Transfer Pricing in a BEPS Era: Rethinking the Arm’s Length Principle – Part II

In the second of a two-part article, the author considers how the arm’s length principle could be enhanced to meet the substance and value alignment requirements of the OECD BEPS initiative. The boundaries and concepts of the arm’s length principle are explored, taking into account the analysis in the Part I of the article, published previously, and insights from economics. Guidance from the OECD and the case law of various jurisdictions are included in this study. Recommendations are presented to amend the Commentary on Article 9 of the OECD Model and the guidance in the OECD Guidelines.

1. Introduction

This article addresses the impact of the base erosion and profit shifting (BEPS) initiatives on the application of the arm’s length principle. The G20-led initiative requires the OECD to undertake actions in order to provide assurance that – taking into consideration that the business activities of multinational enterprises (MNEs) are increasingly globalized – transfer pricing outcomes are in line with value creation.1

First, this article presents a historical analysis of the implementation of the arm’s length principle in transfer pricing, and a comparison of several domestic applications of the arm’s length principle in practice (regarding Australia, the Netherlands, the United Kingdom and the United States) is made. Subsequently, the boundaries of the arm’s length principle – including the role of contracts – are analysed, taking into account insights from economics, as transfer pricing not only is inherently a legal topic, but is also affected by economic considerations. This is followed by an analysis of guidance found in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines),2 and in the recent OECD discussion drafts.3 A future role is envisioned for “relational contracting”, depending in force on the governance structure within the MNE and the attributes of the transaction. Recommendations for amendments to the OECD Guidelines and the Commentary on article 9 of the OECD Model are presented. Finally, the author concludes that the arm’s length principle could meet the requirements in a BEPS era if it is enhanced (again), focusing on economic substance in order to tackle the increasing anti-abuse and value alignment requirements emerging in a BEPS era.

This article is divided into two parts. Part I, published previously, covered the historical and comparative analysis of the implementation of the arm’s length principle in Part I of this article. Three major boundaries of the arm’s length principle are considered here: taxing the economic profit, transactions not found between independent parties, and divergence in the objective and in the domestic implementation of the arm’s length principle.

2. The Boundaries of the Arm’s Length Principle

Based on the historical and comparative analysis of the implementation of the arm’s length principle in Part I of this article, three major boundaries of the arm’s length principle are considered here: taxing the economic profit, transactions not found between independent parties, and divergence in the objective and in the domestic implementation of the arm’s length principle.

2.1. Taxing the economic profit

The arm’s length principle is based on a comparison to the conditions made or imposed between independent parties. However, the associated entity concerned is part of an integrated group, while the independent party is not. The economic profit of the group may then not always be taken into account within the arm’s length principle.5

This first boundary can be understood from the historical analysis of the arm’s length principle. Initially, the standard was developed for a permanent establishment context. Here, the residence state of the MNE, after remunerating the permanent establishments for their services, retained

5. This flaw of the arm’s length principle is addressed in the OECD Guidelines at para. 1.10.
the residual economic profit and was the location of the central management and vital part of the MNE.\(^6\)

However, the business model of MNEs has changed considerably since then, and the allocation of the economic profit as residual to the residence state of the MNE may not fit the business models any longer.\(^7\) Many MNEs are far more integrated than typically was true in the past, and the residual profit is no longer necessarily related to one separate central and vital entity.

This inherent flaw of the arm’s length principle for associated entities possibly not taxing all economic profit of the MNE, becomes especially significant when residual profit is reported in a low-tax jurisdiction (contractual reallocations of risk and cost sharing arrangements as used in the last decades have allegedly led to a shifting of residual profit to low-tax jurisdictions) and the relative amount of this profit in the low-tax jurisdiction seems out of sync with the relative substantive operations within that same jurisdiction.\(^8\)

2.2. Transactions not found between independent parties

Associated entities may engage in transactions that independent parties would not, due to different commercial circumstances. This does not mean these transactions cannot be arm’s length.\(^9\) It does imply a more complex comparability analysis due to the need to hypothesize what conditions would have been established by independent enterprises.

The necessity to hypothesize arm’s length conditions for a transaction not found between independent parties leads to a focus on the commercial and economic rationale of the transaction. The arm’s length principle, as internationally developed, refers explicitly to the economic and commercial reality of the transaction and the economic principles that generally govern relationships between independent parties.\(^10\)

Guidance on economic principles and on the extent to which transactions between associated enterprises not found between independent parties may be hypothesized then needs to be internationally developed. How far may tax authorities go to adjust this type of transaction as actually undertaken between associated enterprises is the issue, specifically concerning the extent to which reallocation and/or recharacterization are within the scope of the tax authorities.

Ordinarily, a tax administration should base the examination of a controlled transaction on the transaction actually undertaken by the associated enterprises as it has been structured by them.\(^11\) Only in two particular circumstances, exceptionally, may a tax administration consider disregarding the structure as adopted by the MNE, as stated in the OECD Guidelines.\(^12\) The first circumstance arises where the economic substance of a transaction differs from its form.\(^13\) The second circumstance arises where, while the form and the substance of the transaction are the same, the arrangements made in relation to the transaction – viewed in their totality – differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.\(^14\) Historical analysis relates the first circumstance to the application of domestic substance-over-form rules and specifically to the interaction with domestic thin capitalization rules.\(^15\) Its introduction followed the amendment of the Commentaries on Article 9 of the OECD Model in 1992 to include recharacterization of loan transactions into equity capital within the scope of article 9 of the OECD Model.\(^16\) The second circumstance relates to the commensurate-with-income standard included in section 482 of the US Internal Revenue Code.\(^17\)

2.3. Divergence in the objective and in the domestic implementations of the arm’s length principle

Where, internationally, the arm’s length principle has mainly been an income allocation approach, in domestic law the arm’s length principle has always embodied an anti-abuse approach.\(^18\)\(^19\) This friction between the interna-
tional and national objectives of the arm’s length principle allows for diverging interpretations of the arm’s length principle, making any international enhancements a difficult task. The friction is illustrated by the divergences in the domestic implementation and application of the arm’s length principle.

The divergences in the domestic implementation and application of the arm’s length principle were analysed in Part I of this article. Major divergences were distinguished regarding the focus on one-sided methods versus total or residual profit scope; substance-over-form versus form-over-substance; and pricing solutions versus recharacterization in exceptional circumstances.20

3. Economic Theories on the Firm, Organization and Contracts

3.1. In general

To explore the boundaries of the arm’s length principle, it is useful to borrow insights from economics. Especially for transactions within MNEs that are not easily found or do not occur between independent parties (the value and profits related to these pure intra-group transactions may be very material to total profits), it is arm’s length to focus on the conduct of the parties and the economic principles that govern the relationships between parties.21

3.2. Some fundamental concepts

“Economics is the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses”, could be an adequate definition.22 During the 20th century, economics was mainly developed as a science of choice. Economics as a science of contract was another development which became more prominent towards the end of the 20th century.23

Some fundamental concepts of economics of choice are maximization, equilibrium and efficiency. Economic actors are expected to maximize: consumers maximize utility and firms maximize profits. Maximization assumes rationality of the economic actors, meaning that a rational economic actor can consider alternatives and choose the one that best fits its goal.24,25 The equilibrium is the pattern of interaction between maximizing economic actors that persists, unless disturbed by outside forces.26 Economists usually assume that markets, as an example of a place of interaction between firms, tend towards equilibrium. Production and resource allocation is to be efficient; resources are to be allocated to their highest-valued use. Economic profit is total revenues minus total costs of production and minus the average rate of return on capital.27

Risk and insurance are further fundamental concepts. Decisions are made under uncertainty. When considering the alternatives to choose from, an economic actor can compare expected values, where the value of each outcome is set against its probability of occurrence. However, each actor can have a different attitude to risk: an economic actor can be risk averse, risk neutral or risk seeking. Economists generally consider individuals risk averse, and business organizations risk neutral.28 To avoid having to face uncertain outcomes, an economic actor can purchase insurance.29 Insurance companies can face the issues of moral hazard and adverse selection. These effects are countered by them, for example, by using co-insurance to mitigate moral hazard.30

Economic actors want to gain from trade; they bargain, i.e. have a dialogue on value to agree on a price.31 Bargaining theory is criticized, however, for being over-inclusive and under-inclusive.32

The contract is an instrument for exchange. It ensures cooperation between economic actors and creates incentives to perform. A perfect contract efficiently allocates the entitlements of the trade at zero transaction cost. Every contingency is anticipated; every risk is internalized; all information is communicated; and there is no deceit, abuse or interpretation issue.33 In practice, real contracts are incomplete: the cost of negotiating and drafting terms to allocate all possible contingencies is considered to be too high.34 When remote risks occur and hamper the performance

20. See Part I of this article, supra n. 4, at 3-6. (analysing the focus of the United States, the United Kingdom, Australia and the Netherlands regarding each criterion; the majority focus on one-sided methods and pricing solutions was seen, as well as tension between substance-over-form and form-over-substance).


22. Williamson, supra n. 22, at 172.

23. Williamson, supra n. 22, at 172.


25. Cooter & Ulen, supra n. 24, at 50-51. Bounded rationality implies that individuals/economic actors cannot oversee all possible alternatives, their capacity is bounded instead of unbounded.


27. Cooter & Ulen, supra n. 24, at 28 and 38-41. So, when the rate of return on invested capital in an industry equals the average rate of return for the economy as a whole, it is said that economic profits are zero.


29. Cooter & Ulen, supra n. 24, at 47. Insurance companies use the law of large numbers: unpredictable events for individuals become predictable on large scale for these companies.

30. Cooter & Ulen, supra n. 24, at 48-49 & 236-240. Insurance companies have developed methods to minimize the effects of moral hazard and adverse selection. Examples are co-insurance or deductibles to mitigate moral hazard, as well as individual premium levels based on experience rating to tackle adverse selection.


32. Cooter & Ulen, supra n. 24, at 281-282. Over-inclusion occurs where, on other grounds (such as coercion or necessity or incompetency), the bargain ought not to be enforced. Under-inclusion occurs where there is no prospect of gain, but actors do want the bargain (such as for gifts or when overcapacity exists), and when there is no consideration but actors do want the bargain (such as with an option-to-buy within a specific period given by the seller without the buyer giving any consideration).


34. Cooter & Ulen, supra n. 24, at 292-293.
formance of the contract, economists expect the liability to be assigned to the party that can reduce or spread the risk at the lowest cost. Efficient contracts unite knowledge and control over resources at the lowest cost, including transaction costs of transmitting information and selling goods. This would enhance innovation and creation of value.

3.3. Theories on the firm and organization

Theories of MNEs started with the theory of the firm by R.H. Coase prior to World War II. This is almost concurrent with, but after, the enactment of the arm’s length principle. According to Coase, firms come into existence where the pricing mechanism of the market is replaced by “entrepreneurship” in an organization. The entrepreneur exercises authority to direct resources and saves costs of the market (or transaction costs, as these costs are later being referred to). An organizational approach focusing on transaction costs and governance was further developed by O.E. Williamson by the 1970s. Williamson works from a combined law, economics, and organization perspective. Williamson described pairings of conditions leading to market structures set aside by organizations: the pairing of the human condition of bounded rationality with uncertainty, complexity, and the pairing of the human condition of opportunism—economic actors/humans tend to act with “guile” – with the condition of small numbers bargaining. Furthermore, Williamson considered organization to be important where relation-specific investments are large. Once relation-specific investments have been made, the parties are “locked in” and opportunistic behaviour could rule. The organizational form, however, will counteract the opportunism, will provide more effective means of monitoring and will provide less costly dispute settlement.

The theory of the firm by Coase and the organizational framework by Williamson both suggest that MNEs arise due to organizational and internalization advantages, and that the return to the MNE will exceed the apparent aggregate of the individual returns imputable to the separate components under any kind of marginal costing notion. In other words, MNEs generate economic profits. MNEs make greater profits by directing the allocation of productive resources, and thereby benefiting from economies of scale, saving on transaction costs, and fully exploiting assets which could not have been fully exploited in the market due to their specific characteristics.

A further theory of MNEs generating economic profits in an industry focuses on competitive advantage and the concept of the value chain. This theory was developed by M.E. Porter in the 1980s. Value chain analysis is helpful to determine the extent of economic profit, and the extent of value creation per activity. It is recognized as a concept in the UN Manual, and the concept of global value chains is included in the BEPS Report and in the Discussion Draft on Revisions to Chapter I.

3.4. Governance and contracts

An organization can be seen as a governance structure of ongoing contractual relations. Williamson distinguishes the governance forms of market, hybrid and hierarchy, and distinguishes the following attributes that each has in a supporting relation to the others: coordinating and control mechanisms; adaptation to disturbances abilities; and a distinct type of contract law.

Regarding the distinct types of contract law, Williamson distinguishes between classical contract law, neoclassical contract law and relational contract law. Classical contract law applies to the perfect transaction in which the identity of the parties is irrelevant. Disputes are settled through courts by the award of monetary damages. An example could be commodity trading contracts. Neo-classical contract law applies to contracts where parties to the transaction “maintain autonomy but are bilaterally

35. Cooter & Ulen, supra n. 24, at 349-352.
38. S.I. Langbein, The Unitary Method and the Myth of Arm’s Length, 30 Tax Notes (1986), at 667, referring to and citing O.E. Williamson. In small numbers bargaining, “it is in the interest of each party to seek terms most favorable to him, which encourages opportunistic representations and haggling” Williamson also considers that initial large number bargaining can become small number bargaining at contract renewal in the market due to first-mover advantages that can upset the parity among suppliers. Information asymmetry arises when these conditions pair. As Williamson puts it, “true underlying circumstances relevant to the transaction, or related set of transactions, are known to one party but cannot be costlessly discerned by or displayed to the others”. O.E. Williamson. Markets and Hierarchies: Analysis and Antitrust Implications. A Study in the Economics of Internal Organization (Free Press 1973).
39. O.D. Hart. Incomplete Contracts and the Theory of the Firm, 41 J Law. Econ. & Organization (1988), at 121 (referring to the work of Coase, Williamson, Klein, Crawford and Alchian, and referring to correspondence of Coase revealing Coase had considered the importance of specific investments as early as 1932).

40. Williamson, supra n. 22, at 173-178; Hart, supra n. 39, at 121 referring to Williamson; Langbein, supra n. 38 at 668 referring to Williamson.
41. Langbein, supra n. 38, at 869.
42. M.E. Porter, Competitive Advantage, ch. 2 (The Value Chain and Competitive Advantage), at 33-61 (The Free Press 1985). Porter formulated the concept of value chain at 33-34 (“The value chain disaggregates a firm into its strategically relevant activities in order to understand the behavior of costs and the existing and potential sources of differentiation. A firm gains competitive advantage by performing these strategically important activities more cheaply or better than its competitors.”)
43. UN, Dept. of Econ. & Soc. Affairs, United Nations Practical Manual on Transfer Pricing for Developing Countries (2013), at 47-51; OECD, Addressing Base Erosion and Profit Shifting, supra n. 1 at 26-28; OECD, Discussion Draft on Revisions to Chapter I, supra n. 3, para. 79.
44. Williamson, supra n. 22, at 173.
dependent to a non-trivial degree. The parties identify themselves and provide for actions when contingencies occur, and provide for arbitration. Examples given by Williamson are public utility regulation, exchange agreements and franchising. 47

The contract law of internal organization, according to Williamson, is that of “forbearance,” or “relational contracting.” The parties to the transaction are fully bilaterally dependent – asset specificity especially creates bilateral dependency and poses added contracting hazards. Asset specificity exists where redeployment of the transaction-specific asset to alternative use or by alternative users comes at loss of productive value. Williamson distinguishes six forms of asset specificity, including site specificity, physical asset specificity, human-asset specificity, brand name capital and dedicated assets. 48 The parties to the transaction bilaterally adapt through “fiat” within the hierarchy. 49 Courts will refuse to hear disputes between one internal division and another over technical issues, and there is a presumption that such differences are resolved internally. Examples of such disputes relate to transfer pricing, accounting, failures of quality and the like. 50 See Figure 1 and 2.

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47. Williamson, supra n. 45, at 271-272.
48. Williamson, supra n. 45, at 281-282; and Williamson, supra n. 22, at 176.
49. Williamson, supra n. 45, at 274-275 (discussing incentive efficiency for internal organization). As compared to markets, internal incentives for employees in hierarchies are flat, (meaning changes in effort have little effect on compensation), and these flat incentives help create greater cooperation. Unwanted side effects are checked by internal control, and employees will accommodate to cooperation, as unwillingness to accommodate, and litigating, will damage promotion prospects (as cooperation is an essential criterion).
50. Williamson, supra n. 45, at 273; Williamson, supra n. 22, at 178.
As a consequence of transaction costs (and hierarchy), parties to a relationship will not write a contract that anticipates all events, nor all appropriate actions in these events. Thus, parties will write a contract that is incomplete. Subsequent events will occur in which parties desire to act differently from the manner (generally) specified in the contract. Consequently, parties will seek to revise the contract.\(^5\)

The work of O.D. Hart, building on Coase and Williamson, focused on incompleteness of contracts and the theory of the firm, and emphasized the notion of residual rights of control (over physical assets).\(^3\) A key difference according to Hart “between an arm’s length transaction and a transaction inside an organization concerns who has residual control rights – that is who has the right to determine what happens in events not covered by explicit contractual terms.”\(^4\) Consequently, in an arm’s length situation where events occur which were not covered in an initial contract, the parties will renegotiate the initial contract or disputes may arise.\(^7\)

Furthermore, an analysis by N. Bastian Johnson focusing specifically on the transfer pricing of intangible assets and divisional performance measurement, concludes that a royalty-based transfer price that can be renegotiated provides better investment incentives than either a non-negotiable royalty-based transfer price or a purely negotiated (lump sum) transfer price.\(^5\) This incentive analysis is consistent with Williamson and Hart. The initial contract is incomplete and the asset is so specific that the hierarchy form of organization is the most investment- and cost-efficient structure. The renegotiation aspect answers to the investment efficiency and to the adaptation through cooperation needs. Finally, the insights that could (additionally) be valuable to the arm’s length principle are specifically: efficient governance structure, relation-specific investments (i.e. asset specificity), bilateral dependency (i.e. strategic interdependence), relational contracting, incompleteness of contracts, renegotiation of contracts and efficient (re)allocation of risks.


4.1. In general

Concepts of the arm’s length principle relating to its boundaries as discerned in section 2, above, include the following: commercial rationality; economic substance; control over risk and risk allocation; economic profits and synergies; and the tool of recharacterization. Reflecting on these concepts to explore the boundaries of the arm’s length principle, guidance within the OECD Guidelines and the recent discussion drafts are mainly considered, and reference is also made to case law and guidance found from the comparison of domestic implementations of the arm’s length principle in Part I of this article. Furthermore, relational contracting, as developed in economics, is taken into consideration, and special measures which could be considered to go beyond the arm’s length principle and/or to stretch its boundaries are briefly reflected upon.

4.2. Commercial rationality

Commercial rationality is only implicitly described in the OECD Guidelines.\(^5\) The guidance in chapter 1 and chapter 9 includes only relative terms, such as “economically relevant differences”, “plausible expectation of a return”, “anticipated synergies”, “normal commercial behaviour”, “tax motive or purpose”, “group level business reasons” and “at arm’s length for each individual taxpayer”.

The Discussion Draft on Revisions to Chapter I is more explicit and suggests the concept of “fundamental economic attributes of arrangements between unrelated parties” to consider when testing commercial rationality. This Discussion Draft relates this concept to a reasonable expectation to enhance or protect commercial or financial positions on a risk-adjusted (the return adjusted for the level of risk associated with it) basis.\(^7\)

In Australia, the recent taxation ruling on the new transfer pricing regime refers to commercial reality within the context of the substance of commercial and financial relations between entities; relations having commercial purpose, character or rationale. It states that these relations...
tions should accord with normal commercial or business behaviour and practices of the entity and the industry, and make a difference in the creation or addition of economic or commercial value such that these differences affect the net economic position of the parties to those relations.58

Two decades ago in Germany, the “prudent and diligent manager” principle was formed in case law.59 It identifies the prudent and diligent manager who expects a reasonable overall profit:

[... an orderly and diligent manager will, for the corporation managed by him, introduce to the market and distribute a new product only if he can expect, based on a prudent and pre-prepared economic forecast, a reasonable overall profit within a foreseeable period of time with due consideration to the predictable market development.60

The more recent Dixons (2009) case in the United Kingdom can be taken as an example of the guidance on “group level business reasons”.61,62 There are often sound commercial reasons for multinational to establish a captive, such as recapturing underwriting profits, reducing administrative costs and improving risk management, but this may not suffice at the level of the captive itself.63 In the Dixons case, the bargaining power of the related parties to the (series of) transactions was subsequently considered crucial.

Noteworthy is the introduction by the OECD of the investor model in the Intangibles Discussion Draft: the bearing of a funding risk is discussed, and it is concluded that solely bearing a funding risk generally would entitle the funder to a risk-adjusted rate or anticipated return on its capital invested, but not more.64 The investor model was first introduced in the US cost-sharing regulations, aiming to align the returns for investors on their respective aggregate investment to the riskiness of the investor’s activity in developing and exploiting cost-shared intangibles.65 The investor model has been referred to in the recent CCA Discussion Draft, as well.66

The rationality of a risk-adjusted return to the investor seems to contrast to the fund manager example in chapter 9 of the OECD Guidelines, where the fund manager receives a service remuneration and the investor retains the investment risk and the residual profit.67 Insights from economics could help to clarify the seeming controversy between this example and the investor model.

Insights from economics (as seen in section 3, above) indicate that the focus should be on the relation-specific investments involved, the governance relationship between the parties to a transaction, the incompleteness of the contract, the alignment of incentives and the mutual gain for the parties to the transaction.68 For the fund manager example in chapter 9 of the OECD Guidelines, the question would then concern the extent to which the fund manager has knowledge of the investments made: the interdependency of the fund manager and the investor; the completeness of the contract; and the benefits expected by the fund manager and investor. Filling in this example, an economist could expect the fund manager to be an intermediary with less specific knowledge of the underlying investments, performing for a relatively unknown investor, aiming to achieve a targeted return on the investment, receiving a service remuneration and preserving his reputation as fund manager, while the investor could expect a targeted return and receive the actual return minus the service remuneration for the fund manager.

Using the same insights from economics, another example of a fund manager and investor could be given of a private equity fund manager and investor. In such an example, the fund manager would have more knowledge and control of the underlying investment, performing for a known investor committed for a longer period of time, aiming to achieve surplus return, receiving a service remuneration plus a split of the surplus return, while the investor could expect more than a targeted return and receive a minimum return on the capital contribution and a split of the surplus return.69

4.3. Economic Substance

The guidance on economic substance in the OECD Guidelines is more explicit than on commercial rational-

60. DE: BFH, 17 Feb 1993, I R 3/92. The Court assessed the transfer pricing between a Swiss principal and its German loss-making related distributor.
61. UK: FTT, 31 Mar. 2009, DSG Retail Ltd v. HMRC (the Dixons case), TC0001, Tax Treaty Case Law IBFD. See Part I of this article, supra n. 4, at 3.2.
64. OECD, Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (Intangibles Discussion Draft) (OECD 30 July 2013), para. 84 (“Bearing a funding risk, without the assumption of any further risk, and without any control over the use of the contributed funds or the conduct of the funded activity, generally would entitle the funder to a risk adjusted rate or anticipated return on its capital invested, but not more. The key questions in each case are: (i) what is the financial risk assumed by the funding entity, (ii) does it have the financial capacity to bear the risk, (iii) how and by whom is that financial risk controlled, (iv) what are the financing options realistically available to the parties, and (v) what is the arm’s length anticipated compensation for assuming the financial risk in question?”).
65. US: Treas. Reg. 1.482-7T(4) supplemental guidance on methods applicable to PCTs (platform contribution transactions) and 1.482-7T(g)(2) (ii) "consistency with upfront contractual terms and risk allocation – the investor model." The model expects a participant to anticipate a rate of return to its aggregate investment equal to an appropriate discount rate for the participant’s activity over the whole period of its activity. Note that platform contributions are defined in 1.482-7T(c). A platform contribution is any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the CSA (cost-sharing arrangement)) that is reasonably anticipated to contribute to developing cost-shared intangibles.
66. OECD, Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs) (CCA Discussion Draft) (OECD 29 Apr. 2015). At Example 4, explicit reference is made to Example 7 of the Guidance on Transfer Pricing Aspects of Intangibles (2014), supra n. 3, and possible future changes to this Example 7 with regard to language, the treatment of unanticipated profits, the rate of return to the funder or other figures applied, will require conforming changes to Example 4.
68. Williamson, supra n. 22, at 176.
ity, although still abstract. An intercompany transaction is recognized under the OECD Guidelines if it meets the substance requirement, i.e. the substance of the structure should match its form. This is considered the substance-over-form principle, and implies that the outcome of an intercompany transaction is not accepted if the substance requirement is not met.

The OECD Guidelines recognize the transactions as actually undertaken as structured, and state that the contractual relationship of the parties must be deduced from their conduct. Also, explicit reference is made to economic substance and the conduct of the parties. Thus, the OECD Guidelines suggest following the actual transaction as structured, but the substance of the transaction must be discerned and should correspond; this conforms to the substance-over-form principle. This recognition of the transaction as actually undertaken and as reflected by the actual conduct of the parties is explicitly repeated in the latest Discussion Draft on Revisions to Chapter I.

Chapter 9, on determining the economic substance of a transaction or arrangement, states:

The economic substance of a transaction or arrangement is determined by examining all of the facts and circumstances, such as the economic and commercial context of the transaction or arrangement, its object and effect from a practical and business point of view, and the conduct of the parties, including the functions performed, assets used and risks assumed by them.

The substance requirement in the OECD Guidelines aims to ensure that the pricing of the intercompany transaction reflects the way the functions, risks and assets involved are shared between the associated parties, as can be hypothesized between independent parties. A key question for the taxpayer then concerns the level of substance that is necessary to substantiate the intercompany transaction.

Further guidance on the substance regarding functions, risks and assets is found in the OECD Guidelines in the form of the capacity to perform functions; to have control of the capacity to perform functions; to have control, the taxpayer then concerns the level of substance that is necessary to substantiate the intercompany transaction.

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Further guidance on the substance regarding functions, risks and assets is found in the OECD Guidelines in the form of the capacity to perform functions; to have control, the taxpayer then concerns the level of substance that is necessary to substantiate the intercompany transaction.

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ance. On the one hand, this codification is explicitly not intended to amend the tax treatment of certain basic business transactions such as the choice to use a related-party entity in a transaction, provided that the arm's length principle is satisfied. Still, more recent US case law on other business transactions, such as concerning a reorganization provision, has shown that the economic substance (including a meaningful change in control) was carefully considered by the courts concluding that the substance requirement was not met. Thus, on the other hand, more strict application of the economic substance doctrine does relate to, and could have implications implicitly for, the level of substance required for related-party transactions.

The insights from economics presented above, refer indirectly to substance. Where classical contracting fits the transaction, a different degree of substance will be necessary – as opposed to situations of relational contracting where parties to the transaction are bilaterally dependent, contracts are incomplete and revision of the contract to be negotiated by the parties is foreseen. In each type of transaction, however, the net economic position of the parties to the transaction is expected to be affected.

4.4 Risk allocation and control over risk

The identification and allocation of risks between associated enterprises is crucial due to the relationship between risk and return. The guidance on risk allocations and control over risk in the OECD Guidelines is more extensive than on the above concepts.

In chapter 1 of the OECD Guidelines, risk allocation is considered an essential element of a functional analysis, influencing the conditions of a transaction. The notion of control over risk is introduced, including the relationship between control over risk and allocation of risks.

In chapter 9 of the OECD Guidelines, the notion of control over risk is again presented – along with the financial capacity to assume the risk – as an important factor in allocating risks. Control is defined as "the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people – employees or directors – who have authority to, and effectively do, perform those functions.

This guidance on the formal authority and the managing of the risk is difficult, as the level of the people necessary to control the risk is not easily determined. Given the example in the OECD Guidelines of the fund manager, it seems that formal authority is the most significant. Also, if one of the two elements of control is lacking in an independent situation, formal authority would probably be the decisive competence, as a lack of authority would result in a decision being void.

In practice, this means that risk management (and assets) can be separated from the (formal) control functions. And this could be considered an essential aspect of the article 9 separate entity context. However, the extent of the separation is the question. The management of risk also creates value.

The Intangibles Discussion Draft further develops the notion of control over risk and moves to a more "functional control" over risk, emphasizing that important functions be performed by own employees as a condition for claiming returns attributable to an intangible. Control over the performance of any outsourced functions is essential in order to retain entitlement to returns attributable to intangibles. Examples of important functions are given, such as design and control of programs; management and control of budgets; control over strategic decisions; and ongoing quality control.

In the subsequent 2014 guidance on transfer pricing aspects of intangibles however, the separation of legal ownership, outsourced functions and control over those functions is again acknowledged. A legal owner not performing any relevant function could receive a return for the assets used and the risks assumed. A distinction is further drawn between ex ante and ex post remuneration.

81. The United States has an economic substance doctrine dating from the same year the arm's length principle was regulated in the United States. The economic substance doctrine was codified in 2010 and requires both a substantial purpose (apart from tax effects) for entering into the transaction and a meaningful change (apart from tax effects) in economic position. See Doernberg, supra n. 79, at 517.

82. Doernberg, supra n. 79, at 524-526.

83. Borek, Fratallii & Hart, supra n. 53, discussing the Black & Decker and Wells Fargo cases, where the courts ruled for the government and included in their consideration of a meaningful change in the taxpayer's economic position a meaningful change in control. See also at sec. 3 (on the insights from economics).

84. Para. 1.45 OECD Guidelines ("Functional analysis is incomplete unless the material risks assumed by each party have been considered since the assumption or allocation of risks would influence the conditions of transactions between the associated enterprises. Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realized."). Para. 1.46 gives examples of types of risks, including significant risks and controllable and uncontrollable risks. It also refers to the costs of assuming risks. Para. 1.47 refers to the functions carried out as determined to some extent the allocation of risks. In para. 1.48, important guidance is provided linking purported allocations of risk to economic substance and conduct of the parties.

85. Para. 1.49 OECD Guidelines ("In arm's length transactions it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control [...].")
The Discussion Draft on Revisions to Chapter I slightly revises the guidance on risks and allocation of risks. The emphasis is on "capabilities" to make risk-taking and risk-responsive decisions and to mitigate risk, "together with the actual performance of those decision-making functions and such risk mitigation." The term "risk management" receives a different scope, but the guidance remains in line with current guidance in the OECD Guidelines. At arm's length, parties are allocated a greater share of those risks over which they have relatively more control. The functional analysis must establish how each party contributes to risk management and the impact of the risks. The examples concerning risk transfers and possible fees are more explicit than in the current chapter 1 guidance. It is stated that where risk management and control over risk are separated, a possible compensation for risk management must be determined, although a separate compensation for risk management is normally not required. Examples of common risk transfers for a fee within MNEs are consequently confined to transfers of financial risks such as interest rate risk, exchange rate hedges and debt factoring. On the other hand, core risks involving strategic, market and operational risks are given as examples of risks unlikely to be transferred for a fee.

The direction of the Discussion Drafts to expect more unison of capabilities and control is not surprising given the insights from economics. Unison of knowledge and control creates value; see section 3. Furthermore, based on the insights from economics, strategic interdependency could be distinguished as an additional factor in determining (shared) allocation of risk. See Figure 3.

Again as an additional fund managers example, a private equity fund manager example could add beneficial guidance on the allocation of risks. Risks are partly shared between a private equity fund manager and an investor, and consequently the private equity fund manager also receives a proportionate split of the actual returns.

Sharing of risk is mainly addressed only indirectly in the current OECD Guidelines via the guidance on profit split methods and cost-sharing arrangements. See also the analysis in Part I of this article, which notes that, initially, cost-sharing arrangements were endorsed only, and profit split methods were used by courts and referred to as methods of last resort. Eventually, more guidance on cost-sharing arrangements and profit split methods was issued. Referring to economic theory on governance structures and contracts, where relational contracting fits the transaction.

97. OECD, Discussion Draft on Revisions to Chapter I, supra n. 3, paras. 36-78 (on identifying, assuming, allocating, managing and controlling risks).

98. OECD, Discussion Draft on Revisions to Chapter I, supra n. 3, para. 55. The emphasis is, to a lesser degree, on "functional control" as in the context of intangibles, but more generally on "actual performance of control over risk". Control over risk is considered to refer to the decision-making functions on risk-bearing opportunities and on response to the risks associated with the opportunity. Risk management is considered to encompass control over risk and risk mitigation. Outsourcing of risk management is addressed, and thus acknowledged, regarding risk mitigation. Control over risk would then come into play again to assess, monitor, and direct the outsourced mitigation measures.

99. OECD, Discussion Draft on Revisions to Chapter I, supra n. 3, para. 38.

100. OECD, Discussion Draft on Revisions to Chapter I, supra n. 3, para. 76.

101. OECD, Discussion Draft on Revisions to Chapter I, supra n. 3, para. 74.

102. OECD, Discussion Draft on Revisions to Chapter I, supra n. 3, para. 67. In paras. 51 and 77, an oil distribution and securing of credit example is given where a fee by reference to guarantee fees and high value services could be determined.

103. OECD, Discussion Draft on Revisions to Chapter I, supra n. 3, para. 67.

104. OECD Guidelines, ch. 9 guidance. Strategic interdependency would then compliment control over risk and financial capacity to bear the risk.

105. Naidech, supra n. 69; Breslow & Schwartz, supra n. 69.
sharing of (control over) risk can indeed be expected. The more asset specificity and strategic interdependency between the parties, the more “relational contracting”, and the more sharing of risk will occur. The reference within the Intangibles Discussion Draft to the use of (residual) profit split methods refers to this sharing of risk.\footnote{106} In the examples, alternative approaches using (residual) profit split methods are also suggested.\footnote{107} Furthermore, the recent CCA Discussion Draft suggests alignment of the returns to a participant with the value of its contribution, and expects balancing payments between participants where the relative returns of the respective participants are not proportionate to their contributions.\footnote{108}

Referring to the theory on governance structures and contracts again, where relational contracting fits the transaction, revision of incomplete contracts (ex post) may be expected. Any event that hinders the performance of the incomplete contract will necessitate renegotiation; this could include risk allocation and/or pricing. The OECD Guidelines, on the subject of intangibles, for example, recognize that price adjustment clauses in contracts could be expected for high risk, uncertain transactions.\footnote{109} However, the current guidance focuses on the initial setting of a price and confines such adjustments to fundamental changes, while the economic theory for relational contracting focuses on ongoing adaptation through cooperation.

4.5. Synergies and economic profit

MNEs generate economic profits.\footnote{110} The arm’s length principle, as originally developed, captured the economic profit by retaining the residual profit within the residence state of the MNE after remuneration of the outlying establishments for their services. Many MNEs are far more integrated than typically was true in the past, however, and the residual economic profit is no longer necessarily related to one separate central and vital entity.

“Group synergies” is the term used for economic profits in the OECD Guidelines. The existence of group synergies is acknowledged in the preface and chapter I of the OECD Guidelines on the one hand, while on the other hand it is also made clear that the arm’s length principle does not always account for these synergies.\footnote{111} Only in cases where specific activities can be identified, aimed at integration

\footnote{110. OECD, Intangibles Discussion Draft, supra n. 64, paras. 163, 166-170 & 220-223.}

\footnote{107. OECD, Intangibles Discussion Draft, supra n. 64, paras. 250 (Example 7), 274 (Example 13) & 278 (Example 14). In the Guidance on Transfer Pricing Aspects of Intangibles (2014), supra n. 3, the corresponding example numbers are 11, 17 and 18.}

\footnote{108. OECD, CCA Discussion Draft, supra n. 66, at C3-C6 and Examples 1-4.}

\footnote{109. Price adjustment clauses could be seen as revision of the incomplete contract for high risk uncertain transactions. Price adjustment clauses are mentioned, with much caution added, in the current ch. 6 guidance, and in the Intangibles Discussion Draft.}

\footnote{106. OECD, Intangibles Discussion Draft, supra n. 64, paras. 250 (Example 7), 274 (Example 13) & 278 (Example 14). In the Guidance on Transfer Pricing Aspects of Intangibles (2014), supra n. 3, the corresponding example numbers are 11, 17 and 18.}

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\footnote{109. Price adjustment clauses could be seen as revision of the incomplete contract for high risk uncertain transactions. Price adjustment clauses are mentioned, with much caution added, in the current ch. 6 guidance, and in the Intangibles Discussion Draft.}

\footnote{111. Only in cases where specific activities can be identified, aimed at integration benefits, would these be separately remunerated under the arm’s length principle.\footnote{112} The Intangibles Discussion Draft and the Discussion Draft on Revisions to Chapter I add guidance on the treatment of group synergies.\footnote{113} Examples regarding central purchasing and financing activities with intra-group guarantees are given. Only where a deliberate, concerted action of group members or performance of a specific activity gives rise to synergistic benefits, are these benefits expected to be separately compensated or allocated between group members.\footnote{114} Incidental group association benefits (also referred to as passive association benefits) are not to be separately compensated.\footnote{115}

The Canadian GE Capital (2000) case challenges the assumption within the current arm’s length principle that incidental group association benefits are not to be separately compensated.\footnote{116} In other words, the decision challenges the long-standing assumption in the arm’s length principle that each entity is wholly independent. The Canadian tax authorities argued that, in a group, the default risk is reduced, as the parent would not allow a strategically crucial subsidiary to fail. Implicitly, the credit rating of the subsidiary is then closer to that of the parent, instead of the rating on a stand-alone basis. The Court partly acknowledged the argument by accepting an adjustment to the stand-alone rate due to a group affiliation benefit.\footnote{117}

In this GE Capital case, the support of the parent was explicit in the form of a guarantee arrangement. It is not clear, however, what the impact would have been if the support of the parent had been implicit, without a legally binding contract. The parent’s willingness and ability to provide support would have to be assessed – in other words the strategic interdependency between the parties would have to be assessed – as would be done by an independent lender. This would reflect the insights from economics and the practice in the finance industry. However, there is friction with the current OECD Guidelines, in that they state that incidental benefits from passive association of integration should not impair the application of the arm’s length principle.\footnote{118}

The UK Dixons case (2009) illustrates taking into account group synergies.\footnote{119} It first acknowledges the group business reason for establishing a captive, and then goes on to allocate the total profit. The profits from the warranty business were to be split between the parties based on their relative contributions, and the captive – not possessing significant negotiation power – was to receive an appropriate market

\footnote{112. Para. 7.13 OECD Guidelines.}

\footnote{113. OECD, Intangibles Discussion Draft, supra n. 64, D5. In Guidance on Transfer Pricing Aspects of Intangibles (2014), supra n. 3, D8 and Discussion Draft on Revisions to Chapter I, supra n. 3, (D8), this is repeated.}

\footnote{114. OECD, Discussion Draft on Revisions to Chapter I, supra n. 3, para. 123 (referring to para. 7.13 of the OECD Guidelines, as well).}

\footnote{115. Para. 7.13 OECD Guidelines.}

\footnote{116. CA: FCA, 15 Dec. 2010, General Electric Capital Canada, Inc. v. The Queen, para. 7.13.}

\footnote{117. A. Russo & O. Moerer, Transfer Pricing and Intra-Group Financing ch. 1, (Introduction) at 21. Topical Analysis IBFD.}

\footnote{118. Russo & Moerer, supra n. 117, at 21.}

\footnote{119. Dixons, supra n. 61.}
return to its economic capital. In this case of more complex economic reality, a form of profit split was required.120

The release of the Profit Split Discussion Draft is telltale to the issue of capturing group synergies and economic profit.121 (Residual) profit split methods ensure the capture of total profit, including economic profit. Also, (residual) profit split methods can be used as corroborative analysis to one-sided transactional transfer pricing methods.

Referring back to the insights from economics, strategic interdependence is a key factor in determining whether relational contracting is the most cost-effective governance structure. Strategic interdependence is a factor that is not yet always accounted for under the arm’s length principle. Furthermore, where relational contracting fits the transaction, revision of incomplete contracts is expected. Renegotiation of incomplete contracts, apart from recognition of possible price adjustment clauses in chapter 6 of the OECD Guidelines, is generally not accounted for under the arm’s length principle.

4.6. Recharacterization

The OECD Guidelines explicitly recognize the transactions as actually undertaken.122 Only in two particular circumstances, exceptionally, may a tax administration consider disregarding the structure as adopted by an MNE. See the discussion of paragraph 1.65 in section 3 on the second boundary of the arm’s length principle (the extent to which transactions may be hypothesized).123

As indicated in the historical analysis in Part I of this article, the roots of the recharacterization language in the OECD Guidelines can be found in the 1980s.124,125 The recharacterization option for tax authorities with regard to thin capitalization issues was introduced in the 1992 Commentary on Article 9 of the Model.126 Subsequently, the 1995 OECD Guidelines included the two particular circumstances of current paragraph 1.65 in which recharacterization is an option for the tax authorities. The second particular circumstance seems to have been written to be consistent to the US commensurate-with-income standard.127

Recharacterizations – other than for thin capitalization purposes – which have withstood judicial challenge are few. The major US Glaxo case was settled, so it is not clear if this could be regarded as a successful recharacterization.128 In the Netherlands, two lower court cases concerned the disregarding of a sale-and-licence back of an intangible right, and the recharacterization of an offshore captive.129 A Dutch Supreme Court case on the impairment of an intercompany loan did involve characterization of the loan as “non-commercial”, or “non-arm’s length” using a broader interpretation, but there was no recharacterization into equity capital.130

The UK Dixons case is not considered a recharacterization case. However, it does concern a broad interpretation of the phrase “provision”, so that there was something to price despite the insertion of a third party and the absence of a recognized transaction.131 Although the difference in bargaining power was considered a crucial argument,132 it could be questioned if this can be seen as an example of a purported allocation of risk or a difference in substance that was adjusted for.

The Canadian GE Capital case, which concerned the group association benefit that needed to be accounted for when determining the guarantee fee, leaves the question open as to whether it concerned a comparability adjustment or an adjustment to the condition of the guarantee agreement.133 As it is not discussed as an example of a recharacterization, it could be a good example of a difference in substance that was adjusted without needing a recharacterization provision.

In Australia, the recharacterization option for the tax authorities was recently, in 2013, codified. To provide further guidance on the “reconstructive” powers, the ATO published Taxation Ruling TR 2014/6 on transfer pricing, including an example on the interaction with thin capitalization rules. In the example, the arm’s length amount of debt and interest rate are first determined, and then compared to the safe harbour debt amount.134 Subsequently, the allowable debt deduction is calculated using the safe harbour debt amount (not the arm’s length amount of debt) and the arm’s length interest rate.135

120. A. Casley & I. Sinclair, DSG Retail Limited v. Commissioners for Her Majesty’s Revenue and Customs, 16 Inl. Transfer Pricing 1.5 (2009), Journals IBFD.


122. Ch. VIII OECD Guidelines provide guidance on possibly disregarding part or all of a cost contribution arrangement (CCA) in paras. 8.29 and 8.30, with reference to the guidance in paras. 1.64 to 1.69 of the OECD Guidelines, when the reality of the arrangement differs from the terms purportedly agreed by the parties. An example given is when a participant is performing all of the subject activity, but is expected to have only a small fraction of the overall expected benefits.

123. Supra n. 15. The 1987 OECD thin capitalization report concluded that art. 9 OECD Model was relevant in determining whether a loan transaction could be recharacterized into equity capital. Before, the 1979 OECD report concluded that art. 9 would not restrict the application of domestic substance-over-form rules.

124. Wittendorf, supra n. 15. The 1987 OECD thin capitalization report concluded that art. 9 OECD Model was relevant in determining whether a loan transaction could be recharacterized into equity capital. Before, the 1979 OECD report concluded that art. 9 would not restrict the application of domestic substance-over-form rules.

125. Wittendorf, supra n. 15, at 120. Wittendorf contemplates that tax policy considerations may have influenced the incorporation of the recharacterization options: several OECD countries wanted to retain or introduce thin capitalization rules applicable in cross-border cases, and that this was problematic due to the non-discrimination article of the model. Where art. 11 OECD Model now covers interest rates and thin capitalization, art. 9 could cover the prima facie loan, and the non-discrimination provision would not be applicable. OECD countries were then free to adopt thin capitalization rules incorporating an arm’s length safe harbour.

126. Supra n. 15, at 117.
Coming back to more current guidance from the OECD on recharacterization, the Intangibles Discussion Draft – in Examples 13 and 14 – does not provide a single solution. The solution is left open: either via pricing (profit split and/or valuation techniques) or recharacterization.\textsuperscript{136} However, the Discussion Draft on Revisions to Chapter I, released subsequently, reiterates that recharacterization should be necessary only in exceptional circumstances.\textsuperscript{137}

Referring to the Dixons case and the GE Capital case, as well as to the work of Williamson on “relational contracting”, a solution for Examples 13 and 14 of the Intangibles Discussion Draft can be conceived via pricing as a result of conditions adjusted for. In economic terms, the solution is a revision of incomplete contracts.

4.7. Special measures stretching the boundaries of the arm’s length principle

A broadened interpretation of the arm’s length principle, including special measures beyond the arm’s length principle, are contemplated in this BEPS era in order to address the alignment of value creation with transactions and reported profits. Options such as profit split methods, formulary arrangements, recharacterization, reallocation of profits, commensurate-with-income standards and price adjustment clauses are considered and briefly mentioned here.\textsuperscript{138, 139}

Profit split methods stretch the boundaries of the arm’s length principle in the sense that they focus on internal data, instead of on comparison with third-party data. A looser tax parity with the uncontrolled taxpayer is the result, while this parity was an important policy consideration for implementing the arm’s length principle. A clear advantage of the profit split is that it takes the overall (economic) profit into account. Furthermore, the profit split method carefully considers which contribution each party makes to the overall profit, and thus complies with the economic substance and risk management requirements.

“Formulary arrangements” is a broader term to indicate the use of formulas. Profit split and cost sharing can, to some extent, be seen as formulary arrangements. A formulary arrangement beyond the arm’s length principle would be a formulary apportionment as described in the OECD Guidelines,\textsuperscript{140} and the common consolidated corporate tax base (CCCTB) initiative of the European Union.\textsuperscript{141} Formulary arrangements receive scepticism mainly due to the infeasibility and compliance costs of a worldwide transition, while the possible advantages are not yet proven and might not outweigh disadvantages. It must not be forgotten, however, that the earliest transfer pricing legislations, as seen in Part I of this article, were formulary arrangements. And the United States, the United Nations, and the European Union have each considered formulary approaches.\textsuperscript{142}

Cost-sharing arrangements are endorsed within the arm’s length principle. The participants share costs and risks in proportion to their reasonable expectations of the extent to which they will benefit from their separate exploitation of intangibles. The United States has issued separate cost-sharing regulations, and these include an attempt to curb the excess returns of cash box participants in cost-sharing arrangements via the introduction of the investor model.\textsuperscript{143} The OECD has also introduced the investor model in the Intangibles Discussion Draft, and refers to it in the recent CCA Discussion Draft as well.\textsuperscript{144} Furthermore, the recent CCA Discussion Draft emphasizes “value” (instead of cost) as a contribution to establish alignment with substance and value creation.\textsuperscript{145}

The commensurate-with-income standard under the US regulations applies to transfers of intangibles, and thus also applies to US cost-sharing regulations. The commensurate-with-income standard could be seen as going beyond the arm’s length principle mainly due to the use of hindsight to correct royalty income and also due to its involving an upward adjustment only.\textsuperscript{146}

In the OECD Guidelines, the possible use of price adjustment clauses is included where valuation of an intangible is highly uncertain at moment of transfer.\textsuperscript{147} Retrospective adjustments are not intended and, due to this caution

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\textsuperscript{136} Intangibles Discussion Draft, supra n. 64, footnote 5 to Example 14. Some countries delegate believes that fact patterns like those reflected in Examples 13 and 14 could be appropriately addressed by disregarding or recharacterising transactions under paragraph 65 in some instances because such transactions would not normally occur between independent enterprises. The BEPS action plan calls for additional consideration to be given to the circumstances in which it is appropriate to disregard or recharacterise transactions. The analysis of these Examples will be discussed further in the context of the work on BEPS’. Repeated in Guidance on Transfer Pricing Aspects of Intangibles (2014), supra n. 3, at Examples 17 & 18.

\textsuperscript{137} OECD, Discussion Draft on Revisions to Chapter I, supra n. 3, paras. 82 and 84. The example on non-recognition (the term used within the Draft) in paras. 90–92 is confusing, although new guidance is pending.

\textsuperscript{138} OECD, Discussion Draft on Revisions to Chapter I, Part II (Special measures), supra n. 3. OECD, Profit Split Discussion Draft.

\textsuperscript{139} Ch. 1, at C. OECD Guidelines.

\textsuperscript{140} EU CCCTB 2011 proposal, currently being reassessed. Another initiative of the European Union is the pilot project on home state taxation for small and medium-sized enterprises, which would also use formulary arrangements to overall profit where overall profit is determined by the tax rules of the home state.

\textsuperscript{141} See Part I of this article, supra n. 4, at sec. 2 and 3.1.

\textsuperscript{142} U.S. Treas. Reg. 1.682-7(g) “supplemental guidance on methods applicable to PCIs” and 1.482-7(f)(2)(ii) “consistency with up-front contractual terms and risk allocation – the investor model”. See also n. 65.

\textsuperscript{143} OECD, CCA Discussion Draft, supra n. 66. In Example 4, explicit reference is made to Example 7 of the Guidance on Transfer Pricing Aspects of Intangibles (2014), supra n. 3, and it is stated that to the extent that changes are made to example 7 with respect to language, the treatment of unanticipated profits, the rate of return to the funder or other figures applied, “conforming changes are also likely to be required to Example 4”.

\textsuperscript{144} OECD, CCA Discussion Draft, supra n. 66, at C4 and Examples 1-3.

\textsuperscript{145} A brief Discussion Draft on hard-to-value intangibles was issued by the OECD in June 2015 and considers how ex-post profit levels could either be a “pointer” to tax administrations about the arm’s length nature of the ex-ante pricing agreement between associated enterprises, or could be used inappropriately as hindsight by not taking into consideration whether information could or should reasonably have been known and considered by the associated enterprises at the time of the transfer. OECD, BEPS Action 8 – Hard-To-Value Intangibles (OECD, 4 June 2015).

\textsuperscript{146} OECD Guidelines, para. 6.34. The guidance in para. 6.34 intends to allow tax administrations to determine pricing based on a price adjustment clause that third parties would have concluded, or to modify the pricing due to unforeseeable subsequent developments that would have led to renegotiation of the pricing of a transaction. The Annex to ch. 6 of the OECD Guidelines provides three examples on the use of price adjustment clauses and on renegotiation of pricing.
on hindsight, this guidance is generally regarded as falling within the arm’s length principle.\textsuperscript{147}

Reallocation of profits where excess profits arise compared to a ratio for over-capitalization or a threshold for minimal functionality, has been proposed in the Discussion Draft on Revisions to Chapter I.\textsuperscript{148} These measures go beyond the arm’s length principle, as they would use indicative (group) numbers or thresholds to reallocate, whereas the arm’s length principle uses comparability and the facts and circumstances of the case to determine any adjustments.

Recharacterization is seen by some OECD member countries as going beyond the boundaries of the arm’s length principle, while other member countries consider it a viable option. This disagreement relates to the confusion on the scope of recharacterization of transactions versus comparability adjustments to profits.

5. Recommendations for Enhancement of the Arm’s Length Principle

Regarding the boundary of the arm’s length principle of reaching the residual economic profit of an MNE, the (residual) profit split method would ensure taxing of the total profit, provided that both tax administrations have access to the relevant information for the application of the method. The residual profit split would first reward the more routine transactions of a taxpayer by comparison with uncontrolled taxpayers, and would subsequently split the residual profit, i.e. the overall profit minus the remunerations at parity.

Furthermore, accounting for group synergies within the arm’s length principle would ensure that more of the economic profit is initially reached. Association benefits may be compensated (the (draft) guidance on group synergies allows for compensation of active association benefits) and passive association benefits should be compensated where an independent party would take these into account. Strategic interdependency should be included as a factor in determining the extent of group synergies.

The release of the Profit Split Discussion Draft (and the methods contained therein) highlights the issue of capturing group synergies and economic profit. Also, (residual) profit split methods can be used as corroborative analysis to one-sided transactional transfer pricing methods.

Regarding the boundary of the arm’s length principle on the need to hypothesize transactions where they cannot be found between independent parties, economic principles need to be considered to determine adherence to the arm’s length principle. International guidance on these principles and concepts, as discussed, will benefit alignment of the arm’s length principle to value creation. This clarification could also respond to or address the boundary of divergences in domestic implementations of the arm’s length principle.

Commercial rationality could be described, as in the draft guidance, as relating to expected enhancement or protection of commercial or financial positions on a risk-adjusted basis. The US and Australian emphasis on an actual change in the net economic position would strengthen this guidance. The German principle of a prudent and diligent manager is indicative as well. Furthermore, the rationality of a risk-adjusted return to an investor adds guidance, although the fund manager example should be fleshed out, and an additional fund manager example with different attributes would strengthen the guidance. Such an additional example could illustrate the necessity to consider economic attributes. Relation-specific investments, the governance relationship, the incompleteness of the contract and the alignment of incentives are a few relevant economic attributes.

Economic substance has been given clarity generally, but care needs to be taken that the transaction as actually undertaken in substance (as evidenced by the conduct of the parties) remains the essence of any transfer pricing analysis. Significantly, the net economic position of the parties to the transaction is expected to be affected. Furthermore, the level of substance required depends on the transaction at issue, and is not to be confused with the level of substance in tax avoidance cases.

Effective control over risk, as developed in the Intangibles Discussion Draft and the Discussion Draft on Revisions to Chapter I, is in alignment with the substance-over-form principle. Economics shows that investment efficiency exists when knowledge and control are united, and that would be the case with (functional) control. The fleshing out of the fund manager example in chapter 9 and adding a private equity fund manager example will help illustrate control over risk.

Sharing of risk is mainly addressed only indirectly in the current guidance. The more asset specificity and strategic interdependency between the parties, the more that sharing of risk will occur. An amendment to the flowchart on risk allocation in chapter 9 is recommended. Besides the factors of control over risk and the financial capacity to bear the risk, the factor of strategic interdependence should be included.

Referring again to the theory on governance structures and contracts, revision of incomplete contracts is expected. This could involve revision due to any major event resulting in renegotiation of conditions and/or price of the transaction. Price adjustment clauses under contracts could be expected for high-risk, uncertain transactions, as recognized in the OECD Guidelines when intangibles are being discussed. The price adjustment clause is a viable option and should be expanded. Example 1 of the Annex to chapter 6 (being Example 25 in the Intangibles Discussion Draft) should be revised to conclude that prospective renegotiation would take place, and that a comparability adjustment at renegotiation – without hindsight – is allowed.\textsuperscript{149}

\textsuperscript{147} OECD Guidelines, paras. 6.32 and 6.35.

\textsuperscript{148} OECD, Discussion Draft on Revisions to Chapter I, supra n. 3, Part II (Special Measures), Options 2 and 3 (on inappropriate returns on providing capital) and Option 4 (on minimal functional entities).

\textsuperscript{149} The first example of the Annex to ch. 6 – new capabilities of the drug discovered in year three of the licence arrangement leading to considerable
Cost-sharing arrangements will remain an option, under stricter conditions. Substance and (functional) control over risk should be requirements. The returns to a participant must align with the value of its contribution, and balancing payments between participants are expected where the relative returns of the respective participants are not proportionate to their contributions. Revision of contributions and risk, including price adjustment clauses, should be addressed as above.

Apart from the recommended additional guidance on economic principles, a major issue under the arm’s length principle is the scope of comparability adjustments versus recharacterization. As seen in Part I of this article, this issue has been a major obstacle in the development of the arm’s length principle. Referring to the substance-over-form principle to which the vast majority of stakeholders in the development of the arm’s length principle adheres – especially in this BEPS era – and to the insights from economics on relational contracting, the author believes the scope of comparability adjustments should include adjustments to the conditions and contractual terms of the transaction. This would be an explicit enhancement of the arm’s length principle. The scope of comparability adjustments needs to be reconfirmed, best in the Commentary on Article 9 of the OECD Model itself, but also in chapters 1 and 9 of the OECD Guidelines. The Commentary on Article 9 ought to make it unquestionably clear that adjustments to conditions (leading to adjustments in prices) are comparability adjustments.

Recharacterization should then remain an option only in exceptional circumstances, and specifically for excessive debt deduction cases, as long as domestic law facilitates the taxing and recharacterization rights. See also Part I of this article. Amendments to conditions of the transaction should be considered and applied via comparability adjustments.

6. Conclusion and Recommendations

From the historical and comparative analysis, one can conclude that the arm’s length principle in domestic legislation has primarily reflected an anti-abuse approach, but that the arm’s length principle within model tax conventions has, firstly and foremost, reflected an income allocation approach. However, the OECD Model did broaden its scope in the 1990s, and the OECD Guidelines facilitate recharacterization (and the commensurate-with-income standard) as from 1995. Slowly then, and with recent injection from the BEPS project, the flavour of anti-abuse is added to the income allocation objective of the arm’s length principle within model tax conventions.

The boundaries of the arm’s length principle that need to be stretched have been analysed here. Insights from economics (and especially on governance structures and contracts) seem to provide valuable guidance. A future role of “relational contracting” and ongoing negotiability of contracts, depending in force on the governance structure and strategic interdependence between the parties within the MNE can be deduced.

Recommendations were made to change the Commentary on Article 9, and to amend the OECD Guidelines. Amendments to the conditions and contractual terms of a transaction (leading to an adjustment of prices) should be considered and applied via comparability adjustments, and by choosing the most appropriate transfer pricing method, which could be the profit split method in more cases than seen to date. Prospective price adjustments should be allowed where renegotiation of incomplete contracts can be expected. Strategic interdependence should be included as a factor in determining risk allocation and the extent of group synergies.

These recommendations are far reaching, as the author fully acknowledges, but they relate to the core boundaries of the arm’s length principle and long-standing issues. It is high time to resolve some of them.

In all, the arm’s length principle could meet the requirements in a BEPS era if it is enhanced and its boundaries are stretched (again). It has already evolved from the very traditional arm’s length principle in the first decades of its implementation, to an expanded arm’s length principle as from the 1990s when net income benchmarking and business restructuring took flight, and could now develop into an enhanced arm’s length principle focusing on economic principles and substance to tackle the more anti-abuse and value alignment requirements in a BEPS era. The concept of “arm’s length” should hold its original meaning not only in the context of a transaction between uncontrolled independent parties, but also in the context of a transaction between two economic actors within an MNE.