

TRANSFER PRICING  
AND MULTINATIONAL  
ENTERPRISES  
THREE TAXATION ISSUES

Reports  
of the OECD Committee  
on Fiscal Affairs  
1984

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In approving the report by the Committee on Fiscal Affairs on "Transfer Pricing and Multinational Enterprises", on 16th May 1979, the OECD Council adopted a Recommendation to the Governments of Member countries and instructed the Committee to pursue its work on issues pertinent to transfer pricing and to the assessment of taxable profits of associated enterprises in general.

The three reports now published in this volume have been prepared by the Committee as part of its work programme and may be regarded as supplementing the 1979 Report. They consider, successively, the ways in which a multinational enterprise may be relieved from "economic double taxation" when transfer prices are adjusted by tax authorities; transfer pricing in the particular sector of banking; and issues related to the allocation of management and service costs for tax purposes.

The report on corresponding adjustments was derestricted by the OECD Council in October 1982, the other two in June 1984.

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TRANSFER PRICING, CORRESPONDING ADJUSTMENTS  
AND THE MUTUAL AGREEMENT PROCEDURE

## INTRODUCTION

1. The topic briefly referred to as "corresponding adjustments" covers a broad area of problems which arise if the transfer prices or allocations of profit adopted by an enterprise in its dealing with an associated enterprise in another country are not accepted by the tax authorities of one or other of the countries concerned. If, in consequence, the prices or allocations are adjusted or are proposed to be adjusted for tax purposes in one of the countries, the question arises of whether or not a "corresponding adjustment" should be made in the other or whether the initial adjustment itself should be modified, with or without an appropriate corresponding adjustment in the second country. A further question arises as to what should happen if the two tax authorities cannot agree on this matter.

2. When drafting the 1979 Report on Transfer Pricing and Multinational Enterprises<sup>1</sup>, the Committee on Fiscal Affairs, while recognising that the subject of corresponding adjustments was relevant to the subject of transfer pricing and created general problems for multinational enterprises, decided that it should not be taken up in the report at that stage (see paragraph 8 of the report). The Committee then took the view that the subject fell outside the boundaries of their task at the time. Moreover, it seemed possible that any discussion of the subject might call for a detailed consideration of the wording of existing provisions in the OECD Model Double Taxation Convention, not only those relating to corresponding adjustments but also those concerned with the mutual agreement procedures (Articles 9 and 25 of the 1977 OECD Model Convention, see Annex) and that this would call for separate study. In its Response to the 1979 Report, BIAC (the Business and Industry Advisory Committee to the OECD), which is generally responsible for representing the views of the private sector to OECD, felt, however, that this was too restrictive an approach and urged "that consideration of this subject be undertaken and concluded as rapidly as possible".

3. In preparing the present report the Committee considered it necessary to review the experience gained to date in this field, both by tax administrations and by multinational enterprises (MNEs), in relation to the making of corresponding adjustments (or obviating the need for them) as well as to consider what possible changes in, or from, the existing arrangements might be called for. They were greatly assisted by the evidence provided both orally and in writing by MNEs represented by BIAC and reference to this evidence is made in various parts of the report. Such references should not, however, be taken necessarily as an endorsement of their views.

4. The report is organised in the following way. After a brief summary of the situations in which the need for corresponding adjustments may possibly arise (Chapter I), the report reviews (in Chapter II) the experience of tax authorities in OECD Member countries in operating the provisions and procedures already available to them for the resolution of disagreements between them in transfer pricing and other matters arising under their double

taxation agreements, and reviews also the problems arising for taxpayers in this context. In Chapter III the report deals with the particular suggestion that arrangements should be made for mandatory corresponding adjustments subject to an arbitration procedure, and in Chapter IV the report discusses a number of ways in which a more satisfactory use of the existing procedures might be made possible. In Chapter V the report summarises the main conclusions reached by the Committee in the course of its consideration of these matters.

## *Chapter I*

### THE PROBLEM OUTLINED

5. Where a transaction takes place across international borders between two associated enterprises, and an adjustment is made to the transfer price for tax purposes by one of the States concerned, the adjustment, if it increases the profits taxable in that State, may result in some economic double taxation. That is to say it may result in the taxation by the two States of the same profits or income in the hands of two separate but associated persons<sup>2</sup>. More generally the same kind of result may occur where income which arises to an MNE and which is allocated by one State for tax purposes to a constituent part of that enterprise situated in that State is also allocated by another State to another constituent part situated in that second State. It is convenient to refer in this report simply, in most instances, to transfer pricing adjustments (or their "corresponding adjustments") but the phrase should be read, where appropriate, as encompassing also such allocations of profits (or their re-allocation).
6. However, economic double taxation will not necessarily be a consequence of these situations. It will perhaps not result if, for example, an adjustment is made to a transfer price in respect of a transaction which has passed through a third associated person in a country with no tax on income or profits (a tax haven). In this case the adjustment may merely bring more profits into liability in the State making the adjustment. Another situation in which economic double taxation will not occur is where profits, although taxable in principle in both States, do not actually bear tax in one of them because of an exemption or relief provided by the law of that State. Thus, it may be mitigated or eliminated if the State of the parent company credits against its own tax on a dividend received from a subsidiary, not only any withholding tax charged on the dividend, but also the tax charged on the subsidiary's profits which underlie that dividend. Nor, of course, will double taxation result if the State imposing tax on the profits or income of the other associated enterprise makes an adequate corresponding adjustment downwards, either to the taxable profits of that enterprise or to the tax chargeable on it.
7. The need for tax authorities to make transfer pricing adjustments and corresponding adjustments is in principle avoided if MNEs consistently adopt, for tax purposes, a transfer pricing policy based on the arm's-length principle and it is certainly not to be supposed that they never do this. It may be objected, however, that the admitted difficulties for tax authorities in the way of ascertaining the arm's-length price in a variety of circumstances may also be experienced by the MNEs themselves and that the genuine efforts of an MNE to follow the arm's-length principle may therefore not necessarily satisfy the tax authorities in all cases. Nevertheless, it seems clear that such efforts should at least limit very considerably the number of occasions on which adjustments by tax authorities are felt to be necessary.

8. So far as the tax authorities themselves are concerned, they too may hope to avoid the necessity of dealing with differences of opinion with other countries' tax authorities about transfer prices if they consistently follow the arm's-length principles set out in the 1977 Model Convention and the 1979 Report. In this context paragraph 15 of that Report may be of particular relevance. Here the point is made that "Since the assessment of an arm's-length price depends very often on careful judgment and the resolution of many, perhaps conflicting, considerations by negotiation between the tax authorities and the enterprise concerned, it follows that if the prices actually paid can be substantiated by acceptable evidence as being arm's-length prices there would be no justification for seeking to make merely minor or marginal adjustments to them for tax purposes. Similarly a tax authority should hesitate to disturb without good reason a pricing arrangement reasonably and consistently operated between associated enterprises if it is also reasonably and consistently operated in comparable dealings with independent parties."

9. However, if, for whatever reason, there is a difference of opinion between tax authorities about the need for a transfer pricing adjustment or its amount, then the questions whether the adjustment should be made, and if so, whether a corresponding adjustment should be made and what the amounts of the adjustment or corresponding adjustment should be, may well depend on the achievement of an explicit consensus between the two tax authorities. The achievement of this consensus may in many cases present no significant problems. But there is a variety of circumstances in which it may be difficult.

10. Thus, where there are no comparable prices for the same or similar transactions between unrelated persons, and the other evidence, if any, does not provide an obvious indication of the arm's-length price, then differences of opinion as to the proper arm's-length price are potential sources of difficulty. Divergences between the national laws of the relevant States, or even differences in their procedures may also give rise to difficulty<sup>3</sup>.

11. As a simple illustration one may take a royalty charged by a parent company in State B to its subsidiary company in State A which the tax authorities of State A decide is too high in relation to the royalty which would be fixed between enterprises dealing at arm's length. In that case the deduction of the royalty payment in arriving at the subsidiary's taxable profits in State A will be reduced (this may be defined as a "primary adjustment"). If State B, in spite of the fact that State A has made this adjustment, still treats the whole payment as an arm's-length royalty the whole amount will be taxed in State B as royalty income of the parent company and in effect therefore some part of the royalty may be taxed in both countries.

12. More complicated possibilities may, however, arise under the laws of some countries. State B, for example, may accept the correctness of the adjustment made by State A and regard only so much of the payment as a royalty as corresponds with the amount allowed as a deduction by State A, but may nevertheless treat the excess part of the royalty as a constructive dividend. If State A had the same approach then this might have the result that the excess over the arm's-length amount, instead of being payable without deduction of tax as a royalty, would as a dividend be treated as a payment from which withholding tax should have been deducted and State A might require payment from the subsidiary of the appropriate withholding tax. On the other hand State B might not be able to apply to the element of the payment treated by State A as a dividend any more advantageous rules applicable to dividends in State B or might be unable to give credit relief for the withholding tax levied by State A. In such circumstances, in order to recognise the fact that the excess of the actual royalty payment over the arm's-length royalty is nevertheless in the hands of the

parent and not those of the subsidiary, appropriate "secondary" adjustments may be necessary if double taxation is to be completely relieved<sup>4</sup>.

13. Similar problems may arise with other types of transaction. Thus, to take a simple case, if a parent company has made a loan to a subsidiary abroad, the tax authorities in the subsidiary's country may adjust the interest rate if they consider that it is not an arm's-length rate. The tax authorities in the country of the lending parent company may perhaps not accept that the adjusted rate is an arm's-length rate – the two countries perhaps may have different views as to the particular financial market in which they should look for evidence of arm's-length interest charges. A more complicated situation may arise if the country of the subsidiary takes the view that the loan is in reality a contribution to the subsidiary's equity capital and not an addition to its debt.

14. Payments of fees for services may also be viewed differently by the tax authorities of the country of the payer and those of the country of the receiver. Thus service fees from a subsidiary may be included in the taxable receipts of the parent company in full, while the tax authorities of the country of the subsidiary restrict the deduction allowable for the payment in arriving at the subsidiary's taxable profits on the grounds that it exceeds the arm's-length price, or possibly even refuse a deduction for the payment altogether on the basis that no real benefit has been conferred upon the payer.

15. Although the examples quoted above are mainly concerned with adjustments made to the tax liability of subsidiaries and the consequences of these adjustments for parent companies, the same sort of problems may, in general, also arise for subsidiaries as the result of adjustments made to the liability of parent companies or to the liability of other associated enterprises.

16. On the other hand, one type of problem may arise only in connection with companies which hold shares in other associated enterprises and receive dividends therefrom. If the country taxing the shareholder company gives a credit against its tax for the tax on the profits out of which the dividend is paid, then this obligation to give credit may be made more burdensome if the tax authorities charging the dividend-paying company do so on the basis of attributing more profits to it in relation to transactions with the shareholder company than do the tax authorities charging the latter – which they might of course do if they took a different view of the arm's-length price for those transactions.

17. Problems of double taxation resulting from the adjustment of transfer prices may also arise for MNEs because of their organisation and the arrangements which they make, in consequence, for intra-group transfers of goods and services, etc. and the payments for them. For example, if a cost contribution arrangement has been concluded within a group for research and development expenditure and if the tax authorities in the country of the parent company consider that the terms and conditions of the arrangement are not in line with the arm's-length principle, this could affect associated enterprises in several countries. Similar problems may arise in relation to costs incurred for the control, co-ordination and supervision of a group, for the provision of services "on call", or for central advertising activities. There could be particular scope for such problems in the situation of highly-integrated multinational groups where different functions, for example, different stages of manufacturing or the R & D functions or the activities of distribution, marketing, selling, transportation, etc., are carried out by different entities in different countries. If, for example, the prices for particular semi-finished products are not recognised in one country, this may have consequences for the transfer pricing system practised in the group as a whole which may in consequence have to be

completely reconsidered. In addition, matters may be complicated by the package-deals and set off arrangements, which are sometimes encountered in dealings between entities within MNEs.

18. However, although it is clear that differences of opinion about transfer prices or the allocation of profits or income may arise in a variety of circumstances, it should not be assumed that serious disagreements between tax authorities are an inevitable consequence of transfer pricing adjustments or the re-allocation of profits or income, or indeed that in practice the inability of tax authorities to arrive at acceptable agreed solutions to their differences of opinion is a common cause of substantial complaint. Nevertheless because such differences of opinion are possible, this report, in the paragraphs which follow, seeks to consider how they may be dealt with or prevented.

19. Similar problems may obviously arise in dealing with the attribution of profits on an arm's-length basis to a permanent establishment in one State of an enterprise of another State. The 1979 Report did not deal specifically with this situation but in general what is said in the Report in relation to associated enterprises is also relevant, *mutatis mutandis*, to the situation of an enterprise and its permanent establishment<sup>5</sup>.

## *Chapter II*

### **EXPERIENCE WITH PROCEDURES CURRENTLY AVAILABLE FOR AVOIDING OR RELIEVING DOUBLE TAXATION**

20. In practice it can be expected that in many cases any double taxation which might arise from transfer pricing adjustments made by one country will be readily alleviated in the other country without involving the tax authorities of the first country, either under domestic law or under provisions of a bilateral treaty corresponding to Article 9(2) of the OECD Model (which provides for relief in cases of economic double taxation) or in some other way.

21. However, it is undoubtedly necessary in a number of cases for there to be some discussion between the tax authorities of the two States concerned and, increasingly therefore, tax authorities are coming together for this purpose. Their discussions may be facilitated by provisions in their bilateral double taxation agreements on the lines of Article 25 of the Model Double Taxation Convention which provides a "mutual agreement procedure" which may be used by tax authorities as a means of seeking solutions to these and other kinds of problem within the scope of bilateral tax treaties. (This is sometimes known also as the "competent authority procedure" because the agreement which is to be sought under it is the agreement of the relevant "competent authorities" as defined in the relevant double taxation relief treaties.)

22. It may be helpful therefore to review here the application of Articles 9 and 25 in the light of the experience of tax authorities and taxpayers.

#### **A. CORRESPONDING ADJUSTMENTS**

23. Article 9(1) provides the arm's-length rule for the tax treatment of transactions between associated enterprises. Article 9(2) provides that where one State taxes profits of an enterprise which feature also in the taxable profits of an associated enterprise in the other State and these doubly taxed profits are profits which would have accrued to the enterprise of the first State if the conditions which have been made between the two enterprises had been those which would have been made between independent enterprises, then the second State should make an appropriate adjustment to the amount of tax charged therein on those profits. This may be done either by recalculating the profits using the relevant revised price or by leaving the calculation to stand and giving the taxpayer relief against his own tax for the additional tax charged by the adjusting State.

24. In theory the adjustment to the arm's-length price under Article 9(1) should create no problems in arriving at the amount of relief due under Article 9(2), but as has been indicated above there are potential difficulties in practice. Moreover there are certain limitations to the scope of Article 9(2). In the first place, because of the requirement that the relief provided by Article 9(2) is to apply only where the doubly taxed profits are those which would have accrued to the first enterprise if it had been at arm's length from its associate, it must follow that, as stated in the Commentary (Paragraph 3), a corresponding adjustment is mandatory only if, and to the extent that, the relevant tax authorities agree with the adjustment of the price made by the tax authorities in the first State. The relief available under Article 9(2) may therefore not be complete if the two authorities have different views on what is the appropriate arm's-length price for a particular transaction. In addition, Article 9(2) makes no provision concerning secondary adjustments although the Commentary notes that nothing in the Article prevents such secondary adjustments from being made where they are permitted under domestic laws. Nor does Article 9(2) deal with the question whether there should be any obligation to make a corresponding adjustment within a specific period of time. Quite apart from this a number of Member States have made reservations concerning Article 9(2). This provision as it stands therefore does not provide, in practice, a complete answer to the problems with which this report is concerned.<sup>1</sup>

25. In their comments on the 1979 Report, MNEs expressed the view that no topic was more directly concerned with the entire area of transfer pricing than the topic of corresponding adjustments and urged the OECD to set forth and endorse a mandatory system of corresponding adjustments binding on all Member countries. In their view, it was unsatisfactory to leave the matter as it stood. They feared that, as things are, taxpayers might be exposed to heavy burdens of tax and vulnerable to arbitrary and capricious pricing adjustments by examining revenue agents. They feared also that "the failure to deal adequately with the question of corresponding adjustments may raise the spectre of increasing cases of double taxation in non-OECD countries opting to follow the principles of the 1979 Report".

26. It is fair to point out nevertheless that a number of OECD Member countries have demonstrated in their bilateral agreements, by articles on the lines of Article 9(2) of the Model Convention and in other ways, acceptance of the obligation to make corresponding adjustments, in the normal case, to relieve economic double taxation where they are satisfied that the original adjustment adequately reflects the arm's-length price.

27. It also seems fair to comment that the taxpayer must look primarily to the domestic tax appeal system of the relevant State or to the domestic law courts or other relevant domestic institutions for protection against arbitrary or capricious transfer pricing adjustments. Imposing a simple mandatory requirement on tax authorities to conform automatically to a transfer pricing adjustment made by the tax authorities of another country would not protect MNEs against arbitrary or capricious adjustment, although it might to some extent mitigate their total impact on an affected enterprise. But providing in this way that tax authorities must conform to the action of other tax authorities over whom they have no control would leave the conforming tax authorities themselves with no protection against any arbitrary or capricious adjustments which might be made in the first place by the other tax authorities concerned, and a provision of this sort is therefore clearly unacceptable for tax authorities.

28. If this expedient is therefore rejected, as it seems to the Committee that it must be, then there seem to be only two other basic possible alternatives. One is to oblige the tax authority, as Article 9(2) does, to make a corresponding adjustment but only to the extent that it can

agree that the result of the original adjustment is to substitute the arm's-length price for the transfer price adopted by the taxpayer (so that if the overall result is to be satisfactory to the tax authorities as well as to the taxpayers there needs to be a voluntary agreement on this matter between the two tax authorities). The second is to compel both tax authorities, if they cannot agree, to submit the matter to a supra-national arbitration, and to abide by its decision. The problems involved in a system of compulsory arbitration are discussed in Chapter III below.

## B. MUTUAL AGREEMENT PROCEDURE

29. As has already been indicated much difficulty in this area may obviously be avoided if the two tax authorities concerned can be brought together to discuss the issues and to seek to arrive at some agreement upon them. The Committee considers that tax authorities should therefore be encouraged to do this whenever it is appropriate and possible, and to do all they can in such circumstances to reach such agreement in order to eliminate double taxation as far as possible.

30. The amount of formality involved in instituting and pursuing discussions between tax authorities will vary from country to country. When less formal arrangements are possible, experience has shown them to be effective for preventing or relieving double taxation in many cases and the Committee does not suggest that the employment of these less formal arrangements should be discouraged.

31. The Commentary on Article 25 of the OECD Model Convention indicates, however, that "as regards adjustments to be made correlatively with the reinstatement of profits in the trading results of associated enterprises under the provisions of paragraphs 1 and 2 of Article 9, there is ground for considering that they may properly be dealt with through the mutual agreement procedure when determining their amount gives rise to difficulty". Article 25 is formally therefore in point in this context.

32. Article 25 sets out procedures for three different types of mutual agreement. The first is dealt with in paragraphs<sup>1</sup> and<sup>2</sup> of the Article which apply to "taxation not in accordance with the provision of the Convention": here the taxpayer himself initiates the procedure. The other two, which do not necessarily involve the taxpayer, are dealt with in paragraph<sup>3</sup>: the first sentence aims at resolving "difficulties and doubts arising as to the interpretation or application of the Convention"; the second sentence refers to the elimination of double taxation in cases not otherwise provided for by the Convention<sup>6</sup>.

33. Competent authorities may obviously wish to discuss general problems arising in connection with adjustments to transfer prices, but so far as any particular taxpayers are concerned, the most important procedures are probably those in the first category – i.e. discussions about problems in particular cases initiated by the taxpayers concerned.

34. An important limitation of the procedure is that the competent authorities have only a duty to negotiate; they are not required to reach an agreement, nor are they required to implement it when reached and, indeed, they may be unable to do so because of conflicting domestic law – such as that imposing time limits on the adjustment of assessments or on the making of refunds of tax. In the view of MNEs this is a serious weakness in the arrangements.

35. The Commentary to Article 25 of the OECD Model Convention recognises that competent authorities may need some outside help in reaching agreement and it suggests that they may agree to ask the opinion of an impartial third party in a particular case or, where it is a question of the correct understanding of the provisions of the Model Convention, to ask for the views of the OECD Committee on Fiscal Affairs. It does not appear that any use has yet been made of these facilities. Thus, while they remain a potentially valuable means of resolving differences between tax authorities there is no basis in experience for estimating how far they may be useful for this purpose.

36. MNEs practical experience of the operation of the mutual agreement procedure has been, moreover, that it is normally time consuming and uncertain in its results. It may be possible to reduce the amount of time involved in operating the procedure but it is difficult to see how to avoid uncertainty. The outcome of any discussions about a disputed matter must to some degree be uncertain and this is so whether the discussions are part of the process of seeking a negotiated settlement, or of securing a favourable decision, from a tribunal or from an arbitrator. MNEs indicate however, that an additional element of uncertainty arises because, in their view, tax authorities tend to lump together all current cases and to negotiate a general settlement on a very rough and ready basis. Thus, they fear the success of one taxpayer in his specific case may jeopardise the chances of another when States try to reach a global agreement for several open issues in a "broad-brush" approach.

37. This fear is perhaps a consequence of other features of the procedure which have also been criticised, viz. that the taxpayer himself has no rights in the matter beyond the right to initiate the procedure, and that he has in particular no right to be informed of the progress of discussions on his case or to submit his observation upon it.

38. Overall, MNEs consider that owing to the protracted nature of this procedure and the risks involved, most enterprises look at the mutual agreement procedure only as a last resort.

39. Without necessarily accepting, or accepting in full, the strictures of enterprises or other critics of the procedure, it is possible to recognise that the mutual agreement procedure is in certain respects a less than perfect instrument for resolving the problems which may arise in the implementation of double taxation agreements. It is clear that, as the Commentary to Article 25 already points out (in paragraph 42), "the conclusion of a mutual agreement depends to a large extent on the power of compromise which the domestic law allows the competent authorities". It is perhaps necessary to underline the point that the legislatures of many countries may well be unwilling to give the tax authorities the discretion to decide the tax liabilities of individuals or companies by way of agreement with the tax authorities of another country, and that for this reason at least it is understandable that OECD Member countries have not been able to recommend more, in the Model Article 25, than that the competent authorities should be obliged to endeavour to reach agreement in the matters raised under the Article. For the same reasons, therefore, no change in this respect is recommended in this report. The possibility that particular bilateral conventions might contain provisions requiring the competent authorities to reach agreement is already, however, raised in paragraph 25 of the Commentary on the Article (that possibility of course remains open and is further discussed in Chapter IV).

40. Notwithstanding the criticisms which have been made of the mutual agreement procedure, it has been widely recognised as an efficient and flexible instrument in the interpretation, application and development of double taxation agreements and a suitable

means for the elimination of both juridical and economic double taxation<sup>7</sup>. Certainly the experience of tax authorities within the OECD at least, is that, within its limitations, the mutual agreement procedure can be a very useful instrument in resolving difficulties arising in transfer pricing cases and that, up to the present, acceptable compromises have in practice nearly always been found. It does not appear that the experience of taxpayers has been significantly different.

### *Chapter III*

## POSSIBILITY OF MANDATORY CORRESPONDING ADJUSTMENTS SUBJECT TO ARBITRATION

41. It is recognised that the attention of tax authorities to transfer pricing practices and their ability to challenge particular prices has been developed only in comparatively recent years, and that it is possible that the numbers of adjustments made to transfer prices for tax purposes may increase in the future and increase accordingly the incidence of unresolvable disputes between tax authorities about the appropriateness of the adjustments. It seems to the Committee, however, that it would be wrong to exaggerate this possibility; many transfer pricing adjustments have in fact been made and comparatively few have resulted in such disputes. Nevertheless the Committee recognises that the fear of this possibility may be at any rate one important element in the desire of the representatives of MNEs that additional facilities should be provided or changes made in the existing arrangements for resolving inter-governmental disputes about transfer prices, and in particular has given rise to the suggestions which have been made by those representatives that there should be instituted a system of mandatory corresponding adjustments coupled with a formal arbitration procedure for this purpose.

42. From the taxpayer's point of view, it has been suggested, a binding arbitration procedure would have a number of important advantages. If recourse to arbitration was required in the absence of a settlement within a specific period, the taxpayer would be provided with the certainty of a decision and the reduction of delay in bringing the problem before a deciding authority (which, quite apart from avoiding the expense associated with delay, would enable the matter to be dealt with while the relevant information was still comparatively fresh in the minds of those concerned and thus enable it to be dealt with more effectively). These perhaps are the main advantages envisaged. Other advantages which it is suggested could be expected are as follows. The arbitration proceedings themselves could be expected to be expeditious – the absence of any need for administrative or procedural rules, it is thought, would speed the decision-making process. An arbitration process – provided that it allowed the taxpayer a full right to present evidence and arguments – would give the taxpayer the opportunity to deploy all the relevant information and to correct any misunderstandings or misinterpretation of the information by the tax authorities in the course of the argument – taxpayers would thus not need to fear that the result of the process might be distorted by the lack of an opportunity to correct such errors of understanding. The problem could be put before impartial experts who would understand the commercial or industrial situation at the time when the price was fixed and would be particularly able from their experience to interpret the pricing information put before them. Because of this there would be less need for elaborate preparation of the case and the process would thus be less expensive, it has been suggested,

than the preparation of a case for competent authority procedure or for litigation in the courts. In practice, the suggestion has also been made, arbitration decisions could be expected to be based less on a strict interpretation of national pricing rules and regulations than on what the arbitrator considered in the light of his experience to be a fair and equitable solution. Moreover, an arbitration system would obviate any danger that the merits of a taxpayer's case would be ignored and his claim abandoned by a tax authority as an expedient in order to achieve more successful results on behalf of other taxpayers.

43. The support expressed by enterprises for the idea of a compulsory arbitration procedure for the resolution of inter-governmental disputes in the field of transfer pricing has been echoed elsewhere. Although it appears that the idea may not be unanimously supported by MNEs in general, it seemed clear to the Committee that the idea had received sufficient support to indicate that it needed to be given serious consideration.

44. An instance of support given to the idea is provided by the favourable reception given to a Draft Directive of the European Communities by the Assembly of the Communities and by the Economic and Social Committee set up under the Treaty of Rome. This EEC Draft Directive was therefore an important constituent of the evidence before the Committee and to a certain extent guided their thinking on the matter. The Draft Directive would, in brief, provide a mutual agreement procedure between tax authorities designed to relieve any double taxation which might persist in the absence of agreement. The procedure would be initiated by the taxpayer and would require a decision within a certain period, failing which the matter would have to be referred, again within a certain period, to a commission consisting of representatives of the competent tax authorities augmented by members of an independent panel. The taxpayers concerned would have the right to present their case to the commission and argue it before them. The Draft Directive envisages that the taxpayers and the tax authorities would then all be obliged to accept the decision of this commission. The Draft Directive remains as yet a draft however, and consequently it is not possible to draw any firm conclusions from it about how such arrangements would work in practice. It was, moreover, drafted for the particular circumstances of the member countries of the European Communities.

45. Nevertheless, a study of its details was instructive for the Committee. It indicated the problems which need to be solved in designing machinery of that sort and drew the attention of the Committee to a number of difficult questions. There can be no doubt that designing such machinery presents considerable problems.

46. There is the question for example whether it would in practice suffice to set up, as the EEC Draft Directive would do, a machinery which is merely an extension of the mutual agreement procedure – albeit an extension designed to produce a decision within a period of time. It has been argued that it is inappropriate for the tax authorities themselves to be part of the body which decides the issue, and that the taxpayer should be able to put the matter to a completely independent tribunal in which the tax authorities take no part. This approach, however, would leave the tax authorities in an odd situation – effectively a difference of opinion between two tax authorities would be litigated before an arbitrator on the initiative of a third party – admittedly a third party interested in the outcome but still, in the context, a third party and one interested, it is possible, only indirectly in the outcome. The system would need to provide adequately for the interests of both taxpayers and tax authorities and it is not easy to see how that could be achieved with this kind of arrangement.

47. Whatever system was adopted, there could also be the problem of how to deal with the taxpayer's rights of appeal to his own domestic courts. According to one view it would be

inappropriate to allow the taxpayer the right to use the arbitration machinery as well as the domestic courts and thus perhaps have the opportunity of requiring the tax authorities to give him the benefit of whichever decision was most advantageous to him. As a practical matter, as well as to a certain extent one of equity, it could be strongly argued that before invoking an arbitration process the taxpayer should have exhausted or abandoned his domestic rights of appeal. As against this it may also be strongly argued that the taxpayer should not in any circumstances be required to give up his rights under domestic law, and indeed to require him to do so might well create constitutional problems in some countries. A possible compromise might be to allow, as the EEC Draft Directive would allow, some countries to require the taxpayer to exhaust or abandon his domestic legal rights before seeking arbitration, while allowing other countries not to impose such a requirement. Even this solution, however, could leave some problems of balance between the situations of different national tax administrations engaged in an arbitration procedure.

48. Then there is the further question whether the arbitration should be final or whether there should be a further right of appeal – either by way of re-trial of the case, or by way of a consideration of whether the arbitrators carried out their task in a proper manner or whether they could reasonably have reached the conclusion which they did. For some the virtue of arbitration would be its finality, that is to say its certainty and the speed of the decision, and, for those, a further right of appeal would to some extent counteract this advantage and would certainly add to the potential expense of the procedure. But it may also be argued that arbitrators should be subject to some possibility of a check on their activities if taxpayers and tax authorities are to be adequately protected from arbitrary decisions. If a further appeal were accepted as appropriate the question would of course arise of which court should be responsible for hearing and deciding it.

49. Then there would also be the question of what should be the object of the arbitrators. Should it be to relieve double taxation? There is an important general consideration here which needs to be looked at first – if the taxpayer were to be sure of complete relief from double taxation there would be no likelihood that any manipulation of transfer prices on his part for a tax advantage could, if the tax authorities corrected it by a transfer pricing adjustment, result for him in a tax penalty. Some tax authorities would regard this as, at the least, overgenerous and provision might well have to be made to deal with this point.

50. If the relief of double taxation were to be the issue the problem would remain of how to deal with the situation where double taxation did not arise because one or other or both of the enterprises concerned were making losses. There would then be no question, at least immediately, of any double taxation. Of course, where the taxpayer concerned is able to carry taxes forward to another year, double taxation may arise in that year (just as there could be a shift backwards of double taxation if the taxes could be carried backwards). But where the base can be carried forward it is likely to be difficult to foresee precisely whether double taxation will in fact arise. These problems might be avoided if the question for the arbitrators to decide was, instead, to be the amount of the transfer price – i.e. in the simplest form, what was the arm's-length price for the relevant transaction, or perhaps, in a more complicated form, what was the proper method to be adopted of arriving at the arm's-length price. But this, certainly in its simplest form, would narrow down, perhaps unsatisfactorily, the area of the arbitrators' consideration.

51. Connected with this question of what should be the object of the arbitrators is the question of the approach which they should adopt. Should they be mainly concerned to produce a pragmatic result, allowing them perhaps to do this by means of a simple compromise

between the different views expressed, or would it be more satisfactory to require them to operate by analogy with a court of law, seeking to establish which of the claims put forward was the more correct or more in accord with natural justice? The adoption of the first approach might produce a result more quickly and perhaps less expensively than the second and, since the issues in such proceedings are likely to be very largely questions of fact and the relative weights to be given to different pieces of evidence, this could be seen to be a considerable advantage. However, careful consideration would need to be given to the effect which the adoption of such an approach might have on the ability of tax authorities to concede points to each other in attempts to negotiate solutions to such problems between themselves at an earlier stage. It would be most unfortunate if tax authorities feared to make such concessions because of a tendency on the part of arbitration simply to seek a middle way between the standpoints reached by the disputant tax authorities in their unsuccessful negotiations.

52. Then there are also questions concerning how the burden of costs should be borne and how the confidentiality of information produced for the purposes of the proceedings should be preserved.

53. These problems vary in difficulty and importance. They are cited not to suggest that an arbitration procedure is impossible but in order to show that the matter is one which would require much international consideration and co-operation if a satisfactory system were to be set up in which a large number of countries could participate, and that an arbitration procedure must inevitably therefore be a matter which tax administrations would have considerable hesitations about seeking to design even if it was recognised that there was an obvious and urgent need for one.

54. It is not in fact clear, however, that there is an obvious and urgent need for such an arbitration process.

55. At the same time it seems to the Committee that the setting up of such a scheme would involve an unprecedented surrender of fiscal sovereignty. Some Member countries have in fact made it clear already that they would find such a scheme quite unacceptable for this reason<sup>8</sup>.

56. It seems to the Committee that these are conclusive arguments against recommending such a scheme. Nevertheless, the case for an arbitration procedure has been pressed so strongly in some quarters that it seems necessary to expand the comment that the need for it has not been established. It is not in fact apparent that existing arrangements are working so unsatisfactorily that a new form of machinery is imperative. Indeed it seems at present that where there are double taxation agreements very few cases of transfer pricing adjustments lead to adjustments which give rise to unresolvable disputes between the relevant tax administrations or leave the taxpayers suffering significant inequity. It has of course been argued that, up to the present, tax administrations have not in practice made a large number of transfer pricing adjustments but that the growing interest of tax authorities in the transfer pricing of MNEs increases the potential area for disputes of this kind. However, it does not follow that an increased interest by tax authorities will inevitably increase the number of disputes between tax administrations which cannot be resolved. This increase in interest in transfer pricing is paralleled by an increase in the interest of tax authorities in consultation and co-operation between each other which it may be hoped will enable them the more easily to resolve such difficulties as arise in this field. It may be hoped too that the 1979 Report will also help to engender a common approach by tax authorities to these problems, which in itself will reduce the occasion for disagreement between tax authorities.

57. It has also been argued that some problems do in fact arise where the tax authorities of one country take a different view of a transfer pricing matter from that of the tax authorities of the other relevant country, but the problems are not brought to the surface. The argument is that double taxation is accepted by the taxpayer, though unwillingly, in such cases because the existing competent authority or mutual agreement procedures are seen as cumbersome or longwinded or unlikely, for one reason or another, to produce a useful result in a reasonable time. The comparatively small number of problems which in fact come to the surface by way of the mutual agreement procedure, it is argued, is therefore not a true guide to the seriousness of the problem. Factual evidence to support this view is obviously, however, difficult to identify, let alone quantify. It is certainly possible that some potential subjects for discussion under the mutual agreement procedure are not pressed by taxpayers because to do so would raise queries about other aspects of their international activities or would put in question the settlement of other aspects of their tax liability. But if such is the case it must be assumed that the overall result is satisfactory to the taxpayer. Possibly also in some cases the tax reliefs given to a parent company by its own domestic tax law in respect of foreign tax on dividends received from an affiliate or on the profits underlying those dividends, may mitigate the effect of a disagreement between the country of the parent and that of the affiliate about the allocation of profits from transactions between them and, as a result, persuade the parent company that it should not press as hard as it might otherwise press to get the disagreement resolved.

58. The suggestion has been made that if, in the last resort, problems which the mutual agreement system had failed within a certain time to solve could be put to a compulsory arbitration, more use might be made of the mutual agreement procedure and that in those circumstances either a different picture would be revealed of the extent of the problem, or the tax authorities would simply, because of the possibility of arbitration, be prompted to come to an agreed decision in more cases and to do so more quickly.

59. Notwithstanding these arguments, however, the fact remains that little evidence has been produced to show that in the absence of an arbitration system taxpayers are left in any significant number of cases to suffer inequity.

60. Thus the immediate or compelling need for an arbitration system remains, in the view of OECD Member countries' tax authorities, still to be demonstrated.

61. Moreover, the advantages claimed for an arbitration system are not unqualified. Thus, if it were an essential requirement that cases must be considered speedily, this might have to be achieved at the expense of a full and proper consideration of all the issues. The absence of administrative or procedural rules, if this were in fact to be a feature of an arbitration process, and a reliance on the arbitrator's broad general view of what seemed fair, though possibly an advantage in some cases, could in other cases give one or other of the parties the impression that a full opportunity to argue the case had not been allowed or that for some other reason justice had not been done. The opportunity to put matters before independent and impartial experts with experience in the particular field could certainly be useful in some cases, but in the most difficult transfer pricing issues it may well be the case that the difficulties arise because of the special situation of the taxpayer concerned (how, for example, to determine the value of a particular patent which is not readily comparable with any other) and it may not be easy to find an expert in the particular matter who is not also connected in some way with the relevant enterprise.

62. This is not to say that the advantages claimed could not be achieved to some extent but they might only be achieved by accepting some corresponding disadvantages.

63. Bearing in mind the considerations set out above, the Committee does not therefore, for the time being, recommend a compulsory arbitration process for the resolution of disputes between tax authorities about transfer prices or the allocation of profits for tax purposes between the different components of an MNE.

## *Chapter IV*

### POSSIBLE IMPROVEMENTS TO MORE SATISFACTORY USE OF EXISTING ARRANGEMENTS FOR AVOIDING DOUBLE TAXATION

64. It is, in consequence, a matter of some importance in this situation to look carefully at the criticisms which have been levelled at the existing arrangements provided in bilateral tax treaties for dealing with transfer pricing adjustments made by the tax authorities of a treaty partner country, and to consider how, if possible, these criticisms may be met and the system made more satisfactory.

65. In fact, although the Committee offers some comment and suggestions in this context in the paragraphs below, and makes a number of recommendations which ought, in its view, to improve the operation of the existing arrangements, it does not put forward any radical recommendations for change. The matter is, however, one in which practice is developing and it seems to the Committee that it might be kept under periodic review in the future.

66. Some of the criticisms which have been levelled at the existing arrangements for relieving or avoiding economic double taxation have been discussed already to a certain extent in Chapter II. The object of the following paragraphs is to go, in rather more detail, into the problems which would be raised in dealing with these and other criticisms, as well as to touch on a number of related items which have not already been mentioned.

67. But this discussion should be seen in its proper context. As has already been pointed out, there are a variety of ways in which tax authorities may without undue difficulty avoid or relieve the imposition of economic double taxation as a consequence of transfer pricing adjustments. There may, for example, be no difficulty in the one State about accepting a transfer pricing adjustment made by the other in a particular case and consequently no difficulty about using the adjusted price as the basis for the computation of tax liability under its own laws. If there is difficulty, the tax authorities may be able to come to an arrangement, under which the adjustment is modified by the State making it, so as to be acceptable to the other. In many cases the tax authorities will thus come to a mutually satisfactory agreement by employment of the existing arrangements. Moreover, tax authorities will be governed in the making of adjustments or corresponding adjustments by the need to be able to defend their decisions before their own domestic courts or other appeal bodies, and this too should reduce the occasions for disputes with the taxpayer.

68. There are, nevertheless, two aspects of the existing arrangements which need to be considered. One is whether the existing provisions in the OECD Model Convention (Articles 9 and 25) and their bilateral equivalents are adequate or should be changed or expanded. The other is whether the procedures and operation of the Mutual Agreement Procedure as provided by Articles on the lines of Article 25 in bilateral agreements could be improved.

## A. CORRESPONDING ADJUSTMENTS

69. As noted earlier, it has been pointed out as a matter for regret by some critics that "secondary adjustments" are not provided for under Article 9. If double taxation is to be fully relieved it is clearly desirable in theory that where a transfer pricing adjustment is made in one State the relief provision should so far as possible take account of both the primary and the secondary consequences of the adjustment. The current absence, however, of any general consensus as to what secondary adjustments are permissible or how relief should be given to take account of them makes it difficult to suggest how this may be done and, in the absence of any indication that many serious problems arise in this area which in practice are not satisfactorily resolved, no change is recommended here. The Committee considers, however, that it would be useful to return to this subject at some time in the future when practice in such matters has developed further.

70. It is necessary to consider also the question whether Article 9 of the Model goes far enough in the obligation which it imposes on treaty partners to make a primary corresponding adjustment. As paragraph 3 of the Commentary on Article 9 points out "an adjustment is not automatically to be made in State B simply because the profits in State A have been increased: the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words, the paragraph does not seek to avoid a double charge to tax which arises where the profits of one associated enterprise are increased to a level which exceeds what they would have been if they had been correctly computed on an arm's-length basis. State B is therefore committed to make an adjustment of the profits of the affiliated company only if it considers that the adjustment made in State A is justified both in principle and as regards the amount". Clearly it would be unacceptable to commit State B to provide an automatic corresponding adjustment, whether or not it considered that the adjustment made in State A was justified in principle and amount, since this would be tantamount to requiring State B to give State A a blank cheque. (The Committee took the view moreover, that Article 9(2) did not in fact impose any obligation to match a corresponding adjustment where the original adjustment was made to correct the deliberate manipulation of a transfer price by the enterprise for the purpose of gaining a tax advantage.) Some possible protection for State B might be provided if the Contracting States were able to agree in some detail in their bilateral arrangements on rules about the way in which to ascertain arm's-length prices in particular cases – by for example agreeing on safe haven rules in specific kinds of case. In this way they might be reasonably assured that the result of accepting the other State's adjustments would be broadly equitable. Arrangements of this sort would be bound, however, to be a compromise and it would be difficult to devise them in such a manner that they did not conflict with the arm's-length principle itself. The Committee does not, therefore, recommend any change in Article 9(2) of the Model or in the Commentary on that Article.

## B. MUTUAL AGREEMENT PROCEDURE

71. A second aspect of this enquiry must clearly be to what extent the mutual agreement procedure can be improved. Some of the criticisms, it will be obvious in the light of preceding paragraphs, cannot be met. There is no way of forcing the competent authorities to come to an

agreed decision short of requiring them to submit to the decision of a supra-national authority and for the reasons already expressed this is not regarded as recommendable. Similarly they cannot otherwise be compelled to reach a decision by a certain time. But there may nevertheless be some scope for facilitating the reaching of agreement and for speeding up the process.

72. The aspects of the mutual agreement procedure discussed below concern in the first instance the resolution of specific transfer pricing cases. The extent and operation of Article 9(2) of the OECD Model Convention may be in point. But so may the extent and operation of Article 25. This is an area where some tax authorities feel that clarification may be desirable to enable taxpayers and tax authorities to know more certainly what may be done in this context and it has therefore been the subject of consideration by the Committee.

#### **1. Clarification of the scope of Article 25 of the OECD Model Double Taxation Convention**

73. The mutual agreement procedure provided by Article 25 is concerned with actions of the Contracting States which the taxpayer considers may or will result in taxation not in accordance with the provisions of the Convention. Thus, under a bilateral convention containing an article on these lines, the question whether a mutual agreement procedure can be undertaken depends on whether the action complained about may, or will, result in taxation not in accordance with the provisions of the convention. The Committee has come to the following conclusions.

74. When a convention contains provisions similar to those of paragraph 2 of Article 9 of the OECD Model Convention, those provisions relieve economic double taxation of profits by requiring a State which has collected excessive tax, as a consequence of transfer prices in dealings with a company of that State, to make a corresponding adjustment to the profits of the company, insofar as they were unjustifiably high. To that extent, taxation initially imposed by that State is "not in accordance with the convention" and the taxpayer is entitled, under the provisions of Article 25, paragraphs 1 and 2, to present his case to the competent authority of the State of which he is a resident (see paragraph 9 of the Commentary on Article 25), within three years from the first notification of the most recent decision or action (cf. paragraph 17 of the Commentary on Article 25). The competent authority which the taxpayer applies to is under the obligation to approach the competent authority of the other State, if the objection appears to it to be justified and it is not itself able to arrive at a satisfactory solution. The mutual agreement procedure therefore provides competent authorities with an adequate legal framework for consultation when the difficulty in determining the profit is due to difficulty in reaching agreement on the appropriate transfer price. In fact, consultation in such cases is expressly provided for in the second part of the last sentence of Article 9, paragraph 2, which, by itself, allows competent authorities to consult directly. Even when paragraph 2 of Article 9 does not include the second part of the last sentence, the mutual agreement procedure, as provided for under Articles 25, paragraph 1 and 2, should apply.

75. The matter is less clear where the convention does not contain the equivalent of Article 9, paragraph 2. However, a number of countries have observed that, in substance, paragraph 1 of Article 9 does not, in itself, fulfill any necessary function, as it only formulates rules which already exist, in broadly similar language, in most domestic laws, which can be applied without conflicting with any provision of the convention, even where the convention

does not contain any Article 9. Following this line of thinking, the inclusion of Article 9 (paragraph 1) in a convention would demonstrate the contracting parties' wish to cover economic double taxation in the convention. As a consequence, any economic double taxation arising from the adjustment of transfer prices would not be in accordance with – at least – the spirit of the convention, and would fall within the scope of the provisions of the mutual agreement procedure, under Article 25, paragraphs 1 and 2.

76. Some countries do not, however, share this view: according to a literal interpretation, they consider that, when Article 9 does not contain any paragraph 2, no provision in the convention imposes a requirement on the State which has included in its tax base profits unduly transferred to a company which is a resident of that State to revise its assessment in order to exclude such excess profits; taxation of such profits is therefore not contrary to the convention, and paragraphs 1 and 2 of Article 25 do not apply; strictly speaking, the taxpayer is accordingly not entitled to have his case reconsidered and he may not invoke the three-year time limit provided in Article 25, paragraph 1. Usually, such States, however, have the possibility of reconsidering a taxpayer's position, in case of economic double taxation, either on the basis of domestic provisions or by the exercise of discretionary power which some tax authorities possess to relieve the most severe cases. Such procedures are more flexible and do not always give to the taxpayers a formal right to submit claims; in practice, they help to alleviate double taxation in all cases when there is no doubt about the good faith of the companies concerned.

77. On the other hand, paragraph 3 of Article 25 of the Model would allow the competent authorities to consult about the elimination of double taxation in cases not provided for in the Convention and this may be sufficient authority, for at least a few countries, to consult on particular cases of transfer pricing adjustments.

78. Some States have to some extent clarified the issue in their bilateral agreements by providing specifically, in the text of the equivalent of Article 25, that the mutual agreement procedure may be used for the resolution of problems of interpretation or application of the Convention related to transfer pricing. However, this is usually done in bilateral conventions containing provisions similar to Article 9(2) of the Model.

79. In order to avoid any doubt in cases where a convention does not contain provisions similar to those of paragraph 2 of Article 9, an additional paragraph should be inserted after paragraph 9 of the Commentary on Article 25 when the OECD Model Convention is next revised. The paragraph might read as follows:

“When the convention between two Contracting States does not contain rules similar to those of Article 9, paragraph 2 (as is usually the case for conventions signed before 1977) the mere fact that contracting parties inserted in the convention the text of Article 9, as limited to the text of paragraph 1 – which usually only confirms broadly similar rules existing in domestic laws – indicates that the intention was to have economic double taxation covered by the convention. As a result, most members of the Committee on Fiscal Affairs consider that economic double taxation resulting from adjustments made to profits by reasons of transfer pricing is not in accordance with – at least – the spirit of the convention and falls within the scope of the mutual agreement procedure set up under Article 25. States which do not share this view do, however, in practice, find the means of remedying economic double taxation in most cases involving bona fide companies by making use of provisions in their domestic laws.”

## 2. Procedural aspects

### a) *Time limits and the time factor*

#### i) *Time limits*

80. An important difficulty in practice with the mutual agreement procedure seems to arise from time limits and the amount of time taken generally before agreement is reached.

81. It may be convenient to take first the question of time limits. The date beyond which no alteration can be made to a taxpayer's liability for a particular period may be reached in one country before the taxpayer can establish the need for an adjustment corresponding to that made to an associate's liability in another country. However, there must obviously be some limit to the period during which claims to relief may be made. Tax liability must become final at some stage or there would be no certainty for the tax authorities or indeed for taxpayers. But the existence of such time limits and the fact that they vary from country to country does mean that in order to minimise the likelihood of unrelievable double taxation their potential impact needs to be borne in mind. Thus, if it is possible for a tax authority in one country to adjust a transfer price ten years after the end of the year in which the transaction took place and the tax authorities of the country of residence of the relevant associated enterprise have long ago finalised the computation of that enterprise's taxable profits, they may well be legally unable to make a corresponding adjustment.

82. The solution which is suggested in Article 25 of the Model Convention is that an agreement reached by the mutual agreement procedure should be implemented regardless of any time limits in the domestic law of the Contracting States. Thus if the mutual agreement procedure is invoked and results in agreement to make a corresponding adjustment it would be possible to do this regardless of any time limits in the relevant Contracting State, and the invocation of the mutual agreement procedure could overcome any difficulty arising in this way from the domestic time limits. If all countries could accept this, as some in fact do, then time limits would present less of a problem in this context. But a number of countries have reservations about overriding their domestic time limits in such a way.

83. Where a provision on these lines is not included in a bilateral treaty it would be necessary, in order to minimise the obstacles provided by time limits, for the discussions between the tax authorities to begin before any relevant time limits have run out and for those time limits to be effectively suspended until the discussions have been concluded. This in its turn indicates the need, in the circumstances, for tax authorities to consider the making of any transfer pricing adjustment at the earliest possible stage.

84. The suggestion has indeed been made that problems arising from time limits and the time lag between transactions and the adjustment of the relevant transfer prices might be avoided or at least reduced by the introduction of provisions into bilateral agreements which would prohibit the making of such adjustments after the expiry of an agreed period. This would be unacceptable to many countries. Tax authorities may need a long time to make the necessary investigations to establish the necessity and extent of an adjustment, and the indications even that an adjustment is necessary may only be brought to their notice late in the day. It would be difficult for many tax authorities to close their eyes to the need for an adjustment, however, late in the day this need became apparent, provided that they were not prevented by their domestic time limits from making it. Nevertheless, where there was

sufficient compatibility between the relevant time limits and other relevant elements (such as the procedure for imposing liability and the appeals system) in the tax structures of two Contracting States to ensure that this arrangement did not impose unequal sacrifices on one or other of the two States, it might prove to be a useful and acceptable expedient and some countries have apparently found it so. However, it does not seem to the Committee to be a suitable matter for a general recommendation.

85. Leaving these particular questions aside, the Committee does, however, recognise that it is desirable in principle to operate the system so as to minimise as far as possible the obstacles to the relief of double taxation which may result from the impact of time limits.

86. Article 25 of the Model Convention requires the taxpayer to invoke the mutual agreement procedure within three years from the first notification of the action complained of. This time limit does not itself create a great deal of difficulty (although some States consider that it provides too short a period for invoking the procedure while other have entered reservations against Article 25 because they regard it as allowing too long a period). The main difficulty in this context is in deciding what is the date of modification. As stated in the Commentary (paragraph 17), the time limit runs from the first notification of the most recent decision or action. It is desirable that tax authorities should take early steps to give the taxpayer clear formal notification of a proposal to make an adjustment if it seems that it is likely to provoke a request to another country for a corresponding adjustment.

87. The consideration of problems arising from time limits suggests in fact that, in order to minimise the possibility that time limits may prevent the mutual agreement procedure from effectively ensuring the relief or avoidance of double taxation, the procedure should be invoked at the earliest possible stage, that is to say as soon as an adjustment is seriously, even if only tentatively, proposed. If this were done, the process of consultation could be begun before any irrevocable steps were taken by either tax authority, with the prospect, therefore, that there would be as few procedural obstacles as possible in the way of achieving a mutually acceptable conclusion to the discussions.

88. Not all competent authorities would, even so, wish to be involved at so early a stage in practice. A proposed adjustment may not result in final action and even a concluded adjustment may not trigger a claim for a corresponding adjustment. Consequently too early an invocation of the mutual agreement process may create unnecessary work.

89. Nevertheless, on balance the Committee recommends that competent authorities should be prepared to enter into discussions under the mutual agreement procedure at as early a stage as is compatible with the economical use of their resources.

## *ii) The time factor generally*

90. On the more general point that the mutual agreement procedure may turn out to be an unsatisfactorily lengthy one, the Committee recognised that international consultations in these sometimes very complex matters could very often take a long time. The occasion for the relevant officials to meet must inevitably be restricted by the long distances which may have to be travelled, correspondence is often an unsatisfactory substitute for face to face discussions, there are language difficulties, differences in procedures and legal and accounting systems to be understood and taken into account and so on. The problem may also be complicated in itself and delays provoked because the taxpayer is slow to provide necessary information – obviously if he has invoked the mutual agreement procedure he will usually be ready to provide

information bearing directly upon the point, but for a full understanding of the transfer pricing situation of an enterprise, and thus for a fully satisfactory solution of the problem, the tax authorities may need more than this, and MNEs are often slow to provide information of this wider kind. It would, on the other hand, be wrong to assume that delays were always a feature of the procedure. In practice the consultations often result in a settlement of the problem in a relatively short time and it may be hoped that developing experience in such consultations may itself speed matters for the future.

91. Nevertheless, the Committee agreed that every effort should be made by tax administrations to seek to avoid delays in these matters, and to improve their practice insofar as their resources permit.

92. One way of doing this would be to encourage face to face or telephone discussion between competent authorities, to supplement the written procedures, which may inevitably be rather lengthy. Such personal contacts can often more quickly establish whether an adjustment by one country is likely to give rise to difficulty for another and can often more quickly resolve any such difficulties, and, although in themselves they may obviously be expensive, they may, if used judiciously, settle complicated matters more quickly and thus less expensively in the long run. The Committee thus recommends the development of these forms of co-operation.

93. The OECD's work on exchange of information for the purposes of preventing avoidance and evasion should be useful for improving the co-operation of tax authorities for this purpose as well, both on a bilateral and possibly in suitable cases on a multilateral basis. It seems likely that an increased willingness on the part of tax authorities to solve transfer pricing problems (and others) in oral discussion with each other and to adopt as flexible an approach as possible to the search for compromise would remove much of the delay and difficulty of which the MNEs have complained. In this context the technique of "simultaneous examination" which is currently being developed by some countries may help in suitable cases. This is a process by which the tax authorities of two countries engaged in the examination of the tax affairs of associated enterprises separately within their own jurisdictions can co-ordinate their examinations, using the exchange of information provisions in the relevant double taxation agreement so as to establish more effectively and economically the facts about such matters as the transfer pricing of transactions between the enterprises. In the process, differences in approach which might lead to double taxation can be identified and discussed at an early stage and, it may be hoped, be more readily reconciled. Moreover, such arrangements will 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. (The question whether the technique is suitable for adoption in any particular case would need, however, to be carefully considered before embarking upon it.)

#### **b) *Delegation of powers and joint consultation***

94. The mutual agreement procedure has generally been regarded as a matter of consultation between high level officials of the relevant tax authorities. The reasons for this are sound; the fewer officials that are involved, the greater the likelihood of ensuring a consistent approach and the confidentiality of taxpayer information. Indeed, without the supervisory control of experts in a central position there would be some real danger of inconsistent decisions and, in consequence, of failure to achieve equitable results. Notwithstanding this need for central control there remains, however, the possibility of speeding up

procedures by some delegation of the discussions to officials at a lower level (if the detailed examination of the taxpayers' transfer pricing is in fact in their hands) provided that the relevant exchanges of information are adequately controlled by the responsible competent authorities.

95. The experience of a number of countries shows that this can be a useful expedient once a mutual agreement procedure has been initiated between the competent authorities. For example, the following procedure has been practised successfully between some countries. The competent authorities in these cases have asked their case officers in the field to prepare a joint report on the case under investigation on, *inter alia*, the following lines: they are required to establish the facts and co-ordinate their findings so that both countries will base their decisions on the same facts and circumstances; they are then required to specify those questions of law (if any) on which the reporting authorities disagree, and, where problems of evaluation are involved, set up agreed lower and upper limits for the appropriate price, 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 central competent authorities have been satisfactorily achieved. This kind of procedure may not be appropriate in all cases but the Committee sees it as a useful technique which in the right situation may help to bring the competent authorities to a speedier decision. The Committee therefore recommends that in appropriate circumstances and under suitable controls competent authorities should be prepared to delegate some part of competent authority discussions on transfer pricing matters to the case officers concerned.

### c) *Taxpayer participation*

96. It has been suggested that taxpayers should have the right to submit a request for the mutual agreement procedure to be instituted and that the request should not be unreasonably denied. Paragraph 21 of the Commentary on Article 25 of the OECD Model Double Taxation Convention makes it clear that this follows from the inclusion of an article on the line of Article 25 in a bilateral tax agreement. The Committee fully endorses this interpretation<sup>9</sup>. The Committee was, however, presented with no evidence to suggest that such requests were in practice being unreasonably denied.

97. It has been argued that the taxpayer should have a right to take part in the mutual agreement procedure, and that he should have the right at least to present his case to both competent authorities, and to be informed of the progress of the discussions, and, some representatives of industry have suggested, he should also have a right to be present at face to face discussions between the competent authorities. The object would be to ensure that there was no misunderstanding by the competent authorities of the facts and arguments which are relevant to his case. The suggestion is based on the view that the mutual agreement procedure is a process resembling litigation and that in litigation affecting his interests the taxpayer would have a right to be heard.

98. The mutual agreement procedure envisaged in Article 25 and adopted in many bilateral agreements on the OECD pattern is not, however, a process of litigation between the taxpayer and the competent authorities: for such disputes the domestic courts are the appropriate forum. The mutual agreement procedure is (unless there is specific provision to the contrary in the relevant law of the countries concerned) simply a process of discussion between the competent authorities in which they seek to explore the possibility of a solution to the relevant problem which can be accepted by all concerned. If it is only possible to find a

solution which is acceptable to the tax authorities the taxpayer may still have the opportunity to achieve a solution more satisfactory from his point of view by invoking the domestic appeal systems of one or other of the States concerned. The taxpayer will not, however, necessarily have an interest in every case. It might well be, for example, that the essential issue in the discussions is simply one of which country should tax and which should give relief for the tax, with the result being effectively the same whatever happens for the taxpayer or, in the case of an MNE, for the taxpaying group. Formal rights for the taxpayer to appear and be heard in the discussion between the competent authorities would therefore, in the view of the Committee, be out of place.

99. On the other hand if the procedure is to be useful and effective it would be sensible for the taxpayer to give the competent authorities all the information which is relevant to the issue and for the tax authorities to allow him every reasonable opportunity to present the relevant facts and arguments to them and to ensure as far as possible that the matter is not subject to misunderstanding.

100. In practice, it appears, taxpayers normally are given such opportunities, are kept informed of the progress of the discussions and are often indeed asked during the course of the discussions whether they can accept the settlements envisaged. The Committee recommends that these practices should be adopted as widely as possible. They would see no objection in principle moreover, in any case where this was convenient and appropriate and agreeable to both competent authorities, to allowing the taxpayer to present his case to them together at a joint meeting.

101. It has been pointed out that in many cases an MNE faced by the problems created by an adjustment of its profits in one State which has an effect on the tax liability of another part of the MNE in another State, has been able to resolve these problems by its own efforts. In fact, it seems likely that an MNE, when faced with an adjustment in State A which might require a counter-adjustment in State B, would thereupon examine the question of such a counter-adjustment under the laws of country B, make appropriate arrangements and seek to settle the case eventually by negotiations with the tax authorities of that State. There are obvious advantages in this procedure and Member country tax administrations would generally wish to encourage MNE's to seek to resolve their problems in this way before pressing for a formal mutual agreement procedure<sup>10</sup>.

102. They would no doubt be so encouraged if each tax administration were prepared to notify a resident affiliate of an MNE, at an early stage, of the intention to adjust its profits, and to discuss with the domestic entity of an enterprise which has received such a notification in another country the problems connected therewith, including the possibilities of a counter-adjustment. In this way a taxpayer which was part of an MNE would have time to inform the relevant affiliate in the group, or the headquarters of the group, which could then take steps to settle the case before irrevocable decisions were made in the adjusting country. The adjusting administration would then have less reason to fear that it would have to face a future demand for a mutual agreement procedure. This would facilitate procedures both for the MNE and the administrations concerned.

103. The obverse of this problem, however, is that a failure on the part of an MNE in one country to advise its affiliate in another country that it proposes to accept an adjustment proposed by the tax authorities of the first country may leave the tax authorities of the second country in difficulty if they come somewhat later to the issue and disagree with the adjustments. They may have to consider refusing relief for any additional tax involved or

asking the tax authorities of the first country to upset a settlement which they have made with their own taxpayer. It would help to avoid this situation if those tax authorities contemplating the making of a significant transfer pricing adjustment which might have this kind of consequence were to alert their partner tax authority in adequate time. But if the taxpayer wishes to avoid double taxation it must be his responsibility to take the necessary steps.

104. It should be clearly understood, however, that a taxpayer, in negotiation with the tax authorities of one country, cannot speak for tax authorities of another (unless he is specifically empowered to do so). It is not intended in these paragraphs to suggest that the taxpayer should in any way be empowered to act for a tax authority.

**d) *Package deals***

105. The Committee has seen no evidence that taxpayers have in practice suffered injury as a result of "package deals" between tax authorities in the course of which complaints put through the competent authority procedure are settled, not on the merits of each individual case, but on the basis of a balance of interest between the competent authorities themselves. Nevertheless, since it is clear that this result is feared by taxpayers, the Committee records the view that competent authority cases should each be settled on their own individual merits and not by reference to any balance of the results in other cases.

**e) *Unilateral information procedures***

106. It has been suggested that it would be helpful to taxpayers, enabling them to make more satisfactory use of the competent authority procedures, if competent authorities were to develop and publicise their own domestic rules or procedures in this field, so that taxpayers may more readily understand what they can do and how to go about it. This could also be helpful to tax authorities especially if they are faced with the possibility of a large or growing number of cases in which mutual agreement with other tax authorities may be necessary or desirable, possibly saving them the need to answer a variety of enquiries or work out procedures afresh in every case.

107. In publicising such rules and procedures it could, for example, be made clear how the taxpayer may bring a problem to the attention of the competent authority in order to start off 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 some indication of the way in which the competent authorities would normally approach the question of transfer pricing adjustment and corresponding adjustments and how they would normally handle such cases. The Committee recommends that this possibility should be explored unilaterally by competent authorities, and that, where appropriate, descriptions of their rules and procedures should be given suitable domestic publicity.

108. Unilateral rules or guidelines governing the operation of the procedure by one competent authority would not require agreement by the other competent authority, since they would be limited in effect to the competent authority's domestic relationship with its own taxpayers. However, it would seem appropriate to communicate such unilateral rules or guidelines to the competent authorities of the other countries with which mutual agreement procedures are usually entered into.

### 3. Other suggestions

109. A number of other suggestions which have been made for the improvement of the mutual agreement procedure under double taxation agreements should also be referred to in this report.

110. One is that the procedure should not be used to review other tax matters not directly connected with the subject of the procedure. The Committee could not accept this as a general rule. Obviously it is easier for the mutual agreement procedure to be operated, both by taxpayers and by tax authorities, if the issues involved are narrowed down as far as possible. But it would be absurd if a request to a tax authority to initiate the mutual agreement procedure on one particular aspect of the taxpayer's affairs were to prevent the tax authorities from examining or exchanging information about other aspects of the taxpayer's affairs.

111. Another suggestion is that, if double taxation has occurred as the result of a court decision, this should not prevent the mutual agreement procedure from being operated or agreements which might be reached under it from being implemented. Again no evidence was produced to the Committee to indicate that this was a widespread problem demanding an urgent solution. The problem here is similar to that arising where time limits prevent the effective operation of the procedure, that is to say the objection in many countries to the substitution of the decision of officials for the domestic law as laid down in the statutes or as decided by the courts. If it is possible for agreements reached under the mutual agreement procedure to override the domestic law then clearly this will facilitate the operation of the mutual agreement procedure in some cases. But the Committee makes no recommendation on the point. The problem can, however, as with the time limit problem, be minimised perhaps if, supposing that the taxpayer concerned is not himself in a position to invoke the mutual agreement procedure, he can alert his associates in the other country, in adequate time, to the possibility that a court decision will affect a potential transfer pricing issue so that they can invoke the procedure at their end. Tax authorities may also consider it to be useful to alert the relevant treaty partner tax authorities if there is a significant chance that a court decision will provoke as a consequence a request for a mutual agreement procedure.

112. A connected suggestion which has also been made is that a taxpayer should not be obliged, as a condition of instituting the competent authority procedure, either to invoke the domestic remedies which are available to him or to have exhausted them. The Committee would not suggest that the legal remedies available to a taxpayer should be exhausted before his case was taken up for discussion under the mutual agreement procedure. Clearly this requirement would mean that in many cases there would be a possibility of conflict between the outcome of the mutual agreement procedure and the outcome of the domestic appeal proceedings with the result that the agreement reached by the competent authorities could not be implemented. So long as the domestic appeal proceedings are not finalised and can be abandoned or concluded by a compromise settlement there should be no difficulty about allowing them to continue parallel with discussions under the mutual agreement procedure. If no agreement results then in each country tax authority and taxpayer each have an equal chance before the domestic courts. (The situation where binding arbitration proceedings were in point would be different: here there would be a question of two different bodies both considering the same issue, and both having power to make a decision binding on the tax authorities but possibly leaving the taxpayer free to choose the one most favourable to him.)

113. The suggestion that taxpayers should not be required to invoke their domestic remedies as a condition of invoking the mutual agreement procedure is not one which permits easy acceptance. In some countries it would be necessary for the domestic appeal provisions to have been invoked, and for the appeal to be kept open, in order that the mutual agreement procedures could usefully operate at all. The Committee agrees nevertheless that it is desirable to keep to a minimum the formalities involved in the operation of the mutual agreement procedure and to eliminate any that are really unnecessary.

114. It has been suggested also that the result of consultations under the mutual agreement procedure and the general rules applied in specific taxpayers' cases should be published provided that the confidentiality of the relevant taxpayers' affairs was safeguarded. This is a possibility which may be worth further consideration at some time in the future. At present it seems that most cases have to be decided so much by reference to their own facts that it would be difficult to publish the details without breach of confidentiality and that little useful guidance would be provided by their publication in any event. However, as experience is gained by tax authorities in these matters it might well be useful for competent authorities to include, in any material publicising their domestic rules, procedures and guidelines in this field, not only some indication of the broad principles adopted by the competent authorities in the actual cases which have come before them, but possibly some indication of the limits within which it is necessary for them to work because, for example, of the incidence of other countries' tax laws (including time limits) or because of the availability or otherwise of evidence of prices and perhaps some indication of the relative usefulness of the methods which have had to be adopted in arriving at arm's-length prices, etc. The Committee recommends that this possibility should be borne in mind.

## Chapter V

# CONCLUSIONS

### A. GENERAL CONCLUSIONS

#### 115. a) *General comments on corresponding adjustments*

- i) The responsibility for minimising as far as possible the likelihood of double taxation arising from transfer pricing adjustments is in the first place that of the MNE itself, which should, at any rate for tax purposes, arrange its' transfer prices to conform with the arm's-length principle;
- ii) Nevertheless, the Committee recognises the desirability in *bona fide* cases of ensuring as fully as possible the relief of any double taxation, whether juridical or economic, which would follow from adjustments to transfer prices made to bring them into conformity, for tax purposes, with the arm's-length standard;
- iii) It fully endorses, however, the view expressed in paragraph 3 of the Commentary on Article 9 of the OECD Model Double Taxation Convention that a State should not be committed to make an adjustment to conform to that made by another State except when it can agree that the original adjustment was correctly computed on an arm's-length basis<sup>11</sup>;
- iv) On the other hand, the Committee recommends that tax authorities should do all they can to reach agreement on disputed transfer pricing adjustments or corresponding adjustments in order that double taxation should not persist where it could, by agreement, be eliminated.

#### b) *The mutual agreement procedure*

- i) The Committee regards the existing mutual agreement procedure provided by Article 25 of the 1977 OECD Model Convention as being a useful and, in general, very effective machinery for resolving disputes between tax authorities in this field as in others, notwithstanding the criticisms which have been levelled at it;
- ii) The Committee recommends, however, for the avoidance of doubt, that it should be made clear, by an addition to the Commentary on Article 25 of the Model Convention, that this Article provides machinery to enable competent authorities to consult with each other with a view to resolving, in the context of transfer pricing problems, not only problems of juridical double taxation but also those of economic double taxation.

### *c) Compulsory arbitration*

The Committee does not, for the time being, recommend the adoption of a compulsory arbitration procedure to supersede or supplement the mutual agreement procedure. In its view the need for such compulsory arbitration has not been demonstrated by the evidence available and the adoption of such a procedure would represent an unacceptable surrender of fiscal sovereignty.

## **B. POSSIBLE PRACTICAL IMPROVEMENTS TO THE MUTUAL AGREEMENT PROCEDURE**

116. The following summarises the proposals made by the Committee:

- i)* The Committee regards it as important that the duty imposed on tax authorities, by an Article on the lines of Article 25, to set in motion the mutual agreement procedure if it appears to the competent authority that the taxation complained of is due wholly or in part to a measure taken in the other State<sup>12</sup> should be implemented as quickly as possible once the obligation is made clear, and that an application to set the mutual agreement procedure in motion should not be rejected without good reason;
- ii)* The Committee endorses the view that the adoption, in bilateral agreements, of the last sentence of paragraph 2 of Article 25 of the Model Double Taxation Convention – viz. “Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States” – would eliminate a wide range of problems. It recognises, however, as does the Commentary on Article 25, that some States are not, on constitutional and other legal grounds, able to override the time limits in their domestic law. In general therefore the Committee recommends that every effort should be made by tax administrations to ensure that as far as possible the mutual agreement procedure is not in any case frustrated by operational delays or, where time limits would be in point, by the combined effects of time limits and operational delays;
- iii)* The Committee in particular draws attention to the value, in transfer pricing matters, of ensuring as early and as full communication as possible on all relevant matters between tax authorities and taxpayers within their domestic jurisdiction and, across international frontiers, between the relevant associated enterprises themselves and the tax authorities concerned. Thus the Committee recommends that tax administrations should be prepared at as early a stage as possible to notify taxpayers of the intention to make a transfer pricing adjustment (and, where the date of any such notification may be important, to ensure that a clear formal notification is given as soon as possible);
- iv)* The Committee recommends that competent authorities should communicate with each other in these matters in as flexible a manner as possible, whether in writing, by telephone, by face to face or round the table discussion, whichever is most suitable, and should seek to develop the most effective ways of solving relevant problems by the use, where appropriate, of simultaneous examination procedures, the controlled delegation of functions to case officers, and such other techniques as are suitable for the purpose;

- v) The Committee recommends that in the course of mutual agreement proceedings on transfer pricing matters, the taxpayers concerned should be given every reasonable opportunity to present the relevant facts and arguments to the competent authorities both in writing and orally, and, where this is convenient and appropriate and agreeable to both competent authorities, to do this in the course of a joint meeting of the competent authorities;
- vi) The Committee recommends that the formalities involved in instituting and operating the mutual agreement procedure should be kept to a minimum and any unnecessary formalities eliminated;
- vii) The Committee emphasizes the view that mutual agreement cases should each be settled on their individual merits and not by references to any balance of the results in other cases;
- viii) The Committee recommends that competent authorities should, where appropriate, develop and publicise domestic rules, guidelines and procedures relating to the use of the mutual agreement (or competent authority) procedure.

### C. FINAL REMARKS

117. The Committee proposes to keep under periodic review the question of how the effectiveness of the arrangements for corresponding adjustments and the use in this context of the mutual agreement procedure may be adapted to meet the needs of changing times or otherwise improved, and to return in the light of developing experience to the consideration of how secondary adjustments should be dealt with.

## NOTES AND REFERENCES

1. *Transfer Pricing and Multinational Enterprises*: report of the OECD Committee on Fiscal Affairs, 1979, hereinafter referred to as *the 1979 Report* or *the Report*.
2. The term "economic" double taxation is thus contrasted with "juridical" double taxation which is the taxation by two States of the same income or profits in the hands of the same juridical person.
3. This was recognised in the Commentary on the 1963 OECD Model Double Taxation Convention (paragraph 4 of the Commentary on Article 25, last sentence). The point was not repeated in the Commentary on the 1977 Model Convention but it remains valid.
4. See paragraphs 5 and 6 of the Commentary on Article 9 of the 1977 OECD Model Convention where an example is given and it is noted that the making of secondary adjustments would depend on the facts of the individual case.
5. In this context, however, it is also relevant to say as in footnote, to paragraph 7 of the 1979 Report, that whereas the principle of arm's-length pricing is valid also for the taxation of permanent establishments, the considerations in this report need to be applied with care to the taxation of permanent establishments because of the special factors involved (for example, because of the limitations normally recognised on the acceptability for tax purposes of loan or royalty contracts between permanent establishments and the remainder of the enterprise of which they form part – see Commentary on Article 7 of the 1977 OECD Model Double Taxation Convention, and the report on the taxation of multinational banking enterprises contained in this publication).
6. These three provisions are sometimes described as the "specific case provision", the "interpretative provision" and the "legislative provision" respectively (see *British Tax Review*: "The legal nature of the mutual agreement procedure under the OECD Model Convention" 1979, page 333, *et seq* and 1980 page 13 *et seq*).
7. For example, Resolution of the International Fiscal Association, September 1981.
8. It has been pointed out that tax authorities, by entering into treaties for the relief of double taxation, have already to some extent surrendered their taxing rights over taxpayers affected by the treaties. But the OECD Model Double Taxation Convention does not provide for decisions on matters of the tax liability of particular taxpayers arising out of the treaty to be imposed upon the tax administrations of the partner countries by a supra-national body.
9. Paragraph 21 of the Commentary on Article 25 reads as follows:  
"If, however, it appears to that competent authority that the taxation complained of is due wholly or in part to a measure taken in the other State, it will be incumbent on it, indeed it will be its duty – as clearly appears by the terms of paragraph 2 – to set in motion the mutual agreement procedure proper."
10. Suggestions to this effect have in fact been incorporated in the guidelines of Germany and the United States.
11. The relevant passage reads as follows:  
"3. It should be noted, however, that an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words, the paragraph does not seek to avoid a double charge to tax which arises where the profits of one associated enterprise are increased to a level which exceeds what they would have been if they had been correctly computed on an arm's-length basis. State B is therefore committed to make an adjustment of the profits of the affiliated company only if it considers that the adjustment made in State A is justified both in principle and as regards the amount."
12. Paragraph 21 of the Commentary on Article 25 of the 1977 Model Convention.

*Annex*

EXTRACTS FROM THE 1977 OECD MODEL DOUBLE TAXATION CONVENTION  
ON INCOME AND CAPITAL

*Article 9*

ASSOCIATED ENTERPRISES

1. Where:

- a) An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or;
- b) The same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State;

and in either case conditions are made or imposed between the two 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.

2. Where a Contracting State included in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

*Article 25*

MUTUAL AGREEMENT PROCEDURE

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs. When it seems advisable in order to reach agreement to have an oral exchange of opinions, such exchange may take place through a Commission consisting of representatives of the competent authorities of the Contracting States.

# THE TAXATION OF MULTINATIONAL BANKING ENTERPRISES

## INTRODUCTION

1. The Report of the OECD Committee on Fiscal Affairs on transfer pricing and multinational enterprises (referred to subsequently in this report as "the 1979 Report") made it clear, in its chapter on loans, that it did not deal with loans between enterprises engaged in banking or financing activities as part of their regular business (paragraphs 181 and 198). Interest income and interest expense account for a substantial share of the total revenue and expenditure of an international bank and accordingly it was recognised that for such enterprises the treatment of interest for tax purposes required special consideration. The purpose of this report is to supplement the 1979 Report in that connection.

2. It is necessary to put the matter in perspective, to consider more generally, in addition, the problems arising for tax administrations in the taxation of the profits of multinational banking enterprises.

3. In principle, the use of the arm's-length principle in the case of the activities of banking and finance subsidiaries is relatively straightforward. Although account has to be taken of the differences between banking and other kinds of business, there is a basic similarity between the activities of an international bank whose activities are carried out through subsidiaries and other affiliates and those of any other multinational enterprise.

4. However, because banking enterprises operate to a large extent through branches, and these operations present complicated transfer pricing issues to which the 1979 Report does not readily provide straightforward solutions, this report concentrates very largely on the problems of applying the arm's-length principle to loan interest in the context of banks operating in that way. The 1979 Report did not deal explicitly with branches except to indicate that its principles are appropriate to branch operations but need particular care in their application to such cases. Paragraph 7 of the 1979 Report states "The report covers not only transfers between parent and subsidiary companies but also those between other enterprises under common control, though the problems arising specifically from transactions between companies under common control have not been dealt with and indeed some countries would regard such transactions as passing through the common parent insofar as the price deviates from arm's length".

5. International transfers between associated enterprises, and within a single enterprise are treated in a not dissimilar way for tax purposes in the 1979 Report of the Committee on Fiscal Affairs "Model Double Taxation Convention on Income and Capital" (referred to subsequently in this report as "the Model Convention"). It is consequently not inappropriate to apply the principles of the 1979 Report in dealing with the transfer pricing problems arising in the context of branch banking.

6. That Report, however, goes on to say: "Whereas the principle of arm's-length pricing is valid also for the taxation of permanent establishments, the considerations set out in this

report need to be applied with care to the taxation of permanent establishments because of the special factors involved (for example, because of the limitations normally recognised on the acceptability for tax purposes of loan or royalty contracts between permanent establishments and the remainder of the enterprise of which they form part – see Commentary on Article 7 of the OECD Model Double Taxation Convention, paragraph 7, footnote 1)”. The following paragraphs of the present report represent to a large extent an attempt to expand this brief comment and to give it more detailed content in relation to branch banking.

7. In addition to their borrowing and lending operations, and as a consequence of their close involvement in their customers’ financial operations, banks – as well as borrowing and lending money – also carry out a wide variety of associated services such as bill discounting and foreign exchange transactions, or act, for example, as financial trustees or advisers and managers. The consideration for such services is generally a fee, commission or brokerage payment. These matters are generally outside the scope of this report and are thus not considered further in it.

8. As with other multinational enterprises, transfer pricing problems may arise in the case of international banks in relation to the allocation of head office (or parent company) expenses other than interest – that is to say, the expenses incurred by the enterprise as a whole (and usually attributed to the head office or parent company) for the benefit of the various parts of the enterprise. In this context, the general conclusions of the 1979 Report are as valid for banks as they are for other multinational enterprises, although the most relevant comments in that Report are likely to be those on the treatment of charges and payments for services. These aspects of the transfer pricing of banking enterprises are also therefore not considered further in this report.

## LAYOUT OF THE REPORT

9. The report begins by describing briefly the origins and operations of international banking. Next it considers the extension of the 1979 Report to banking through subsidiaries. Then the thorny issues of the treatment of branch banking are considered.

## *Chapter I*

# BANKING OPERATIONS

## THE NATURE AND FORM OF BANKING

10. The essential feature of banking is that funds which are entrusted to the bank (on which in some circumstances interest may be paid and in others not) are invested or loaned by the bank at interest in a manner designed to obtain a profit.

11. Banks generally have sought to attract deposits from a wide range of customers many of whom would deposit quite small sums. They would normally give no formal security for such borrowings but would rely on their general creditworthiness to persuade the depositors that they were adequately safeguarded against loss and that the rates of interest paid, which would normally be expected to allow the bank to make a profit when lending the money in its turn, were acceptable.

12. Traditionally also banks have held funds for customers on current accounts. Often individual customers' current accounts would be quite small, withdrawals could be made at little or no notice and the bank would honour cheques drawn on the account in favour of other persons. Very often interest would not be paid at all on current accounts, or if paid, then paid only at modest rates. The cost to the bank of deposits in such accounts could be substantial because they require a multiplicity of local access points and a multiplicity of transactions many of which individually involve small amounts of money. Sometimes, the bank would even charge the customer an amount designed to cover the expenses of keeping the account but this charge would often be waived if the customer maintained a sufficient balance.

13. The loans made by banks operating in this traditional way, though they could vary in amount from small overdrafts for individual customers to massive financial support for governments, would normally, nevertheless, encompass a large number of small loans to individuals and to small and medium-sized businesses.

14. These traditional forms of banking continue and small deposits and current accounts still provide the basic funds for many banking operations, but in the international market new forms of banking operations have developed in which the small depositor and the current account holder are of markedly less importance than they used to be. Under the new forms the amounts involved are very large and the ultimate borrowers are predominantly governments, multinational enterprises and other very large institutions or corporations. These new forms of operation are often described as "wholesale banking" and the traditional forms as "retail banking".

15. The traditional forms of banking operations have, however, governed the development of bank organisation. Depending as they do upon the ability to attract a wide range of depositors and borrowers, banks developed by opening branches wherever business might be obtained. Some branches would tend to receive deposits in excess of advances but others would be able to lend money in excess of their deposits. By appropriate transfers of resources these variations could be resolved. Moreover, the financial strength of the bank is generally concentrated at the head office, the assets of which usually include the cash reserves for the whole enterprise. This financial strength has normally formed the foundation of the bank's business which has meant that it has also been clearly more satisfactory to enable all customers to deal directly with the bank as a whole rather than with one subsidiary company whose activities may be limited by local or national regulations and which may, *prima facie*, be able only to offer security limited to its own resources. Because market participants regard branches as an extension of the central enterprise, a branch may also be able to raise funds more cheaply than a subsidiary. Possibly for these reasons and possibly for others banks have traditionally tended to carry on their domestic business through branches rather than through subsidiaries, and they have to a large extent operated in the same way in other countries.

16. At the same time, for a variety of reasons, there have been a number of exceptions to this tendency, particularly in international banking, where it is frequently the case that a bank sets up a subsidiary company to carry on its banking business in a country other than its own country of origin. This may in fact be required or encouraged by the local law or it may be a matter of practical convenience. The business of international banking may also include related activities such as financing the purchase of specific assets and leasing operations and such activities will almost invariably be conducted through subsidiaries.

17. It does not appear that, normally, taxation has an important influence on the choice made by a bank to operate internationally through a branch or through a subsidiary (although the home country's rules about relief for losses or foreign taxes may have some bearing on the matter). Many ordinary business considerations may influence such a choice. Where a local banking subsidiary company is set up it would normally have to satisfy local capital and reserve requirements in the same way as a domestic bank although in some cases these requirements can perhaps be satisfied by guarantees provided by the parent company. A subsidiary may also be restricted to specified functions and predetermined loan limits by licensing requirements but, subject to this, it could ordinarily be expected to have much the same banking relationship with its parent as a branch would have.

## BANK CAPITAL

18. A banker's standing is primarily dependent upon the state of his capital and reserves – the cushion which protects depositors from any losses on investing or lending by the bank. The basic constituent of this would ordinarily consist of the shareholder's funds and reserves from past earnings upon which no interest is paid. In some countries this may be supplemented, however, by "subordinated loans". These are usually in the form of unsecured loan notes having a fairly long maturity (perhaps ten years or so), title to repayment of which, in the event of earlier liquidation, is subordinated to that of depositors with, and other trade creditors of, the bank. They are frequently obtained in currencies other than that of the country of the head office in order to provide a base for business conducted in such other currencies.

19. Exceptionally a banker may obtain a loan for a specific capital purpose such as the acquisition of premises or equipment.

20. The need of a bank for capital will vary according to circumstances – the kind of business in which it is engaged, the varying requirements of the laws of the countries in which it operates and so on.

## THE NATURE OF INTEREST ON MONEY IN A BANKING BUSINESS

21. In general, commercial enterprises borrow money in order to acquire assets such as premises or equipment or to finance such items as stock holdings, trade debtors, etc. Thus, the money borrowed is absorbed within the enterprise.

22. A bank on the other hand accepts deposits from customers and pays interest thereon as a normal trading transaction, with which is coupled the making of investments and advances and the receipt of interest thereon. Interest paid by it is therefore a fundamental outgoing of a bank's trade just as interest received by it is a fundamental receipt of the trade.

23. The principal elements of the trading account of the commoner type of commercial enterprise, from which is calculated its gross trading profit, will be, for example, the proceeds of the sale of goods and the cost of the goods sold. In a banking business the primary elements in calculating its gross profit will be on the one hand the interest earned on the investments and advances made by it and, on the other, the direct costs of the funds so employed – i.e. the interest paid on deposits and other amounts borrowed in the course of banking.

## THE ORGANISATION OF INTERNATIONAL BANKING

24. Banks may extend their operations from their country of origin for many reasons and the organisation of international banking reflects this variety. It also reflects the varying requirements of both home and host country laws. But two general types of international banking may be distinguished. In former times the main reason for a bank to extend its operations into other countries would usually have been to supply services either to its domestic customers who had foreign interests or to expatriate citizens of the bank's home country who were working or carrying on business in such other countries or more generally to assist in the financing of foreign trade.

25. As already mentioned above, however, a newer and rather different form of international banking has emerged in recent years. This is carried on by bankers who operate largely in the Euro-currency market (which has largely comprised transactions in bank deposits of a particular currency beneficially held outside that currency's country of origin) and in the large syndicated loans which have recently become a feature of international finance (i.e. loans put together for a single borrower by a number of financial institutions acting in co-operation in possibly multi-million dollar flotations). A major characteristic of this newer form of banking is the extremely important part played in it by interbank transactions.

26. The standing of the banker is equally if not more important in these newer, wholesale, forms of banking business than in the older forms. A bank may, of course, engage in both "wholesale" and "retail" operations. But banks engaged mainly in the older retail forms of business where smaller amounts of money and larger numbers of transactions are, in general, involved will tend to have different needs for capital than those engaged mainly in the flotation of Euro-currency loans and the like, for whom the traditional depositor and the current account have ceased to be significant.

27. However, whether banks operate internationally through branches or subsidiaries, or in the older or the newer manner, the object of their activities is the same – to take advantage of the availability of opportunities for obtaining and lending funds profitably. This will often involve substantial movements of funds across national borders not simply from branch to head office or from subsidiary to parent company but vice versa, and also movement from branch to branch or subsidiary to subsidiary. Funds may often in fact flow in both directions between the same two parts of an enterprise, depending on the requirements of the moment: for example, there may be a flow of one type of currency in one direction while a different currency flows the other way.

## MODUS OPERANDI OF INTERNATIONAL BANKING

28. The main task of a bank operating multinationally, whether through branches or through subsidiaries may be seen as the efficient and profitable provision of funds and services to meet the needs of customers in the areas where they are located. Despite the development of rapid communication systems, it is generally recognised in the banking business that for the efficient international operation of a multinational bank a good deal of decentralisation of responsibility is required and it is important that local entities should have the ability to deal directly in the money market centres of the world both locally and further afield. Management controls appear to be generally at their most effective when the local operation is set up as a profit centre with approved budgets against which performance can be measured. In such a case the local office, while also operating further afield, would normally, in all probability, maintain an active presence in the local interbank market, particularly in foreign exchange and money dealing, and might also participate in the local bullion market. The ability of the local office to provide a fully competitive service to its customers may be very dependent upon its access to and reputation in these local markets.

29. The activities of bank branches and subsidiaries are not necessarily, however, limited to the area or country in which they are located; each one may be active on a worldwide level; transactions may be effected in all freely convertible currencies both in the money and the foreign exchange markets.

30. The success of a business transaction may well depend upon a thorough knowledge of all market conditions at the moment when the transaction is performed and these conditions can change very rapidly during the day. In the larger offices of banking enterprises there can be hundreds of transactions in a day, and the rates and prices obtained for the customer in each transaction will depend upon the market situation at the time the transaction is undertaken. This, in general, presupposes a need for highly qualified staff whom the head office of the bank can entrust with far-reaching authority. Local bank supervision requirements would need to be observed, however. So also would head office guidelines: in

addition to monitoring the results of the local office, a bank head office would probably make a daily check on the volume of business transacted by its branches and subsidiaries and upon their risk position.

31. Nevertheless, it is most probable that in order to allow branches or subsidiaries to operate successfully, the head office would as a matter of policy, in the ordinary way, keep to a minimum any efforts to influence rates of interest charged by branches or subsidiaries or any of the other conditions of the business transactions undertaken by them or to require an affiliate to refinance itself with the head office at rates not in line with the market.

32. It could be expected therefore that a high proportion of all the transactions undertaken by a multinational bank, whether concluded with third parties or with the head office or other branches or subsidiaries of the bank, would be based on the "arm's-length" principle. The necessity for adjusting interest rates to arm's-length rates when interest is charged to or paid by an affiliate may therefore not arise in practice very often. This could not be taken for granted however, and the transactions between the various parts of an international banking organisation are so frequent and so complex that the problem of deciding to which particular part of the organisation any particular element of the total profit should be related for tax purposes often becomes one of considerable difficulty. Some of these difficulties are considered in the following paragraphs.

## *Chapter II*

# BANKING AND FINANCIAL ENTERPRISES OPERATING THROUGH SUBSIDIARIES

## ARM'S-LENGTH PRINCIPLE

33. While the 1979 Report "Transfer Pricing and Multinational Enterprises" made it clear in its chapter on loans that it was not dealing with loans between enterprises engaged in banking or financing activities as part of their regular business (paragraphs 181 and 198), it was not the intention to suggest that the principle of arm's-length pricing is not equally valid for associated enterprises engaging in these activities. Despite differences between the organisation of banking and other business and differences between the function of interest for a banking enterprise and its function for other enterprises it is widely accepted that it is neither necessary nor desirable for tax authorities to adopt an essentially different approach to the transfer pricing of bank enterprises from that adopted towards the transfer pricing of other enterprises carrying on other kinds of business. The arm's-length principle is thus regarded as suitable for application in the case of banking enterprises as well as in the case of other enterprises, and no special problems arise in the case of operations conducted through subsidiaries and other affiliated companies.

## LOAN VERSUS EQUITY

34. The question of determining whether a transaction between a parent company and a subsidiary is a loan or a contribution of capital may be as important for associated banking and financial enterprises as it is for other associated enterprises. Here the discussion of this topic in paragraphs 183-191 of the 1979 Report is particularly relevant. However, by the very nature of its business, money advanced to or by a subsidiary banking business will often be a straightforward trading transaction in the ordinary course of the respective businesses.

## RATE OF INTEREST

35. As in the case of associated enterprises not engaged in banking or financial activities, the appropriate arm's-length rate of interest for a loan between associated banking or

financial enterprises is the rate that would be charged in similar circumstances in a transaction between unrelated parties. Again the discussion in the 1979 Report is relevant, especially paragraphs 198-201 (notwithstanding that banking and financial enterprises were specifically excluded from consideration in those paragraphs).

36. The widespread existence of markets for the borrowing and lending of money in various forms, the fact that banks frequently borrow and lend large sums to each other on inter-bank markets and the common phenomenon of recognised inter-bank lending rates indicates that it would normally be possible to derive arm's-length interest rates for transactions between the various parts of a banking enterprise from the rates charged in comparable transactions between independent parties. Information about inter-bank deposit rates applied in the various market compartments is publicly available. For example, the London inter-bank offering rate (Libor) is quoted in the daily financial press. (It should be recognised, however, that the effective rate applied in any individual transaction may diverge somewhat from the rate quoted publicly: Euro-currency rates may vary sharply during a day, as money market rates may do generally in all countries.)

37. There will often therefore be evidence for arm's-length prices on the comparable uncontrolled price basis and the cost-plus or resale-minus bases will be of much less importance in the context of bank interest than in other contexts. It has to be recognised, however, that usable evidence is likely to be more freely available for short-term borrowing than for longer-term borrowing (i.e. for up to five years). Normally the transactions to be used for comparison should be arm's-length transactions between unrelated banks where the amount lent, the term of the loan, the currency involved and the other conditions are the same or similar to those in question.

## OTHER TRANSACTIONS

38. So far as concerns transactions between associated companies in a banking group other than payments of interest (normally, transactions between parent companies and domesticated subsidiaries or between subsidiaries under common control) the Commentary on Article 9 (the associated enterprises Article) of the Model Double Taxation Convention is relevant. So too, again, is the 1979 Report. Since banks do not normally engage in buying and selling goods, or in the provision of technology, the chapter in that Report on intra-group services is perhaps the most relevant. (Since the principle to be followed under Article 9 is the arm's-length principle, much of the comment on the arm's-length approach to the taxation of associated corporations will also apply to transactions between branches, though as a domesticated subsidiary company will commonly have an adequate capital of its own, the problems relating to interest paid on the bank's own capital advanced to a branch, as discussed below, will not usually arise.)

## DOUBLE TAXATION

39. The possibility of double taxation where income flows between associated enterprises engaged in banking and financial activities is essentially the same as it is for other associated

enterprises involved in commercial activity across international frontiers. Issues not only of juridical double taxation but also of economic double taxation may arise. For example, where one State makes an adjustment in the arm's-length interest paid by a subsidiary bank to the parent bank in another State and the other State does not make a corresponding adjustment in the interest income received by the parent, there is the potential for double taxation of the income associated with this transaction. The discussion of this kind of problem in "Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure" is as relevant here as in other cases of transactions between associated enterprises.

### *Chapter III*

## BANKING AND FINANCIAL ENTERPRISES OPERATING THROUGH BRANCHES

40. Problems may arise in the taxation of bank branches, in particular in the context of:
- a) Interest receivable or payable in respect of funds passing between the local branches and the remainder of the bank in other countries (see paragraphs 41-75);
  - b) The capital investment attributable to branches (see paragraphs 76-83);
  - c) The effect of transfers of business from one part of the enterprise to another (see paragraphs 84-87);
  - d) The effect of national tax laws or practices on the operation of branches and subsidiaries in host countries (these problems are explicitly or implicitly considered alongside the other problems mentioned).

### ARM'S-LENGTH PROFIT: ARTICLE 7 OF THE MODEL CONVENTION

41. The general procedure set out in the OECD Model Convention for attributing profits to a permanent establishment is contained in Article 7 of the Model Convention. Article 7 and its commentary is relevant, at any rate, where a double taxation treaty is in force containing a similar Article, in considering the treatment for tax purposes of an internationally operating bank. The thrust of Article 7 is to attribute to a permanent establishment "the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment", [Article 7(2)]. Article 7(3) further goes on to say that in "determining the profits of a permanent establishment, there shall be allowed, as deductions, expenses which are incurred for the purposes of the permanent establishment ... whether in the State in which the permanent establishment is situated or elsewhere". In its paragraph 4, Article 7 deals with a different method (the determination of the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts) which is of a subsidiary character.

42. Paragraph 2 of Article 7 sets forth the principle of the "separate enterprise" which governs the allocation of profits to a permanent establishment. Paragraph 3 "clarifies, in

relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2" (paragraph 15 of the Commentary). This covers both the expenses incurred directly by the permanent establishment and those incurred by the head office and other branches "for the purposes of the permanent establishment". The latter could include both specific expenditures exclusively committed for the needs of the permanent establishment and a fraction of management expenses and general administrative costs incurred for the purposes of the enterprises as a whole.

## INTEREST RECEIVABLE AND PAYABLE

43. The application of Article 7 to banking enterprises calls for the discussion of two questions:

- a) Should interest payments between the head office and a branch be included in determining the profits of the branch?
- b) If interest actually received by a permanent establishment is used as the basis for calculating its gross profit, is it permissible to ignore interest expenses incurred by the permanent establishment and use instead an estimate of its share of the interest paid by the enterprise as a whole?

## INCLUSION OR EXCLUSION OF INTEREST PAYMENTS BETWEEN HEAD OFFICE AND BRANCH

44. First, it seems clear that the permanent establishment of a bank should bear the interest actually incurred by the head office, or by other branches of the enterprise, to the extent that interest is connected to funds borrowed from third parties and put at the disposal of the permanent establishment. This is simply the application to banking enterprises of the rule set for all enterprises by paragraph 3 of Article 7 of the Model Convention.

45. Paragraph 17 of the Commentary indicates that, for enterprises generally, it would not be appropriate to allow as a deduction in computing the business profits of a branch or other permanent establishment any payment of interest to the head office in return for money loaned by the head office to the permanent establishment. Similarly, it indicates that such payments made to a permanent establishment by the head office should be excluded from the computation of the permanent establishment's profits. The assumption would seem to be that the computation of arm's-length profits should in either case relate to the real expenses and receipts of the enterprises which are attributable to the permanent establishment and not relate to payments which are merely movements of funds within the enterprise.

46. However, for banking enterprises, the same paragraph contains a specific comment as follows: "It is, however, recognised that special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances, etc. (as distinct from capital allotted to them) in view of the fact that making and receiving advances is narrowly related to the ordinary business of such enterprises".

47. It is, in the view of the majority of OECD Member countries, necessary to take account of intra-bank payments of interest in ascertaining the arm's-length profits of a branch of a bank, in order to ensure that the taxation of the operating profit of the foreign bank branch is consistent, in principle, with the taxation of the profits of branches of other enterprises (see, however, paragraph 52).

48. The arguments for this conclusion are, in brief, as follows. First, since Article 7 of the Model Convention requires the profits of permanent establishments to be computed as if they were distinct and separate enterprises dealing quite independently with the remainder of the enterprise and, since banks dealing independently with third parties commonly pay interest to, or receive interest from third parties as an essential part of their banking business, then Article 7 of the Model Convention requires intra-bank payments of interest to be taken into account in assessing the profits of a bank's permanent establishments.

49. A second reason for them to be so taken into account is the nature of banking business. In the case of an enterprise not carrying on the business of borrowing and lending money, there is good reason to treat interest payments between branches, or between branches and head office as essentially artificial and properly to be ignored in arriving at the arm's-length profit of the branch, unless they reflect interest actually paid by the enterprise to independent third parties. In the case of banks, however, since it is the main business of a bank to borrow money outside the enterprise for the purpose of lending it outside the enterprise there is every reason to suppose that by far the greater part of money lent by head office to a branch and vice versa and money lent by one branch to another will in fact have been borrowed at some stage from an independent third party and will be lent eventually to independent third parties. Thus, the interest taken into account can be regarded as representing real outgoings or receipts of the enterprise as a whole and from the pragmatic point of view, to take account in this context of all intra-bank interest payments (except those directly related to the provision of capital – see paragraphs 76-83) produces a result consistent with that spelled out in the Commentary on Article 7 in the case of enterprises not carrying on the business of borrowing and lending money. These are the “special circumstances” related to banking activities, which have also been characterised in paragraphs 21-23 above.

50. A simple illustration is provided by the case of an identifiable amount of money borrowed from a particular lender by the head office and transferred directly to the branch which is then lent, in one identifiable amount, by the branch to an independent borrower. It would be wholly unsatisfactory if in the calculation of the profit of the branch arising from this transaction, the interest which it received was included but no deduction was allowed for the interest which the branch would have paid had it been an independent entity borrowing the money from the head office at arm's length. In the absence of other arrangements this would treat the receipt wholly as profit, which would normally be incorrect since it would ignore the fact that some expense and most probably some interest would ordinarily have been incurred by the enterprise in order to make the loan available and the overall result of the transaction may even have been a loss. Moreover, it would treat the receipt as wholly a profit of the branch whereas it might well be appropriate for the profit to be shared for tax purposes by other parts of the enterprise. Some expense ought properly therefore to be deductible from the receipt in order to ascertain the profit element in it, and some mechanism ought to be provided to allocate the right proportion of this profit to the branch. The deduction of interest expense calculated by reference to the arm's-length rate of interest for such a loan as if the branch and the head office were independent enterprises would, of itself, produce a figure of profit or loss attributable on the arm's-length basis to the branch, leaving to the head office, where appropriate, its own arm's-length element of the total profit or loss.

51. To illustrate the point in more detail: if a branch of a foreign bank borrows from a third party at 10 per cent in its host country and lends the same amount to head office at an arm's-length rate of 11 per cent, it is acting just as an independent bank would have done: in accordance with the arm's-length principle it should pay tax on a profit computed on this basis (i.e. on 1 per cent less its incidental expenses). If the head office lends the money on to independent third parties at 12 per cent then the world profit of the bank is 2 per cent (less incidental expenses), but it is the 1 per cent less individual expenses which is appropriately attributed to the branch. If the head office borrows from third parties at 10 per cent and lends to a branch at 11 per cent at arm's length, the branch profit, if it lends on to independent third parties at 12 per cent, is 1 per cent while the bank's world profit is 2 per cent, and so on. (These rates are used for illustration only: it is not suggested that the margins would in practice necessarily be of this order of size.)

52. Japan and the United States are of the view that the conclusions reached by the majority of OECD Members that intra-bank payments of interest are required to be taken into account go too far and in particular do not properly reflect the words or apparent intent of paragraph 17 of the Commentaries to Article 7 of the OECD Model Convention. In the view of Japan and the United States there is no basis for requiring that intra-bank interest should be taken into account. Paragraph 17 of the Commentary merely states that while, in general, interest payments between a branch and its head office should not be taken into account "special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other ...". The Commentary does not indicate what operative rule should flow from these "special considerations". Japan and the United States therefore believe that a proper interpretation of paragraph 17 of the Commentary is to permit, but not require, the taking into account of interest between a branch bank and its head office or other branches. It should be understood, however, that both Japan and the United States do provide for a deduction for interest paid when the profits of a branch of a foreign bank are being computed for tax purposes. It is on the question of what payments are to form the basis for calculating this deduction that they differ from other OECD Member countries.

## SPECIFIC PAYMENTS APPROACH – TRACING METHOD

53. Most OECD countries take the view that intra-bank payments of interest should be taken directly into account, that is to say by reference to the specific payments made between the relevant parts of the enterprise, possibly adjusted to arm's-length amounts (see paragraph 72 below). In principle this requires the identification of the source and amount of the particular funds loaned by the branch. It is recognised, however, by the countries which take this view that because of the complex nature of a bank's transactions and the fact that money, from whatever source it arises, may, to a certain extent (and possibly even to a large extent), be interchangeable with money from other sources, this identification may often be difficult. It would be an exceptional banking transaction in which money borrowed from a single depositor was loaned as a single advance to one borrower, or even divided up into several advances on the same terms to a number of borrowers. A bank accepts deposits or seeks finance as a principal. It obtains funds from a variety of sources and often from a multitude of depositors and that fund is then used for advances or other investment normally without regard to its constituent sources. It will often be necessary in consequence to adopt some

simplification of approach to overcome this kind of difficulty. Thus, it may be convenient to look at groups or categories of transaction rather than at each separate transaction individually, and to use rates of interest perhaps derived from averages of rates paid in a comparable market situations to unrelated parties. Though the difficulties cannot be ignored and the need for such expedients may be accepted, the majority of OECD Member countries are convinced that it does not follow that it is, in principle, permissible to ignore the actual payments of interest by the branch.

54. While Japan and the United States do not feel that the Model Convention requires intra-bank payments to be included, nevertheless they allow for the use of a tracing approach that does take account of these payments. The tracing approach is a process of tracing back the loans made by a branch out of funds supplied by other parts of the enterprise to the original provision of funds by persons outside the enterprise.

55. In particular, the Japanese method provides for the deduction of the actual inter-branch or head office/branch interest in calculating the taxable profit of the Japanese branch. The interest cost is measured by the amount incurred to the third party provider of the funds only when the source of the funds can be traced and is demonstrable by documentation. Usually, however, such tracing of funds to specific sources is impossible and the interest cost reasonably estimated by the Japanese branch is accepted so long as this estimated cost reflects the prevailing arm's-length rate of interest. Here, so long as the interest rate used corresponds broadly to that paid in the open market for similar kinds of loan, the Japanese approach may often not differ very significantly from that of the other OECD Member countries.

56. Similarly, one method of dealing with interest expense which is available under United States law to United States branches of foreign banks is also a tracing method. This method is known as the branch book/dollar pool method. It also uses the original third party price of funds procured by one part of a bank and loaned out by another – if that price is the price of Eurodollar borrowing. (The assumption is that if the funds are procured from third party sources outside the United States for loan to third party customers inside the United States, then the funds will be borrowed in dollars in the Eurodollar market or converted into dollars so that the Eurodollar price will ordinarily be the price to the original provider). On the assumption, therefore, that all third party borrowing by the United States branch is used to generate United States connected income and the cost of borrowing Eurodollars to produce United States connected income is equal to the average cost of all Eurodollar borrowing by the bank, this method, it is thought, produces much the same result as the specific payments method adopted by the majority of OECD Member countries.

57. To sum up, although very different, both the Japanese method and the United States tracing method described above may well, in many cases, produce results which are the same or very close to those which would be produced by using the specific payments approach adopted by the other OECD Member countries.

## FUNGIBILITY APPROACH

58. The United States law, however, gives foreign corporations a choice between the tracing method described in paragraph 56 and another – the separate currency pools method. This latter is a refinement of an earlier United States approach which was based on the

doctrine that money is fungible. This doctrine in its pure form regards money borrowed by one part of a banking enterprise as contributing to the whole enterprise's capacity to lend, and not simply to the lending capacity of particular parts. It therefore ignores the actual movements of funds within the enterprise and the actual payments of inter branch and head office/branch interest and provides for the branch to deduct an average rate of interest based on the interest paid by the whole enterprise.

59. A justification for fungibility methods would be that the banking industry is pre-eminently one in which the affairs of branches are very much interwoven with those of the head office and other parts of the enterprise. Normally, as has already been indicated, creditors subject money advanced to a bank to the risk of the bank's entire activities and look to the general credit of the bank for repayment. Thus, a bank's receipts and payments of interest may be regarded as all flowing into and out of one common pool. From this viewpoint, money which is taken out of the pool at one point is thus not identifiable as money which came into the pool at that or any other point; all that can be said is that the inflow at any one point helps to make the outflow at that or another point possible. When money is borrowed by the bank for a specific purpose this is still the case since such borrowing generally frees other funds for other purposes. On this basis, it is inappropriate to seek to calculate a balance of inflow and outflow at each point of access to the pool by reference to a precisely calculated locally related outflow to the rest of the pool or inflow from it. The activity of the whole enterprise contributes so much, it is argued, to the profit or loss derived by each part of the enterprise that, though it may not be possible to quantify the contribution precisely, it must be acknowledged in the attribution of profit or loss to any particular permanent establishment of the enterprise. It would be going too far to do this by simply attributing to the permanent establishment a share of the total profit or loss of the whole enterprise, and in any case, if such an attempt were made, there would remain the question of what basis should be used for that attribution and all the other problems of the whole enterprise approach (Article 7, paragraph 4 of the OECD Model Convention). But it would be appropriate, it is argued, to regard the interest expenses of the whole enterprise as incurred for the common purposes of the enterprise and thus as properly attributable to each part on some average basis. Thus on this basis the inflow to the point of access from sources outside the pool is regarded as an appropriate starting point for calculating the profit arising at that point, and on this basis, the calculation of the tax liability in State A of a branch of a foreign bank would in essence take into account first, the interest received by the branch from sources within State A and second, interest received from sources outside State A where the loans were effectively connected with that branch's business. No account would be taken of any payments of interest by the branch to any other part of the bank or vice versa. Nor, in general, would any deduction be allowed in computing the branch's profits for the actual interest paid by the branch. On the other hand, there would be set, against the branch's receipts from third parties, a share of the average interest paid by the bank as a whole.

60. But this approach, too, presents difficulties. Thus, if the tax authorities seek simply to attribute, to the domestic branch of a foreign bank, a proportion of the bank's worldwide interest payments, based perhaps on the relationship between the branch's assets and the bank's total assets, the difficulty has to be faced that the branch's business may not be typical of the bank's business as a whole and that its liabilities may not necessarily therefore be properly represented as a simple proportion of those of the bank as a whole. Thus, other things being equal, a branch which borrows at a lower rate than the average will be under-assessed to tax and one which borrows at a higher than average rate will be over-assessed. Put another way, the branch may be either inadequately or over-remunerated for the expenditure which it

has incurred. Moreover, internationally at least, money may not in fact be wholly fungible: exchange controls, it is clear, may limit the type of currency which a bank can make available to a foreign branch, or in any case the branch may, for its own particular commercial needs, require its own particular mix of currencies. (The type and profitability of a branch's business may vary considerably from that of other parts of a banking enterprise.) Interest cannot realistically be attributed evenly to all kinds of loans and the rate will vary for example from currency to currency depending on such circumstances as the strength or weakness of the currency or the risk of inflation in the relevant country. There are therefore considerable difficulties in using this sort of approach as a means of arriving at a wholly satisfactory realistic assessment of the branch's profit. Inevitably it is likely to produce results which are inconsistent with the arm's-length principle.

61. This pure doctrine of fungibility is no longer applied by the United States to foreign corporations. The United States law now recognises that variations in rates of exchange between currencies provide obstacles to complete fungibility, and that, unless proper account is taken of foreign exchange gains and losses, money of different currencies is not completely fungible. The United States take the view nevertheless that, with few exceptions, money of the same currency is fungible. Accordingly their procedures for determining the interest expense of a branch of a foreign corporation take into account the differences in interest rates across currencies. Under these procedures, however, the actual payments of intra-bank interest are still ignored and the deduction for interest allowed to the branch is still calculated by reference to average rates of interest paid by the whole enterprise. The essential difference between this and the pure fungibility approach is that the average rate for interest on borrowing in each different currency is separately calculated. The view of the majority of the OECD Member countries, however, is that this approach is not in principle compatible with the approach set out in paragraphs 2 and 3 of Article 7 of the Model Convention, and thus the answer of the majority of OECD Member countries to question b) in paragraph 43 above is negative [see paragraph 70 d) below].

62. It has been argued that this approach is nevertheless simpler to operate than the approach adopted by the other Member countries since it does not require the tax authorities to look at the detail of the branch's payments of interest to or receipts of interest from its head office or other branches, and to compare them with arm's-length amounts. However, the task of arriving at average rates of interest for the whole enterprise, on any but the broadest basis, may itself present a problem of some complexity to both tax administrations and taxpayers and could create administrative burdens for both. Furthermore, any method using as a deduction the identified original cost of financing the enterprise suffers from the not inconsiderable drawback (since it entails paying back to the branch which originally borrowed the foreign funds only the effective cost incurred) that it does not remunerate the branch for its function in the enterprise. Only the attribution of a profit margin would enable the original borrower to meet the costs incurred for its functions (e.g. management expenses related to servicing the loan, holding of unrewarded obligatory reserves) – see paragraphs 73-75.

63. Also relevant is the danger that if the divergencies from arm's-length profit which result are in the taxpayer's favour, a temptation will be provided to exploit them. Similarly, if the divergences in one country are disadvantageous to the taxpayer while those in another are advantageous, there will be a temptation for taxpayers to arrange transactions so that the advantageous results offset the disadvantageous results. In such circumstances the potential tax consequences may distort the commercial activities. It is not easy to assess the importance of these dangers but the experience of some countries indicates that they cannot be regarded as unimportant.

## INTERPRETATION OF PARAGRAPH 23 OF COMMENTARY ON ARTICLE 7

64. Paragraph 23 of the Commentary on Article 7, the text of which is reproduced in the annex to this report, is relevant in the context of fungibility methods, whether these are used fully or partly. This paragraph deals with the question of how the separate enterprise method should be applied. It is apparent from the fact that paragraph 23 refers explicitly to paragraphs 2 and 3 of Article 7 and to the aim of arriving at the profits of a permanent establishment on a "separate enterprise" footing, that it is referring to the method prescribed in paragraphs 2 and 3 and not to the subsidiary "whole enterprise" method referred to in paragraph 4 of the Article. This is further borne out by the fact that paragraph 23 forms part of that section of the Commentary dealing with paragraph 3.

65. Paragraph 23 considers two methods of applying the "separate enterprise" criterion:

- a) The first sentence of the paragraph refers to the case where the accounts for each part or section of an enterprise make it possible to establish with relative precision the profits and expenses that can be allocated to each part or section (that is to say, in particular, to the permanent establishment); this is obviously the more accurate and thus the preferable method;
- b) The second half of paragraph 23 refers to cases where profits and expenses cannot be allocated with accuracy to the permanent establishment; in which case appropriate coefficients or suitable criteria need to be applied.

However, there is nothing to indicate that this should be interpreted as covering coefficients or criteria relating to total profits. On the contrary, it is implied by the general tenor of this paragraph, its place in the Commentary on paragraph 3 of the article, as well as the reference to "arm's-length profits" in the penultimate sentence of the paragraph, that these criteria or coefficients should relate to factors specific to the permanent establishment and its economic environment, i.e. to comparable situations in the country where the permanent establishment is located, whatever the industry or sector in question. This is illustrated by an example from insurance where, according to paragraphs 2 and 3, the coefficients to be applied to the premiums received by the permanent establishment of an insurance company should be determined by reference to profits recorded in the same branch of insurance by enterprises operated by local companies in the country where the permanent establishment is located. This method is, in fact, prescribed by law in certain countries.

66. It would be helpful, in the view of the majority of OECD countries, in order to avoid any misunderstanding, if paragraph 23 of the Commentary could be amended to make it clear that it is directed only to the separate enterprise method and, in this context, that the "appropriate coefficients" or the "suitable criteria" are those applying to the permanent establishment or to enterprises located in the same country and that these coefficients or criteria do not relate to the total profits of the permanent establishment's parent enterprise, which is reserved exclusively to the cases falling under paragraph 4.

67. While Japan does not employ a fungibility method it joins with the United States in dissenting from this majority interpretation. These two countries believe that there is no basis in either Article 7 of the Model Convention or in the Commentaries for the conclusion that when applying "appropriate coefficients" or "suitable criteria" for determining the profits of a permanent establishment, as provided for in paragraph 23 of the Commentaries, the

coefficients or criteria should be related to similar enterprises located in the same country as the permanent establishment. In their view, logic would seem to dictate that the nature of these coefficients and criteria should be determined with reference to the market situation and modes of operation within the industry in question, and thus would regard this as particularly true for international banking which by definition transcends country boundaries.

68. However, the method referred to in paragraph 4 of the Article is quite different from that described in paragraphs 2 and 3 and is designed to cover relatively exceptional cases. This interpretation follows from the actual wording of paragraph 4 of Article 7, which states that “insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary”. The use of this method is therefore of a subsidiary character in the sense that it should be used only if the separate enterprise method cannot be applied. It is further stipulated in the same paragraph that “the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article”.

69. This interpretation is also supported by the Commentary on Article 7, paragraph 4, where it is stipulated in paragraph 24, first, that “in general the profits to be attributed to a permanent establishment should be determined by reference to the establishment’s accounts if these reflect the real facts” and, secondly, that a method of allocating total profits “is generally not as appropriate as a method which has regard only to the activities of the permanent establishment” and should be used only where it “is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory”. A method derived from the separate enterprise method provided for in paragraphs 2 and 3 of the Article, in the sense that it would take into consideration the actual receipts of the permanent establishment, but would attribute to the latter expenses determined by reference to data concerning the whole enterprise, would thus not give acceptable results in relation to the objectives of Article 7. In practice, the data relevant to the application of the two methods differ widely in most cases, and their combination would contain a risk of not reflecting in an adequate way the real profits of the permanent establishment.

70. To summarise, the conclusions of paragraphs 40 to 69 are as follows:

- a) Countries were in agreement that the main aim of Article 7 of the Model Convention is to attribute profits to a permanent establishment on a “separate enterprise” basis and that the determination of the profits to be attributed to a permanent establishment on the basis of the apportionment of the total profits of the enterprise to its various parts under Article 7 (4) is of a subsidiary character;
- b) With the exception of Japan and the United States, OECD Member countries are of the opinion that the “appropriate coefficients” or the “suitable criteria”, mentioned in paragraph 23 of the Commentary on Article 7, are those applying to similar enterprises located in the same country and that these coefficients or criteria do not relate to the total profits of the enterprise of which the permanent establishment is a part;
- c) In interpreting paragraph 17 of the Commentary on Article 7, it is, in the view of the majority of the OECD Member countries, necessary to take account of intra-bank payments of interest in ascertaining the arm’s-length profits of a

branch of a bank. Japan and the United States are of the opinion that there is nothing in Article 7 or the Commentary thereon to require such payments to be taken into account. (Nevertheless, Japan and the United States allow for the use of methods that do take account of these payments. The Japanese tracing method and the United States “branch book/dollar pool” method may, under certain assumptions, produce much the same result as the separate entity approach adopted by the majority of OECD Member countries);

- d) With the exception of the United States, it is the view of OECD Member countries that the “fungibility” approach is not compatible with the “separate enterprise” approach. Consequently, these countries are of the opinion that it is not permissible, when calculating the gross profits of a permanent establishment, to ignore interest expenses actually incurred by the permanent establishment and to use instead an estimate of its share of the interest paid by the enterprise as a whole.

## DOUBLE TAXATION

71. Where two countries use the same methods there is always some possibility still of double taxation. This possibility is exacerbated where different methods based on divergent principles are adopted. In the final analysis, if different approaches give rise to double taxation which cannot otherwise be relieved, it may still be possible to arrive at a reasonably satisfactory compromise by a mutual agreement or mutual consultation procedure under the equivalent in a bilateral treaty of Article 25 of the Model Convention, although such compromises would of course have to be in accordance with the terms of the treaty concerned.

## ARM'S-LENGTH INTEREST RATES

72. The existence of arm's-length interest rates has been discussed in connection with banking subsidiaries (cf. paragraphs 36 and 37 above). Since it is common, especially in the international market, for independent banks to advance money to other independent banks, it is consistent with both commercial reality and the treatment of other types of enterprise, as well as correct in principle, to appraise intra-bank payments of interest by reference to arm's-length rates.

## AGENCY OR CONDUIT TRANSACTIONS

73. The comments in the previous paragraphs are based on the assumption that, with regard to its structure, its organisation and its acceptance of responsibilities and risks, the relevant branch exercises the full functions of a bank, i.e. a borrower and lender of money. If this is the case, then the appropriate remuneration of the branch would be the same as that of an independent bank, i.e. interest at open market rates. This may be expected to be the normal

case. Exceptionally, however, it may occur that one branch of a bank will use another branch simply as an instrument for raising funds on a foreign capital market for its own purposes, e.g. where the second branch borrows particular funds in its host country solely and specifically for the purpose of transferring them to the first branch in another country for on-lending by that branch in that country. It may in fact be doing little more than providing services as a conduit for the funds. In such a case under a separate enterprise approach the branch which raises the funds may properly be regarded, in appropriate circumstances, as acting as a representative or a commission agent or a provider of services remunerated not by interest but by an appropriate fee. This consideration could take the form of a "turn" – a small fraction of the funds raised or a small fraction of the profit made – if this is how independent enterprises would have arranged the transaction.

74. The size of such a fee would appropriately be related to the expenses involved and the risk, if any, which the branch acting as a conduit or agent has to bear in respect of its resources and potential for generating profits while keeping within the principles of sound banking practice (and here it may be important that the placement of the loan can be regarded as assured, and that the loan itself is made initially to part of an enterprise which has greater resources than the branch by itself). Where a branch claims in its host country to have acted as a mere agent or conduit in this kind of way, the host country tax administration may properly require detailed evidence showing that the case is in fact dealt with in the same way in the country of the other branch before accepting the claim. The tax authorities concerned would ordinarily need to be satisfied also that raising or finding the money in the domestic market for lending elsewhere was an activity commonly carried on by independent banks in that domestic market, that the independent clients to whom the money had been on-lent were not clients to whom banks in that domestic market would normally lend direct, and that the domestic entity had not sacrificed to the other part of the enterprise a profit which it could have made in the normal course by lending the money to an independent client itself.

75. Exceptionally, in such a case some tax authorities might be disinclined to allow any deduction at all for the interest paid by the borrowing branch on the basis that all the profit is to be earned in the country where the on-lending takes place and that the interest does not therefore rank as an expense of earning local profits. This treatment, however, raises the difficulty that, if the branch pays interest on the borrowing, its profits will be over-assessed insofar as it receives any reimbursement of the interest or of related expenses from other parts of the enterprise and those reimbursements are treated as receipts in arriving at the branch's taxable profit. To achieve a logically consistent result, the tax authorities should equally exclude from the calculation any reimbursement of that interest or related expenses paid by other parts of the enterprise to that branch. OECD countries adopting the specific payment approach, described in paragraphs 53-57, consider that the interest charged can always be treated as receipts or expenses when determining the relevant branch's profits.

## INTEREST ON CAPITAL ALLOTTED TO BRANCHES

76. Bank legislation in many countries requires branches of foreign banks – even if they are not independent from a legal point of view – to show allotted capital in their balance sheets. Regulations of this kind will frequently form the basis of taxation but will not necessarily do so. Independently of such legislation, transnational banks will sometimes make such

allotments in order to ensure that their branches have capital of their own. T. is allotted capital will normally be covered by assets (e.g. real estate, bonds or debentures, cash funds, etc.) held by the branch as if it were their owner. In this case, the income from such assets would properly be attributed to the permanent establishment, according to the general principles of Article 7 of the Model Convention. Problems with respect to transfer pricing do not arise at this stage. In calculating the profits of bank branches it is necessary, however, to deal with the question of interest on capital whatever general approach is adopted to the treatment of intra-bank interest payments.

77. It may occur, however, that the capital allotted to a branch is not covered by assets held by the branch itself as if it were the owner. If the head office, instead, transfers money or other assets to the branch as capital by way of loan, the question arises as to whether the interest or other consideration paid for the loan is deductible from the branch's profit. The answer here is "no". The passage quoted from page 76 of the Commentary on the Model Convention precludes the deductibility of interest on capital allotted by head office, and it can clearly be seen that, insofar as such capital is used for the purposes of the capital infrastructure of the enterprise as such, rather than for trading purposes of the branch, then the payment of interest on it to head office is no different from interest paid by a branch of a non-banking concern to its head office. It may also be argued that it would be inappropriate for the branch to pay interest since this kind of capital is akin to the capital which entitles the bank's shareholders to a share in the profit. On the other hand, where the head office of a bank makes an advance to a branch in some form other than allotted capital, there does not seem, by reference to the arm's-length principle, to be any case for refusing a deduction in respect of interest paid to the head office even though the source of the advance happens to be capital funds. An independent bank would not refrain from requiring another independent bank to pay interest merely because the source of the advances made was a capital one. Such advances would therefore be treated appropriately as advances on exactly the same basis as if their source had been borrowing from third parties and an arm's-length rate of interest normally therefore would appropriately be allowed in computing the profit of the branch.

78. The comments in the previous paragraph refer primarily to cases where amounts are assimilated to equity capital in the branch's balance sheet, in accordance with either bank legislation or regulations in general commercial law in the country where the branch is situated, and these balance sheet statements are followed for tax purposes. Where the bank legislation of a state exceptionally permits banks resident in that state to declare equity capital in excess of the normal statutory minimum requirements or to step up declared amounts or to increase their equity capital by profits not distributed, and such increases of capital are recognised for tax purposes, it would be appropriate to recognise in the same way similar declarations by local branches of foreign banks.

79. In exceptional circumstances a branch's "allotted capital" might be claimed to be in excess of the equity resources of the enterprise as a whole. It will seldom be possible to decide with certainty whether this is the case, since the methods and criteria used in drawing up balance sheets vary from one country to another. However, allotted capital would be partly financed in such cases out of funds borrowed by the head office; the interest paid on this would need to be treated in the same way as remuneration for the use of equity capital in a subsidiary set up abroad. It would not therefore be properly deductible from the branch's profits, any more than it would from the subsidiary's. It may, however, happen that in appropriate circumstances a deduction for interest paid by head office falls to be allowed against the branch profits for other reasons, e.g. because it is incurred for the purposes of the permanent

establishment and thus falls within Article 7(3) of the Model Convention. In that case it would be appropriately charged by the head office to the branch.

80. The question may also arise whether the tax authorities may require a branch to treat part of its funds as allotted capital where bank legislation in the country concerned does not require it to do so and the branch has not done so. Under Article 24, paragraph 4 of the Model Convention, the taxation on a permanent establishment in another state should not be less favourably levied than taxation levied on enterprises of that other state carrying on the same activities. If in that other state banking law does not require a resident bank to show allotted capital and the tax authorities cannot require such capital to be shown where the enterprise has not done so of its own accord, the same rule has to be applied to the branch of a foreign bank; consequently, it cannot be required to show allotted capital in its balance sheet. This is not to say, however, that, in a country where it is necessary or permissible for the tax accounts and the financial accounts of an enterprise to differ from each other, it is not possible for the tax authorities to treat an appropriate part of the payment by a branch of a foreign bank to its head office as remuneration for the use of equity capital, if this is in fact what it does represent, and this treatment is not in itself discriminatory, notwithstanding that the financial accounts of the branch do not show such equity capital. The consideration mentioned in paragraph 81 below would be relevant in deciding the amount of capital to be attributed to the branch for this purpose.

81. Where loans made by head office cover a branch's allotted capital, interest on that amount, as has been pointed out above, would not be deductible in arriving at the branch's profits. In many cases, the branch's accounts would not, however, indicate any specific interest liability for the capital allotted by head office. This raises the question of how to determine the amount of non-deductible interest. An appropriate method might be to use a weighted average of rates actually charged by the head office for its loans to the branch (not taking into account mere offsetting or self-balancing items). Of necessity, however, such a method must produce a result which is to some extent arbitrary, and it would be desirable to ensure that other methods could be used if they produced results more acceptable to both taxpayer and tax authorities.

82. Alternatively it may be possible to deal with the question of interest on capital as a special category of "thin capitalisation", applying the domestic rules or practice on this topic so far as they are appropriate. Such an approach is, however, subject to the objection that it may go too far in accepting that a branch should be treated in exactly the same way as a domesticated company. Although paragraph 2 of Article 7 of the OECD Model Convention says that "the profits attributed to a branch shall be those which it might be expected to make if it were a distinct and separate enterprise" it goes on to say that the enterprises should be regarded as "engaged in the same or similar conditions". It can thus be argued that the capital to be attributed to the distinct and separate enterprise is that which it actually uses as a branch rather than the amount which it might be required to put up under thin capitalisation legislation or rules of practice relating to domestic companies. Much may, therefore, depend on the facts of the individual case.

83. It seems to be generally accepted, however, that where some part of the working capital of the branch of a bank is treated as derived from equity sources and a deduction consequently denied for interest thereon, the proportion of such capital to total assets is to be expected to be comparatively small and to be of much the same order as the proportion for the bank as a whole. Some countries may find it convenient to use a fixed percentage of the bank's total worldwide capital, although this procedure, because it must to a certain extent be arbitrary,

carries the risk of producing distorted results and may need to be accompanied by provisions enabling the branch to substitute another amount if it can show good cause for doing so.

## ATTRIBUTION OF INCOME: SPLIT FUNCTION OR TRANSFERRED BUSINESS

84. Another problem with which taxing authorities will often be concerned is testing whether the accounts of a branch include all the receipts and expenses which should properly be attributed to that branch. There may, of course, be both fiscal and commercial reasons for transferring business which originated with one branch to a branch in a different country. In such cases it will often be difficult to decide whether it is appropriate that the whole profit of the relevant transaction should be included in the accounts of the first branch or whether it would be adequately remunerated either by a share of the profit on the whole transaction or by a commission or "turn". The range of possible transactions is wide. At one end of the range there may be cases where business has artificially been transferred to a tax haven and the whole profit would *prima facie* be appropriately treated as accruing to the original branch, on the basis that the tax haven branch effectively does nothing, and the original branch everything, in the matter. At the other end, there could be cases where the branch has merely rendered minor or ancillary services to the bank as a whole and where it might be appropriate for the branch to seek simply the reimbursement of its own expenses.

85. Whether the profits arising from banking operations should be attributed to a particular branch depends, as has already been pointed out, following the principles laid down in the Model Convention, on whether they are profits which the branch might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment [Article 7(2) of the Model Convention]. An important factor in the case of loan transactions where more than one branch has performed economic functions with respect to the asset or where the business has been transferred from one branch to another will often be whether the debt claims or other interest-bearing assets arising from the transactions (see Article 11, paragraph 3 of the Model Convention) are effectively part of the business assets of the branch. If they are, then the implication may be *prima facie* that the profits to which they give rise are appropriately attributed to that branch. Such assets can be so regarded if:

- a) They are held beneficially by the permanent establishment for use in its business, or;
- b) They are held by another part of the enterprise specifically to promote or support the activities of that permanent establishment.

86. Another factor which may be more decisive in some areas, however, will be whether the income produced by the relevant assets can be regarded as having been substantially generated by the activities of the permanent establishment. This will depend on the extent to which the negotiation and conclusion of the transaction has been the work of that permanent establishment. Normally the negotiations and conclusion of a transaction will involve the following activities:

- a) Obtaining the offer of new business;
- b) Establishing the potential borrower's credit rating and the risk involved in providing credit;
- c) Negotiating the terms of the loan with the borrower;
- d) Deciding on whether to make or extend the relevant loan and, if so, on what terms and conditions;
- e) Concluding the contract and disbursing the proceeds of the loan;
- f) Administering the loan (including handling and monitoring the service of it) and holding and controlling the securities pledged.

The first four activities are of decisive economic importance. The fact that debt claims against customers and similar assets were the results of these activities undertaken by a particular branch would thus form a firm foundation for the attribution of the profits from the relevant transactions to that branch notwithstanding that the assets themselves had been transferred to another branch. This would be particularly the case if the risk of default on the loan remained to be borne by the first branch or was in any case not assumed by the branch to which the business had been transferred.

## NATURE OF DEEMED INTEREST

87. The question may sometimes be raised, in connection with banks, whether, if the arm's-length principle requires a bank branch to be treated as paying interest to its head office or another part of the enterprise on loans therefrom, it does not also require the branch to deduct withholding tax from such deemed payments on behalf of the tax authority. The interest may not in fact be paid – it is merely a figure in a computation of tax liability, and this requirement would go very much further than the mere adjustment of interest to arm's-length prices with the object of correctly taxing the profits of the branch. The result would be that the enterprise as a whole would be taxed in the country of the branch not only on the arm's-length profit attributable to the branch but also on the interest deemed to be paid by the branch and, accordingly, to require a deduction of withholding tax would be to deny the fact that both parties to the deemed payment are merely parts of the whole enterprise. Similar problems would arise in the converse situation of payments deemed to be made for tax purposes by head office to a branch.

*Annex*

TEXT OF PARAGRAPH 23 OF THE COMMENTARY ON ARTICLE 7 OF THE 1977  
OECD MODEL DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL

“23. It is usually found that there are, or there can be constructed adequate accounts for each part or section of an enterprise so that profits and expenses, adjusted as may be necessary, can be allocated to a particular part of the enterprise with a considerable degree of precision. This method of allocation is, it is thought, to be preferred in general wherever it is reasonably practicable to adopt it. There are, however, circumstances in which this may not be the case and paragraphs 2 and 3 are in no way intended to imply that other methods cannot properly be adopted where appropriate in order to arrive at the profits of a permanent establishment on a “separate enterprise” footing. It may well be, for example, that profits of insurance enterprises can most conveniently be ascertained by special methods of computation, e.g. by applying appropriate co-efficients to gross premiums received from policy holders in the country concerned. Again, in the case of a relatively small enterprise operating on both sides of the border between two countries, there may be no proper accounts for the permanent establishment nor means of constructing them. There may, too, be other cases where the affairs of the permanent establishment are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of branch accounts. Where it has been customary in such cases to estimate the arm’s-length profit of a permanent establishment by reference to suitable criteria, it may well be reasonable that that method should continue to be followed, notwithstanding that the estimate thus made may not achieve as high a degree of accurate measurement of the profit as adequate accounts. Even where such a course has not been customary, it may, exceptionally, be necessary for practical reasons to estimate the arm’s-length profits.”

THE ALLOCATION OF CENTRAL MANAGEMENT  
AND SERVICE COSTS

## INTRODUCTION

### A. Nature of problem

1. The Report of the OECD Committee on Fiscal Affairs on transfer pricing and multinational enterprises (referred to subsequently in this report as "the 1979 Report") dealt, in Chapter IV, with certain intra-group services. The present report considers in greater detail some aspects of the activities of parent companies and group service centres in multinational enterprises (MNEs) in providing such services and takes into account comments on that section of the 1979 Report by BIAC (the Business and Industry Advisory Committee to the OECD) which is generally responsible for representing the views of the private sector to the OECD. Intra-group services are services rendered by one part of the group for other parts or for the group as a whole. The 1979 Report indicated that they should be distinguished from activities performed solely on behalf of a parent company itself, the costs of which were described as "shareholder costs" – a distinction which is also discussed in more detail in this paper. As noted in paragraph 141 of Chapter III of the Report, intra-group arrangements for making available the use of intangibles have certain features in common with those for rendering services. Similarly many of the considerations mentioned in this paper may also be relevant to the provision of intangibles.

2. It is characteristic of MNE's that group centres incur costs in connection with management, co-ordination and control functions for the whole group or parts of the group. Furthermore, it is usual for international groups of companies to create international advisory departments, international service centres or international research laboratories which operate on behalf of the group as a whole or of parts of it. These functions are often centralised in the parent company, but in many cases subsidiaries or branches render services for the whole group or for regional or functional parts of it.

3. The nature and number of the services rendered by group centres depend on the kind of business and on the organisational structure of the group, but in general the following centralised activities may be distinguished:

- Administrative services such as planning, co-ordination, budgetary control, financial advice, computer services;
- Assistance in the field of production, buying, distribution and marketing;
- Services in staff matters such as recruitment and training.

Group centres also often carry out research and development or administer and protect intangible property for the whole group or for parts of it.

4. In the country where a parent company or a group service centre is established, the above organisational structure presents the tax authorities and the MNE with the problem of determining which part of the total costs incurred by the parent company or the group service

centre should be borne by them and which costs should be passed on to other members of the group, the majority of which – in the case of MNEs – may be established in other countries. The criterion in this matter is the question of “who benefits from the activities”. When costs are passed on according to this criterion, the question arises how they should be quantified, which includes the question whether or not a profit margin should be included.

5. In the country where an associated enterprise is established, the tax authorities and that enterprise itself both face the same two-fold problem: are the costs charged to be borne by the associated enterprise, and are the amounts of the charges as well as the computation systems used to arrive at the remuneration appropriate?

6. The MNE runs the risk of incurring economic double taxation when the tax authorities of the country of the parent company (or the service centre) insist on the allocation of certain costs to associated enterprises abroad but the competent tax authorities for the latter enterprises:

- a) Do not accept the allocation of these specific costs (e.g. because they disagree on the scope of shareholder costs see Chapter II B below);
- b) Do not accept the allocation because in their view no real benefit is conferred on the associated enterprise;
- c) Only partly recognise the allocation because – for instance – they contest the amount of the consideration (e.g. they consider that the service can be obtained cheaper on the local market), or they do not accept a profit mark-up in certain cases.

7. The tax authorities of the country where the parent company (or group service centre) is established face the danger that costs, which should in principle be allocated to foreign group members, will be borne by the parent (or the group service centre) if the fiscal situation in the country where the parent or the centre is established makes such a course of action attractive. In the case of the tax authorities in the country of the associated enterprise there is the risk that the parent company will allocate costs to it in order to obtain a tax advantage or to neutralise a tax disadvantage. For example, an MNE – in order to avoid double taxation – may try to shift costs to associated enterprises in countries where tax authorities are less strict in accepting the allocation of centrally incurred expenditure.

8. Suggestions for reducing the possibility of disagreement between tax authorities with regard to the allocation of central costs are set out in Chapters II and III of this report. To a certain extent, however, problems of this kind are always likely to arise. Apart from problems created by differences in approach among tax authorities, the circumstances of MNEs vary widely in practice and it does not seem possible therefore to provide solutions which are valid in all circumstances. In the final analysis mutual agreement procedures may be needed to provide solutions. It should be recognised that in *bona fide* situations the competent authorities may well, in seeking to reach a solution by mutual agreement, need to take into account the special circumstances of MNEs and the problems they are faced with as a result of the fact that they operate in many countries.

## B. Terms used

9. “Parent company”: company controlling the MNE and providing services to associated enterprises;  
“Group service centre”: special department within parent company or regional holding company or other associated enterprise providing services to associated enterprises;

“Country A”: country of residence of the parent company or of the group service centre;

“Country B”: country of residence of the associated enterprise which benefits (or is intended to benefit) from activities carried out by the parent company or group service centre.

## *Chapter I*

# THE VIEWS OF MULTINATIONAL ENTERPRISES: A DISCUSSION

10. Following the publication of the 1979 Report, representatives of MNEs raised a number of points, which they thought should have been dealt with or dealt with rather differently in the Report, concerning the tax treatment of central costs and the ways in which they thought that this might affect international investment by MNEs. Most of these points are the subject of brief discussion in the present chapter, but the topics referred to under Sections E (shareholder costs) and F (benefits) are of particular importance in the context of this report and are dealt with more fully in Chapter II.

## A. NATIONAL TREATMENT

11. It has been argued that there should be no difference between the way in which national tax authorities approach expenditure charged by foreign entities within the group for the services provided to domestic entities, and the way in which the same tax authorities approach expenditure incurred by a domestic entity and charged to another domestic entity, so that national treatment would require, it has been argued, that the same yardsticks should be used in each case. It has been argued also that the burden of proof tends to be stricter in the former situation both as regards the amount and necessity of expenditure charged and the actual benefit derived from it.

12. However, the relevant distinction in this context seems to be whether or not the parent company is resident. The obligation to give national treatment is not an important factor, since the nationality of the companies concerned is usually irrelevant. (Take, for instance, the case of a company incorporated under the law of country A, but residing in country B with subsidiaries in country B; or the case of a company incorporated under the law of country A with subsidiaries within that country but having its place of effective management in country B.) In addition, the transactions in question include not only parent companies rendering services to subsidiaries, but also subsidiaries rendering services to associated enterprises (including the parent).

13. It is agreed that it would be undesirable if it occurred in practice that non-resident enterprises or enterprises owned by non-residents unreasonably incurred greater difficulties than resident enterprises in establishing their claims to deductions for expenditure on services, this possibly acting as a deterrent to investment by non-resident enterprises in that country.

14. OECD tax administrations would accept that in principle there should be no difference in the burden of proof for resident firms and for subsidiaries owned by non-residents, although they recognise that in practice it may be sometimes more difficult for the latter to supply the necessary information. While agreeing that tax authorities should avoid being unreasonable in this regard, they would consider it relevant to recall the OECD Guideline that enterprises should disclose adequate information. It is important to recognise in this context that, if information is to be adequate, it may need to include information from the parent company or other relevant parts of the enterprise in other countries (see paragraph 25 of the 1979 Report).

## B. ROLE OF TAX AUTHORITIES

15. The MNEs have underlined the danger that, in questioning the allocation of service expenses or the levying of service charges by MNEs, the tax authorities may risk putting themselves improperly into the shoes of the entrepreneur and substituting for his commercial judgment their own view of the business necessity of the relevant expenditure and whether it has contributed to profit.

16. Indeed it is generally accepted that tax authorities should not substitute their own judgment for the commercial judgment of the entrepreneur (see paragraphs 15 and 23 of the 1979 Report). However, in evaluating whether it is acceptable for tax purposes to charge an associated enterprise for any part of centrally incurred expenditure, it is not a matter of questioning the appropriateness of the expenditures actually incurred by the parent company or group service centre, or whether it has contributed to profit, but rather of applying the arm's-length principle. This may be of relevance both in domestic and in international situations. For example, regional differences in domestic tax treatment (or in investment incentives) may provide a motive for charging expenditure to associated enterprises which would not otherwise be charged to them; continuous losses in a certain company or, more generally, limited opportunities to offset losses, may provide an incentive for artificial charging of expenses to such companies.

## C. DEDUCTION OF CENTRAL COSTS

17. Another view which has been expressed by MNEs is that central group costs should all be deductible somewhere in arriving at the taxable profits of entities in the relevant group. The underlying thought is that the recognition of this principle would eliminate any danger that MNEs might suffer double taxation as a consequence of disputes between the tax authorities of the home and host countries.

18. It is not, however, possible to give such a categorical endorsement to this principle since it does not necessarily follow that because an expenditure has been incurred it should be deductible in arriving at taxable profits. In some jurisdictions costs connected with exempted income are not deductible. Interest expenses, for instance, related to loans whereby a

participation in a subsidiary in country B is financed, may not be deductible in country A if a participation exemption applies to income earned by the parent from that subsidiary. In such a case double taxation does not arise because the income connected with these costs is tax exempt in the country concerned. It is recognised, however, that, because of divergent national laws and practices, double taxation may sometimes arise which cannot be alleviated unless the point is specifically dealt with in a bilateral double taxation agreement between the two countries concerned.

#### D. ACCEPTANCE OF TAXPAYERS' DATA

19. It has also been suggested:

- a) That tax authorities commonly find little difficulty in accepting the figures for costs which are reported by their taxpayers when these costs have been incurred domestically;
- b) That costs incurred outside the jurisdiction of a tax authority are no more likely to be incorrectly reported by the taxpayer, and;
- c) That, therefore, if these latter costs are scrutinised more carefully by tax authorities than those incurred domestically, an unfair burden of work may be inflicted upon the taxpayer, and some real injustice may be suffered by the taxpayer if the costs are disallowed.

20. However, it is necessary for tax authorities to be able to investigate costs, whether they have been incurred domestically or abroad, in order to ensure they have been allocated in such manner and amounts as is acceptable under their tax laws. In the international context it may be particularly relevant, for example, to investigate the costs relating to exempt income in order to ensure they are not deducted in arriving at taxable income. Nevertheless, it may be possible for tax authorities to avoid putting international taxpayers to unnecessary trouble: for example, a certificate by the tax authorities of one country that the expenses reported as having been incurred by one of their taxpayers have been examined and found acceptable might enable the tax authorities of another country to minimise the scope of their own enquiries into the figures.

21. MNEs have also urged that when it has been established that an open, clear, uniform and auditable technique is being used to quantify service charges, the price arrived at by the use of the technique should be regarded as being at arm's length.

22. The use of such techniques is highly appreciated by tax authorities, and would undoubtedly assist MNEs and tax authorities to achieve a mutually satisfactory solution of transfer pricing problems, but it has to be said that they do not guarantee that the price resulting from their use is always at arm's length. Apart from the possibility that an open market price for similar transactions under similar circumstances can be recognised which differs from the price calculated within the MNE, the latter price may not be acceptable to tax authorities, for instance because no profit mark-up has been applied. Furthermore, conflicting interests within MNEs may influence transfer prices, whether towards or away from arm's-length prices.

## E. SHAREHOLDER COSTS

23. While accepting that shareholder costs are costs of the parent company only and not allocable to other members of the group, MNEs have expressed the view that the 1979 Report interprets shareholder costs too broadly. The concept of shareholder costs is considered in more detail in Chapter IIB below.

## F. BENEFIT TEST

24. In the 1979 Report some emphasis is laid on the benefit test, i.e. the requirement that if a charge is to be justified, a group member must demonstrate that it has derived a benefit (or was expected to derive a benefit) in consideration for payments made to another affiliate (often the parent) for services or certain intangible property rights.

25. This concept seems to have been generally regarded as acceptable by MNEs insofar as it relates to specific services rendered and specific property transferred. MNEs have argued, however, that costs of central activities for the benefit of the group as a whole should be paid for by the group members, whether or not a specific benefit (actual or intended) can be demonstrated, each respective share being determined by an appropriate apportionment formula.

26. Benefit problems are considered in more detail in Chapter IIC below.

## *Chapter II*

# CLASSIFICATION AND ALLOCATION PROBLEMS

## A. INTRODUCTION

27. Paragraphs 143-145 of the 1979 Report mention a number of centrally provided intra-group activities of a servicing nature. These may give rise to costs which are incurred centrally (i.e. by the parent company or group service centres) and which are connected with the central management, co-ordination and supervision of the group or with specialised services. Such services were sub-divided into three categories:

- a) Activities of the parent company acting in its capacity as shareholder giving rise to costs commonly described as "shareholder costs";
- b) Activities unequivocally performed for the benefit of one or more associated enterprises;
- c) Activities which may benefit to varying degrees the parent (or the group service centre), the group as a whole or one or more of the associated enterprises in particular.

28. The classification of certain particular activities under one of these categories is not always self-evident and problems may consequently arise. One major problem is the vagueness of the concept "shareholder costs", which is discussed in Section B.

29. With regard to the third group of costs, problems arise in interpreting the term 'benefit' and – depending upon the interpretation – in the practical problem of dividing the costs into those which must be passed on to the parts of the group and those which must be borne by the parent or the group service centre.

30. Paragraphs 151-159 of the 1979 Report deal with the problem of deciding whether a benefit has been conferred and which part of the enterprise should pay for it. The tax authorities of country A will be inclined to apply a rather general (overall) benefit criterion: the costs of certain services will be regarded as to be charged to the associated enterprises since they are incurred to benefit those associated enterprises – for example, the costs of a central management consultancy service. The tax authorities of country B on the other hand may take the view that, as enterprise B has not made use of the services in a particular year, no benefit has been gained and as a result no costs may be charged to enterprise B (specific benefit test).

31. The application of a general benefit test on the one hand and a specific benefit test on the other may thus lead to certain costs being deductible in neither country A nor country B in a given year.

32. The 1979 Report advises, in paragraph 152, that "it would be appropriate to look at the continuous stream of activities and the benefits received over a period of more than one year, as it may well happen that even if the services are not used in a given year they may be used intensively in another year". However, this problem may occasionally arise and, in paragraphs 66 to 73 below, some suggestions are made which may reduce the problem in practice.

## B. THE SCOPE OF SHAREHOLDER COSTS

33. In paragraph 154 of the 1979 Report the point is made that expenses incurred by a parent company in managing and protecting its investments are incurred by the parent company as shareholder and would not be properly chargeable therefore to the other members of the group. Other expenses incurred by the parent company, the paragraph continues, may also be distinguished as *prima facie* incurred solely for its benefit and similarly not chargeable to the other members of the group. These latter expenses (which are not, however, categorised in that paragraph as, necessarily, "shareholders' expenses") would include, for example, the cost of the parent's audit of its subsidiaries, expenses incurred by the parent company in arranging meetings of its own shareholders and for consolidating the results of the members of the group, including the necessary auditing, and in providing finance for the extension of the group itself. In paragraphs 155-159 of the Report the point is made, furthermore, that expenditure of these kinds may be partly incurred for the benefit of a subsidiary, for instance the audit of a subsidiary's accounts, central group co-ordination and control, and the decision-making activities of the top management of the parent company. Paragraph 176 of the Report summarises the issue as follows. Costs clearly belonging to the sphere of the parent company as shareholder cannot properly be chargeable to its subsidiaries. Expenses incurred by a parent company in arranging meetings of its own shareholders or for consolidating the results of the members of the group or by way of administrative expenses in providing finance for the extension of the group itself ought not, to the extent that they have to be regarded as shareholders' expenses, to be chargeable to the members of the group.

34. It has been suggested on behalf of MNEs that it would be wrong for tax authorities of country B to go very far in refusing deductions for expenditure on these grounds. More specifically it has been suggested that non-deductible "shareholder costs" should be limited strictly to those incurred by a parent company solely in its capacity as an investor in the other group affiliates. On this view they should not include any costs attributable to co-ordinating the various business activities of the group. The cost of internal auditors, for example, should not, on this basis, be included as a shareholder cost, since examinations carried out by internal auditors are intended to provide information which may, *inter alia*, be used for management purposes and not merely to protect the investment of the parent company. This approach seems to be somewhat oversimplified. Nevertheless the fact that it has been forcefully urged indicates that a fuller discussion of the issues may be of some value. This is attempted in the following paragraphs.

35. Shareholder costs may be defined as costs related to managing and protecting (monitoring) the investments made by the parent company (paragraph 154 of the Report). They may be distinguished from costs which are incurred in order to render the conglomerate more profitable than the total of various individual parts of it would be if not related.

36. This distinction may be clarified by two examples. In certain MNEs the structure of the concern is so loose, the mandate of the board of the parent company so limited and the degree of decentralisation so high that in fact all the activities of the parent company solely relate to the monitoring of the participations and the whole cost of these activities can consequently be qualified as shareholder costs. In other MNEs the management is highly centralised, the board of the parent company makes all the investment decisions above a certain value and many services (marketing, training, consultancy) are provided centrally. In the latter case the question arises whether the costs of “additional” activities (i.e. activities above the level of typical shareholders activities as indicated in the first example) should be borne totally or partly by the parent company or by the subsidiaries.

37. Two approaches may be distinguished. Under the first approach, any extra profits arising from these “additional” activities of the parent company are seen as accruing primarily to the subsidiaries and only indirectly to the parent company (in the form of dividends or an increase in the value of the participations). The underlying justification for this approach is the view that it is characteristic of MNEs that the subsidiaries or other affiliates contain the profit-making capacity which is often (example 2. of paragraph 36 above) enhanced by the managerial and co-ordinating activities of the parent company. These considerations lead to the conclusion that a considerable part of the costs of central management, co-ordinating and control activities should not be borne by the parent company but should be allocated to the various parts of the MNE.

38. On the basis of this approach the categories of central costs to be borne by the parent company would not be extensive, but clearly at least the following categories of costs would be regarded as shareholder costs appropriately borne by the parent company:

- a) Costs of activities relating to the juridical structure of the parent company itself, such as meetings of shareholders of the parent, issuing of shares in the parent company and costs of the supervisory board;
- b) Costs relating to reporting requirements of the parent company including the consolidation of reports;
- c) Cost of raising funds for the acquisition of its participations;
- d) Costs of managerial and control (monitoring) activities related to the management and protection of the investment as such in participations.

39. Category *d)* should be distinguished from the costs of managerial, control and co-ordinating activities performed to improve the operation of the subsidiaries, since these latter activities primarily benefit those subsidiaries; problems may arise in practice because they may be performed by the same persons and the same departments as activities in category *d)* and may, therefore, be intertwined with them. If this first approach is adopted, a practical solution may be to split the total costs of the persons and departments concerned (board of directors, staff departments, control and auditing department) according to an estimate of the proportion of their time which the persons and departments concerned spend on the different activities.

40. A subsidiary should not be required to pay for benefits derived simply from being part of a concern (i.e. benefits which cannot be related to the specific activities of the parent) for instance the higher credit-standing – apart from guarantee agreements – resulting from being part of a concern with a good reputation.

41. The second approach is based on the view that it is not appropriate to require a charge to be made during any particular accounting period for tax purposes except to the extent that

it is possible to identify and quantify with a reasonable degree of certainty services which have been rendered during that period and which provide a real or expected benefit to the chargeable entity and reduce its costs. Under this approach, costs incurred by the parent company would tend to be regarded as appropriately borne by the parent company unless there was a positive case for charging them out.

42. One country, indeed, explains its commitment to this second approach as a consequence of constraints in its tax law which require a benefit test to be applied on a strictly annual basis without taking any account of the fact that the company concerned is part of an MNE.

43. It is unlikely that these two diverging approaches can be easily reconciled within the non-binding framework of OECD recommendations. Three possible bilateral approaches as a solution may, however, be suggested:

- a) When negotiating or renegotiating conventions on the avoidance of double taxation, tax authorities of the countries where problems in this field exist could deal with this matter as a specific issue of economic double taxation: a protocol provision based on Article 9 of the Model Convention, in which the scope of shareholder costs is indicated, could be devised for that purpose;
- b) As a follow-up to simultaneous tax audits or to other bilateral consideration of the tax liability of the MNE, agreement could be reached for a given period of years between the tax authorities involved on the scope of non-chargeable costs and costs which should be allocated to associated enterprises;
- c) In suitable cases, mutual agreement procedures (possibly even initiated before double taxation occurs) may help in practice to reduce any unfortunate consequences for the taxpayer which may arise from the adoption of divergent approaches by tax authorities; certainly, it is desirable that tax authorities should give careful consideration to the difficult situation which may arise for the MNE if they cannot agree on a single approach.

## C. METHODS OF ALLOCATION AND APPORTIONMENT

### Introduction

44. Where it is accepted that central costs should be charged out for tax purposes, the question arises of the basis on which the amount of the charge should be compiled. It should be noted first of all that it is not exclusively a tax requirement that costs incurred to benefit associated enterprises should be borne by those enterprises. Many MNEs consider it also to be necessary, from an economic point of view, that the separate parts of the enterprise should each bear the costs of activities carried out on their behalf by other parts, so that the full costs of producing the goods or services can be accurately ascertained for the purpose of fixing the price to be charged to the public at a profitable level, and also so that the profitability or viability of the separate parts of the enterprise can themselves be ascertained. Furthermore, from a financial point of view, it may well be necessary, or at any rate convenient, for the parent company, or the group service company, in a multinational group, to be remunerated in full for the services they provide by the entities to which these services are provided, so that their financial resources are kept in a state to match their responsibilities.

45. MNEs use various methods of charging group members for costs incurred by parent companies or group service centres for services provided to associated enterprises. In practice, the following methods are perhaps most commonly employed to charge central management and service costs:

- a) Charging directly for individualised services;
- b) Allocating and apportioning costs to each of the associated enterprises (usually by reference to an estimate of their share in the benefits arising from the services) – “cost-sharing”;
- c) Remunerating the group service centre by a contribution from other parts of the enterprise related to some broad aspect of the business of the enterprises concerned – e.g. by reference to their gross turnover – “cost funding” or what has sometimes been called the “fixed key” method;
- d) The inclusion of a mark-up in the price of products sold to an affiliate by the company which incurs the central costs.

Methods b), c) and d) are referred to as “indirect methods”, since the relation between the service and the remuneration is only indirect.

#### Attitude of tax authorities

46. The attitude of the tax authorities of Member countries with respect to allocation methods varies quite considerably.

47. In one country, no deduction is allowed for payments by subsidiaries in respect of central management costs. The only deductible payments are those for specific services which confer a concrete benefit on the associated company concerned.

48. The tax authorities of another country take the view that only when a direct method is being applied can the separate enterprise principle *stricto sensu* be met and the corresponding benefit be measured adequately. Only in extreme cases – when direct charging is not possible and it is clear that real benefits are conferred on the paying companies – are they prepared to accept an indirect method, i.e. such as cost-sharing.

49. Most Member countries' tax authorities would prefer, in principle, that MNEs should, at any rate for tax purposes, use the direct-charge method, since this should *prima facie* make for greater transparency in the transactions between associated enterprises and consequently reduce the possibility of profit shifting. They accept nevertheless that it would in many situations impose a disproportionate administrative burden upon an MNE to insist upon the use of the direct-charge system, and they recognise therefore that, for many services provided to benefit a wide range of associated enterprises, the allocation of the benefit (and thus of the cost of providing it) must inevitably be done, to a certain extent, on an approximate or estimated basis. They would not therefore insist in all cases on the use of the direct-charge method in priority to others. In paragraph 165 of the 1979 Report, the comment is made that where it is not possible to compare the service fee charged by an associated enterprise with the price charged in a sufficiently similar open market transaction, a cost-oriented method may be helpful in providing an approximation to arm's-length prices. This would often be the situation in cases where it was recognised that a direct-charge method was inappropriate and in such a situation some form of cost-contribution arrangement (whether cost-funding or cost-sharing as these are described in the 1979 Report) may have to be accepted by the tax authorities.

However, this would be acceptable to tax authorities only if the taxpayer provided sufficient information to verify the application of the method.

50. In the case of countries adopting the “second approach” described in paragraph 41 above, it would, however, only be in extreme cases, where direct charging is impossible but it is clear that benefits of an immediate nature are being obtained by the paying company, that the tax authorities would be prepared to accept an indirectly calculated charge. In such a case, they would accept the cost-contribution basis (whether cost sharing or cost funding) which could be considered the most satisfactory in that particular case.

51. Charges based on the fixed-key method would ordinarily be regarded as unacceptable in principle by the tax authorities of some countries since such charges are insufficiently closely related to the benefits derived by the paying entity, and may often not be very closely related even to the costs incurred by the entity making the charges.

52. The tax authorities of one country are of the opinion that no priority should be given to the direct method in view of the disproportionate workload it may involve. They also consider that it would be wrong, from an economic viewpoint, to impute entirely to one company expenses incurred at a given point in time for services performed for that company's benefit, where such activities – and the related expenses – result in knowledge and experience which are later put at the disposal of another company in the group. In practice, therefore, they view the direct method as applicable only to specific services rendered to a company, which are of interest only to that company.

#### Direct method

53. The direct method is sometimes used by group service centres which specialise in certain types of service which are also rendered to third parties. This method has the advantage that economic reality and fiscal principles are reflected as fully as possible: costs relating to the services are borne by the associated enterprises which actually make use of the services concerned.

54. It is clear that in general the direct-charge method, since it makes it possible to achieve the highest degree of separation and passing on of cost in proportion to the benefits received, is of great practical convenience to tax authorities, and for that reason is likely to be more acceptable to them than indirect methods.

55. It may be stated, moreover, that in any event, if specific services are rendered not only to affiliates but also to third parties, then, in the tax computation, those which are rendered to affiliates should normally also be paid for by way of a direct charge. If it is possible to organise clerical matters in such a way that work and costs can be broken down per non-related client, it would seem permissible to require the same in an intra-group situation as a special aspect of the arm's-length principle. It is accepted, however, that this approach may not always be appropriate if, for example, the services to third parties are merely occasional or marginal [see paragraph 67 f)].

56. The arm's-length criterion is met under direct methods as long as the amount charged is an arm's-length amount. The benefit question, described in paragraph 30 above will not normally arise under a direct-charge system if the services are actually rendered. In addition the risk of duplication (see paragraph 153 of the 1979 Report) will be less.

57. Although it is unlikely that tax authorities will have legal power to insist on the application of the direct method, the preference of the tax authorities of many Member countries for that method is of relevance for MNEs. Problems with the tax authorities of countries where service-receiving companies are located may be reduced if MNEs adopt the direct-charge method for those kinds of centrally provided services to which this method can reasonably be applied, for instance, services provided by a separate group service centre.

### Indirect Methods

58. As indicated above, there are central services in relation to which it is so difficult to apply the direct-charge method that in practice it may be accepted that it is impossible. There are at least two basic situations in which this may occur.

59. The first is that the proportion of the value of the benefit arising to the various relevant entities cannot be quantified except on an approximate or estimated basis: this problem may occur, for example, where sales promotion activities carried on centrally (e.g. at international fairs or in the international press) may affect the quantity of goods manufactured or sold by a number of affiliates.

60. The second is that a complete recording and analysis of the relevant activities would involve a burden of administrative work which would be disproportionately heavy in relation to the activities themselves: this problem may arise, for example, with regard to the activities of the central management and its secretariat.

61. In such cases, MNEs may reasonably claim that they have no alternative but to use indirect cost allocation and apportionment methods, though as has been pointed out in paragraph 55 above, this would not be the case where the same services are provided to third parties.

62. The methods referred to in paragraphs 45 *b*) and 45 *c*) may be preferred by highly-integrated groups of companies, since the benefit of the central activities which are peculiar to such companies often cannot be precisely related to individual group members. The fixed-key method is based on figures relating to the business of the enterprises receiving services and may be somewhat arbitrary since the relation between benefit and payment is not a direct one (cf. paragraph 162 of the 1979 Report). The mark-up method is sometimes practised in cases where a production or buying entity within the group also provides services (e.g. technical assistance, marketing) to the intra-group buyers.

63. The question then arises whether these methods satisfy the arm's-length criterion. While, in the case of direct charges for individual services, the question is only whether the amount charged is an arm's-length amount, in the other cases, the method may be regarded as being an arm's-length method if it can be shown to have been used for similar costs between unrelated parties. The question then is, again, simply whether the amount charged is an arm's-length amount. As indicated in paragraph 62 above, cost-sharing or cost-funding arrangements may be preferred by MNEs since such arrangements provide, for MNEs, a comparatively simple method of charging managerial and co-ordination costs which have been incurred for the benefit of the associated enterprises, but which normally cannot easily be separated for individual group members. It may, however, be questioned whether such arrangements correspond to the arrangements which would be made between unrelated parties. Nevertheless, it would be wrong to ignore completely the special situation of MNEs,

and the fact that these methods are not applied, or are very seldom applied, between unrelated parties ought not to lead one to conclude that they necessarily produce charges which must be regarded as not at arm's length. In making a judgment as to whether any particular instance of the use of such methods is acceptable, there should also be taken into consideration such relevant factors as the amount of the charge or the terms of any formal contract, and the reasons why the method has been used.

64. When an indirect method of charging is used, the relationship between the costs and the services provided is obscured and it may become difficult to assess the value of the benefit provided. Indeed, it may mean that the contributing enterprise is less aware than in the case of the direct-charge method that it is incurring costs for certain facilities and, in consequence, is less aware of whether or not it is benefiting from them.

65. The most appropriate indirect method is generally recognised to be one which is based on sharing among the beneficiaries, in proportion to the benefits received or expected, the actual costs incurred in providing the services.

66. As described in paragraph 30 to 32 above, the problem may arise that the tax authorities in country B permit deductions in a given year only for costs which are in accordance with the actual use of the services available. The double non-deductibility of costs in such cases may produce economic double taxation. This may, in principle, be considered unjustified, especially if the indirect method has to be used because the direct method cannot be applied for the reasons mentioned in paragraphs 58-60 above. The risk of double taxation can be reduced considerably, however, if MNEs apply indirect methods in accordance with the rules described in paragraph 67 below and tax authorities also accept indirect methods applied in accordance with them.

67. It would be easier for tax authorities to accept the cost-sharing or cost-funding arrangements of MNEs if they could be set up and applied in a manner which would remove the fear that these indirect methods could lead to the shifting of profits for tax reasons. Thus it would help in this context if the following principles were observed:

- a) The method should be laid down in clearly formulated and binding contracts, concluded in advance;
- b) These contracts should be observed consistently over several years;
- c) The contracts should apply to those associated enterprises which will benefit, or from an ex ante point of view may be expected to benefit, from the activities;
- d) The costs of the relevant activities should be determined on the basis of generally-acceptable accounting principles (such as those underlying the consolidated group's annual report);
- e) The group members which share the costs should have full access to the services concerned;
- f) Where the services are provided to third parties as well as to affiliates and, exceptionally, the remuneration from third parties cannot satisfactorily be used as the basis for the use of a direct-charge method (see paragraph 55) then the costs chargeable should be reduced by the remuneration received from the third parties;
- g) The contracting group members must not pay for the services concerned in any other way;
- h) Alterations in the responsibilities and activities of group members which influence their benefit position should be taken account of as soon as possible in the contracts (changes in profitability would not normally justify amendment of the contract).

Other principles could be added to this list, depending on the actual circumstances in any particular case.

68. If the application of an indirect method in a specific case is acceptable, it would evidently be helpful if the tax authorities concerned could give guidance in advance about the acceptability of the contract. In that case, they may need to require from the MNE as detailed information as seems necessary to them about the structure and organisation of the MNE and the functions and responsibilities of its components in order to be able to determine whether, for example, the circumstances mentioned in paragraphs 58-60 are present and the principles set out in paragraph 67 are being followed (so far as this can be judged *ex ante*).

69. It is clear too that for this purpose, the tax authorities of country B may have to obtain information from the tax authorities of country A and other countries involved under the relevant tax conventions or other mutual assistance instruments.

70. In fact, one way in which the tax authority might be enabled to give satisfactory advanced guidance would be for it to arrange a simultaneous examination or other investigation of the MNE's affairs by both countries A and B, which would enable both tax administrations, using their exchange of information arrangements, to check the allocation system for internal consistency and appropriate application to individual cases and so on. Such an examination could in fact serve as a basis for the future avoidance of conflicting treatment in the two countries. Some tax authorities would indeed feel unable to give any kind of advance guidance, however, informal, except where the taxpayer's affairs were in the process of being examined, since only in these circumstances would there be, in their view, a sufficiently satisfactory possibility of taking all the facts and circumstances into account.

71. There are, however, problems involved in giving advance rulings and some administrations would find it very difficult to accept a general obligation to do this. Nevertheless, it is likely that the effect of the tax administration's examination of any particular MNE's affairs will be to indicate to the MNE what sort of charging policies will be acceptable for the immediate future in any case, and it is recommended that tax authorities which cannot give advance rulings as such should bear in mind the possibility of giving less formal guidance in the process of any examination of the MNE's charging practices.

72. Any commitments entered into in the course of giving such guidance would obviously need to be dependant upon the facts and circumstances remaining substantially the same as they were or were expected to be, when the guidance was given. If the contract is acceptable and carried out correctly (especially with regard to condition *h*) of paragraph 67), tax authorities should refrain from making a profit adjustment based on a benefit test applied to one single fiscal year. In the case of fluctuating volumes of services, consideration should be given over a period of years as to whether the remuneration adequately reflects the services rendered.

73. It would aid an *ex post* consideration by the tax authorities of country B, of the amount of costs and the way in which they are allocated, if the tax authorities of country A could provide a certificate testifying to the accuracy of the amounts of cost and allocation method (see paragraph 20 above).

### *Chapter III*

## AMOUNT OF REMUNERATION

74. After the question of whether a direct charge or a charge based on an indirect method is appropriate for the costs concerned, it has to be decided whether, in the case where a direct charge is possible, a price based on the open-market value should be used or whether a cost-oriented method (whether or not including a profit mark-up) is appropriate. In cases where only an indirect method can be used, the problem is whether or not the charge should include a profit mark-up.

75. Paragraph 160 of the 1979 Report states that the general principle to be followed is that prices for services performed between associated enterprises should be those which would be paid between unrelated enterprises. Normally, to determine the arm's-length price, the open-market value of the service rendered would have to be determined (see paragraph 164).

76. Where it is not possible to find a comparable open-market price or where such price is not indicative of an arm's-length charge, then the Report indicates that a cost-oriented method may be appropriate. The charge should then reflect all relevant direct and indirect costs and should normally include an appropriate profit element (paragraphs 165-167).

77. From the general rule in paragraph 160 of the 1979 Report it is possible to conclude that a profit mark-up need not be made in cases where the service is usually performed between unrelated parties on a cost-price basis.

78. However, paragraph 168 of the 1979 Report identifies three cases in which a profit mark-up is always appropriate:

- a) If the provision of such services is one of the main activities of an enterprise;
- b) If the provision of such services is not a main part of its business but the enterprise is particularly capable of supplying such services and the value of the services to the recipient is considerably greater than the cost;
- c) If the cost of the services represents a substantial proportion of the expenses of the recipient's business.

79. The above list is not meant to be exhaustive but it has proved difficult to point to further general cases where a profit mark-up is invariably appropriate. Cases 1 and 2 seem to be more clear-cut than case 3. In the first two cases the activities concerned are in any event one of the potential sources of profit for the company concerned. If the management of the group and/or the service centres are centralised in one company established solely for that purpose, a profit mark-up is an economic and fiscal exigency. Otherwise, that company would

not have any profit-making capacity. In the third case, it may occur that providing the service is, in fact, merely an ancillary activity for the company which provides it, but that in a certain period one of the associated companies renders the service extensively. Should the charge to that company then include a profit mark-up? The answer may be that if this case is an example of the kind of case referred to in paragraph 78 b) above – the value to the recipient is considerably greater than the cost – then the charge should include a profit element.

80. When a *direct* method can be used, which may be the case for separate central service departments, and services of the same kind are also rendered between independent parties, the charge should, as paragraph 164 of the 1979 Report points out, be based on the open-market value. As in the case of an independent service company, the service department will make a profit when using its capacity fully and efficiently but when “production” is low the charges may not cover the cost and the department may incur a loss.

81. However, it is necessary to realise that, even when an open-market price for the service concerned can be determined, it is not always appropriate to apply that price to the services rendered by service departments of MNEs. Tax authorities of certain Member countries in fact take the view that, when the direct method is being used, the charge should include a profit element whether the services are also rendered to third parties or solely to group members. On the other hand, in some circumstances, it is arguable that a profit mark-up may be inappropriate and that it is necessary to take into account the special circumstances of such companies within an MNE. In practice the function and situation of service departments of MNEs may differ considerably from those of independent businesses performing the same kinds of service. One important difference is that in many cases group service departments render services to group members only. The function of a department of this kind is essentially to reduce the costs of the group and thus to assist the group as a whole to make a profit, rather than, as in the case of an independent business, to make a profit for itself. If the demand for its services from other group members diminishes in a certain period it may not be possible for the department to increase profitable production or other activities by increased marketing effort. In such a case, it may be reasonable (so long as the circumstances described in paragraph 78 above do not appertain) to accept that the company could not seek to recover more than its costs from the other members of the group.

82. Nevertheless, if the function of the department rendering the services includes that of competing in the open market with other suppliers of such services and if in fact a substantial proportion of its activity consists of rendering such services to unrelated parties, then the prices which it charges those parties would also be appropriate in charging related customers for those services.

83. The question arises whether or not the remuneration for services with respect to *indirect methods* should include a profit element. Paragraph 168 of the 1979 Report does not distinguish between cases where direct methods are employed and those where indirect methods are employed. It would follow that a profit mark-up would be appropriate in the situations set out in paragraph 78 above, whether direct or indirect methods were employed. But where the tax authority accepts the use of indirect methods which are based on sharing the costs of providing the services, in a manner proportionate to the respective benefits received from those services, by each entity in the group, then it may, ordinarily, be inappropriate to look for a profit mark-up in the case of one of the receiving companies (because, for example, the value of the services represents a substantial proportion of the expenses of that particular company) when such a mark-up is not looked for in the case of other members of the group (because the other companies are not in any of the situations listed in paragraph 78).

84. One country in fact takes the view that a profit mark-up is not required in the case, listed in paragraph 78 above, where indirect methods are employed in calculating the charges for services.

85. This may lead to problems where other countries normally insist on a profit mark-up when the activity concerned forms an integral part of the activities of the service rendering company. However, the differences in practice may be reduced by the fact that the country concerned allows the total costs to be shared to include a fee for the invested capital. Such a fee represents profit under the law of most countries, but may not be equal to the “plus” in cost-plus calculations upon which cost-sharing contracts should be based in the aforementioned circumstance.

86. To summarise this chapter, enquiries made into the approaches adopted by Member countries to the question of what should be the appropriate basis for calculating the amount of the charge to be required for central services reveal no fundamental differences of opinion between them except on the points mentioned in paragraphs 83-85 above. However, because circumstances vary widely in practice, practical problems may arise. In the final analysis, solutions may need to be found in mutual agreement procedures – or in discussions between tax authorities as a follow-up to simultaneous tax examination or audits

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