

Chapter IV

Administrative Approaches to Avoiding and Resolving Transfer Pricing Disputes

A. Introduction

4.1 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.

4.2 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.

4.3 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 (Paragraph 2 of Article 9 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 Advance Pricing Arrangements, which address 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

4.4 Tax compliance practices are developed and implemented in each Member country according to its own domestic legislation and administrative procedures. Many domestic tax compliance practices have three main elements: 1. to reduce opportunities for non-compliance (e.g. through withholding taxes and information reporting); 2. to provide positive assistance for compliance (e.g. through education and published guidance); and 3. to provide disincentives for non-compliance. As a matter of domestic sovereignty and to accommodate the particularities of widely varying tax systems, tax compliance practices remain within the province of each country. Nevertheless a fair application of the arm's length principle requires clear procedural rules to ensure adequate protection of the taxpayer and to make sure that tax revenue is not shifted to countries with overly harsh procedural rules. However, when a taxpayer under examination in one country is a member of an MNE group, it is possible that the domestic tax compliance practices in a country examining a taxpayer will have consequences 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 the associated enterprises involved in the controlled transaction. If the same transfer pricing is not accepted in the other tax jurisdictions, the MNE group may be subject to double taxation as explained in paragraph 4.26. Thus, tax administrations should be conscious of the arm's length principle when applying their domestic compliance practices and 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.

4.5 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. While other tax law compliance practices are in common use in

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OECD Member countries -- for example, the use of litigation and evidentiary sanctions where information may be sought by a tax administration but is not provided -- these three aspects will often impact on how tax administrations in other jurisdictions approach the mutual agreement procedure process and determine their administrative response to ensuring compliance with their own transfer pricing rules. 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, and so it is not possible to describe a uniform set of principles or issues that will be relevant in all cases. 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 tax administrations involved in a transfer pricing inquiry.

i) Examination practices

4.6 Examination practices vary widely among OECD Member countries. Differences in procedures may be prompted by such factors as the system and 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.

4.7 Transfer pricing cases can present special challenges to the normal audit or examination practices, both for the tax 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.

4.8 Because 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 when the tax administration proposes to use a methodology, for example a transactional profit method, that is not the same as that used by the taxpayer.

4.9 In a difficult transfer pricing case, because of the complexity of the facts to be evaluated, 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, 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 tied to business realities. Therefore, tax examiners should undertake to begin their analyses of transfer pricing from the perspective of the method that the taxpayer has chosen in setting its prices. The guidance provided in Chapter I in the section dealing with the use of transfer pricing methods (paragraphs 1.68-1.70) also may assist in this regard.

4.10 A tax administration should keep in mind in allocating its audit resources the taxpayer's process of setting prices, for example whether the MNE group operates on a profit center basis. See paragraph 1.5.

ii) Burden of proof

4.11 Like examination practices, the burden of proof rules for tax cases also differ among OECD Member countries. In most jurisdictions, the tax administration bears the burden of proof both in its own internal dealings with the taxpayer (e.g. assessment and 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. In this respect, however, the conclusions of paragraphs 4.16 and 4.17 should be noted.

4.12 The implication for the behaviour of the tax administration and the taxpayer of the rules governing burden of proof should be taken into account. 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.

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Even in such a case, of course, the tax administration might still reasonably oblige the taxpayer to produce its records that would enable the tax administration to undertake its examination. In some countries, taxpayers have a duty to cooperate with the tax administration imposed on them by law. In the event that a taxpayer fails to cooperate, the tax administration may be given the authority to estimate the taxpayer's income and to assume relevant facts based on experience. In these cases, tax administrations should not seek to impose such a high level of cooperation that would make it too difficult for reasonable taxpayers to comply.

4.13 In jurisdictions where the burden of proof is on the taxpayer, tax administrations are generally not at liberty to raise assessments against taxpayers which are not soundly based in law. A tax administration in an OECD Member country, for example, could not raise an assessment based on a taxable income calculated as a fixed percentage of turnover and simply ignore the arm's length principle. In the context of litigation in countries where the burden of proof is on the taxpayer, the burden of proof is often seen as a shifting burden. Where the taxpayer presents to a court a reasonable argument and evidence to suggest that its transfer pricing was arm's length, the burden of proof may legally or *de facto* shift to the tax administration to counter the taxpayer's position and to present argument and evidence as to why the taxpayer's transfer pricing was not arm's length and why the assessment is correct. On the other hand, where a taxpayer makes little effort to show that its transfer pricing was arm's length, the burden imposed on the taxpayer would not be satisfied where a tax administration raised an assessment which was soundly based in law.

4.14 When transfer pricing issues are present, the divergent rules on burden of proof among OECD Member countries will 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 under examination 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 in the second jurisdiction nor the tax administration in the first jurisdiction 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.

4.15 Consider the same facts as in the example in the preceding paragraph. If the burden of proof is again guiding behaviour, a taxpayer in the first jurisdiction being a subsidiary of a taxpayer in the second jurisdiction (notwithstanding the burden of proof and these Guidelines), may be unable or unwilling to show that its transfer prices are arm's length. The tax administration in the first jurisdiction after examination makes an adjustment in good faith based on the information available to it. The parent company in the second jurisdiction is not obliged to provide to its tax administration any information to show that the transfer pricing was arm's length as the burden of proof rests with the tax administration. This will make it difficult for the two tax administrations to reach agreement in competent authority proceedings.

4.16 In practice, neither countries nor taxpayers should misuse the burden of proof in the manner described above. Because of the difficulties with 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 misused 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 that their transfer pricing is consistent with the arm's length principle regardless of where the burden of proof lies.

4.17 The Commentary on paragraph 2 of Article 9 of the OECD Model Tax Convention makes clear that the State from which a corresponding adjustment is requested should comply with the request only if that State "considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length". This means that in competent authority proceedings the State that has proposed the primary adjustment bears the burden of demonstrating to the other State that the adjustment "is justified both in principle and as regards the amount." Both competent authorities are expected to take a cooperative approach in resolving mutual agreement cases.

iii) Penalties

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4.18 Penalties are most often directed toward providing disincentives for non-compliance, where the compliance at issue 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 non-compliance more costly than compliance. The Committee on Fiscal Affairs has recognized that promoting compliance should be the primary objective of civil tax penalties. OECD Report *Taxpayers' Rights and Obligations* (1990). If a mutual agreement between two countries results in a withdrawal or reduction of an adjustment, it is important that there exist possibilities to cancel or mitigate a penalty imposed by the tax administrations.

4.19 Care should be taken in comparing different national penalty practices and policies with one another. First, any comparison needs to take into account that there may be different names used in the various countries for penalties that accomplish the same purposes. Second, the overall compliance measures of an OECD Member country should be taken into account. National tax compliance practices 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 or limit opportunities for non-compliance (e.g. imposing a duty on taxpayers to cooperate with the tax administration or reversing the burden of proof in situations where a taxpayer is found not to have acted in good faith) and the use of monetary deterrents (e.g. additional tax imposed as a consequence of underpayments of tax in addition to the amount of the underpayment). The nature of tax penalties may also be affected by the judicial system of a country. Most countries do not apply no-fault penalties; in some countries, for example, the imposition of a no-fault penalty would be against the underlying principles of their legal system.

4.20 There are 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 (or administrative) 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

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the taxpayer is uncooperative and an effective penalty results from a discretionary adjustment).

4.21 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.

4.22 Although some countries may refer to a "penalty", the same or similar imposition by another country may be classified as "interest". Some countries' "penalty" regimes may therefore include an "additional tax", or "interest", for understatements which result in late payments of tax beyond the due date. This is often designed to ensure the revenue recovers at least the real time value of money (taxes) lost.

4.23 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 OECD Member countries impose civil monetary penalties for negligence or wilful intent, while only a few countries penalise "no-fault" understatements of tax liability.

4.24 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 (see paragraph 4.28).

4.25 Improved compliance in the transfer pricing area is of some concern to OECD Member countries and the appropriate use of penalties may play a role in addressing this concern. However, owing to the nature of transfer pricing

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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.

4.26 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 contrary to Article 9. If this happens, the penalty system fails in its primary objective to promote compliance and instead leads to non-compliance of a different sort -- non-compliance with the arm's length principle and under-reporting in the other jurisdiction. Each OECD Member country should ensure that its transfer pricing compliance practices are not enforced in a manner inconsistent with the objectives of the OECD Model Tax Convention, avoiding the distortions noted above.

4.27 It is generally regarded by OECD Member countries that the fairness of the penalty system should be considered by reference to 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.

4.28 Since penalties are only one of many administrative and procedural aspects of a tax system, it is difficult to conclude whether a particular penalty is fair or not without considering the other aspects of the tax system. Nonetheless, OECD Member countries agree that the following conclusions can be drawn regardless of the other aspects of the tax system in place in a particular country. First, imposition of a sizable "no-fault" penalty based on the mere existence of an understatement of a certain amount would be unduly harsh when it is attributable to good faith error rather than negligence or an actual intent to avoid tax. Second, it would be unfair to impose sizable penalties on taxpayers that made a reasonable effort in good faith to set the terms of their transactions with related parties in a manner consistent with the arm's length principle. In particular, it would be inappropriate to impose a transfer pricing penalty on a taxpayer for failing to consider data to which it did not have access, or for failure to apply a transfer pricing method that would have required data that was not available to the taxpayer. Tax administrations are encouraged to take these observations into account in the implementation of their penalty provisions.

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

i) The mutual agreement procedure

4.29 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.

4.30 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 on 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 paragraphs 1 and 2 of Article 9.

4.31 The mutual agreement procedure does not compel competent authorities to reach an agreement and resolve their tax disputes. The competent authorities are obliged only 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 OECD 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: Paragraph 2 of Article 9

4.32 To eliminate double taxation in transfer pricing cases, tax administrations may consider requests for corresponding adjustments as described in paragraph 2 of Article 9. A corresponding adjustment, which in practice may

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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.

4.33 Paragraph 2 of Article 9 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 paragraph 2 of Article 9. Paragraph 10 of the Commentary on Article 25 of the OECD Model Tax Convention now expressly states the view of most OECD 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 paragraph 2 of Article 9. Paragraph 10 also notes that those OECD 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 .

4.34 Under paragraph 2 of Article 9, a corresponding adjustment may be made by a contracting state 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.

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4.35 Corresponding adjustments are not mandatory, mirroring the rule that tax administrations are not required to reach agreement under the mutual agreement procedure. Under paragraph 2 of Article 9, 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 OECD Member country.

4.36 Once a tax administration has agreed to make a corresponding adjustment it is necessary to establish 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. This issue also often raises the question of a taxpayer's entitlement to interest on the overpayment of tax in the jurisdiction which has agreed to make the corresponding adjustment (discussed in paragraphs 4.64-4.66). 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 of 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 of 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.

4.37 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.

4.38 At least one OECD Member country has a procedure that may reduce the need for primary adjustments by allowing the taxpayer to report a transfer

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price for tax purposes that is, in the taxpayer's opinion, 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 taxable income by taxpayers in accordance with the arm's length principle, recognizing that information about comparable uncontrolled transactions may not be available at the time associated enterprises establish the prices for their controlled transactions. Thus, for the purpose of lodging a correct tax return, a taxpayer would be permitted to make a compensating adjustment that would record the difference between the arm's length price and the actual price recorded in its books and records.

4.39 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

4.40 While corresponding adjustment and mutual agreement procedures are able to resolve most transfer pricing conflicts, serious concerns have been expressed by taxpayers. For example, because transfer pricing issues are so complex, taxpayers fear that there may not be sufficient safeguards in the procedures against double taxation. These concerns are addressed in the Commentary on 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.

4.41 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. Taxpayers should not be deterred from initiating mutual agreement procedures where Article 25 is applicable.

4.42 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*

4.43 Relief under Article 9(2) may be unavailable if the time limit provided by treaty or domestic law for making corresponding adjustments has expired. Paragraph 2 of Article 9 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.

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4.44 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.

4.45 Paragraph 2 of Article 25 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. OECD Member countries therefore are encouraged as far as possible to extend domestic time limits for purposes of making corresponding adjustments when mutual agreement procedures have been invoked.

4.46 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, OECD 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.

4.47 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. 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. Further, where domestic time limits can be extended with the agreement of the taxpayer, such an extension should be made only when the taxpayer's consent is truly voluntary. 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 in the context of a prospective mutual agreement procedure.

4.48 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 on 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".

4.49 The three year time limit raises an issue about determining the date of the adjustment action. Paragraph 18 of the Commentary on 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."

4.50 In order to minimise the possibility that time limits may prevent the mutual agreement procedure from effectively ensuring relief from 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

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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.

4.51 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

4.52 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.

4.53 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.

4.54 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. 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 and high-level position, there would be a real danger of inconsistent decisions and, as a result, of failure to achieve equitable results. It is therefore recommended that any delegation of authority below the competent authority itself should be limited to a small number of senior officials. An ancillary matter generally agreed upon by OECD Member countries is that when considering to which officials any delegation of the competent authority's role should be given, the officer responsible for the development of the primary adjustment should not be placed in charge of proceedings but might, quite appropriately, advise and participate in the proceedings. This approach reinforces the independence of the mutual agreement procedure and of the role of the competent authority.

4.55 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 coordinate 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

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

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4.57 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.

4.58 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.

4.59 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.

4.60 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

4.61 It would be helpful to taxpayers if competent authorities were to develop and publicise their own domestic rules or procedures for utilizing the

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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.

4.62 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).

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4.63 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

4.64 The process of obtaining relief from double taxation through a corresponding adjustment can be complicated by issues relating to the 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 MNE group 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, although subject to the right to seek security as protection against possible default by the taxpayer..

4.65 Whether or not collection of the deficiency is suspended or partially suspended, 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. Tax administrations should be aware that inconsistent interest rules across the two jurisdictions may result in additional cost for the MNE group, or in other cases provide a benefit to the MNE group (e.g. where the interest paid in the country making the corresponding adjustment exceeds the interest imposed in the country making the primary adjustment) that would not have been available if the controlled transactions had been undertaken on an arm's length basis originally, and this should be taken into account in their mutual agreement proceedings.

4.66 The amount of interest (as distinct from the rate at which it is applied) may also have more to do with the year in which the jurisdiction making the corresponding adjustment attributes the corresponding adjustment. The

jurisdiction making the corresponding adjustment may decide to make the adjustment in the year in which the primary adjustment is determined in which case relatively little interest is likely to be paid (regardless of the rate of interest paid) whereas the jurisdiction making the primary adjustment may seek to impose interest on the understated and uncollected tax liability from the year in which the controlled transactions took place (notwithstanding that a relatively low rate of interest may be imposed). The issue of in which year to make a corresponding adjustment is raised in paragraph 4.36. 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

4.67 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 not consistent with the result that would have arisen if the controlled transactions had been undertaken on an arm's length basis. To make the actual allocation of profits consistent with the primary transfer pricing adjustment, some countries having proposed a transfer pricing adjustment will assert under their domestic legislation 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. Ordinarily, the secondary transactions will take the form of 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 attempt to account for the difference between the redetermined taxable profits and the originally booked profits. The subjecting to

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tax of a secondary transaction gives rise to a secondary transfer pricing adjustment (a secondary adjustment). Thus, secondary adjustments may serve to prevent tax avoidance. The exact form that a secondary transaction takes and of the consequent secondary adjustment will depend on the facts of the case and on the tax laws of the country that asserts the secondary adjustment.

4.68 Another example of a tax administration seeking to assert a secondary transaction may be where the tax administration making a primary adjustment treats the excess profits as being a constructive loan from one associated enterprise to the other associated enterprise. In this case, an obligation to repay the loan would be deemed to arise. The tax administration making the primary adjustment may then seek to apply the arm's length principle to this secondary transaction to impute an arm's length rate of interest. The interest rate to be applied, the timing to be attached to the making of interest payments, if any, and whether interest is to be capitalised would generally need to be addressed. The constructive loan approach may have an effect not only for the year to which a primary adjustment relates but to subsequent years until such time as the constructive loan is considered by the tax administration asserting the secondary adjustment to have been repaid.

4.69 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.

4.70 The Commentary on paragraph 2 of Article 9 of the OECD Model Tax Convention notes that the Article does not deal with secondary adjustments, and thus it neither forbids nor requires tax administrations to make secondary adjustments. In a broad sense, the purpose of double tax agreements can be stated as being for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital. 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. Some countries might refuse to grant relief in respect of other countries' secondary adjustments and indeed they are not required to do so under Article 9.

4.71 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. It would be inappropriate for minority shareholders that are not parties to the controlled transactions and that have accordingly not received excess cash to be considered recipients of a constructive dividend, even though a non-pro-rata dividend might be considered inconsistent with the requirements of applicable corporate law. In addition, as a result of the interaction with the foreign tax credit system, a secondary adjustment may excessively reduce the overall tax burden of the MNE group.

4.72 In light of the foregoing difficulties, tax administrations, when secondary adjustments are considered necessary, are encouraged to structure such adjustments in a way that the possibility of double taxation as a consequence thereof would be minimised, except where the taxpayer's behaviour suggests an intent to disguise a dividend for purposes of avoiding withholding tax. In addition, countries in the process of formulating or reviewing policy on this matter are recommended to take into consideration the above-mentioned difficulties.

4.73 Some countries that have adopted secondary adjustments also give the taxpayer receiving the primary adjustment another option that allows the taxpayer to avoid the secondary adjustment by having the taxpayer arrange for the MNE group of which it is a member repatriate the excess profits to enable the taxpayer to conform its accounts to the primary adjustment. The repatriation could be effected either by setting up an account receivable 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).

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4.74 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.

4.75 When the repatriation involves establishing an account receivable, 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 (as discussed in paragraph 4.68). Some countries may be willing to waive the interest charge on these accounts as part of a competent authority agreement.

4.76 Where a repatriation is sought, a question arises about how such payments or arrangements should be recorded in the accounts of the taxpayer repatriating the payment to its associated enterprise so that both it and the tax administration of that country are aware that a repatriation has occurred or has been set up. The actual recording of the repatriation in the accounts of the enterprise from whom the repatriation is sought will ultimately depend on the form the repatriation takes. For example, where a dividend receipt is to be regarded by the tax administration making the primary adjustment and the taxpayer receiving the dividend as the repatriation, then this type of arrangement may not need to be specially recorded in the accounts of the associated enterprise paying the dividend, as such an arrangement may not affect the amount or characterisation of the dividend in its hands. On the other hand, where an account payable is set up, both the taxpayer recording the account payable and the tax administration of that country will need to be aware that the account payable relates to a repatriation so that any repayments from the account or of interest on the outstanding balance in the account are clearly able to be identified and treated according to the domestic laws of that country. In addition, issues may be presented in relation to currency exchange gains and losses.

4.77 As most OECD Member countries at this time have not had much experience with the use of repatriation, it is recommended that agreements between taxpayers and tax administrations for a repatriation to take place be discussed in the mutual agreement proceeding where it has been initiated for the related primary adjustment. The Committee on Fiscal Affairs is studying the issue of secondary adjustments and repatriation as necessary to develop additional guidance that might be given to taxpayers and tax administrations in this area.

D. Simultaneous Tax Examinations

i) Definition and background

4.78 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 information based in a third country 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, it is suggested 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. It has also been suggested 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. In a simultaneous examination, if a reassessment is made, both countries involved should endeavour to reach a result that avoids double taxation for the MNE group.

4.79 Simultaneous tax examinations are defined in Part A of the OECD Model Agreement for the Undertaking of Simultaneous Tax Examinations ("OECD Model Agreement"). 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

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to be exchanged via the competent authorities, with all the safeguards that are built into such exchanges.

4.80 While provisions that follow Article 26 of the OECD Model Tax Convention 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

4.81 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 exchanges, and automatic exchanges).

4.82 Simultaneous tax examinations may be 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.

4.83 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. The taxpayers affected are normally 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 Article 26. 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

4.84 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.

4.85 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. In those countries where the taxpayer has the right to be consulted before information is transferred to another tax administration, this procedure should also be followed in the context of a simultaneous examination. In this situation, that tax administration should inform in advance its treaty partners that it is subject to this requirement before the simultaneous examination is begun.

4.86 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

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contribution arrangements, and profit allocation methods in special fields such as global trading and innovative financial transactions. As a result, tax administrations may acquire a better understanding of and insight into the overall activities of an MNE 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.

4.87 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 the taxpayer in its jurisdiction does not cooperate or fails 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.

4.88 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 transfer pricing conditions which exist between the associated enterprises 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 controlled transactions between the associated enterprises, stating any disagreements about the evaluation of facts, and any differences with respect to the legal treatment of the transfer pricing conditions which exist between the associated enterprises. 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 minimise mutual agreement procedure difficulties due to the lack of relevant information.

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4.89 In some cases the simultaneous tax examination procedure may allow the participating tax administrations to reach an agreement on the transfer pricing conditions of a controlled transactions between the associated enterprises. Where an agreement is reached, 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 associated enterprises' transfer pricing is reached with the taxpayers' consent, time-consuming and expensive litigation may be avoided.

4.90 Even if no agreement between the tax administrations can be reached in the course of a simultaneous tax examination with respect to the associated enterprises' transfer pricing, the OECD Model Agreement envisions that either associated enterprise 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 a 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 a 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.

4.91 The associated enterprises 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 transfer pricing between associated enterprises may provide the opportunity for an MNE 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 associated enterprises may help avoid misunderstandings and facilitate the tax administrations' concurring determination and evaluation of their transfer pricing

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conditions. Thus, the associated enterprises may obtain certainty with regard to their transfer pricing at an early stage. See paragraph 4.78.

iv) Recommendation on the use of simultaneous tax examinations

4.92 As a result of the increased use of simultaneous tax examinations among OECD Member countries, the Committee on Fiscal Affairs decided it would be useful to draft the OECD Model Agreement 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.

4.93 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 in the examination of transfer pricing cases and to facilitate exchange of information and the operation of mutual agreement procedures. In a simultaneous examination, if a reassessment is made, both countries involved should endeavour to reach a result that avoids double taxation for the MNE group.

E. Safe harbours

i) Introduction

4.94 Applying the arm's length principle can be a fact-intensive process and can require proper judgment. It may present 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

4.95 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 administration, 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.

4.96 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 F of this chapter. The discussion in this section does not extend to tax provisions designed to prevent "excessive" debt in a foreign subsidiary ("thin capitalisation" rules), which will be the subject of subsequent work.

4.97 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.

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iii) Factors supporting use of safe harbours

4.98 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

4.99 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.

4.100 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

4.101 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

4.102 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

4.103 The availability of safe harbours for a given category of taxpayers would have a number of adverse consequences which must carefully be weighed by tax administrations against the expected benefits. 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 enterprises 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.

4.104 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.

4.105 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

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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.

4.106 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.

4.107 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 to 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

4.108 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.

4.109 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.

4.110 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.

4.111 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.

4.112 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

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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 for 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 be granted in the foreign country only if the taxpayer can prove that the results of meeting the safe harbour are consistent with the arm's length principle.

4.113 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 mutual agreement 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.

4.114 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.

4.115 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

4.116 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.

4.117 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.

4.118 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.

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4.119 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 a taxpayer's liability.

c) Equity and uniformity issues

4.120 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 opposite sides 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

4.121 The foregoing analysis suggests that while safe harbours could accomplish a number of objectives relating to the compliance with 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 enterprises 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.

4.122 Under the normal administration of tax laws, certainty cannot be guaranteed for the taxpayer, because 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.

4.123 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

4.124 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, critical assumptions as to future events) 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, one or more associated

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enterprises, 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 mechanisms fail or are difficult to apply.

4.125 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, the way it will be applied, and the critical assumptions, because more specific conclusions rely on predictions about future events.

4.126 The reliability of any prediction used in an APA 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 on intra-group borrowings will remain at six percent during the entire coming three years. It would be more plausible to predict that the rate will be LIBOR plus a fixed percentage. The prediction would become even more reliable if an appropriate critical assumption were added regarding the company's credit rating (e.g. the addition to LIBOR will change if the credit rating changes).

4.127 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 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.

4.128 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.

4.129 In sum, the reliability of a prediction depends on the facts and circumstances of 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 and its application can usually be predicted, and the relevant critical assumptions made, with more reliability than future results (price or profit level).

4.130 Some countries allow for unilateral arrangements where the tax administration and the taxpayer in its jurisdiction 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.

4.131 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 taxpayers, so that APAs can be concluded with the competent authority of a treaty partner only under the mutual agreement procedure. For purposes of the discussion in this Part, an APA is not intended to include a unilateral arrangement except where specific reference to a unilateral APA is made.

4.132 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 Tax Convention relating to allocation problems, permanent establishments, and branch operations.

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4.133 APAs, including unilateral ones, differ in some ways from more traditional private rulings that some tax administrations issue to taxpayers. 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 analysed 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 usually is binding only for a particular transaction.

4.134 The cooperation of the associated enterprises 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 they consider most reasonable under the particular facts and circumstances. The associated enterprises also should submit documentation supporting the reasonableness of their 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' businesses 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.

4.135 Typically, associated enterprises are allowed to participate 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 the transfer pricing issues. From the associated enterprises' perspective, this ability to participate may be seen as an advantage over the conventional mutual agreement procedure.

4.136 At the conclusion of an APA process, the tax administrations should provide confirmation to the associated enterprises in their jurisdiction that no transfer pricing adjustment will be made as long as the taxpayer follows the terms of the arrangements. There should also be a provision in an APA (perhaps by reference to a range) that provides for possible revision or cancellation of the arrangement for future years when business operations change significantly, or when uncontrolled economic circumstances (e.g., significant changes in currency exchange rates) critically affect the reliability of the methodology in a manner

that independent enterprises would consider significant for purposes of their transfer pricing.

4.137 An APA may cover all of the transfer pricing issues of a taxpayer (as is preferred by some countries) or may provide a flexibility to the taxpayer to limit the 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 associated enterprises may limit their 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.

4.138 Each tax administration involved in the APA will naturally wish to monitor compliance with the APA by the taxpayers in its jurisdiction, and this is generally 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 and that critical assumptions remain relevant. 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 APA proposal and determining whether or not the taxpayer has complied with the terms and conditions of the APA. With regard to transfer pricing, a 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.

4.139 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. Where an APA is proposed to be cancelled or revoked, the tax administration proposing the action should notify the other tax administrations of its intention and of the reasons for such action.

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

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4.140 APAs involving the competent authority of a treaty partner should be considered within the scope of the mutual agreement procedure under 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 paragraph 32 of the Commentary 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. In a number of cases, APAs arise from cases where the application of transfer pricing to a particular category of taxpayer gives rise to doubts and difficulties. 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.

4.141 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 OECD 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.

4.142 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 taxpayers 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

4.143 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 the taxpayers involved 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.

4.144 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.

4.145 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

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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.

4.146 Bilateral and multilateral APAs substantially reduce or eliminate the possibility of juridical or economic double or non taxation since all the relevant countries participate. By contrast, unilateral APAs do not provide 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.

4.147 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 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.

iv) Disadvantages relating to advance pricing arrangements

4.148 Unilateral APAs may present significant problems for tax administrations and taxpayers alike. From the point of view of other tax administrations, problems arise because they may disagree with the APA's conclusions. From the point of view of the associated enterprises involved, one problem is the possible effect on the behaviour of the associated enterprises. Unlike bilateral or multilateral APAs, the use of unilateral APAs may not lead to an increased level of certainty for the taxpayer involved and a reduction in economic or juridical double taxation for the MNE group. 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.

4.149 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 their pricing to the range of permissible pricing in the APA. In a unilateral APA, it is critical that this flexibility preserve 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, in its view, with the arm's length principle.

4.150 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.

4.151 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 a tax administration by taxpayers seeking the earliest possible conclusion to an APA request, keeping in mind their business objectives and time scales, and the APA programme as a whole will tend to be led by the demands of the business community. These demands 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 authorities of both Contracting States is to be obtained on the renewal of an APA to avoid double taxation (or non-taxation).

4.152 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 way similar to those previously concluded without sufficient regard being had to the conditions

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operating in other markets. Care should therefore be taken with interpreting the results of previously concluded APAs as being representative across all markets.

4.153 Concerns have also been expressed that, because of the nature of the APA procedure, it will interest taxpayers with a good voluntary compliance history. Experience in some countries has shown that, most often, taxpayers which would be interested in APAs are very large corporations which would be audited on a regular basis, with their pricing methodology then being examined in any event. The difference in the examination conducted of their transfer pricing would be one of timing rather than extent. As well, it has not been demonstrated that APAs will be of interest solely or principally to such taxpayers. Indeed, there are some early indications that taxpayers, having experienced difficulty with tax administrations on transfer pricing issues and not wishing these difficulties to continue, are often interested in applying for an APA. 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. 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 may be 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.

4.154 In addition to the foregoing concerns, there are a number of possible 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.

4.155 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, except for the fact that in an APA the tax administration will need to have details of predictions and the basis for those predictions, which may not be central issues in a transfer pricing examination that focuses on completed transactions. In fact, an APA should seek to limit the documentation, as discussed above, and focus the documentation

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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.

4.156 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, depending on the facts and circumstances. 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. Tax administrations should, therefore, seek to ensure that APA procedures are not unnecessarily cumbersome and that they do not make more demand of taxpayers than are strictly required by the scope of the APA application.

4.157 Problems could also develop if tax administrations misuse information obtained in an APA in their 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, any nonfactual information provided by the taxpayer in connection with the APA request, such as settlement offers, reasoning, opinions, and judgments, cannot be treated as relevant in any respect to the examination. In addition, the fact that a taxpayer has applied unsuccessfully for an APA should not be taken into account by the tax administration in determining whether to commence an examination of that taxpayer.

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4.158 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. Therefore, domestic rules against disclosure should be applied. In a bilateral APA the confidentiality requirements on treaty partners would apply, thereby preventing public disclosure of confidential data.

4.159 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. In evaluating APAs, tax administrations can alleviate these potential problems by ensuring that the level of inquiry is adjusted to the size of the international transactions involved.

v) Recommendations

a) In general

4.160 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.

4.161 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. While 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 that choose to use them.

b) Coverage of an arrangement

4.162 When considering the scope of an APA, taxpayers and tax administrations need to pay close attention to the reliability of any predictions so as to exclude unreliable predictions. In general, great care must be taken if the APA goes beyond the methodology, its application, and critical assumptions. See paragraphs 4.124-4.129.

c) Unilateral versus bilateral (multilateral) arrangements

4.163 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 being doubly taxed. 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.

d) Equitable access to APAs for all taxpayers

4.164 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, since taxpayers in identical situations should not 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 streamlined access for small taxpayers. Tax administrations should take care to adapt their levels of inquiry, in evaluating APAs, to the size of the international transactions involved.

e) Developing working agreements between competent authorities and improved procedures

4.165 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

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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.

4.166 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

4.167 As trade and investment have taken on an increasingly international character, the tax disputes that, on occasion, arise from such activities have likewise become increasingly international. And more particularly, the disputes no longer involve simply controversy between a taxpayer and its tax administration but also concern disagreements between tax administrations themselves. In many of these situations, the MNE group is primarily a stakeholder and the real parties in interest are the governments involved. Traditionally, problems of double taxation 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.

4.168 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 Energy Charter Treaty.

4.169 In the tax area as well, there has been some interest in the use of arbitration to resolve tax disputes. Most publicized is the "Convention dealing

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with Transfer Pricing agreed by Member States of the European Community's (the "Arbitration Convention"), which came into force on 1 January 1995, but, in addition, some bilateral tax conventions have provisions for arbitration. Neither the Arbitration Convention nor these bilateral treaty provisions have yet been applied.

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

4.171 It is in the context of transfer pricing that arbitration has received the most attention by the OECD. The 1984 Report contains a discussion of the use of arbitration procedures to ensure that corresponding adjustments would be made on a consistent basis. After discussing some of the advantages and disadvantages of arbitration, the Report concluded 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 1984 Report was written. The Arbitration Convention referred to above 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.