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Tax Treaty, Transfer Pricing and Financial Transaction
Division of the OECD's Centre for Tax Policy and Administration

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Subject: Comments from Academia on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

The Netherlands, 27 September 2013

Dear Mrs. De Ruiter, Mr. Andrus and Mr. De Baets,

The OECD requested public comments regarding the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles. In my capacity as an associated professor on transfer pricing at the Maastricht University, the Netherlands, I would like to submit humbly the following comments related to the revised discussion draft.

My comments deal with two aspects:

1. The concept of legal ownership as stated in paragraph 73
2. The concept of associated enterprises, not stated in the Discussion Draft.

1. The Concept of Legal Ownership as stated in paragraph 73 of the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles.

Paragraph 73 of the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles states:

The question of legal ownership is separate from the question of remuneration under the arm's length principle. *It is important to note that, for transfer pricing purposes, legal ownership of intangibles, by itself, does not confer any right ultimately to retain any return from exploiting2 the intangible that may initially accrue to the legal owner as a result of its legal or contractual right to exploit the intangible*. The return ultimately retained by the legal owner depends upon the contributions it makes to the anticipated value of the intangibles through its functions performed, assets used, and risks assumed, and upon the contributions to the anticipated value of intangibles made by other MNE group members through their functions performed, assets used, and risks assumed. For example, where the legal owner makes no contributions that are anticipated to enhance the value of the intangible, the legal owner will not ultimately be entitled to retain any portion of the return attributable to the intangible. *Legal ownership is simply a reference point for identifying and analysing controlled transactions relating to the intangible and for determining the appropriate remuneration to members of a controlled group with respect to those transactions.* In most cases, the legal owner will accrue receipts from the exploitation of the intangible in the first instance. It must remit to other MNE group members arm's length remuneration reflecting the anticipated value of their contributions. Thus, identification of legal ownership, combined with the identification of relevant functions performed, assets used or contributed, and risks assumed by all contributing members, provides the analytical framework for identifying arm's length prices and other conditions for transactions involving intangibles."

The wording in paragraph 73 "***It is important to note that, for transfer pricing purposes, legal ownership of intangibles, by itself, does not confer any right ultimately to retain any return from exploiting the intangible that may initially accrue to the legal owner as a result of its legal or contractual right to exploit the intangible***" introduces a concept of legal ownership which may conflict with the purpose of the arm's length principle, that is to put associated enterprises and independent enterprises on an equal footing for tax purposes. In a transaction between independent enterprises the legal ownership is generally recognized as a starting point, whereas it seems now that the OECD– by using the above quoted phrase- rejects the view that ownership of intangibles is or may be relevant for the remuneration under the arm's length principle.
Also the wording in paragraph 73"***Legal ownership is simply a reference point for*** **may indicate the irrelevance of a de jure concept for transfer pricing purposes.**

However, the OECD states in paragraph 89:

"The legal owner of an intangible is entitled to ***all*** returns attributable to the intangible only if, in substance, it:" (bold and italics by Dwarkasing).

Apparently there are several levels of importance and relevance of the legal ownership for the arm's length remuneration (or the amount of returns attributable). In paragraph 89 the OECD provides clearly when the legal owner of an intangible is entitled to *all* returns attributable to the intangible.
I would like to recommend the OECD - for the sake of clarity- to remove the above quoted phrases in paragraph 73 and to provide more information on these so-called levels where legal ownership (and thus legal rights and contractual arrangements) is (are) the basis and starting point(s), and eventually turns into a concept that is "simply a reference point" for identifying and analysing controlled transactions relating to the intangible and for determining the appropriate remuneration to members of a controlled group with respect to those transactions.

2. The Concept of Associated Enterprises.

2.1 The OECD Transfer Pricing Guidelines does not deal with the important concept of *Associated Enterprises.* However, as the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles can be considered as one of the most important revisions of the OECD TP Guidelines, the Draft could include more explanation on the concept of *Associated Enterprises* as to avoid double taxation and unjustified additional taxation.[1]

The concept of *Associated Enterprises* is essential for the application of the arm's length principle, which is the internationally recognised tax standard for transfer pricing. Despite the importance of the notion of *Associated Enterprises*, there is a lack of clarity on its meaning, in particular concerning the term "control". The arm's length principle is only applicable to transactions between *associated enterprises.* Under the OECD Model and virtually all tax treaties, the concept of associated enterprises covers a direct or indirect participation in management, control or capital of an enterprise in another enterprise or direct or indirect participation in management, control or capital of the same person(s) in other enterprises.

The problem on which this letter focuses is twofold. First, different interpretations and applications of the concept of associated enterprises may result in economic double taxation, particularly in a situation where a country with a relatively broad concept of associated enterprises (for instance with a participation-in-capital criterion of over 20%) makes a transfer pricing adjustment and the other country involved refuses to apply a corresponding adjustment, because it applies a narrow concept of associated enterprises (for instance based on a participation-in-capital criterion of over 50%).

[1] See also Dwarkasing, R., "The Concept of Associated Enterprises" 41 *Intertax* (Aug/Sep 2013 peer reviewed), pp. 412-429; Dwarkasing, R.S.J., *Associated Enterprises – A Concept Essential for the Application of the Arm's Length Principle and Transfer Pricing* (The Netherlands: Dwarkasing & Partners, 2011), pp. 17-119.

Secondly, several countries apply a very broad concept of associated enterprises, which not only covers *de jure* relationships such as participation in capital or management, but also purely *de facto* control situations. Such a broad concept of associated enterprises may result in transfer pricing adjustments in cases to which the arm's length principle is not applicable, for instance in situations of a mere dominant market position. The following example illustrates this problem.

An Indian software development company has a customer in the Netherlands (also an enterprise) who is responsible for more than 90% of the turnover of the Indian software developer. The Dutch customer is able to dictate the prices of the Indian software developer. The Indian software developer is therefore only able to charge a price with a 1% margin/mark-up, which is very low compared to his Indian competitors (who for instance apply an average mark-up of 6%).

According to Indian transfer pricing law, if the goods or articles manufactured or processed by one enterprise, are sold to another enterprise abroad or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise, the two enterprises shall be deemed to be associated enterprises.[2]

The Indian tax authorities consider the Indian software developer and its Dutch customer to be associated. They may adjust the prices and tax an unrealised profit, i.e. the difference between the real result and a result based on prices derived from other software developers in India. The Netherlands does not consider the companies to be associated as it applies a narrow concept of associated enterprises that does not include "*de facto* control" as a criterion for association. Although both companies are unrelated and the prices are a result of open market negotiations, the arm's length principle is applied by the Indian tax authorities, *because of their domestic concept of associated enterprises.* As a result, the Indian company has to pay taxes over profits that have not been made, it faces heavy documentation requirements and other transfer pricing compliance requirements and, moreover, it faces a penalty for not applying the "correct" prices.

It is to be expected that the problems caused by the various different interpretations of "associated enterprises" will increase. Important emerging economies, such as Brazil, China, India and Vietnam, and important traditional industrialised countries, such as the United States, Germany, the Netherlands and the United Kingdom apply different concepts of "associated enterprises". As business transactions and direct investments between these countries increase, the problems caused by different interpretations of "associated enterprises" may also increase. Because of the leading role of the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines in transfer pricing all over the world, the double taxation problems and unjustified additional taxation problems arising from incorrect interpretation of the concept of associated enterprises may be addressed by Working Party 6 in a revision of Chapter 6 of the OECD Transfer Pricing Guidelines.

This letter provides an appropriate interpretation of the concept of "associated enterprises" in the OECD Model in the light of its history and its purposes, which is able to remedy the problems above.

2.2 The arm's length principle

As early as 1872 descriptions were provided of arm's length dealing. In the United States courts related the notion of arm's length dealing to the doctrine of "undue influence".[3] The arm's length principle was introduced in the early reports of the League of Nations as a corollary of the separate accounts principle. The separate accounts principle was introduced for the allocation of taxable income to permanent establishments, which at that time included branches and subsidiaries. Since its introduction in the early reports of the League of Nations, the separate accounts principle and the arm's length principle have become the foundations of Art. 7, concerning the taxation of permanent establishments, and Art. 9 of the OECD Model.

When a special article for the taxation of affiliated companies (associated enterprises) was introduced in the League of Nations reports of 1933, the arm's length principle became the underlying principle of this article. In this context, Mitchell B. Carroll wrote:

[2] Sec. 92 A (2) (i) ITA 1961

[3] Baker, R. and Baker, D., "The Pricing of goods in International Transactions between Controlled Taxpayers", 10 *Tax Executive* 23 5 (1957-1958), pp. 247-248 and *Parfitt v. Lawless* (1872), L.R.2 P & D. 462, 468.

"The legal transactions between the parent and the subsidiary should be conducted in the same manner as similar transactions between independent legal persons."[4]

With respect to the tax treatment of permanent establishments, Carroll also referred to the arm's length principle:

"The fundamental principle laid down is that, for tax purposes, permanent establishments must be treated in the same manner as independent enterprises operating under the same or similar conditions, with the corollary that the taxable income of such establishments is to be assessed on the basis of their separate accounts."[5]

According to the OECD and the United Nations, arm's length transfer pricing has been the international standard for the allocation of taxable income to members of multinational enterprises (MNEs) and to permanent establishments for many years. The arm's length principle requires associated enterprises to deal with each other as if they were independent enterprises. The concept of associated enterprises is essential for the application of the arm's length principle. No re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms.[6] When enterprises are *associated*, only then may the arm's length principle be applied if the prices between the enterprises are not *at arm's length*. *A contrario*, it may be concluded that if enterprises are *not* associated, prices and transactions reflect an open market situation that is "automatically" at arm's length. Thus, the concept of associated enterprises can be considered as "the trigger" for the application of the arm's length principle.
As shown in the first example above, the concept of associated enterprises also delimits the application of the arm's length principle. If the concept of associated enterprises is relatively broad it will cover more enterprises and, as a consequence, the arm's length principle will be applicable to the transactions between those enterprises. A large number of taxpayers run the risk of profit adjustments and are required to meet documentation obligations.

When independent enterprises deal with each other, the conditions of their commercial and financial relations are established by open market forces.[7] When associated enterprises, for instance members of an MNE, deal with each other, their commercial and financial relations may not be directly affected by external market forces in the same way as independent parties. When transfer prices do not reflect market prices, the tax liabilities of the associated enterprises and the tax base of the countries concerned may be distorted. Therefore, associated enterprises are required to apply the arm's length principle when dealing with each other. As a consequence, the effects and distortions of their special commercial and financial conditions on their intra-group transactions should be eliminated.[8] This results in tax parity between MNEs and independent enterprises. As the concept of associated enterprises is an essential part of the arm's length principle, it should be interpreted conform to the purposes of the arm's length principle.

As elaborated on by the League of Nations and the OECD, the application of the arm's length principle has the following purposes:

- To make the correct application of the separate entity approach possible and therefore secure the appropriate tax base in each jurisdiction involved;
- To eliminate effects and distortions of the associated enterprises' special commercial and financial conditions on the levels of profits;
- To provide broad parity of tax treatment for MNEs and independent enterprises, that is to provide a tax treatment which is neutral towards the type of entity;
- In the light of the previously mentioned purposes: to put associated enterprises and independent enterprises on an equal footing for tax purposes;

[4] League of Nations, *Taxation of Foreign and National Enterprises - Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217 (b).1933.II.A., 1933); p. 109.
[5] League of Nations, *Report of the Fiscal Committee to the Council*, Fourth Session, Document No. C.399.M.204.1933.II.A (Geneva: League of Nations 1933), p. 2.
[6] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995).
[7] See also OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.2.
[8] Ibid.

- To serve the general principles of equality and neutrality in tax law;
- To avoid a distortion of the relative competitive positions between associated and independent enterprises;
- To promote international trade and investment by removing tax considerations from economic decisions.

The "boundaries" of the concept of associated enterprises are determined by the main purposes of the arm's length principle; that is, to put associated enterprises and independent enterprises on a more equal footing for tax purposes (equality) and to avoid the creation of tax advantages that would otherwise distort the relative competitive positions of either type of entity (neutrality).

As a principle, the price established between two independent enterprises is of an arm's length nature. Both parties to the transactions have their own interests. A buyer would like to pay the lowest price possible. A seller would like to receive the best price possible. The negotiation process determines the final price. The price between two independent enterprises need not be necessarily or usually similar to prices charged/paid between other unrelated parties. There are many valid reasons for the existence of differences with respect to commercial and financial conditions in business transactions between different independent parties. An important difference may be the negotiating power of parties.

As indicated above, one of the consequences of a broad concept of associated enterprises is that the arm's length principle may be applied to open market situations. Looking at the purposes and the historical development of the arm's length principle, the arm's length principle has never aimed at adjusting prices of independent enterprises. In the above-mentioned example of the Indian software developer, the arm's length principle may be applied by the Indian tax authorities although both companies are unrelated and the prices are the result of negotiations in the open market. This example shows that a broad scope of associated enterprises covering various forms of *de facto* control relationships between independent parties engaging in business on an open market may lead to the risk of application of the arm's length principle to situations for which it is not meant.

2.3. Distinction between the arm's length principle and anti-avoidance measures

Whereas the arm's length principle is considered to be an anti-tax avoidance and anti-tax evasion measure by various countries, the OECD considers the arm's length principle as a general principle of international tax law. Since the early 1920s onwards, the arm's length principle has developed into a separate, important principle of taxation in drafts and reports of the League of Nations, the OEEC and the OECD. The following text of the Fiscal Committee of the OEEC in 1960 is illustrative:

"[...] The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of European double taxation Conventions concluded since the war, and it is fair to say *that the solutions adopted have generally conformed to a standard pattern.* It is generally recognised *that the essential principles* on which this standard pattern is based are well founded [...]"[9]

In the 1979 OECD Report on Transfer Pricing and Multinational Enterprises, the Committee on Fiscal Affairs states that the need to adjust the actual price to an arm's length price, in order to arrive at a proper level of taxable profits, arises *irrespective* of any contractual obligation undertaken by the parties to pay a particular price, or of any *intention* of the parties to *minimise tax.* Hence, the consideration of transfer pricing problems should *not* be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes.[10]

Neutrality and parity of treatment are the foundations of the arm's length principle. Hamaekers stated in 1992:

[9] See also OEEC, FC(60), annex E, p. 22, para. 2, (Paris: 25 May 1960) FC(60) 157.
[10] Ibid., see also OECD, Committee on Fiscal Affairs, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises*, (Paris: OECD, 1979), para. 3.

"Taxpayers with a controlling interest in a company are placed in the same position as other taxpayers through the application of the arm's length principle which neutralises the advantage of the former."[11]
In 1995 the OECD TP Guidelines formulated a basis for the arm's length principle:

"[...] broad parity of tax treatment for MNEs and independent enterprises. Because the arm's length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity."[12]

The arm's length principle seeks to avoid a distortion of the relative competitive positions between associated and independent enterprises, and therefore promotes international trade and investment.[13] In this context, the arm's length principle itself can be considered a general principle of taxation. The arm's length principle contains features which are based on general principles of tax law recognised in most industrialised countries. In 2010 the revised OECD TP Guidelines reaffirmed the arm's length principle as being the most reasonable means for achieving equitable results and minimising the risk of unrelieved double taxation. In line with the 1979 OECD Report on Transfer Pricing and Multinational Enterprises, the OECD stated that the consideration of transfer pricing should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes.[14]

Also, from the purpose of Art. 9 (2) OECD Model it may be concluded that the arm's length principle is not meant to be an anti-avoidance measure. Art. 9 (2) OECD Model is an integral part of the arm's length principle. The application of the arm's length principle may cause economic double taxation when adjustments are made to correct the prices of the transaction. For example, as a consequence of special conditions within the meaning of Art. 9 (1) OECD Model, the profits of one associated enterprise are increased in one Contracting State via an upward adjustment of the profits of the enterprise resident in this State and – as a result - the tax authority imposes tax on the increased profits. The increased element of profit bears tax in both Contracting States, albeit in the hands of different taxpayers.[15] This is the result of the arm's length principle. Art. 9 (2) OECD Model was introduced in order to eliminate the resulting economic double taxation.

If the arm's length principle were a mere anti-tax avoidance and anti-tax evasion measure, there would be no reason for avoiding double taxation. Anti-tax avoidance measures generally do not go with measures to relieve double taxation arising from the application of these anti-tax avoidance measures.

If the main purpose of Art. 9 (1) OECD Model were to prevent tax avoidance and tax evasion, it seems that this does not correspond with Art. 9 (2) OECD Model, a rule dealing with the avoidance of economic double taxation.

Looking at Art. 9 OECD Model, I conclude that the arm's length principle is a general principle of taxation based on the equality and neutrality principles. It prevents double taxation (through Art. 9 (2) OECD Model) and achieves an equitable inter-nation allocation of taxing rights.[16] The view that Art. 9 OECD Model is a mere anti-avoidance measure and that therefore the concept of associated enterprises may be broadly interpreted so as to cover various situations of tax avoidance and evasion must be rejected. The usefulness of a distinction between the application of the arm's length principle and anti-tax avoidance and – anti-tax evasion measures will be demonstrated in the next parts of this comment.

[11] Hamaekers, H., "The Arm's Length Principle and the Role of Comparables", 12 *Bulletin of International Fiscal Documentation* (1992), p. 602.
[12] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.7
[13] Ibid., para. 1.3
[14] Ibid., para. 1.2.
[15] See also Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 553.
[16] Dwarkasing, R.S.J., *Associated Enterprises – A Concept Essential for the Application of the Arm's Length Principle and Transfer Pricing* (Tilburg: Dwarkasing & Partners, 2011), pp. 17-119.

2.4. Art. 9 OECD Model

As indicated in the previous Section, the concept of associated enterprises delimits the application of the arm's length principle. According to Art. 9 OECD Model, "associated enterprises" exist when one enterprise participates directly or indirectly in the management, control or capital of the other enterprises, or when the same persons participate directly or indirectly in the management, control or capital of both enterprises.
Art. 9 OECD Model implies a two-step analysis: tax authorities should first determine the existence of "associated enterprises" and if associated enterprises exist, then it should be examined whether the conditions which are made or imposed between the two enterprises are at arm's length, and apply the –in case of intangibles- the revised Chapter 6 of the OECD TP Guidelines.

Art. 9 (1) OECD Model gives two forms of association:

(a) One enterprise participates directly or indirectly in the management, control or capital of the other enterprise (Art. 9 (1) (a) OECD Model); or
(b) The same persons participate directly or indirectly in the management, control or capital of both enterprises (Art. 9 (1) (b) OECD Model).

A definition of what participation in management, control or capital means is not given. The Commentary and the OECD TP Guidelines do not provide a definition of associated enterprises either. The 1979 OECD Report states that it was not thought to be necessary to define expressions such as "associated enterprises" and "under common control" as a *broad basis of common understanding* of what was meant was assumed to exist.[17] This indicates that there must be an autonomous interpretation of "associated enterprises".

Art. 9 OECD Model only deals with profit adjustments between *enterprises*.[18] A specific phrase from Chapter IV concerning the Foreign Enterprise with Local Subsidiary of the 1933 Report supports this view:

"To verify this declaration and accounts, the tax authorities may enquire into the current of business between the local subsidiary and the parent company or other subsidiary companies of the parent, which may for convenience be termed *associated companies."*[19]

At this point Carroll introduces the term "associated companies" for "convenience purposes". He did not refer to *persons*, but only to companies and subsidiaries. The OECD TP Guidelines also refer to enterprises: "Transfer Pricing Guidelines for *Multinational Enterprises* and Tax Administrations".
The Commentary on Arts. 11 and 12 OECD Model indicates that Art. 9 OECD Model does not cover relationships by blood or marriage. Paragraph 34 of the Commentary on Art. 11 OECD Model provides examples of relationships that are covered by Art. 11 OECD Model but that are not covered by Art. 9 OECD Model.

The "bracket definition" in the Commentary cannot be considered to be a proper definition of "associated enterprises".[20] The term "bracket definition" refers to the definition between brackets of "associated enterprises" in the Commentary on Art. 9 OECD Model:

"This Article deals with [...] associated enterprises (*parent and subsidiary companies and companies under common control)* [...]"

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[17] OECD Committee on Fiscal Affairs, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises*, (Paris: OECD, 1979)
[18] See also Vogel, K., *Klaus Vogel on Double Taxation Conventions - A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 524.
[19] League of Nations, *Taxation of Foreign and National Enterprises - Methods of Allocating Taxable Income*, Volume IV, League of Nations Document No. C.425(b).M.217 (Geneva: 1933), p. 109.
[20] See Dwarkasing, R.S.J., *Associated Enterprises – A Concept Essential for the Application of the Arm's Length Principle and Transfer Pricing* (The Netherlands: Dwarkasing & Partners, 2011), pp. 126-134.

The bracket definition cannot be considered to be a comprehensive proper definition of "associated enterprises", but it indicates that a mere "*de facto"* control situation is not covered by Art. 9 (1) (a) OECD Model. The term "common control" used for explaining the situations under Art. 9 (1) (b) OECD Model remains unexplained. It must be concluded that it would have been stated explicitly if a broad meaning covering also "*de facto"* control would be covered.

The OECD Model does not elaborate on the specific order of the terms "management, control or capital". Though a participation in capital through a sole or majority participation including voting rights in the capital of an enterprise is the most common form of association (in particular parent-subsidiary relationships), the OECD Model does not explain why the term "capital" is mentioned as the last criterion. One would expect that participation in capital would be the first criterion mentioned for associated enterprises in Art. 9 OECD Model.

According to the OECD, the term "capital" should be understood as it is understood in *company law*.[21] Company law covers the shareholders' relationships and the relationships between management, shareholders and the company. Therefore, company law is very important for the concept of associated enterprises. It deals with various aspects of "capital" and "management". From a company law perspective, the criteria "participation in capital" and "participation in management" refer to the controlling power that shareholders (may) have and management has over the enterprises.

The term "participation in capital" refers to shareholding and voting power. The question arises whether the shareholder has sufficient voting power to be able to influence or control the company, or - in the context of Art. 9 OECD Model - whether this shareholder is able to control the transfer prices.
Company law generally identifies two types of shareholding: a passive, non-controlling shareholder and a shareholder that has sufficient voting power to be able to influence or control this company. In this context, control can be defined as the power to direct the strategic financial or operating activities of an entity, and thus the right to exercise whatever discretion exists in strategic decision-making.
Art. 9 OECD Model focuses on those "participants in capital and management" who are able to influence the transfer prices, so those that have sufficient power to be able to influence or control the company. By requiring minimum thresholds (with regard to a participation in capital) to determine whether there is a participation in capital for transfer pricing purposes, tax authorities may confuse foreign portfolio investment (FPI) with foreign direct investment (FDI) and vice versa. Holding a specific amount of shares does not always imply that the holder has the *power* to control the company.
For instance, share certificates holders generally have no voting power to influence or control the company.

In the light of the aforesaid, company law also provides various "mechanisms" that delimit the power of majority shareholders or increase the power of minority shareholders. For instance, control-enhancement mechanisms may result in minority shareholders who control enterprises or majority shareholders that do not possess control over an enterprise because a minority shareholder does. Control-enhancement mechanisms allocate control rights and may give minority shareholders control over the enterprise. Control-enhancement mechanisms available in company law may limit the control of an enterprise participating in the capital of another enterprise, for example through multiple-voting rights, voting-rights ceilings, ownership ceilings, non-voting shares etc. Specifically because of the so-called separation of ownership and control in company law, I conclude that a specific required percentage to fulfil the participation-in-capital criterion is not decisive to determine whether one enterprise can influence or control the transfer prices of the other enterprise. The concept of control and power is related to the structure of decision-making within the company; the influence of control-enhancing mechanisms on the control or decision-making power of a shareholder is ignored when the transfer pricing legislation applies specific thresholds for participation in capital (for instance, where a country applies a minimum of 25% participation in capital to determine the existence of associated enterprises).

Another aspect of company law illustrates its relevance for Art. 9 OECD Model: the protection of minority shareholders under company law. As shown in the *Ford Canada* case, company law may restrict the control

[21] See also the OECD Commentary on Art. 10 (2) (a) OECD Model and Vogel, K., *Klaus Vogel on Double Taxation Conventions - A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 525.

of majority shareholders with respect to the transfer pricing system if the rights of minority shareholders are harmed (minority shareholders' protection).[22]

The above shows that company law is relevant to the application of Art. 9 OECD Model, as it may restrict the control of majority shareholders and/or provide minority shareholders with control.
Economic control/voting models, for instance dealing with voting power indices, may be useful to measure the formal shareholder's voting power and control.

Although the word "or" in Art. 9 OECD Model seems to indicate that "participation in control" is a separate, independent criterion for association, the presence of control is required for identifying whether one holds a "participation in capital or management" that could potentially influence the transfer prices. For instance, control is required to identify whether there is a FDI or a FPI.

Based on the above I conclude that – for the sake of clarity - the terms "participation in management" and "participation in capital" should be supplemented with the adjective "controlling". The matter of whether "participation in control" is a criterion independent from the other designations of "associated enterprises" will be discussed below.

2.5. Tax treaty interpretation: an autonomous interpretation?

Tax treaties recognise that each Contracting State applies its own law. The most widely-held view has been that treaty obligations limit the Contracting States' application of that law. Tax treaties do not attribute the "right to tax" to the Contracting States. According to the Vienna Convention on the Law of Treaties (hereinafter: VCLT), the ordinary meaning of a term is not to be determined in the abstract but in the context of the treaty and in the light of its object and purpose. According to the VCLT, it is not the function of interpretation to revise treaties or read into them what they do not contain, expressly or by implication. Contracting States are to be presumed to have that intention which appears from the ordinary meaning of the terms used by them.

The purpose of the OECD Model is to remove the obstacles that double taxation presents to the development of economic relations between countries and promoting the exchange of goods and services and movements of capital, technology and persons by avoiding double taxation and preventing tax avoidance. The OECD states that when Member countries conclude or revise bilateral conventions, they should conform to the OECD Model Tax Convention as interpreted by the Commentaries thereon, taking into account the reservations contained therein. The OECD emphasises that "although the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, which *unlike the Model* are legally binding international instruments, they can nevertheless be of great assistance in the application and *interpretation* of the conventions and, in particular, in the settlement of any disputes."[23]

The worldwide recognition of the provisions of the Model Convention and their incorporation into a majority of bilateral conventions have helped make the Commentaries on the provisions of the Model Convention a "widely-accepted guide to the interpretation and application of the provisions of existing bilateral conventions".[24]

Art. 3 (2) of the OECD Model states that any term not defined in the convention shall have the meaning that it has at that time under the law of that State, *unless the context otherwise requires.*
The phrase "unless the context otherwise requires" refers to situations where a reference to an interpretation according to domestic law fails to provide a clear solution to the particular tax issue.
With regard to "context" Lang states:

"[...] the object and purpose of the OECD Model suggests putting considerable weight on the phrase "unless the context otherwise requires" and that the term "context" may have a very broad meaning. It covers not only the whole OECD Model but also the preparatory work of the OECD Model such as the

[22] *Ford Motor Company of Canada, Limited v. Ontario Municipal Employees Retirement Board* et al., Ontario Superior Court of Justice (Commercial List), [No. 98-CL-3075], decision filed 22 January 2004.
[23] Introduction OECD Commentary, para. 29.1
[24] Ibid., para. 15.

Commentary. All historical, systematical and teleological aspects that are important for the interpretation of the OECD Model may be taken into account."[25]

As stated earlier, almost all tax treaties contain the same formula for associated enterprises as the OECD Model: participation in management, control or capital. None of the OECD Member States has made reservations on Art. 9 (1) OECD Model.

Various countries have different and broad concepts and interpretations of "associated enterprises" in their domestic legislation. Double taxation may arise because of different interpretations of the concept of associated enterprises under domestic transfer pricing rules. For instance, in country A a 26% shareholding is covered and an adjustment is made, whereas country B's transfer pricing legislation requires at least a 50% shareholding for the existence of associated enterprises. Country B may therefore not be prepared to apply a corresponding adjustment.
Reference to domestic law for the interpretation of "associated enterprises" may also lead to the risk of application of the arm's length principle to situations for which it is not meant, in particular "*de facto* control" situations, based on a strong negotiation position in the open market.

Therefore, it may be concluded that reference to domestic law fails to provide a clear solution. An autonomous interpretation of associated enterprises avoids the reference to the domestic laws. This seems to be the appropriate way to reach a common interpretation by the Contracting States, which may be followed also by non-OECD Member States.[26]
The OECD assumption that a broad basis of common understanding exists as to what is meant by the term "associated enterprise" and "under common control" supports the argument for an autonomous interpretation of "associated enterprises".[27] Furthermore, in the 1960s the Fiscal Committee of the OEEC stated that with regard to the question of how to allocate profits to a permanent establishment and how to allocate profits from transactions between enterprises under common control, it was fair to "say that the solutions adopted have generally conformed to a standard pattern. It is generally recognised that the essential principles on which this standard pattern is based are well-founded".[28] From this "standard pattern" and the "well founded essential principles", the statement of the Fiscal Committee that "this Article seems to call for very little comment" and the purposes of the arm's length principle that indicate the "boundaries" of the concept of associated enterprises, I conclude that an autonomous interpretation of "associated enterprises" must exist.

Because of the view that treaty obligations limit the Contracting States' application of that law, a domestic interpretation of "associated enterprises" broader than that of the OECD Model will be "overruled" by the narrower concept of associated enterprises in the OECD Model.

2.6. Historical analysis of Art. 9 OECD Model

The phrase "participation in management, control or capital" in Art. 9 OECD Model seems to indicate that the concept of associated enterprises consists of three independent elements. However, when one analyses the development of Art. 9 OECD Model, it becomes clear that "control" is not a separate, independent criterion. The two criteria for the concept of associated enterprises are the participation-in-management criterion and the participation-in-capital criterion. This conclusion is based on the following.

Several years before the first meetings of the Fiscal Committee of the League of Nations were held, the term "control" was used in the domestic legislation of two countries that played an important role in the work of this Committee: the United Kingdom and the United States.
The Finance Act 1915 of the United Kingdom provided transfer pricing rules focussing on a concept of control that originates from a close connection between two companies. One party should be able to arrange the course of business between two parties so that the first party would either have no profits or less than

[25] Lang, M., Burgstaller, E. and Haslinger, K. (eds.), *Conflicts of Qualification in Treaty Law* (Vienna: Linde Verlag Wien, 2007), p. 32.
[26] Ibid., p. 31.
[27] See also Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Series on International Taxation, Vol. 35 (The Netherlands: Kluwer Law International, 2010), p. 215.
[28] See also OEEC, FC(60), annex E, p. 22, para. 2 (Paris: OEEC, 25 May 1960), FC(60) 157.

the "ordinary profits which might be expected to arise from that business". Control existed by means of the holding of shares or the possession of voting rights or by virtue of any powers conferred by the articles of association or similar documents. Control was apparently based on *de jure* relationships.
However, in the United States the concept of associated enterprises has been formulated differently. As the arm's length principle was considered to be an anti-avoidance and anti-evasion measure, the concept of "control" was very broad. Although in other US tax law articles "control" was exclusively based on a *de jure* relationship, for transfer pricing purposes "control" included all forms of control including *de facto* control: any kind of control, direct or indirect, whether legally enforceable and however exercisable or exercised. For US transfer pricing purposes it was the reality of control which was decisive, not its form or the mode of its exercise.
The question arises which of the two above-mentioned approaches, the UK or the US approach, has been adopted by the Fiscal Committee of the League of Nations.

The Committee of Economic Experts of the League of Nations used the term "control" in their 1923 report to indicate managerial control and a so-called "final" control.[29] However, the first League of Nations drafts did not need any provisions along the lines of Art. 9 OECD Model as affiliated companies were considered permanent establishments. In 1929 the International Chamber of Commerce requested the inclusion of a separate article concerning the taxation of associated enterprises in the Model from the League of Nations:

"The fact that an undertaking has business dealings with a foreign country through a local company the stock of which it owns in whole or in part should not be held to mean that the undertaking in question has a permanent establishment in that country".[30]

In order to discuss this issue, a Subcommittee drafted a detailed questionnaire on the rules for apportionment of profits from undertakings operating in several countries. The term "control" was used in this questionnaire without any explanation. It may therefore be argued that the term "control" was already generally understood and probably applied by the Member countries, as their answers to the questionnaire did not include any comments on the term "control". Apparently, the Member countries accepted the term "control", even though the term was not explained in the earlier Reports.

The Committee stated that the issue of taxation of associated enterprises, though of great importance, only affected a small number of cases. This may be one of the reasons why the League of Nations did not focus earlier on the taxation of associated enterprises.
In 1933 Carroll recommended in his report to include a separate article dealing with the taxation of associated enterprises in the Draft Convention. In the Draft Convention of the 1933 Report the predecessor of Art. 9 OECD Model was included as Art. 5. This Art. 5 reads as follows:

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

Carroll applied the following interpretation of the concept of associated companies:

"To verify this declaration and accounts, the tax authorities may enquire into the current of business between the *local subsidiary and the parent company or other subsidiary companies of the parent*, which may for convenience be termed associated companies."[31]

[29] League of Nations Economic and Financial Commission, *Report on Double Taxation, submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*, Document E.F.S. 73.F.19. (Geneva: 5 April 1923). See also Dwarkasing, R.S.J., *Associated Enterprises – A Concept Essential for the Application of the Arm's Length Principle and Transfer Pricing* (The Netherlands: Dwarkasing & Partners, 2011), pp. 265-269.

[30] Id, p. 5. The correct resolution was given in the 1930 Report, Fiscal Committee of the League of Nations, *Report to the Council on the work of the second session of the Committee*, held in Geneva on 31 May 1930, Document number C.340. M.140, p. 5, ad 1. The text of the Resolution voted by the ICC at the Amsterdam Congress in July 1929 reads: "The fact that an undertaking has business dealings with a foreign country through a local company the stock of which it owns in whole or in part, should not be held to mean that the undertaking in question has a permanent establishment in that country."

Although Carroll had worked in the US Treasury, he interpreted the concept of associated enterprises in accordance with the UK approach: as a concept based on a capital/managerial criterion (subsidiaries). The Commentary on Art. 5 states:

"Article 5 deals with *subsidiaries* which will be taxed as independent enterprise provided no profits or losses are transferred as a result of the relations between the affiliated companies."[32]

The main textual difference with the current Art. 9 OECD Model is the absence of the term "participation in control". Art. 5 also includes the term "dominant" in the phrase "*dominant* participation in the management or capital of an enterprise of another Contracting State". These differences are very important for this study as they give a clue as to how to interpret the current participation criteria of Art. 9 OECD Model. Not every level of participation results in association for the purpose of this article. Association only exists if there is a participation in capital or management that can dominate or control the other company. The second part of Art. 5 considered a situation in which both enterprises are owned or controlled by the same interests. In Art. 9 OECD Model the term "interests" was replaced by the term "persons". As a consequence, Art. 9 OECD Model would not cover situations where one person controls both enterprises. It seems that this would not be in line with the other parts of Art. 9 OECD Model and apparently the OECD did not take into account that replacing "interests" with "persons" would exclude some forms of association. Therefore, the term "persons" must be interpreted as "interests".

I conclude that the first predecessors of Art. 9 OECD Model did not consider "control" to be a separate independent criterion. Carroll referred to an interconnection envisaged under company law for the application of Art. 5. The expression "owned or controlled by the same interests" did not refer to *de facto* control. Carroll considered the concept of associated enterprises to be a concept based on company law: subsidiary companies that are "*control(led) through ownership of stock in a local company*". The "associated enterprises" article did not change in the 1946 London Draft. In the London Draft the articles concerning the taxation of dividend and royalties referred to the concept of "associated enterprises" by using the phrase "dominant participation in management or capital".

In the early 1960s the Fiscal Committee submitted a draft convention for the avoidance of double taxation with respect to taxes on income and capital to the Council of the OEEC. The Fiscal Committee introduced Art. XVI, the precursor of Art. 9 OECD Model. This Art. XVI was based on Art. VII of the Protocols of the 1943 Mexico Draft and of the 1946 London Draft. Art. VII of the London Draft reads as follows:

"When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and, as the result of such situation, there exist in their commercial or financial relations conditions different from those which would have existed between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise."[33]

The Fiscal Committee of the OEEC reformulated Art. XVI as follows:

"*Where*
a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State [...]"

[31] League of Nations, *Taxation of Foreign and National Enterprises - Methods of Allocating Taxable Income*, Volume IV, League of Nations Document No. C.425(b).M.217 (b).1933.II.A (Geneva: 1933), p. 109.
[32] Fiscal Committee of the League of Nations, *Report to the Council on the fourth session of the Committee, held in Geneva from June 15th to 26th, 1933*, League of Nations Document number C.399. M.204 (Geneva: 1933), annex p. 4.
[33] Fiscal Committee of the League of Nations, *London and Mexico Draft Model Tax Conventions, Commentary and Text*, Document number: C.88.M. 88.1946 II.A (Geneva: November 1946), p. 83, Art. VII of the Protocol of the Mexico and London Draft Model Tax Convention.

The expression "dominant participation in management or capital" used by the League of Nations was replaced by the expression "participation in management, control or capital".

Evidence to support the conclusions that Art. XVI was still based on a *dominating* or *controlling* participation in management or capital and that Art. XVI did not consider "participation in control" to be an independent criterion for association is a statement of the Fiscal Committee of 1961, confirming that neither Article (XV and XVI) is strikingly novel or particularly detailed:

"*The question ...how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of European double taxation Conventions concluded since the war, and it is fair to say that the solutions adopted have generally conformed a standard pattern.*"[34]

This "standard pattern" has developed since the 1920s, when the first League of Nations reports were published. From the analysis above of the various Reports written by the Fiscal Committee it appears that the Fiscal Committee used the word "control" as a generally accepted term. The Fiscal Committee did not provide any explanation of the term "control", using the term in specific phrases such as "where one enterprise *controls* the other or both enterprises are under common *control*". Especially because the Fiscal Committee emphasised that it had readopted the underlying principles of the Mexico and London Model Conventions it can be concluded that the Fiscal Committee did not intend to make "control" a separate, independent criterion; otherwise it would have mentioned this in its reports or drafts. The term "participation in control" should be considered to have the same function as the term "dominant" has had in the London and Mexico Drafts; a qualification only to the criteria of *participation in capital and management.*

Also, the Commentaries on the articles concerning the taxation of interest (Art. 11) and royalties (Art. 12) indicate that the concept of association in Art. 9 OECD Model is narrower than the "special relationship" concept of those articles:

"On the other hand, the concept of special relationship also covers relationships by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise [...]".

It must therefore be concluded that the associated enterprises concept, reformulated by the OEEC, was still based on a dominating or controlling participation in the management or capital, and that "participation in control" was not a separate, independent criterion for association. This conclusion is also supported by the "bracket definition" in the OECD Commentary that refers to relationships based on company law (parent and subsidiary companies and companies under company law), and paragraph 7 of the 1979 Report on Transfer Pricing and Multinational Enterprises:

"The report covers not only transfers between *parent and subsidiary companies* but also between companies under common control though the problems arising specifically from transactions between companies under common control have not been dealt with and indeed some countries would regard such transactions as passing *through the common parent* insofar as the price deviates from arm's length."[35] (*Italics, RD)*

In 1963 the Fiscal Committee presented Art. XVI as Art. 9 in the 1963 Draft Double Taxation Convention on Income and Capital of the OECD. The text of the Commentary on this Art. 9 stated that this "Article seems to call for very little comment". The conclusion must therefore be drawn that the underlying concept of "associated enterprises" of 1946 remained unchanged in the new Art. 9 OECD Model.

For the reasons mentioned above I conclude that the concept of associated enterprises under Art. 9 OECD Model is based on a *dominating* or *controlling* participation in capital or management. The term "participation in control" is not meant to be an independent criterion for association, but the term is a substitute for the term "dominating" used in Art. 5 of the 1933 Report. Therefore, the concept of associated enterprises is a concept based on *de jure* control that follows from company law. The view that the concept of associated enterprises under Art. 9 OECD Model covers *de facto* control must – for the above-mentioned reasons - be rejected.

[34] OEEC, FC(60), annex E, p. 22, para. 2 (Paris: 25 May 1960), FC(60) 157.

[35] OECD, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises*, adopted by the Committee on Fiscal Affairs in January 1979, approved by the Council of the OECD for publication. The Council of the OECD adopted the Recommendation annexed to it on 16 May 1979, para. 7.

2.7. Domestic interpretations of the Concept of Associated Enterprises

It can be concluded from an analysis of the different domestic concepts of *associated* enterprises that there are three types of domestic interpretations.[36] The first type is a concept of associated enterprises that is in line with the OECD concept and it is limited to *de jure* control, relationships generally covered by company law, for instance shareholding (partnerships) and management. For instance, this concept of associated enterprises is applied by the Netherlands, Sweden and the United Kingdom.

The second type is a concept of associated enterprises that is an open-ended concept based on control. This concept is applied by the United States and Germany. For instance, the US concept covers any kind of control between two or more taxpayers. It focuses on the reality of control, not its form or the mode of its exercise. Germany applies the term "controlling influence". The scope of controlled taxpayers under US transfer pricing and German transfer pricing rules is broader compared to the scope of the transfer pricing laws of the Netherlands, the United Kingdom and Sweden. The scope of control under US rules covers any kind of control between two or more taxpayers, including enterprises and individual taxpayers. In this regard, any two or more taxpayers with no shareholding or managerial relationships could be considered taxpayers controlled "by the same interest" if a common design or a plan for arbitrarily shifting of income or deductions between them exists. However, as may be concluded from recent jurisprudence (for instance *Xilinx)*, it is very doubtful whether the term "control" will be interpreted by US and German courts as covering open market situations (for instance, a buyer with very strong negotiating power) as this would be in conflict with the arm's length principle itself.

The third type is a concept of associated enterprises that not only covers *de jure* relationships, such as shareholding and managerial relationships, but also *de facto* relationships that are contrary to the purposes of the arm's length principle. The scope of associated parties under the Chinese, Indian and Brazilian rules can be considered to fall within this third concept of associated enterprises.
It is interesting to note that particularly emerging economies, such as China, Brazil and India, incorporate broad definitions of associated enterprises in domestic tax laws. Not only *de jure* relationships covering relationships based on company law, such as shareholding and managerial relationships, result in associated enterprises, but also various forms of *de facto* relationships between companies and even individuals are covered by the scope of associated enterprises in the domestic tax laws of these countries. The Indian, Chinese and Brazilian transfer pricing regulations describe in detail situations where one party is considered to be associated with another party.
For instance, the Chinese and Indian rules specify various forms of *de facto* relationships such as transactions between parties concerning loans, guarantees, services or sales in the open market. Brazil expands its transfer pricing rules based on predetermined margins to transactions between entities in Brazil with entities resident in tax havens or in countries that allow secrecy regarding corporate ownership even though the parties are completely independent and the terms and conditions in the transactions were established at arm's length. In addition, the Brazilian scope of associated parties also covers relationships between entities such as partners of joint ventures, and exclusive agents, distributors or dealers for the purchase and sales of goods, services or rights. The broad Brazilian scope is not exceptional. India characterises legally independent companies that are dependent in a commercial way from an otherwise unrelated foreign trading partner as associated.

It may be possible that the wording of the US Regulations and the lack of clarity on the term "control" in the formula of Art. 9 OECD Model and the UN Model have misled the Chinese and Indian legislator (but also other emerging economies, such as Vietnam), which carefully studied the US Regulations and OECD TP Guidelines before drafting their transfer pricing laws.

From this analysis the conclusion can be drawn that in several jurisdictions there is a "hotchpotch" of application of the arm's length principle and anti-avoidance and anti-evasion rules, for instance the United States with a control concept based on a common design or plan for arbitrarily shifting of income and Brazil with a concept of associated enterprises that may even cover the relationships between otherwise unrelated partners in a joint venture. Other examples are India and China; those States apply the arm's length

[36] See also Dwarkasing, R.S.J., *Associated Enterprises – A Concept Essential for the Application of the Arm's Length Principle and Transfer Pricing* (The Netherlands: Dwarkasing & Partners, 2011), pp. 333-463.

principle to transactions between independent enterprises, where one party has a dominant negotiation position.[37]

As indicated above, problems arise from the lack of a sharp distinction between application of the arm's length principle and anti-tax avoidance/evasion rules, and the lack of clarity on the concept of "associated enterprises" and in particular "control" in the formula of Art. 9 OECD Model and the UN Model.
Confusion about the scope of associated enterprises and application of the arm's length principle could be avoided by proper definitions in domestic laws, on the one hand including a definition of "associated enterprises" based on control through shareholding or management, and on the other hand specific anti-tax avoidance and anti-tax evasion measures.

[37] For instance, Australia applies the arm's length principle to all "connections between any two or more parties", including independent parties.

2.8. Conclusions and Recommendations

The following final conclusions are drawn:

- The arm's length principle is a general principle of tax law and not a mere anti-tax avoidance or anti-tax evasion measure. It puts associated enterprises and independent enterprises on a more equal footing for tax purposes (equality) and avoids the creation of tax advantages that would otherwise distort the relative competitive positions of either type of entity (neutrality). The view that Art. 9 OECD Model is an anti-tax avoidance measure and that therefore the concept of associated enterprises may be broadly interpreted must be rejected. Anti-avoidance or anti-evasion measures must be formulated outside the scope of the arm's length principle.
- Problems arise from the lack of a sharp distinction between application of the arm's length principle and anti-tax avoidance/evasion rules; as a result the arm's length principle may be wrongly applied to open market situations without any intentions of tax avoidance or evasion. The problems are expected to increase because several emerging economies, such as India, China, Brazil and Vietnam, apply a broad, incorrect interpretation of associated enterprises.
- The concept of associated enterprises delimits the application of the arm's length principle. A broad concept of associated enterprises may lead to the risk of application of the arm's length principle to situations for which it was not intended. The arm's length principle is not meant to cover legally independent enterprises.
- An autonomous interpretation of "associated enterprises" under Art. 9 OECD Model exists and therefore reference to domestic tax law for the meaning and scope of this concept must be rejected. Reference to domestic law for the interpretation of "associated enterprises" may lead to the application of the arm's length principle to situations for which it was not intended, in particular to *de facto* control situations.
- Since its introduction in 1933 the concept of associated enterprises has been based on a *dominating* or *controlling* participation in capital or management. The term "participation in control" is not meant to be an independent criterion for association, but the term is a substitute for the term "dominating" used in Art. 5 of the 1933 Report. Therefore, the concept of associated enterprises is based on *de jure* control that results from company law. The view that the concept of associated enterprises covers *de facto* control, such as mere economic dominance, outside relationships vested in company law, must be rejected. The current wording of Art. 9 OECD Model is only a textual modification of Art. 5 of the 1933 Report and does not contain any material differences from the 1933 Report, the 1946 London Draft and the OEEC Report of 1960.
- As company law provides various "(control-enhancement) mechanisms" that delimit the power of majority shareholders or increase the power of minority shareholders, the term "participation in capital" and the term "participation in management" should be supplemented with the adjective "controlling". A participation based on company law (participation in capital or management) must have sufficient (voting) power to control the company.
- Because of the view that treaty obligations limit the Contracting States' application of domestic law, a domestic interpretation of "associated enterprises" broader than that of the OECD Model as described above will be overruled by the narrower OECD concept as included in tax treaties.

The above conclusions lead to the following recommendations:

- A distinction should be made between the pure application of the arm's length principle – a general principle of international tax law with a restricted interpretation of the concept of "associated enterprises"– and anti-tax avoidance and anti-tax evasion rules. Distinct from the concept of associated enterprises as formulated above, countries may include various anti-tax avoidance and anti-evasion measures in their tax legislation, such as measures that cover individuals, CFCs, thin capitalisation and also relationships with tax havens. As these rules against tax avoidance and tax evasion fall outside the scope of transfer pricing and the arm's length principle, they should be formulated separately.
- It is recommended to include the definition of "associated enterprises" below in the OECD Model, the UN Model, in tax treaties and in the domestic transfer pricing legislation of countries.

- This concept of associated enterprises should not be interpreted broadly. Therefore, in the proposed definition of associated enterprises the element of "control" is required, but not as an independent criterion.
- Only relationships based on shareholding, voting rights and management, covered by domestic company law, which provide sufficient control to influence prices and conditions should be included in this concept of associated enterprises.
- When an enterprise has a minority participation in the capital or management of the other enterprise, the tax authorities should prove that this participation provides a dominating or controlling influence if they disagree with the taxpayer.

Taking into account the recommendations mentioned above, the concept of associated enterprises in Art. 9 OECD Model could be defined as follows, or the Revision of Chapter 6 of the OECD TP Guidelines could include a clarification on the concept of *Associated Enterprises:*

"Where
a. an enterprise of a Contracting State has a direct or indirect *controlling* participation in the capital or management of an enterprise of the other Contracting State, or
b. the same persons have a direct or indirect *controlling* participation in the capital or management of an enterprise of a Contracting State and an enterprise of the other Contracting State (..)"

I will be pleased to answer any questions you may have regarding these comments. For further clarification on any aspects in this letter, please contact Dr. Ramon Dwarkasing, phone +31-612181621 or email: ramon.dwarkasing@maastrichtuniversity.nl

Sincerely yours,

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