

## *Chapter I*

### **The Arm's Length Principle**

#### **A. Introduction**

1.1 This Chapter provides a background discussion of the arm's length principle, which is the international transfer pricing standard that OECD Member countries have agreed should be used for tax purposes by MNE groups and tax administrations. The Chapter discusses the arm's length principle, reaffirms its status as the international standard, and sets forth guidelines for its application.

1.2 When independent enterprises deal with each other, the conditions of their commercial and financial relations (e.g. the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces. When associated enterprises deal with each other, their commercial and financial relations may not be directly affected by external market forces in the same way, although associated enterprises often seek to replicate the dynamics of market forces in their dealings with each other, as discussed in paragraph 1.5, below. Tax administrations should not automatically assume that associated enterprises have sought to manipulate their profits. There may be a genuine difficulty in accurately determining a market price in the absence of market forces or when adopting a particular commercial strategy. It is important to bear in mind that the need to make adjustments to approximate arm's length dealings arises irrespective of any contractual obligation undertaken by the parties to pay a particular price or of any intention of the parties to minimize tax. Thus, a tax adjustment under the arm's length principle would not affect the underlying contractual obligations for non-tax purposes between the associated enterprises, and may be appropriate even where there is no intent to minimize or avoid tax. The consideration of transfer pricing should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes.

1.3 When transfer pricing does not reflect market forces and the arm's length principle, the tax liabilities of the associated enterprises and the tax revenues of the host countries could be distorted. Therefore, OECD Member countries have agreed that for tax purposes the profits of associated enterprises may be adjusted as necessary to correct any such distortions and thereby ensure that the arm's length principle is satisfied. OECD Member countries consider that

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an appropriate adjustment is achieved by establishing the conditions of the commercial and financial relations that they would expect to find between independent enterprises in similar transactions under similar circumstances.

1.4 Factors other than tax considerations may distort the conditions of commercial and financial relations established between associated enterprises. For example, such enterprises may be subject to conflicting governmental pressures (in the domestic as well as foreign country) relating to customs valuations, anti-dumping duties, and exchange or price controls. In addition, transfer price distortions may be caused by the cash flow requirements of enterprises within an MNE group. An MNE group that is publicly held may feel pressure from shareholders to show high profitability at the parent company level, particularly if shareholder reporting is not undertaken on a consolidated basis. All of these factors may affect transfer prices and the amount of profits accruing to associated enterprises within an MNE group.

1.5 It should not be assumed that the conditions established in the commercial and financial relations between associated enterprises will invariably deviate from what the open market would demand. Associated enterprises in MNEs commonly have a considerable amount of autonomy and often bargain with each other as though they were independent enterprises. Enterprises respond to economic situations arising from market conditions, in their relations with both third parties and associated enterprises. For example, local managers may be interested in establishing good profit records and therefore would not want to establish prices that would reduce the profits of their own companies. Tax administrations should bear in mind that MNEs from a managerial point of view have an incentive to use arm's length prices to be able to judge the real performance of their different profit centres. Tax administrations should keep these considerations in mind to facilitate efficient allocation of their resources in selecting and conducting transfer pricing examinations. Sometimes, it may occur that the relationship between the associated enterprises may influence the outcome of the bargaining. Therefore, evidence of hard bargaining alone is not sufficient to establish that the dealings are at arm's length.

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### **B. Statement of the arm's length principle**

#### *i) Article 9 of the OECD Model Tax Convention*

1.6 The authoritative statement of the arm's length principle is found in paragraph 1 of Article 9 of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties involving OECD Member countries and an increasing number of non-Member countries. Article 9 provides:

"[When] conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances, the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the dealings between those members.

1.7 There are several reasons why OECD Member countries and other countries have adopted the arm's length principle. A major reason is that the arm's length principle provides broad parity of tax treatment for MNEs and independent enterprises. Because the arm's length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment.

1.8 The arm's length principle has also been found to work effectively in the vast majority of cases. For example, there are many cases involving the purchase and sale of commodities and the lending of money where an arm's length price may readily be found in a comparable transaction undertaken by comparable independent enterprises under comparable circumstances. Nevertheless, there are

some significant cases in which the arm's length principle is difficult and complicated to apply, for example, in MNE groups dealing in the integrated production of highly specialized goods, in unique intangibles, and/or in the provision of specialised services.

1.9 The arm's length principle is viewed by some as inherently flawed because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses. There are, however, no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises. The issue of possible alternatives to the arm's length principle is discussed in Section C of Chapter III.

1.10 A practical difficulty in applying the arm's length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Such transactions may not necessarily be motivated by tax avoidance but may occur because in transacting business with each other, members of an MNE group face different commercial circumstances than would independent enterprises. For example, an independent enterprise may not be willing to sell an intangible (e.g. the right to exploit the fruits of all future research) for a fixed price if the profit potential of the intangible cannot be adequately estimated and there are other means of exploiting the intangible. In such a case, an independent enterprise may not want to risk an outright sale because the price might not reflect the potential for the intangible to become extremely profitable. Similarly, the owner of an intangible may be hesitant to enter into licensing arrangements with independent enterprises for fear of the value of the intangible being degraded. In contrast, the intangible owner may be prepared to offer terms to associated enterprises that are less restrictive because the use of the intangible can be more closely monitored. There is no risk to the overall group's profit from a transaction of this kind between members of an MNE group. An independent enterprise in such circumstances might exploit the intangible itself or license it to another independent enterprise for a limited period of time (or possibly under an arrangement to adjust the royalty). However, there is always a risk that the intangible is not as valuable as it seems to be. Therefore, an independent enterprise has to make the choice between selling the intangible and so diminishing the risk and safeguarding the profit, and

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exploiting the intangible and taking the risk that the profit will vary from the profit which could be gained by selling the intangible. Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises.

1.11 In certain cases, the arm's length principle may result in an administrative burden for both the taxpayer and the tax administrations of evaluating significant numbers and types of cross-border transactions. Although an associated enterprise normally establishes the conditions for a transaction at the time it is undertaken, at some point the enterprise may be required to demonstrate that these are consistent with the arm's length principle. (See Chapter V on Documentation). The tax administration may also have to engage in this verification process perhaps some years after the transactions have taken place. The tax administration would then attempt to gather information about similar transactions, the market conditions at the time the transactions took place, etc., for numerous and varied transactions. Such an undertaking usually becomes more difficult with the passage of time.

1.12 Both tax administrations and taxpayers often have difficulty in obtaining adequate information to apply the arm's length principle. Because the arm's length principle usually requires taxpayers and tax administrations to evaluate uncontrolled transactions and the business activities of independent enterprises, and to compare these with the transactions and activities of associated enterprises, it can demand a substantial amount of data. The information that is accessible may be incomplete and difficult to interpret; other information, if it exists, may be difficult to obtain for reasons of its geographical location or that of the parties from whom it may have to be acquired. In addition, it may not be possible to obtain information from independent enterprises because of confidentiality concerns. In other cases information about an independent enterprise which could be relevant may simply not exist. It should also be recalled at this point that transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer.

*ii) Maintaining the arm's length principle as the international consensus*

1.13 While recognizing the foregoing considerations, the view of OECD Member countries continues to be that the arm's length principle should govern the evaluation of transfer prices among associated enterprises. The arm's length principle is sound in theory since it provides the closest approximation of the workings of the open market in cases where goods and services are transferred between associated enterprises. While it may not always be straightforward to apply in practice, it does generally produce appropriate levels of income between members of MNE groups, acceptable to tax administrations. This reflects the economic realities of the controlled taxpayer's particular facts and circumstances and adopts as a benchmark the normal operation of the market.

1.14 A move away from the arm's length principle would abandon the sound theoretical basis described above and threaten the international consensus, thereby substantially increasing the risk of double taxation. Experience under the arm's length principle has become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administrations. This shared understanding is of great practical value in achieving the objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation. This experience should be drawn on to elaborate the arm's length principle further, to refine its operation, and to improve its administration by providing clearer guidance to taxpayers and more timely examinations. In sum, OECD Member countries continue to support strongly the arm's length principle. In fact, no legitimate or realistic alternative to the arm's length principle has emerged. The global formulary apportionment approach, sometimes mentioned as a possible alternative, would not be acceptable in theory, implementation, or practice. (See Chapter III, Part C, for a discussion of the global formulary apportionment method.)

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### C. Guidance for applying the arm's length principle

#### *i) Comparability analysis*

##### *a) Reason for examining comparability*

1.15 Application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. In determining the degree of comparability, including what adjustments are necessary to establish it, an understanding of how unrelated companies evaluate potential transactions is required. Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive. For example, one enterprise is unlikely to accept a price offered for its product by an independent enterprise if it knows that other potential customers are willing to pay more under similar conditions. This point is relevant to the question of comparability, since independent enterprises would generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk or other comparability factors discussed below) when valuing those options. Therefore, when making the comparisons entailed by application of the arm's length principle, tax administrations should also take these differences into account when establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability.

1.16 All methods that apply the arm's length principle can be tied to the concept that independent enterprises consider the options available to them and in comparing one option to another they consider any differences between the options that would significantly affect their value. For instance, before purchasing a product at a given price, independent enterprises normally would be expected to consider whether they could buy the same product at a lower price from another party. Therefore, as discussed in Chapter II, the comparable

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uncontrolled price method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative to the controlled transaction. However, the method becomes a less reliable substitute for arm's length dealings if not all the characteristics of these uncontrolled transactions that significantly affect the price charged between independent enterprises are comparable. Similarly, the resale price and cost plus methods compare the gross profit margin earned in the controlled transaction to gross profit margins earned in similar uncontrolled transactions. The comparison provides an estimate of the gross profit margin one of the parties could have earned had it performed the same functions for independent enterprises and therefore provides an estimate of the payment that party would have demanded, and the other party would have been willing to pay, at arm's length for performing those functions. Other methods as discussed in Chapter III are based on comparisons of profit rates or margins between independent and associated enterprises as a means to estimate the profits that one or both of the associated enterprises could have earned had they dealt solely with independent enterprises, and therefore the payment those enterprises would have demanded at arm's length to compensate them for using their resources in the controlled transaction. In all cases adjustments must be made to account for differences between the controlled and uncontrolled situations that would significantly affect the price charged or return required by independent enterprises. Therefore, in no event can unadjusted industry average returns themselves establish arm's length conditions.

1.17 As noted above, in making these comparisons, material differences between the compared transactions or enterprises should be taken into account. In order to establish the degree of actual comparability and then to make appropriate adjustments to establish arm's length conditions (or a range thereof), it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm's length dealings. Attributes that may be important include the characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties. These factors are discussed in more detail below.

1.18 The extent to which each of these factors matters in establishing comparability will depend upon the nature of the controlled transaction and the pricing method adopted. For a discussion of the relevance of these factors for the

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application of particular pricing methods, see the consideration of those methods in Chapters II and III.

### *b) Factors determining comparability*

#### 1. Characteristics of property or services

1.19 Differences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market. Therefore, comparisons of these features may be useful in determining the comparability of controlled and uncontrolled transactions. In general, similarity in the characteristics of the property or services transferred will matter most when comparing prices of controlled and uncontrolled transactions and less when comparing profit margins. Characteristics that it may be important to consider include the following: in the case of transfers of tangible property, the physical features of the property, its quality and reliability, and the availability and volume of supply; in the case of the provision of services, the nature and extent of the services; and in the case of intangible property, the form of transaction (e.g. licensing or sale), the type of property (e.g. patent, trademark, or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property.

#### 2. Functional analysis

1.20 In dealings between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, comparison of the functions taken on by the parties is necessary. This comparison is based on a functional analysis, which seeks to identify and to compare the economically significant activities and responsibilities undertaken or to be undertaken by the independent and associated enterprises. For this purpose, particular attention should be paid to the structure and organisation of the group. It will also be relevant to determine in what juridical capacity the taxpayer performs its functions.

1.21 The functions that taxpayers and tax administrations might need to identify and compare include, e.g., design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing, and management. The principal functions performed by

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the party under examination should be identified. Adjustments should be made for any material differences from the functions undertaken by any independent enterprises with which that party is being compared. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.

1.22 It may also be relevant and useful in identifying and comparing the functions performed to consider the assets that are employed or to be employed. This analysis should consider the type of assets used, such as plant and equipment, the use of valuable intangibles, etc., and the nature of the assets used, such as the age, market value, location, property right protections available, etc.

1.23 It may also be relevant and useful in comparing the functions performed to consider the risks assumed by the respective parties. In the open market, the assumption of increased risk will also be compensated by an increase in the expected return. Therefore, controlled and uncontrolled transactions and entities are not comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made. Functional analysis is incomplete unless the material risks assumed by each party have been considered since the assumption or allocation of risks would influence the conditions of transactions between the associated enterprises. Theoretically, in the open market, the assumption of increased risk must also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised.

1.24 The types of risks to consider include market risks, such as input cost and output price fluctuations; risks of loss associated with the investment in and use of property, plant, and equipment; risks of the success or failure of investment in research and development; financial risks such as those caused by currency exchange rate and interest rate variability; credit risks; and so forth.

1.25 The functions carried out (taking into account the assets used and the risks assumed) will determine to some extent the allocation of risks between the parties, and therefore the conditions each party would expect in arm's length dealings. For example, when a distributor takes on responsibility for marketing and advertising by risking its own resources in these activities, it would be entitled to a commensurately higher anticipated return from the activity and the conditions of the transaction would be different from when the distributor acts

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merely as an agent, being reimbursed for its costs and receiving the income appropriate to that activity. Similarly, a contract manufacturer or a contract research provider that takes on no meaningful risk would be entitled to only a limited return.

1.26 In line with the discussion below in relation to contractual terms, it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk. If, for example, a manufacturer sells property to a related distributor in another country and the distributor is claimed to assume all exchange rate risks, but the transfer price appears in fact to be adjusted so as to insulate the distributor from the effects of exchange rate movements, then the tax administrations may wish to challenge the purported allocation of exchange rate risk.

1.27 An additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in arm's length transactions. In arm's length dealings it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control. For example, suppose that Company A contracts to produce and ship goods to Company B, and the level of production and shipment of goods are to be at the discretion of Company B. In such a case, Company A would be unlikely to agree to take on substantial inventory risk, since it exercises no control over the inventory level while Company B does. Of course, there are many risks, such as general business cycle risks, over which typically neither party has significant control and which at arm's length could therefore be allocated to one or the other party to a transaction. Analysis is required to determine to what extent each party bears such risks in practice. When addressing the issue of the extent to which a party to a transaction bears any currency exchange and/or interest rate risk, it will ordinarily be necessary to consider the extent, if any, to which the taxpayer and/or the MNE group have a business strategy which deals with the minimisation or management of such risks. Hedging arrangements, forward contracts, put and call options, etc, both "on-market" and "off-market", are now in common use. Failure on the part of a taxpayer bearing currency exchange and interest rate risk to address such exposure may arise as a result of a business strategy of the MNE group seeking to hedge its overall exposure to such risks or seeking to hedge only some portion of the group's exposure. This latter practice, if not accounted for appropriately, could lead to significant profits or losses being made which are capable of being sourced in the most advantageous place to the MNE group.

### 3. Contractual terms

1.28 In arm's length dealings, the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties. As such, an analysis of contractual terms should be a part of the functional analysis discussed above. The terms of a transaction may also be found in correspondence/communications between the parties other than a written contract. Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises.

1.29 In dealings between independent enterprises, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract, and that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties. The same divergence of interests may not exist in the case of associated enterprises, and it is therefore important to examine whether the conduct of the parties conforms to the terms of the contract or whether the parties' conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction.

### 4. Economic circumstances

1.30 Arm's length prices may vary across different markets even for transactions involving the same property or services; therefore, to achieve comparability requires that the markets in which the independent and associated enterprises operate are comparable, and that differences do not have a material effect on price or that appropriate adjustments can be made. As a first step, it is essential to identify the relevant market or markets taking account of available substitute goods or services. Economic circumstances that may be relevant to determining market comparability include the geographic location; the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers; the availability (risk thereof) of substitute goods and services; the levels of supply and demand in the market as a whole and in particular regions, if relevant; consumer purchasing power; the nature and extent of government regulation of the market; costs of production, including the costs of land, labour, and capital; transport costs; the level of the market (e.g. retail or wholesale); the date and time of transactions; and so forth.

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### 5. Business strategies

1.31 Business strategies must also be examined in determining comparability for transfer pricing purposes. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws, and other factors bearing upon the daily conduct of business. Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions and enterprises. It will also be relevant to consider whether business strategies have been devised by the MNE group or by a member of the group acting separately and the nature and extent of the involvement of other members of the MNE group necessary for the purpose of implementing the business strategy.

1.32 Business strategies also could include market penetration schemes. A taxpayer seeking to penetrate a market or to increase its market share might temporarily charge a price for its product that is lower than the price charged for otherwise comparable products in the same market. Furthermore, a taxpayer seeking to enter a new market or expand (or defend) its market share might temporarily incur higher costs (e.g. due to start-up costs or increased marketing efforts) and hence achieve lower profit levels than other taxpayers operating in the same market.

1.33 Timing issues can pose particular problems for tax administrations when evaluating the legitimacy of a taxpayer's claim that it is following a business strategy that distinguishes it from potential comparables. Some business strategies, such as those involving market penetration or expansion of market share, involve reductions in the taxpayer's current profits in anticipation of increased future profits. If in the future those increased profits fail to materialize because the purported business strategy was not actually followed by the taxpayer, legal constraints may prevent re-examination of earlier tax years by the tax administrations. At least in part for this reason, tax administrations may wish to subject a taxpayer's claim that it is following such a business strategy to particular scrutiny.

1.34 When evaluating a taxpayer's claim that it was following a business strategy that temporarily decreased profits in return for higher long-run profits, several factors should be considered. Tax administrations should examine the conduct of the parties to determine if it is consistent with the professed business

strategy. For example, if a manufacturer charges its related distributor a below-market price as part of a market penetration strategy, the cost savings to the distributor may be reflected in the price charged to the distributor's customers or in greater market penetration expenses incurred by the distributor. A market penetration strategy of an MNE group could be put in place by the manufacturer or by the distributor acting separately from the manufacturer (and the resulting cost borne by either of them). Furthermore, unusually intensive marketing and advertising efforts would often accompany a market penetration or market share expansion strategy. Another factor to consider is whether the nature of the relationship between the parties to the controlled transaction would be consistent with the taxpayer bearing the costs of the business strategy. For example, in arm's length dealings a company acting solely as a sales agent with little or no responsibility for long-term market development would generally not bear the costs of a market penetration strategy. Where a company has undertaken market development activities at its own risk and enhances the value of a product through a trademark or tradename or increases goodwill associated with the product, this situation should be reflected in the analysis of functions for the purposes of establishing comparability.

1.35 An additional consideration is whether there is a plausible expectation that following the business strategy will produce a return sufficient to justify its costs within a period of time that would be acceptable in an arm's length arrangement. It is recognised that a business strategy such as market penetration may fail, and the failure does not of itself allow the strategy to be ignored for transfer pricing purposes. However, if such an expected outcome was implausible at the time of the transaction, or if the claimed business strategy is unsuccessful but nonetheless is continued beyond what an independent enterprise would accept, the taxpayer's claim may be doubtful. In determining what period of time an independent enterprise would accept, tax administrations may wish to consider evidence of the commercial strategies evident in the country in which the business strategy is being pursued. In the end, however, the most important consideration is whether the strategy in question could plausibly be expected to prove profitable within the foreseeable future (while recognising that the strategy might fail), and that a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions.

*ii) Recognition of the actual transactions undertaken*

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1.36 A tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapters II and III. In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured.

1.37 However, there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. The first circumstance arises where the economic substance of a transaction differs from its form. In such a case the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance. An example of this circumstance would be an investment in an associated enterprise in the form of interest-bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for a tax administration to characterise the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital. The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price. An example of this circumstance would be a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract (as previously indicated in paragraph 1.10). While in this case it may be proper to respect the transaction as a transfer of commercial property, it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in their entirety (and not simply by reference to pricing) to those that might reasonably have been expected had the transfer of property been the subject of a transaction involving independent enterprises. Thus, in the case described above it might be appropriate for the tax administration, for example, to adjust the

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conditions of the agreement in a commercially rational manner as a continuing research agreement.

1.38 In both sets of circumstances described above, the character of the transaction may derive from the relationship between the parties rather than be determined by normal commercial conditions and may have been structured by the taxpayer to avoid or minimise tax. In such cases, the totality of its terms would be the result of a condition that would not have been made if the parties had been engaged in arm's length dealings. Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm's length.

1.39 Associated enterprises are able to make a much greater variety of contracts and arrangements than can unrelated enterprises because the normal conflict of interest which would exist between independent parties is often absent. Associated enterprises may and frequently do conclude arrangements of a specific nature that are not or are very rarely encountered between unrelated parties. This may be done for various economic, legal, or fiscal reasons dependent on the circumstances in a particular case. Moreover, contracts within an MNE could be quite easily altered, suspended, extended, or terminated according to the overall strategies of the MNE as a whole and such alterations may even be made retroactively. In such instances tax administrations would have to determine what is the underlying reality behind a contractual arrangement in applying the arm's length principle.

1.40 In addition, tax administrations may find it useful to refer to alternatively structured transactions between independent enterprises to determine whether the controlled transaction as structured satisfies the arm's length principle. Whether evidence from a particular alternative can be considered will depend on the facts and circumstances of the particular case, including the number and accuracy of the adjustments necessary to account for differences between the controlled transaction and the alternative and the quality of any other evidence that may be available.

1.41 The difference between restructuring the controlled transaction under review which, as stated above, generally is inappropriate, and using alternatively structured transactions as comparable uncontrolled transactions is demonstrated in the following example. Suppose a manufacturer sells goods to a controlled

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distributor located in another country and the distributor accepts all currency risk associated with these transactions. Suppose further that similar transactions between independent manufacturers and distributors are structured differently in that the manufacturer, and not the distributor, bears all currency risk. In such a case, the tax administration should not disregard the controlled taxpayer's purported assignment of risk unless there is good reason to doubt the economic substance of the controlled distributor's assumption of currency risk. The fact that independent enterprises do not structure their transactions in a particular fashion might be a reason to examine the economic logic of the structure more closely, but it would not be determinative. However, the uncontrolled transactions involving a differently structured allocation of currency risk could be useful in pricing the controlled transaction, perhaps employing the comparable uncontrolled price method if sufficiently accurate adjustments to their prices could be made to reflect the difference in the structure of the transactions.

### *iii) Evaluation of separate and combined transactions*

1.42 Ideally, in order to arrive at the most precise approximation of fair market value, the arm's length principle should be applied on a transaction-by-transaction basis. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. Examples may include 1. some long-term contracts for the supply of commodities or services, 2. rights to use intangible property, and 3. pricing a range of closely-linked products (e.g. in a product line) when it is impractical to determine pricing for each individual product or transaction. Another example would be the licensing of manufacturing know-how and the supply of vital components to an associated manufacturer; it may be more reasonable to assess the arm's length terms for the two items together rather than individually. Such transactions should be evaluated together using the most appropriate arm's length method or methods. A further example would be the routing of a transaction through another associated enterprise; it may be more appropriate to consider the transaction of which the routing is a part in its entirety, rather than consider the individual transactions on a separate basis.

1.43 While some separately contracted transactions between associated enterprises may need to be evaluated together in order to determine whether the conditions are arm's length, other transactions contracted between such enterprises as a package may need to be evaluated separately. An MNE may package as a single transaction and establish a single price for a number of

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benefits such as licenses for patents, know-how, and trademarks, the provision of technical and administrative services, and the lease of production facilities. This type of arrangement is often referred to as a package deal. Such comprehensive packages would be unlikely to include sales of goods, however, although the price charged for sales of goods may cover some accompanying services. In some cases, it may not be feasible to evaluate the package as a whole so that the elements of the package must be segregated. In such cases, after determining separate transfer pricing for the separate elements, the tax administration should nonetheless consider whether in total the transfer pricing for the entire package is arm's length.

1.44 Even in uncontrolled transactions, package deals may combine elements that are subject to different tax treatment under domestic law or an income tax convention. For example, royalty payments may be subject to withholding tax but lease payments may be subject to net taxation. In such circumstances, it may still be appropriate to determine the transfer pricing on a package basis, and the tax administration could then determine whether for other tax reasons it is necessary to allocate the price to the elements of the package. In making this determination, tax administrations should examine the package deal between associated enterprises in the same way that they would analyze similar deals between independent enterprises. Taxpayers should be prepared to show that the package deal reflects appropriate transfer pricing.

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### *iv) Use of an arm's length range*

1.45 In some cases it will be possible to apply the arm's length principle to arrive at a single figure (e.g. price or margin) that is the most reliable to establish whether the conditions of a transaction are arm's length. However, because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable. In these cases, differences in the figures that comprise the range may be caused by the fact that in general the application of the arm's length principle only produces an approximation of conditions that would have been established between independent enterprises. It is also possible that the different points in a range represent the fact that independent enterprises engaged in comparable transactions under comparable circumstances may not establish exactly the same price for the transaction. However, in some cases, not all comparable transactions examined will have a relatively equal degree of comparability. Therefore, the actual determination of the arm's length price necessarily requires exercising good judgment. As discussed in Chapter III, use of a range may be particularly appropriate where, as a last resort, the transactional net margin method is applied.

1.46 A range of figures may also result when more than one method is applied to evaluate a controlled transaction. For example, two methods that attain similar degrees of comparability may be used to evaluate the arm's length character of a controlled transaction. Each method may produce an outcome or a range of outcomes that differs from the other because of differences in the nature of the methods and the data, relevant to the application of a particular method, used. Nevertheless, each separate range potentially could be used to define an acceptable range of arm's length figures. Data from these ranges could be useful for purposes of more accurately defining the arm's length range, for example when the ranges overlap, or for reconsidering the accuracy of the methods used when the ranges do not overlap. No general rule may be stated with respect to the use of ranges derived from the application of multiple methods because the conclusions to be drawn from their use will depend on the relative reliability of the methods employed to determine the ranges and the quality of the information used in applying the different methods.

1.47 Where the application of one or more methods produces a range of figures, a substantial deviation among points in that range may indicate that the data used in establishing some of the points may not be as reliable as the data

used to establish the other points in the range or that the deviation may result from features of the comparable data that require adjustments. In such cases, further analysis of those points may be necessary to evaluate their suitability for inclusion in any arm's length range.

1.48 If the relevant conditions of the controlled transactions (e.g. price or margin) are within the arm's length range, no adjustment should be made. If the relevant conditions of the controlled transaction (e.g. price or margin) fall outside the arm's length range asserted by the tax administration, the taxpayer should have the opportunity to present arguments that the conditions of the transaction satisfy the arm's length principle, and that the arm's length range includes their results. If the taxpayer is unable to establish this fact, the tax administration must determine how to adjust the conditions of the controlled transaction taking into account the arm's length range. It could be argued that any point in the range nevertheless satisfies the arm's length principle. In general, and to the extent that it is possible to distinguish among the various points within the range, such adjustments should be made to the point within the range that best reflects the facts and circumstances of the particular controlled transaction.

*v) Use of multiple year data*

1.49 In order to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction, it generally might be useful to examine data from both the year under examination and prior years. The analysis of such information might disclose facts that may have influenced (or should have influenced) the determination of the transfer price. For example, the use of data from past years will show whether a taxpayer's reported loss on a transaction is part of a history of losses on similar transactions, the result of particular economic conditions in a prior year that increased costs in the subsequent year, or a reflection of the fact that a product is at the end of its life cycle. Such an analysis may be particularly useful where as a last resort a transactional profit method is applied.

1.50 Multiple year data will also be useful in providing information about the relevant business and product life cycles of the comparables. Differences in business or product life cycles may have a material effect on transfer pricing conditions that needs to be assessed in determining comparability. The data from earlier years may show whether the independent enterprise engaged in a comparable transaction was affected by comparable economic conditions in a

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comparable manner, or whether different conditions in an earlier year materially affected its price or profit so that it should not be used as a comparable.

1.51 Data from years following the year of the transaction may also be relevant to the analysis of transfer prices, but care must be taken by tax administrations to avoid the use of hindsight. For example, data from later years may be useful in comparing product life cycles of controlled and uncontrolled transactions for the purpose of determining whether the uncontrolled transaction is an appropriate comparable to use in applying a particular method. Subsequent conduct by the parties will also be relevant in ascertaining the actual terms and conditions that operate between the parties.

### *vi) Losses*

1.52 When an associated enterprise consistently realizes losses while the MNE group as a whole is profitable, the facts could trigger some special scrutiny of transfer pricing issues. Of course, associated enterprises, like independent enterprises, can sustain genuine losses, whether due to heavy start-up costs, unfavourable economic conditions, inefficiencies, or other legitimate business reasons. However, an independent enterprise would not be prepared to tolerate losses that continue indefinitely. An independent enterprise that experiences recurring losses will eventually cease to undertake business on such terms. In contrast, an associated enterprise that realizes losses may remain in business if the business is beneficial to the MNE group as a whole.

1.53 The fact that there is an enterprise making losses that is doing business with profitable members of its MNE group may suggest to the taxpayers or tax administrations that the transfer pricing should be examined. The loss enterprise may not be receiving adequate compensation from the MNE group of which it is a part in relation to the benefits derived from its activities. For example, an MNE group may need to produce a full range of products and/or services in order to remain competitive and realize an overall profit, but some of the individual product lines may regularly lose revenue. One member of the MNE group might realize consistent losses because it produces all the loss-making products while other members produce the profit-making products. An independent enterprise would perform such a service only if it were compensated by an adequate service charge. Therefore, one way to approach this type of transfer pricing problem would be to deem the loss enterprise to receive the same type of service charge that an independent enterprise would receive under the arm's length principle.

1.54 A factor to consider in analysing losses is that business strategies may differ from MNE group to MNE group due to a variety of historic, economic, and cultural reasons. Recurring losses for a reasonable period may be justified in some cases by a business strategy to set specially low prices to achieve market penetration. For example, a producer may lower the prices of its goods, even to the extent of temporarily incurring losses, in order to enter new markets, to increase its share of an existing market, to introduce new products or services, or to discourage potential competitors. However, specially low prices should be expected for a limited period only, with the specific object of improving profits in the longer term. If the pricing strategy continues beyond a reasonable period, a transfer pricing adjustment may be appropriate, particularly where comparable data over several years show that the losses have been incurred for a period longer than that affecting comparable independent enterprises. Further, tax administrations should not accept specially low prices (e.g. pricing at marginal cost in a situation of underemployed production capacities) as arm's length prices unless independent enterprises could be expected to have determined prices in a comparable manner .

*vii) The effect of government policies*

1.55 There are some circumstances in which a taxpayer will claim that an arm's length price must be adjusted to account for government interventions such as price controls (even price cuts), interest rate controls, controls over payments for services or management fees, controls over the payment of royalties, subsidies to particular sectors, exchange control, anti-dumping duties, or exchange rate policy. As a general rule, these government interventions should be treated as conditions of the market in the particular country, and in the ordinary course they should be taken into account in evaluating the taxpayer's transfer price in that market. The question then presented is whether in light of these conditions the transactions undertaken by the controlled parties are consistent with transactions between independent enterprises.

1.56 One issue that arises is determining the stage at which a price control affects the price of a product or service. Often the direct impact will be on the final price to the consumer, but there may nonetheless be an impact on prices paid at prior stages in the supply of goods to the market. MNEs in practice may make no adjustment in their transfer prices to take account of such controls, leaving the final seller to suffer any limitation on profit that may occur, or they may charge

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prices that share the burden in some way between the final seller and the intermediate supplier. It should be considered whether or not an independent supplier would share in the costs of the price controls and whether an independent enterprise would seek alternative product lines and business opportunities. In this regard, it is unlikely that an independent enterprise would be prepared to produce, distribute, or otherwise provide products or services on terms that allowed it no profit. Nevertheless, it is quite obvious that a country with price controls must take into account that those price controls will affect the profits that can be realised by enterprises selling goods subject to those controls.

1.57 A special problem arises when a country prevents or "blocks" the payment of an amount which is owed by one associated enterprise to another or which in an arm's length arrangement would be charged by one associated enterprise to another. For example, exchange controls may effectively prevent an associated enterprise from transferring interest payments abroad on a loan made by another associated enterprise located in a different country. This circumstance may be treated differently by the two countries involved: the country of the borrower may or may not regard the untransferred interest as having been paid, and the country of the lender may or may not treat the lender as having received the interest. As a general rule, where the government intervention applies equally to transactions between associated enterprises and transactions between independent enterprises (both in law and in fact), the approach to this problem where it occurs between associated enterprises should be the same for tax purposes as that adopted for transactions between independent enterprises. Where the government intervention applies only to transactions between associated enterprises, there is no simple solution to the problem. Perhaps one way to deal with the issue is to apply the arm's length principle viewing the intervention as a condition affecting the terms of the transaction. Treaties may specifically address the approaches available to the treaty partners where such circumstances exist.

1.58 A difficulty with this analysis is that often independent enterprises simply would not enter into a transaction in which payments were blocked. An independent enterprise might find itself in such an arrangement from time to time, most likely because the government interventions were imposed subsequent to the time that the arrangement began. But it seems unlikely that an independent enterprise would willingly subject itself to a substantial risk of nonpayment for products or services rendered by entering into an arrangement when severe government interventions already existed unless the profit projections or

anticipated return from the independent enterprise's proposed business strategy are sufficient to yield it an acceptable rate of return notwithstanding the existence of the government intervention that may affect payment.

1.59 Because independent enterprises might not engage in a transaction subject to government interventions, it is unclear how the arm's length principle should apply. One possibility is to treat the payment as having been made between the associated enterprises, on the assumption that an independent enterprise in a similar circumstance would have insisted on payment by some other means. This approach would treat the party to whom the blocked payment is owed as performing a service for the MNE group. An alternative approach that may be available in some countries would be to defer both the income and the relevant expenses of the taxpayer. In other words, the party to whom this blocked payment was due would not be allowed to deduct expenses, such as additional financing costs, until the blocked payment was made. The concern of tax administrations in these situations is mainly their respective tax bases. If an associated enterprise claims a deduction in its tax computations for a blocked payment, then there should be corresponding income to the other party. In any case, a taxpayer should not be permitted to treat blocked payments due from an associated enterprise differently from blocked payments due from an independent enterprise.

*viii) Intentional set-offs*

1.60 An intentional set-off is one that associated enterprises incorporate knowingly into the terms of the controlled transactions. It occurs when one associated enterprise has provided a benefit to another associated enterprise within the group that is balanced to some degree by different benefits received from that enterprise in return. These enterprises may claim that the benefit each has received should be set off against the benefit each has provided as full or part payment for those benefits so that only the net gain or loss (if any) on the transactions needs to be considered for purpose of assessing tax liabilities. For example, an enterprise may license another enterprise to use a patent in return for the provision of know-how in another connection and claim that the transactions result in no profit or loss to either party. Such arrangements may sometimes be encountered between independent enterprises and should be assessed in accordance with the arm's length principle in order to quantify the value of the respective benefits claimed as set-offs.

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1.61 Intentional set-offs may vary in size and complexity. Such set-offs may range from a simple balance of two transactions (such as a favourable selling price for manufactured goods in return for a favourable purchase price for the raw material used in producing the goods) to an arrangement for a general settlement balancing all benefits accruing to both parties over a period. Independent enterprises would be very unlikely to consider the latter type of arrangement unless the benefits could be accurately quantified and the contract created in advance. Otherwise, independent enterprises normally would prefer to allow their receipts and disbursements to flow independently of each other, taking any profit or loss resulting from normal trading.

1.62 Recognition of intentional set-offs does not change the fundamental requirement that for tax purposes the transfer prices for controlled transactions must be consistent with the arm's length principle. It would be helpful for taxpayers to disclose the existence of set-offs intentionally built into two or more transactions between associated enterprises and demonstrate (or acknowledge that they have relevant documentation and have undertaken sufficient analysis to be able to show) that, after taking account of the set-offs, the conditions governing the transactions are consistent with the arm's length principle at the time of filing the tax return.

1.63 It may be necessary to evaluate the transactions separately to determine whether they each satisfy the arm's length principle. If the transactions are to be analysed together, care should be taken in selecting comparable transactions and regard had to the discussion in Section *iii*) of Part C. The terms of set-offs relating to international transactions between associated enterprises may not be fully consistent with those relating to purely domestic transactions between independent enterprises because of the differences in tax treatment of the set-off under different national tax systems or differences in the treatment of the payment under a bilateral tax treaty. For example, withholding tax would complicate a set-off of royalties against sales receipts.

1.64 A taxpayer may seek on examination a reduction in a transfer pricing adjustment based on an unintentional over-reporting of taxable income. Tax administrations in their discretion may or may not grant this request. Tax administrations may also consider such requests in the context of mutual agreement procedures and corresponding adjustments (see Chapter IV).

### *ix) Use of customs valuations*

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1.65 The arm's length principle is applied, broadly speaking, by many customs administrations as a principle of comparison between the value attributable to goods imported by associated enterprises and the value for similar goods imported by independent enterprises.

1.66 Both customs officials and tax administrations, however, generally seek to determine the value of the products at the time they were transferred or imported. (For tax administrations, the relevant time is generally when the contract for transfer is concluded, but in many cases this coincides with the time of transfer). Thus, customs valuations, because they may occur at or about the same time the transfer takes place, may be useful to tax administrations in evaluating the arm's length character of a controlled transaction transfer price. In particular, customs officials may have contemporaneous documentation regarding the transaction that could be relevant for transfer pricing purposes, especially if prepared by the taxpayer.

1.67 Although customs officials and tax administrations may have a similar purpose in examining the reported values of cross-border controlled transactions, taxpayers may have competing incentives in setting values for customs and tax purposes. In general, a taxpayer importing goods is interested in setting a low price for the transaction for customs purposes so that the customs duty imposed will be low. (There could be similar considerations arising with respect to value added taxes, sales taxes, and excise taxes.) For tax purposes, however, the taxpayer may want to report a higher price paid for those same goods in order to increase deductible costs. Cooperation between income tax and customs administrations within a country in evaluating transfer prices is becoming more common and this should help to reduce the number of cases where customs valuations are found unacceptable for tax purposes or vice versa. Greater cooperation in the area of exchange of information would be particularly useful, and should not be difficult to achieve in countries that already have integrated administrations for income taxes and customs duties. Countries that have separate administrations may wish to consider modifying the exchange of information rules so that the information can flow more easily between the different administrations.

### *x) Use of transfer pricing methods*

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1.68 The methods set forth in Chapters II and III establish whether the conditions imposed in the commercial or financial relations between associated enterprises are consistent with the arm's length principle. No one method is suitable in every possible situation and the applicability of any particular method need not be disproved. Tax administrators should hesitate from making minor or marginal adjustments. Moreover, MNE groups retain the freedom to apply methods not described in this Report to establish prices provided those prices satisfy the arm's length principle in accordance with these Guidelines. However, a taxpayer should maintain and be prepared to provide documentation regarding how its transfer prices were established. For a discussion of documentation, see Chapter V.

1.69 The arm's length principle does not require the application of more than one method, and in fact undue reliance on such an approach could create a significant burden for taxpayers. Thus, this Report does not require either the tax examiner or taxpayer to perform analyses under more than one method. While in some cases the choice of a method may not be straightforward and more than one method may be initially considered, generally it will be possible to select one method that is apt to provide the best estimation of an arm's length price. However, for difficult cases, where no one approach is conclusive, a flexible approach would allow the evidence of various methods to be used in conjunction. In such cases, an attempt should be made to reach a conclusion consistent with the arm's length principle that is satisfactory from a practical viewpoint to all the parties involved, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration.

1.70 It is not possible to provide specific rules that will cover every case. In general, the parties should attempt to reach a reasonable accommodation keeping in mind the imprecision of the various methods and the preference for higher degrees of comparability and a more direct and closer relationship to the transaction. It should not be the case that useful information, such as might be drawn from uncontrolled transactions that are not identical to the controlled transactions, should be dismissed simply because some rigid standard of comparability is not fully met. Similarly, evidence from enterprises engaged in controlled transactions with associated enterprises may be useful in understanding the transaction under review or as a pointer to further investigation. Further, any method should be permitted where its application is agreeable to the members of the MNE group involved with the transaction or transactions to which the

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methodology applies and also to the tax administrations in the jurisdictions of all those members.