer's competitor or because it is unpublished and cannot be obtained by normal enquiry or market data.

292. In many cases, information about foreign associated enterprises is essential to transfer pricing examinations. However, gathering such information may present a taxpayer with difficulties that it does not encounter in producing its own documents. When the taxpayer is a subsidiary of a foreign associated enterprise or is only a minority shareholder, information may be difficult to obtain because the taxpayer does not have control of the associated enterprise. In any case, accounting standards and legal documentation requirements (including time limits for preparation and submission) differ from country to country. The documents requested by the taxpayer may not be of the type that prudent business management principles would suggest the foreign associated enterprise would maintain, and substantial time and cost may be involved in translating and producing documents. These considerations should be taken into account in determining the taxpayer's enforceable documentation obligation.

293. It might not be necessary to extend the information required to the whole MNE group. For example, in establishing a transfer price for a distributor with limited functions performed, it might be adequate to obtain information about those functions without extending the information requested to that about the MNE group as a whole.

294. Tax administrations should take care to ensure that there is no public disclosure of trade secrets, scientific secrets, or other confidential data. This type of information should be requested from the taxpayer with discretion and only if the tax administration can undertake that it will remain confidential from outside parties, except to the extent disclosure is required in public court proceedings or judicial decisions. Every endeavour should be made to ensure that confidentiality is maintained to the extent possible in such proceedings and decisions.

295. Taxpayers should recognize that notwithstanding limitations on documentation requirements, a tax administration will have to make a determination of arm's length transfer pricing even if the information available is incomplete. As a result, the taxpayer must take into consideration that adequate record-keeping practices and the voluntary production of documents can improve the persuasiveness of its approach to transfer pricing. This will be true whether the case is relatively straightforward or complex, but the greater the complexity and unusualness of the case, the more significance will attach to documentation.

296. Tax administrations should limit the amount of information that is requested at the stage of filing the tax return. At that time, no particular transaction has been identified for transfer pricing review. It would be quite burdensome if detailed documentation were required at this stage on all cross-border transactions between associated enterprises, and to all enterprises engaging in such transactions. Therefore, it would be unreasonable to require the taxpayer to submit documents with the tax return specifically demonstrating the appropriateness of all transfer price determinations. The result could be to impede international trade and foreign investment. Any documentation requirement at the tax return filing stage should be limited to requiring the taxpayer to provide information sufficient to allow the tax administration to determine approximately which enterprises need further examination.

C. Useful information for determining transfer pricing

297. The information relevant to an individual transfer pricing enquiry depends on the facts and circumstances of the case. For that reason it is not possible to define in any generalized way the precise extent and nature of information that would be reasonable for the tax administration to require and for the taxpayer to produce at the time of examination. However, there are certain features common to any transfer pricing enquiry that depend on information in respect of the taxpayer, the associated enterprises, the nature of the transaction, and the basis on which the transaction is priced. The following section outlines the information that could be relevant, depending on the individual circumstances. It is intended to demonstrate the kind of information that would facilitate the enquiry in the generality of cases, but it should be underscored that the information described below should not be viewed as a minimum compliance requirement. Similarly, it is not intended to set forth an exhaustive list of the information that a tax administration may be entitled to request.

298. An analysis under the arm's length principle generally requires information about the associated enterprises involved in the controlled transactions, the transactions at issue, the functions performed, information derived from independent enterprises engaged in similar transactions or businesses, and other factors discussed elsewhere in this Report, taking into account as well the guidance in paragraph 236. Some additional information about the controlled transaction in question could be relevant. This could include the nature and terms of the transaction, economic conditions and property involved in the transactions, how the product or service that is the subject of the controlled transaction in question flows among the associated enterprises, and changes in trading conditions or renegotiations of existing arrangements. It also could include a description of the circumstances of any known transactions between the taxpayer and an unrelated party that are similar to the transaction with a foreign associated enterprise and any information that might bear upon whether independent enterprises dealing at arm's length under comparable circumstances would have entered into a similarly structured transaction. Other useful information may include a list of any known comparable companies having transactions similar to the controlled transactions.

299. In particular transfer pricing cases it may be useful to refer to information relating to each associated enterprise involved in the controlled transactions under review, such as:

- (I) an outline of the business;
- (II) the structure of the organization;
- (III) ownership linkages within the MNE group;
- (IV) the amount of sales and operating results from the last few years preceding the transaction;
- (V) the level of the taxpayer's transactions with foreign associated enterprises, for example the amount of sales of inventory assets, the rendering of services, the rent of tangible assets, the use and transfer of intangible property, and interest on loans;

300. Information on pricing, including business strategies and special circumstances at issue, may also be useful. This could include factors that influenced the setting of prices or the establishment of any pricing policies for the taxpayer and the whole MNE group. For example, these policies might be to add a mark-up to manufacturing cost, to deduct related costs from sales prices to end-users in the market where the foreign related parties are conducting a wholesale business, or to employ an integrated pricing or cost sharing policy on a whole group basis. Information on the factors that lead to the development of any such policies may well help an MNE to convince tax administrations that its transfer pricing policies are consistent with the transactional conditions in the open market. It could also be useful to have an explanation of the selection, application, and consistency with the arm's length principle of the transfer pricing method used to establish the transfer pricing. It should be noted in this respect that the information most useful to establishing arm's length pricing may vary depending upon the method being used.

301. Special circumstances would include details concerning any set-off transactions that have an effect on determining the arm's length price. In such a case, documents are useful to help describe the relevant facts, the qualitative connection between the transactions, and the quantification of the set-off. Contemporaneous documentation helps minimise the use of hindsight. As discussed in Chapter I, a set-off transaction may occur, for example, where the seller supplies goods at a lower price, because the buyer provides services to the seller free of charge; where a higher royalty is established to compensate for an intentionally lower price of goods; and where a royalty-free cross-license agreement is concluded concerning the use of industrial property or technical know-how.

302. Other special circumstances could involve management strategy or the type of business. Examples are circumstances under which the taxpayer's business is conducted in order to enter a new market, to increase share in an existing market, to introduce new products into a market, or to fend off increasing competition.

303. General commercial and industry conditions affecting the taxpayer also may be relevant. Relevant information could include information explaining the current business environment and its forecasted changes; and how forecasted incidents influence the taxpayer's industry, market scale, competitive conditions, regulatory framework, technological progress, and foreign exchange market.

304. Information about functions performed (taking into account assets used and risks assumed) may be useful for the functional analysis that ordinarily would be undertaken to apply the arm's length principle. The functions include manufacturing, assemblage, management of purchase and materials, marketing, wholesale, stock control, warranty administration, advertising and marketing activities, carriage and warehousing activities, lending and payment terms, training, and personnel.

305. The possible risks assumed that are taken into account in the functional analysis may include risks of change in cost, price, or stock, risks relating to success or failure of research and development, financial risks including change in the foreign exchange and interest rates, risks of lending and payment terms, risks for manufacturing liability, business risk related to ownership of assets, or facilities.

306. Financial information may also be useful if there is a need to compare profit and loss between the associated enterprises with which the taxpayer has transactions subject to the transfer pricing rules. This information might include documents that explain the profit and loss to the extent necessary to evaluate the appropriateness of the transfer pricing policy within an MNE group. It also could include documents concerning expenses borne by foreign related parties, such as sales promotion expenses, or advertising expenses.

307. Some relevant financial information might also be in the possession of the foreign associated enterprise. This information could include reports on manufacturing costs, costs of research and development, and/or general and administrative expenses.

308. Documents also may be helpful for showing the process of negotiations for determining or revising prices in controlled transactions. When taxpayers negotiate to establish or to revise a price with associated enterprises, documents may be helpful that forecast profit and administrative and selling expenses to be incurred by foreign subsidiaries, such as personnel, depreciation, marketing, distribution, or transportation expenses; and that explain how transfer prices are determined; for example, by deducting appropriate gross margins for subsidiaries from the estimated sales prices to end-users.

D. Summary of recommendations on documentation

309. Taxpayers should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm's length principle. Tax administrations should have the right to obtain the documentation prepared or referred to in this process

as a means of verifying compliance with the arm's length principle. However, the extensiveness of this process should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity. Moreover, the need for the documents should be balanced by the costs and administrative burdens, particularly where this process suggests the creation of documents that would not otherwise be prepared or referred to in the absence of tax considerations. Documentation requirements should not impose on taxpayers costs and burdens disproportionate to the circumstances. Taxpayers should nonetheless recognize that adequate record-keeping practices and voluntary production of documents facilitate examinations and the resolution of transfer pricing issues that arise.

310. Tax administrations and taxpayers alike should commit themselves to a greater level of cooperation in addressing documentation issues, in order to avoid excessive documentation requirements while at the same time providing for adequate information to apply the arm's length principle reliably. Taxpayers should be forthcoming with relevant information in their possession, and tax administrations should recognize that they can avail themselves of Exchange of Information Articles in certain cases so that less need be asked of the taxpayer in the context of an examination. The Committee on Fiscal Affairs intends to study the issue of documentation further to develop additional guidance that might be given to assist taxpayers and tax administrations in this area.