

**OECD Conference:
Transfer Pricing and Treaties
in a Changing World**
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Opening Speech

Ladies and Gentlemen,

It is a great pleasure to welcome you to the OECD for this Conference “Transfer Pricing and Treaties in a Changing World”. We have almost 700 participants today, from nearly 100 countries, representing governments, the business community, the academic world and international organisations. An event like this illustrates a key dimension of the work we do at the OECD: providing a global platform for the sharing of experience and for dialogue between stakeholders from OECD and non-OECD economies.

Our world is changing. The financial turmoil of the past year has led policy-makers to develop new thinking about regulations and markets, about accountability and ethics and about the kind of economy we want to build. The ambition of the OECD as a leading international organisation is to help governments devise better policies, better regulations and better institutional frameworks, in order to enable businesses to flourish and the public interest to be safeguarded in a stronger, cleaner and fairer world economy. Tax policies are an essential part of this.

A lot is happening these days in the fight for more transparent tax systems, and you have seen from recent headlines on the outcomes from the Mexican Meeting of the Global Forum that the OECD is at the forefront of this debate. But important as those developments are, they should not obscure the broader significance of our other tax work or create the impression that tax policy is only about preventing evasion. Tax is a complex matter which goes way beyond the need to raise revenue and the starting premise for any tax policy matter should be that the vast majority of taxpayers are trying to comply in good faith. We need tax rules that serve the multiple goals of promoting trade and investment, achieving a fair division of tax revenues, avoiding double taxation, and being administrable.

Nowhere is the need for such rules more evident than in the area which is the topic of this conference: transfer pricing and related treaty issues. In a global economy where multinational enterprises play a prominent role, transfer pricing is a top issue for governments, business and society. It’s interesting to recall just how fundamental a part of the international tax structure this topic is.

The international consensus on transfer pricing with which we’re all so familiar today is the arm’s length principle, according to which the conditions of cross-border transactions between associated enterprises should not be distorted by the special relationship between the parties. This concept dates back more than 75 years, to the League of Nations’ 1933 Draft Convention on the Allocation of Business Profits between States.

By the late 1950s, the Fiscal Committee of the O.E.E.C (the predecessor organisation to the OECD) was working on a new model tax convention, and they appointed a Working Group to “consider the definition and apportionment of profits between the head office of an undertaking, its permanent establishments and its subsidiary companies”. Their work culminated with the drafting of Articles 5, 7 and 9 of what became the OECD’s 1963 Draft Convention.

The wording of Article 9(1), which sets forth the arm’s length principle, has remained unchanged since the 1963 Draft Convention. Paragraph 2 of Article 9, which deals with corresponding adjustments, was added in the 1977 Model, thus balancing the Article by explicitly incorporating in it the objective of eliminating the economic double taxation that can result from transfer pricing adjustments made by application of Article 9(1). This search for balance has ever since been setting the parameters for all the OECD work in the transfer pricing area.

In those early years of transfer pricing history, the OECD did little more than specify the basic principle as it applied to associated enterprises. Indeed, the 1963 Commentary on Article 9 consisted of a sole paragraph which started as follows:

“This article deals with associated enterprises (e.g. companies under common control) and provides that in such cases the taxation authorities of a particular country may, for the purpose of calculating tax liabilities, re-write the accounts of the enterprises if, as a result of the special relations between the enterprises, the accounts do not show the true taxable profits arising in that country. **It is evidently appropriate that rectification should be sanctioned in such circumstances, and the article seems to call for very little comment.**”

The drafters of the 1963 Draft Convention did an excellent job of drafting Article 9, but perhaps lacked vision when they wrote that Commentary! We all know now that this Article does in fact call for significant comment, as our later work has shown.

For example, in 1979, the OECD released its report *Transfer Pricing and Multinational Enterprises*, followed by the reports *Three taxation issues* in 1984 and *Thin capitalisation* in 1987. The 1979 report was replaced in 1995 by the *Transfer Pricing Guidelines for Tax Administrations and Multinational Enterprises*.

Since 1995, the Guidelines have been under constant discussion and monitoring by the OECD -- let me mention some of the results of this work:

Between 1995 and 2000, the Guidelines were expanded to include guidance on intangibles, cross-border services, cost contribution arrangements and advanced pricing arrangements. They were also updated in 2009 to reflect the latest developments in the area of dispute resolution, including the introduction of mandatory arbitration to the OECD Model Tax Convention.

We’ve devoted a considerable amount of work in the last decade to developing guidance on applying the arm’s length principle and the Guidelines by analogy to dealings between a permanent establishment and the rest of the enterprise to which it belongs, culminating with the 2008 *Report on the Attribution of Profits to Permanent Establishments*.

We also released an important discussion draft in 2008, dealing with the application of the arm’s length principle to business restructurings, i.e. to the cross-border redeployment of functions, assets and risks within a multinational enterprise.

Most recently, the first substantial proposed revision of the Guidelines, dealing with Chapters I and III in respect of comparability issues, the selection of the most appropriate transfer pricing method and the application of transactional profit methods, was released for public comment just two weeks ago.

All these topics and others will be addressed during this Conference.

Participants in last year's Conference on the 50th Anniversary of the OECD Model Tax Convention overwhelmingly voted the adoption of the OECD's Transfer Pricing Guidelines in 1995 as the most important tax treaty development (besides the OECD Model Tax Convention itself) of the past 50 years. This was not a surprise to me.

In 1995, despite its decades-old conceptual underpinning, the actual law of transfer pricing was still in its infancy. In those days, only a handful of countries around the world had adopted transfer pricing regimes. By 2005, that number had grown to over 40, and the number has continued to mount rapidly since then -- some of the most recent countries include Oman and Uruguay. Virtually all of these regimes are based upon the arm's length principle, and a large number rely explicitly on the OECD's Transfer Pricing Guidelines for their design.

Moreover, the explosive growth of international trade in an era of globalisation, together with the fact that one-third or more of that trade is generally considered to take the form of transactions between associated enterprises, has contributed to the importance of transfer pricing. Recent surveys show that multinational enterprises rank transfer pricing as their single most important international tax issue and I am sure that a survey of governments would yield the same results.

What began as a relatively straightforward expression of a simple principle has since developed into an increasingly sophisticated technical matter which involves both legal and economic concepts. On the conceptual level, an inherent and acknowledged difficulty is how to allocate profits to various parts of multinational enterprises as if they were independent parties, while recognising that multinational enterprises are more than ever behaving globally. On the more technical side, we are seeing the development of increasingly sophisticated economic analysis of risks, comparability adjustments, intangible valuation, etc. This creates challenges for tax administrations – particularly in developing countries - and taxpayers alike, as enforcement and compliance are becoming ever more complex and resource-intensive.

Developing economies in particular are increasingly aware of the importance of establishing a robust legislative and administrative framework to deal with transfer pricing issues. The challenge for these countries is in essence the same as for OECD countries: protecting their tax base while not hampering foreign direct investment and cross-border trade. The arm's length principle can be instrumental in achieving this dual objective. Whilst some have suggested replacing this well-established principle with alternate approaches (e.g. unitary taxation), none have set out a detailed plan of how this could be achieved. And let's not deceive ourselves: such a change would not address the underlying problem of profit shifting; it would just change the way it is undertaken.

But how can the arm's length principle, with its difficult conceptual and technical challenges, be usefully applied in countries around the world?

The key to success is to tailor the legislative measures and the deployment of the administrative capacities to the strategic needs and administrative resources of each particular country. Indeed, while there is no doubt that the application of the arm's length principle can become complex and resource-intensive, one should keep in mind that most OECD countries have started modestly and built their transfer pricing legislation and practices progressively over a decade or two and are still in the process of improving them.

This typically means prioritising transfer pricing enforcement activities in accordance with the circumstances of each particular economy; setting enforcement objectives that are realistic given the administration's capacities; and designing compliance requirements that are reasonable for taxpayers given the size of the cross-border trade. Administrative safe harbours are often used to provide simplification and certainty to small taxpayers, small transactions, or less complex transactions. A significant part of the OECD's activities in the transfer pricing area consists in developing a strong policy dialogue with non-OECD economies to share experience on the development of legislative measures that fit each country's particular needs in accordance with the most recent international standards and the progressive deployment of administrative capacities.

The current economic and financial crisis presents both dangers and opportunities for governments and the private sector. In order to weather these difficult times, concerted efforts from OECD and non-OECD economies, from governments and from the business community are needed. These considerations are high in the mind of governments and private sector representatives engaged in the OECD work on transfer pricing and are reflected in the programme for these two days. We are hopeful that the discussions to take place here will contribute to a greater understanding of the transfer pricing challenges that exist today and to a deepened commitment on all sides to work together towards necessary solutions.

Before I conclude, I would like to express my sincere appreciation to all the sponsors of the Conference for their generous support.

I wish you all a very pleasant, informative and intellectually challenging Conference.