

4-1-1996

# International Cooperation and Understanding: What's New About The OECD's Transfer Pricing Guidelines

Frances M. Horner

Follow this and additional works at: <http://repository.law.miami.edu/umlr>



Part of the [Taxation-Transnational Commons](#)

---

## Recommended Citation

Frances M. Horner, *International Cooperation and Understanding: What's New About The OECD's Transfer Pricing Guidelines*, 50 U. Miami L. Rev. 577 (1996)

Available at: <http://repository.law.miami.edu/umlr/vol50/iss3/8>

# International Cooperation and Understanding: What's New About The OECD's Transfer Pricing Guidelines

FRANCES M. HORNER\*

I. STATEMENT OF THE ARM'S LENGTH PRINCIPLE .....	578
A. <i>Comparability Analysis and Business Strategies</i> .....	579
B. <i>Recognition of the Actual Transactions</i> .....	581
C. <i>Evaluation of Separate and Combined Transactions</i> .....	582
D. <i>Use of an Arm's Length Range</i> .....	583
E. <i>Set-offs</i> .....	584
F. <i>Selection of Transfer Pricing Methods</i> .....	585
II. TRADITIONAL TRANSACTION METHODS .....	586
A. <i>The Comparable Uncontrolled Price (CUP) Method</i> .....	586
B. <i>Resale Price and Cost Plus Methods</i> .....	587
III. TRANSACTIONAL PROFIT METHODS .....	589
A. <i>The Profit Split Method</i> .....	590
B. <i>Transactional Net Margin Method</i> .....	591
IV. ADMINISTRATIVE ISSUES .....	592
V. DOCUMENTATION .....	593
VI. FOLLOW-UP .....	594

On July 27, 1995, the Organisation for Economic Cooperation and Development (OECD) announced new transfer pricing guidelines<sup>1</sup> to replace its outdated 1979 Report<sup>2</sup> on the same topic. This action sent an unequivocal message to the international community: Cancel all plans for a global tax war. The tax delegations to the OECD courageously demonstrated how countries can resolve disputes and smooth the functioning of international trade by valuing agreement over self-interest. The OECD guidelines have been heralded as a new international consensus,<sup>3</sup> and an important achievement both for the twenty-five member countries<sup>4</sup> and for the international business community. Countries have agreed on a principle for analysing transfer pricing and on a means to

---

\* Deputy Head, Fiscal Affairs Division, Organisation for Economic Cooperation and Development. The views expressed in this article are those of the author only and should not be taken as reflecting the position of the OECD or its member countries.

1. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Organisation For Economic Co-operation And Development (OECD) (July 1995) [hereinafter "1995 Guidelines"].

2. *Transfer Pricing and Multinational Enterprises*, OECD (May 1979) [hereinafter "1979 Report"].

3. See, e.g., Arnaud Leparmentier, *Les pays de l'OCDE s'accordent sur la fiscalite des multinationales*, LE MONDE, Aug. 1, 1995.

4. OECD membership increased to 26 countries with the accession of the Czech Republic in late 1995.

implement that principle. Surely this is a welcome development, a significant step towards minimizing conflicts and avoiding double taxation.

But this agreement can hardly be considered new. The OECD's 1979 report on transfer pricing embodied the same arm's length principle. The reaffirmation of this principle is notable, given the widely-reported doubts that had been cast on its continuing viability. So what, then, is new? How, and why, does this 140-page document differ from the 1979 report?

There are many differences to observe, but they reflect no deviation from the 1979 concepts. Instead, the changes endorse, elaborate and extend the principles established in 1979. Perhaps the most distinguishing part of the 1995 guidelines is the third chapter, which addresses "Other Methods,"<sup>5</sup> including profit methods that might be used to approximate arms length conditions. But this work on profit methods should not overshadow other, substantial advances that the new guidelines make. Given the role to which profit methods are relegated in the new consensus, other analytic developments likely will be far more important in daily practice. To this end, the discussion below describes the most significant developments in the new guidelines as compared with the 1979 report, including the issue of profit methods.

#### I. STATEMENT OF THE ARM'S LENGTH PRINCIPLE

The new guidelines indicate expressly, for the first time, that Article 9, Paragraph 1 of the OECD Model Tax Convention is the "authoritative statement of the arm's length principle."<sup>6</sup> Conversely, the 1979 report indicated that the arm's length principle was "the underlying assumption" of Article 9, Paragraph 1<sup>7</sup> and stated that "the arm's length principle as expressed in the OECD Model Double Taxation Convention has to be followed . . . ."<sup>8</sup> Thus, the 1979 report merely implied that Article 9, Paragraph 1 and the arm's length principle were equivalent, while the new guidelines explicitly make this point.

This development is relevant because it helps clarify the means for determining conformity with the arm's length principle. The language of Article 9, Paragraph 1 makes clear that an adjustment satisfies the arm's length principle when the adjustment includes in an associated enterprise's profit any profits that would have accrued to that enterprise "but for" conditions made or imposed between associated enterprises in their financial relations that differ from the conditions that would be

---

5. 1995 Guidelines, *supra* note 1, ¶¶ 3.1-3.74.

6. *Id.* ¶ 1.6.

7. 1979 Report, *supra* note 2, ¶ 3.

8. *Id.* ¶ 37.

made between independent enterprises.<sup>9</sup>

This statement has both positive and negative implications for profit methods. The positive implication is that Article 9, Paragraph 1 does not *per se* preclude adjustments that arise from profits accruing to an associated enterprise. This should hardly be surprising, given that two of the traditional methods the 1979 report endorsed, resale price and cost plus, examine profit margins. The negative implication is more sobering. Article 9, Paragraph 1 requires a “but for” connection between the improper accrual of profits and the existence of improprieties in the economic and financial relations between the associated enterprises. This requirement, once taken seriously, presents an insurmountable obstacle to the regular use of profit methods on an overall company-wide basis (or to the use of any method in such a way). Many factors can affect the overall accrual of profits by an independent enterprise, some of which may be wholly unrelated to the controlled transaction for which transfer pricing is in question. When a transfer pricing inquiry extends beyond profits of the controlled transaction,<sup>10</sup> it examines conditions unrelated to those between the associated enterprises involved in the transaction, thereby risking a violation of the arm’s length principle. This analysis ultimately led the OECD to articulate for the first time the concept of a “transactional profit method,”<sup>11</sup> and to reject any profit-based analysis inconsistent with that concept.

#### A. *Comparability Analysis and Business Strategies*

The new guidelines include seven pages of discussion about the factors that can influence the comparability of controlled and uncontrolled transactions for purposes of applying the arm’s length principle.<sup>12</sup> Most of this material is new and has no counterpart in the 1979 report. It is the product of the experience of tax administrations and businesses in applying the arm’s length principle since 1979, and generally has been perceived by the business community as helpful in providing guidance and direction.

The 1979 report cited the need for comparability of: geographic markets,<sup>13</sup> market levels,<sup>14</sup> goods,<sup>15</sup> functions performed and risks

---

9. 1995 Guidelines, *supra* note 1, ¶ 1.6.

10. The “transaction” could be several controlled transactions that are appropriately aggregated. The new guidelines include a discussion of aggregation rules, as discussed *infra* section II.C.

11. 1955 Guidelines, *supra* note 1, ¶ 3.2.

12. *Id.* ¶¶ 1.19-3.5.

13. 1979 Report, *supra* note 2, ¶ 49.

14. *Id.* ¶ 50.

15. *Id.* ¶¶ 51-54.

assumed by resellers,<sup>16</sup> and other considerations, such as product innovativeness,<sup>17</sup> market conditions,<sup>18</sup> custom of the trade,<sup>19</sup> how the MNE is organized,<sup>20</sup> general economic functions, and "all other relevant facts and circumstances of each individual case . . . ."<sup>21</sup> The new guidelines provide much more detail about the relevant factors, including a discussion of functional analysis applicable to all transfer pricing methods.<sup>22</sup>

In addition to the expanded comparability discussion, it is also important to note a significant development regarding business strategies. The 1979 report barely recognized the possible effects of business strategies on pricing policy, as well as the need to adjust for any differences in business strategies between controlled and uncontrolled transactions. It acknowledged two examples of business strategies that might properly influence price. In the first example, a supplier waives payment from a customer "in temporary difficulties in order to preserve a potentially valuable outlet for his goods."<sup>23</sup> In the second, sellers temporarily lower prices as part of a market penetration or start-up strategy.<sup>24</sup>

In contrast, the new guidelines recognize a whole list of business strategies that could influence price,<sup>25</sup> and that list is not even meant to be exhaustive.<sup>26</sup> The guidelines offer market penetration schemes as one example.<sup>27</sup> There is a specific acknowledgement that market penetration schemes may fail, and the guidelines give guidance on how to evaluate a strategy that results in temporarily decreased profits in return for higher expected profits in the longer term.<sup>28</sup>

---

16. *Id.* ¶ 59. This functional analysis is only implicit in the discussion of the cost-plus pricing method discussed in paragraph 65 of the report. However, functional analysis should not be overemphasized. It is specifically mentioned as a useful way to "begin" in "examining the transfer prices adopted within a multinational enterprise . . . ." *Id.* ¶ 17.

17. *Id.* ¶ 55.

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. 1995 Guidelines, *supra* note 1, ¶¶ 1.19-1.35. For this discussion, interested parties should refer directly to the text of the guidelines and not to a condensation, because the value of the discussion is in its technical detail.

23. 1979 Report, *supra* note 2, ¶ 40.

24. *Id.* ¶ 43.

25. 1995 Guidelines, *supra* note 1, ¶¶ 1.31-1.35.

26. Note the phrases "such as" and "could include" when referring to business strategies. *Id.* ¶¶ 1.31-1.32.

27. *Id.* ¶¶ 1.32-1.35.

28. *Id.* ¶ 1.35.

### B. Recognition of the Actual Transactions

The new guidelines provide instruction on when a tax administration may disregard the structure the taxpayer adopts in entering into a controlled transaction.<sup>29</sup> In this respect, the new guidelines are both more precise and more limiting than the 1979 report. The 1979 report indicated that a tax administration "as a general principle"<sup>30</sup> should base the search for arm's length pricing on actual transactions, while acknowledging that "there may be some circumstances where the form of transaction has effectively to be ignored."<sup>31</sup> Those circumstances, although described as "exceptional cases,"<sup>32</sup> seem to extend to any arrangements "frequently"<sup>33</sup> encountered between associated enterprises that "are not or are very rarely encountered between unrelated parties . . . ."<sup>34</sup> The report also states that "[i]n such instances tax authorities would have to determine what is the underlying reality behind an arrangement in considering what the appropriate arm's length price would be."<sup>35</sup>

This language, while open to differing interpretations, could be read to suggest that restructuring could occur whenever the associated enterprises enter into an arrangement that differs from what independent enterprises would have done. The tax administration would be free in such a case to search for the "reality" as reflected by the behavior of independent enterprises.

The new guidelines limit the possibility of such an interpretation. First, they expressly state that "[i]n other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them."<sup>36</sup> The guidelines recognize only two circumstances when restructuring may be appropriate and legitimate.<sup>37</sup> The first is "where the economic substance of a transaction differs from its form,"<sup>38</sup> such as where an investment in an associated enterprise is structured as debt in economic circumstances where the substance is a subscription of capital.<sup>39</sup> The second circumstance is where the "arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent

---

29. *Id.* ¶¶ 1.36-1.41.

30. 1979 Report, *supra* note 2, ¶ 15.

31. *Id.*

32. *Id.* ¶ 23.

33. *Id.* ¶ 24.

34. *Id.*

35. *Id.*

36. 1995 Guidelines, *supra* note 1, ¶ 1.36.

37. *Id.* ¶ 1.37.

38. *Id.*

39. *Id.*

enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price."<sup>40</sup>

This rule is far more restrictive than the 1979 rule that allowed restructuring whenever the parties arranged their affairs differently than independent enterprises. The new rule sets up two additional hurdles. First, independent enterprises must not have considered the arrangements "commercially rational" under the circumstances.<sup>41</sup> Second, the tax administration must effectively have no other recourse for fixing arm's length pricing.<sup>42</sup> Both of these conditions must be met for restructuring to occur where the form and substance of a transaction are the same.<sup>43</sup>

### C. *Evaluation of Separate and Combined Transactions*

In keeping with the Article 9 articulation of the arm's length principle, the new guidelines provide that ideally the principle "should be applied on a transaction-by-transaction basis."<sup>44</sup> At the same time, the guidelines recognize that there are circumstances in which it would be appropriate to aggregate transactions. The guidelines articulate a specific standard for when this may occur: "where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis."<sup>45</sup> They cite a number of examples, such as long-term contracts for the supply of commodities or services, rights to use intangible property, and pricing a range of closely linked products when determining the price for each product or transaction is "impractical."<sup>46</sup>

The 1979 report provides less instruction on this point. It states that, "[i]t may be reasonable in some circumstances to analyse the transfer prices for product lines or other groupings rather than to ascertain an arm's length price for each individual product or sale."<sup>47</sup> The report cites as examples situations where some products are sold below market price to allow a higher profit on related products.<sup>48</sup> It also discusses "package deals,"<sup>49</sup> where "a single charge is made for a variety of benefits,"<sup>50</sup> such as patent licenses, technical and administrative services, and

---

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.* ¶ 1.42.

45. *Id.*

46. *Id.*

47. 1979 Report, *supra* note 2, ¶ 41.

48. *Id.*

49. *Id.* ¶ 19.

50. *Id.*

selling or leasing production facilities, "all for an undifferentiated payment."<sup>51</sup>

The main difference between the 1995 guidelines and the 1979 report is that the new guidelines provide a standard for determining whether aggregation of controlled transactions is appropriate. This standard is important for both taxpayers and tax administrations. From the taxpayer's perspective, the standard will protect against the global application of pricing methods by tax administrations. The arm's length principle will require a transaction-by-transaction analysis, except where transactions are "so closely linked or continuous"<sup>52</sup> that a separate analysis will not work. The standard will help tax administrations protect against the combination of transactions in a way that impedes a proper arm's length analysis. Thus, the new guidelines recognize that in some cases, package transactions may need to be evaluated separately. However, after such an analysis the tax administration should still consider "whether in total the transfer pricing for the entire package is arm's length."<sup>53</sup> This latter qualification should prevent tax examiners from inappropriately selecting for adjustment ("cherry-picking") the part of the package that is not arm's length without considering whether offsets exist in other parts of the package.

In short, both taxpayers and tax administrations now have flexible rule allowing separate transactions to be combined to permit a practical analysis, in keeping with business realities. At the same time, the new guidelines have attempted to articulate a standard to prevent aggregation from being abused.

#### D. *Use of an Arm's Length Range*

Using an arm's length range of transfer pricing is perhaps one of the most important additions that the new guidelines make. The 1979 report acknowledged that "an arm's length price will in many cases not be precisely ascertainable and that in such circumstances it will be necessary to seek for [sic] a reasonable approximation to it."<sup>54</sup> The report relied on this observation to justify the conclusion that it may be useful to employ more than one method to reach a satisfactory approximation of an arm's length price, but it still seemed to envision only one price (albeit an approximate one).<sup>55</sup> The 1979 report also indicated that, in light of the need for judgment in determining transfer pricing, if a price

---

51. *Id.*

52. 1995 Guidelines, *supra* note 1, ¶ 1.42.

53. *Id.* ¶ 1.43.

54. 1979 Report, *supra* note 2, ¶ 46.

55. *Id.* ¶¶ 46-47.



appeared to be arm's length "there would be no justification for seeking to make merely minor or marginal adjustments . . . ." <sup>56</sup>

The new guidelines also state that "[t]ax administrators should hesitate from making minor or marginal adjustments."<sup>57</sup> However, the guidelines go further, specifically endorsing an arm's length range in many situations: "However, because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable."<sup>58</sup> Several paragraphs elaborate on the concept of the arm's length range.<sup>59</sup> The 1979 report contained none of this material. New paragraph 1.48 states specifically that "[i]f the relevant conditions of the controlled transactions (e.g. price or margin) are within the arm's length range, no adjustment should be made."<sup>60</sup> When a taxpayer's pricing is outside the range that the tax administration determines, the taxpayer may present evidence that the range should be expanded.<sup>61</sup> "[A]djustments should be made to the point within the range that best reflects the facts and circumstances of the particular controlled transaction," where possible.<sup>62</sup>

#### E. *Set-offs*

The discussion of set-offs in the new guidelines and the 1979 report are very similar. Both acknowledge that intentional set-offs should be allowed.<sup>63</sup> An intentional set-off is one where the associated enterprises knowingly include a balancing of benefits in their arrangements with each other.<sup>64</sup> Under the new guidelines, intentional set-offs may occur only between two associated enterprises. The guidelines give no explicit indication whether set-offs involving more than two parties (i.e., a triangular arrangement) should be recognized. Unlike the 1979 report, the new guidelines address the unintentional over-reporting of income on a transaction that a taxpayer makes to obtain a reduction in a transfer pricing adjustment on another transaction.<sup>65</sup> For this type of unintentional set-off, the Guidelines leave it to the discretion of tax administrations whether to grant the request, making a clear distinction from intentional

---

56. *Id.* ¶ 15.

57. 1995 Guidelines, *supra* note 1, ¶ 1.68.

58. *Id.* ¶ 1.45.

59. *Id.* ¶¶ 1.45-1.48.

60. *Id.* ¶ 1.48.

61. *Id.*

62. *Id.*

63. *Id.* ¶ 1.60; 1979 Report, *supra* note 2, ¶ 20.

64. 1995 Guidelines, *supra* note 1, ¶ 1.60.

65. *Id.* ¶ 1.64.

set-offs.<sup>66</sup>

#### F. Selection of Transfer Pricing Methods

The new guidelines give more specific guidance on selecting transfer pricing methods than the 1979 report did, although the two documents are generally consistent. The 1979 report preferred the comparable uncontrolled price (CUP) method, but recognized that "there may be cases where the evidence of resale profit mark-ups, production costs or other data may be more complete, more conclusive and more easily obtained than undisputable evidence of open market prices."<sup>67</sup> The 1979 report continued:

There should always be the possibility, therefore, of selecting the method which provides the most cogent evidence in a particular case . . . . Frequently, it may be useful to take account of more than one method of reaching a satisfactory approximation to an arm's length price in the light of the evidence available.<sup>68</sup>

The new guidelines similarly favor the CUP method: "Where it is possible to locate comparable uncontrolled transactions, the CUP Method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP Method is preferable over all other methods."<sup>69</sup> The 1995 guidelines also prefer the traditional transaction methods (such as CUP, cost plus and resale price) over transactional profit methods (such as transactional net margin method and profit split).<sup>70</sup> These latter methods are considered appropriate only in cases of last resort.<sup>71</sup> Thus, all the methods do not have equal standing.

Still, like the 1979 report, the new guidelines do not establish a rigid hierarchy of methods that would force a taxpayer to disprove the application of one method before using another. The new guidelines have an order of preference based on "higher degrees of comparability and a more direct and closer relationship to the transaction."<sup>72</sup> The guidelines state that "[n]o one method is suitable in every possible situation and the applicability of any particular method need not be disproved."<sup>73</sup> They further provide: "[T]his Report does not require either the tax examiner or taxpayer to perform analyses under more than one

---

66. *Id.*

67. 1979 Report, *supra* note 2, ¶ 46.

68. *Id.*

69. 1995 Guidelines, *supra* note 1, ¶ 2.7.

70. *Id.* ¶ 2.49.

71. *Id.*

72. *Id.* ¶ 1.70.

73. *Id.* ¶ 1.68.

method.”<sup>74</sup> The guidelines also recognize that there will be difficult cases where “no one approach is conclusive,”<sup>75</sup> and that in such circumstances:

an attempt should be made to reach a conclusion consistent with the arm’s length principle that is satisfactory from a practical viewpoint to all the parties involved, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration.<sup>76</sup>

## II. TRADITIONAL TRANSACTION METHODS

### A. *The Comparable Uncontrolled Price (CUP) Method*

The CUP method continues to be regarded as the most theoretically pure application of the arm’s length principle, and so it continues to be the preferred method. However, during the revision process the business community and tax administrations complained that, in practice, the CUP method had become obsolete for all but the simplest cases because the comparability standard was being too rigidly applied. This concern suggested a more relaxed comparability standard for the CUP and other traditional methods. The counterargument is that the standard of comparability must not be so loose for the CUP method that one could, with impunity, compare apples and oranges.

The 1995 guidelines take a practical approach to the problem, making clear that the standard is not as rigid as some had previously thought, but still requiring “reasonably accurate adjustments”<sup>77</sup> for any material effects of differences between the controlled and uncontrolled transactions.<sup>78</sup> This is an improvement over the 1979 report, which focused on transactions in “the same or similar goods.”<sup>79</sup> The comparability standard has perhaps been broadened, but only to the extent that the CUP method is not automatically rejected. Rather, when in doubt, the CUP method is weighed in terms of reliability against other possible methods. It may prove to be the most reliable method when all the facts and circumstances are considered.

Thus, the new guidelines provide that  
the difficulties that arise in attempting to make reasonably accurate

---

74. *Id.* ¶ 1.69.

75. *Id.*

76. *Id.*

77. *Id.* ¶ 2.9.

78. *Id.*

79. 1979 Report, *supra* note 2, ¶ 45. The 1979 report recognizes that even where “the differences are important a useful comparison may still be possible so long as appropriate adjustments can be reasonably made to the uncontrolled price to take account of the differences.” *Id.* ¶ 51.

adjustments should not routinely preclude the possible application of the CUP method. Practical considerations dictate a more flexible approach to enable the CUP Method to be used and to be supplemented as necessary by other appropriate methods, all of which should be evaluated according to their relative accuracy.<sup>80</sup>

The new guidelines also adopt a general formulation of the comparability standard for determining whether “an uncontrolled transaction is comparable to a controlled transaction (i.e. it is a comparable uncontrolled transaction) . . . .”<sup>81</sup> The standard requires that “none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect”<sup>82</sup> the measure used to determine the transfer pricing—open market price in the case of the CUP method,<sup>83</sup> resale price margin or cost plus mark-up for the other two traditional methods,<sup>84</sup> or net margin in the case of the transactional net margin method (TNMM).<sup>85</sup> This standard makes it clear that comparability must be considered no matter what method of transfer pricing is used.<sup>86</sup>

### B. *Resale Price and Cost Plus Methods*

The two sections of the new guidelines describing the resale price and cost plus methods perhaps bear the greatest similarity to the 1979 report. These two traditional methods required few changes; experience seemed to indicate that they had been operating well.

Only one point required substantial rewriting: the treatment of operating expenses and whether net or gross profit margins should be compared in these traditional methods. This question grew in importance when the OECD replaced its discussion of the comparable profits method with the TNMM, which allows only a transactional comparison of net profit margins in last-resort cases. The question in the traditional methods centered around the cost plus method, necessitating a clarification of the extent to which operating (below-the-line) expenses could be accounted for in the cost plus mark-up, and how the analysis would dif-

---

80. 1995 Guidelines, *supra* note 1, ¶ 2.9.

81. *Id.* ¶ 2.7.

82. *Id.*

83. *Id.*

84. *Id.* ¶¶ 2.16, 2.34.

85. *Id.* ¶ 3.26.

86. It is important to ensure that comparability is not too rigidly applied under the CUP method, and to ensure that comparability is not overlooked or treated less seriously once the case is treated as “last resort.” The delegates were especially concerned that comparability concerns be stressed for the TNMM, and they devoted a special section of the Guidelines to this topic. *Id.* ¶¶ 334.-3.40.

fer from what the OECD was allowing (subject to more severe restrictions) in the TNMM.

The new guidelines deal with this issue by first recognizing that accounting consistency is important in applying any transfer pricing method.<sup>87</sup> Because accounting standards and terms may vary, precluding a precise definition of operating expenses, the guidelines recognize that it may be necessary in some cases to account for some operating expenses to achieve consistency and comparability.<sup>88</sup> The level and types of expenses should also be examined for purposes of comparability, and may suggest some adjustment. For example, "[i]f expenses reflect a functional difference . . . an adjustment to the cost plus mark up may be required."<sup>89</sup>

Perhaps most importantly, the new guidelines set forth a clear, yet flexible, distinction between the cost plus and net margin approaches. This distinction acknowledges that there is a spectrum, and the more operating expenses that are taken into account, the more the cost plus method "starts to approach a net rather than gross margin."<sup>90</sup> The guidelines' conclusion is best conveyed in the following paragraph:

The distinction between gross and net margin analyses may be understood in the following terms. In general, the cost plus method will use margins computed after direct and indirect costs of production, while a net margin method will use margins computed after operating expenses of the enterprise as well. It must be recognised that because of the variations in practice among countries, it is difficult to draw any precise lines between the three categories described above. Thus, for example, an application of the cost plus method may in a particular case include the consideration of some expenses that might be considered operating expenses, as discussed in paragraph 2.39. Nevertheless, the problems in delineating with mathematical precision the boundaries of the three categories described above do not alter the basic practical distinction between the gross and net margin approaches.<sup>91</sup>

The foregoing paragraph helps explicate the difference between the cost plus method and the TNMM, yet at the same time shows that the difference is not mammoth. It appears that a fully net cost plus analysis may have been used at times in the past, although the 1979 report did not precisely describe it.<sup>92</sup> This would probably qualify as an applica-

---

87. *Id.* ¶ 2.39.

88. *Id.*

89. *Id.* ¶ 2.38.

90. *Id.* ¶ 2.39.

91. *Id.* ¶ 2.41.

92. *See, e.g.*, 1979 Report, *supra* note 2, ¶ 12 ("the cost plus method starting from the cost of providing the goods or services, etc. and adding whatever cost and profit mark-up is appropriate

tion of TNMM under the new guidelines. The explanation also helps illustrate that the TNMM is not quite as new a method as one might think at first glance, but rather one that both tax administrations and taxpayers have used when data has not been sufficiently detailed to perform a traditional cost plus or resale price analysis.

### III. TRANSACTIONAL PROFIT METHODS

The new guidelines accept the two types of transactional profit methods, the profit split method and the transactional net margin method, as methods of last resort.<sup>93</sup> Both methods are labelled "transactional" because they must be applied to the profit arising from a controlled transaction or controlled transactions that are appropriate to aggregate.<sup>94</sup> "Last resort" status means that transactional profit methods cannot be used when traditional transaction methods can be reliably applied. However, the guidelines make clear that even in such cases, "it would be inappropriate to automatically apply a transactional profit method without first considering the reliability of that method."<sup>95</sup>

The new guidelines represent the first clear international acceptance (albeit limited) of profit methods, while at the same time articulating a distinction between transactional and overall profit methods. The 1979 report was more ambiguous about profit methods, and included some language that was open to interpretation. For example, Paragraph 13 indicated that "[t]he complexities of real life business situations" may require the application of "other methods" than traditional transaction methods,<sup>96</sup> but did not clearly articulate those other methods. Paragraph 70 similarly referred to the possible use of "other reasonable approaches" to arrive at an arm's length price in cases where the CUP, cost plus, and resale price methods were not satisfactory.<sup>97</sup> Methods "used in practice" are described, but said to be "by no means exhaus-

---

. . ."); ¶ 69 (profit mark-up may be determined by estimating seller's gross profit). Both paragraphs imply that the cost-plus mark-up is a gross margin. Although there is room for the contrary interpretation, most tax administrations and taxpayers had interpreted the method as a gross margin method, with exceptions for a few types of operating expenses. The new guidelines offer a rational means of resolving this issue by allowing both gross margins and net margins to be used. But as the margin gets close to full net, it is necessary to take additional precautions in determining comparability to account for the potential effect of the company's characteristics (e.g. competitive position, management efficiency) on operating expenses.

93. 1995 Guidelines, *supra* note 1, ¶ 3.1.

94. *Id.* ¶ 3.5 (profit split); ¶ 3.26 (TNMM).

95. *Id.* ¶ 3.50.

96. 1979 Report, *supra* note 2, ¶ 13.

97. *Id.* ¶ 70.

tive."<sup>98</sup> Those methods include comparable profits,<sup>99</sup> the profit split,<sup>100</sup> and a return on capital approach.<sup>101</sup> While Paragraph 70 suggested that these methods may be used "with care,"<sup>102</sup> some of the language describing each method could be interpreted more negatively. Thus, the 1979 report took an indefinite position on profit methods, perhaps because of a lack of experience at the time with the types of cases for which these methods would be necessary.

#### A. *The Profit Split Method*

The new guidelines accept the profit split method as one of last resort, and describe in some detail two approaches—a "contribution analysis" and a "residual analysis"—for applying the method.<sup>103</sup> The 1979 report stopped at providing a simple reference to a method that attempted "to allocate some proportion of the combined net income arising from a sales transaction to the various associated enterprises concerned in it on the basis of their proportionate contribution to the final profit."<sup>104</sup> There was no analysis, only a somewhat confusing reference to Paragraph 14 of the report, which is concerned primarily with global formulary apportionment.<sup>105</sup>

Paragraph 14 rejects global formulary apportionment, sometimes called unitary taxation, as a method of arm's length pricing.<sup>106</sup> The new guidelines do the same.<sup>107</sup> An entire section of Chapter III of the guidelines is devoted to this approach and the reasons for its rejection.<sup>108</sup> But unlike the 1979 report, the guidelines avoid confusing the profit split method and global formulary apportionment. The latter method operates according to a predetermined formula; the former method divides profits based upon the specific facts and circumstances of each case. Most importantly, the guidelines' profit split method is not global. It is a transactional method, and in this respect is clearly distinct from the approach that Paragraph 14 of the 1979 report described.

The 1979 report did not give thorough consideration to the type of profit split method that the guidelines describe. That method was neither rejected nor accepted in 1979; the report simply acknowledged it

---

98. *Id.*

99. *Id.* ¶ 71.

100. *Id.* ¶ 72.

101. *Id.* ¶ 73.

102. *Id.* ¶ 70.

103. 1995 Guidelines, *supra* note 1, ¶¶ 3.15-3.22.

104. 1979 Report, *supra* note 2, ¶ 72.

105. *Id.* ¶¶ 72, 14.

106. *Id.* ¶ 14.

107. 1995 Guidelines, *supra* note 1, ¶ 3.63.

108. *Id.* ¶¶ 3.58-3.74.

as one of the possible alternatives "used in practice."<sup>109</sup> With a degree of prescience, the 1979 report through its reference to Paragraph 14 underscored the concern over a nontransactional application of this method, thereby making the transactional limitation developed in 1995 a natural and logical progression.

### B. *Transactional Net Margin Method*

Much of the interest in the new guidelines has focused on a newly described method, the transactional net margin method (TNMM). As previously discussed, it is unclear how new the method really is, given the apparent use in practice of fully net resale price and cost plus analyses for some years. What is new is the OECD's articulation of the method. This method is supposed to operate similarly to the cost plus and resale price methods, looking only at full net margins rather than gross or semi-gross margins.<sup>110</sup> It is subject to the same "last resort" status as the profit split method,<sup>111</sup> and it has been adorned with a specific discussion of concerns about finding adequately comparable transactions.<sup>112</sup> Thus, the method, while permitted, is severely limited.

The 1979 report did not discuss this method, except to the extent that some might find it inherent in the discussion of cost plus. The report did address a "comparable profits" approach, but described this approach as an *overall* comparison of profits,<sup>113</sup> not at all what the TNMM envisions. The 1979 report did not reject an overall comparable profits approach. Paragraph 71 of the report stated that "[t]ax authorities may find some help in a comparison of an enterprise's overall performance with that of other similar enterprises in the same or similar circumstances."<sup>114</sup> It concluded that such profit comparisons "could normally be regarded only as pointers to further investigation."<sup>115</sup> The report did not say whether in last resort cases the method could be used, as it did not address the question of what should happen outside "normal" circumstances.

This is one area in which the OECD has clearly changed its position since 1979. The new guidelines reject a method that compares overall levels of profits, even in cases of last resort: "In particular, so-called 'comparable profits methods' or 'modified cost plus/resale price methods' are acceptable only to the extent that they are consistent with

---

109. 1979 Report, *supra* note 2, ¶ 70.

110. 1995 Guidelines, *supra* note 1, ¶ 3.26.

111. *Id.* ¶ 3.50.

112. *Id.* ¶ 3.26.

113. 1979 Report, *supra* note 2, ¶ 71.

114. *Id.*

115. *Id.*



these Guidelines."<sup>116</sup> The TNMM allows only a comparison of net margins, only on a transactional basis, and only in last resort situations. These restrictions impose substantial limitations on profit comparisons that the 1979 report lacked. Most importantly, the guidelines remove any ambiguity that had been present about the boundaries for using such methods.

#### IV. ADMINISTRATIVE ISSUES

Chapter IV of the new guidelines discusses a host of administrative issues that the 1979 report did not cover.<sup>117</sup> One important new section covers transfer pricing compliance practices.<sup>118</sup> In this section, tax examiners "are encouraged to be flexible in their approach"<sup>119</sup> and "to take into account the taxpayer's commercial judgment . . . so that transfer pricing is tied to business realities."<sup>120</sup> The section suggests that tax examiners "begin their analyses of transfer pricing from the perspective of the method that the taxpayer has chosen in setting its prices."<sup>121</sup> It also cautions that neither tax administrations nor taxpayers should "misuse the burden of proof"<sup>122</sup> and so should "use restraint"<sup>123</sup> in relying on it while examining a transfer pricing case. Both sides should be prepared to make "a good faith showing"<sup>124</sup> that the proposed transfer pricing is consistent with the arm's length principle, according to the guidelines.<sup>125</sup>

The section on compliance practices also discusses penalty systems,<sup>126</sup> another issue the 1979 report did not address. The discussion makes clear that the severity of a penalty should be balanced against the conditions under which it is imposed, and that "the harsher the penalty the more limited the conditions in which it would apply."<sup>127</sup> The discussion concludes as follows:

First, imposition of a sizable 'no-fault' penalty based on the mere existence of an understatement of a certain amount would be unduly

116. 1995 Guidelines, *supra* note 1, ¶ 3.1.

117. One of these issues—corresponding adjustments and the mutual agreement procedure, was addressed in part in a 1984 Report by the OECD Committee on Fiscal Affairs entitled *Transfer Pricing and Multinational Enterprises: Three Taxation Issues*. See ¶¶ 23-40.

118. 1995 Guidelines, *supra* note 1, ¶¶ 4.4-4.28.

119. *Id.* ¶ 4.9.

120. *Id.*

121. *Id.*

122. *Id.* ¶ 4.16.

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.* ¶¶ 4.18-4.28.

127. *Id.* ¶ 4.27.

harsh when it is attributable to good faith error rather than negligence or an actual intent to avoid tax. Second, it would be unfair to impose sizable penalties on taxpayers that made a reasonable effort in good faith to set the terms of their transactions with related parties in a manner consistent with the arm's length principle. In particular, it would be inappropriate to impose a transfer pricing penalty on a taxpayer for failing to consider data to which it did not have access, or for failure to apply a transfer pricing method that would have required data that was not available to the taxpayer. Tax administrations are encouraged to take these observations into account in the implementation of their penalty provisions.<sup>128</sup>

Other significant changes in the chapter on administrative issues are the concerns expressed over double taxation and other difficulties that secondary adjustments raise,<sup>129</sup> the rejection of safe harbors,<sup>130</sup> and guidance on the use of advance transfer pricing arrangements (APA).<sup>131</sup> The guidelines express particular caution concerning the scope of APAs. They recommend that taxpayers and tax administrations "pay close attention to the reliability of any predictions so as to exclude unreliable predictions. In general, great care must be taken if the APA goes beyond the methodology, its application, and critical assumptions."<sup>132</sup> The guidelines also state that the OECD Committee on Fiscal Affairs has agreed to study arbitration, and to supplement the guidelines when that study is completed.<sup>133</sup>

## V. DOCUMENTATION

The 1979 report touched only tangentially on the issue of documentation. The new guidelines devote a separate chapter, albeit a brief one, to this important topic.<sup>134</sup> The significance of the chapter is that it articulates a new standard for determining the appropriate level of documentation from a taxpayer.<sup>135</sup> The chapter indicates that "[t]axpayers should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm's length principle."<sup>136</sup> In determining what constitutes reasonable efforts, the chapter provides that "[t]he taxpayer's process of considering whether transfer pricing is appropriate for tax

---

128. *Id.* ¶ 4.28.

129. *Id.* ¶¶ 4.67-4.77.

130. *Id.* ¶¶ 4.94-4.123.

131. *Id.* ¶¶ 4.124-4.166.

132. *Id.* ¶ 4.162.

133. *Id.* ¶ 4.171.

134. *Id.* ¶¶ 5.1-5.29.

135. *Id.* ¶ 5.1.

136. *Id.* ¶ 5.28; *see also Id.* ¶ 5.3.

purposes should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance."<sup>137</sup>

The Chapter further makes clear that documents that "would not have been prepared or obtained other than for tax purposes"<sup>138</sup> should be expected "only if they are indispensable for a reasonable assessment of whether the transfer pricing satisfies the arm's length principle and can be obtained or prepared by the taxpayer without a disproportionately high cost being incurred."<sup>139</sup> This standard envisions tax administrators conducting a type of cost-benefit analysis before asking for documents other than those kept in the ordinary course of business. Finally, the chapter provides nonprescriptive detail about the type of information that may be relevant to a transfer pricing inquiry.<sup>140</sup>

## VI. FOLLOW-UP

The OECD guidelines are an important first step in the process of building a long-lasting international understanding on transfer pricing. Much work remains to be done, including the addition of practical examples and chapters on intangibles, services,<sup>141</sup> cost contribution arrangements, permanent establishments, and aspects of financial arrangements. The July 1995 agreement will allow this work to go forward in an atmosphere of cooperation and understanding.

It is notable that the guidelines were issued in loose-leaf form both to facilitate updating and to recognize the new monitoring role assigned to the OECD's Committee on Fiscal Affairs. In this respect, the OECD Council recommendation, included as an appendix to the Guidelines, makes for more interesting reading than it might appear at first glance. The recommendation specifically charges the committee "to monitor the implementation of the [guidelines] in cooperation with the tax authorities of Member countries and with the participation of the business community. . . ."<sup>142</sup> Thus, the new guidelines are a beginning, not an end.

Some changes may be necessary, depending on experience. What is most important is that the member countries stand ready to review this work and to keep it current, so that there might never again be the threat

---

137. *Id.* ¶ 5.4.

138. *Id.* ¶ 5.7.

139. *Id.*

140. *Id.* ¶¶ 5.16-5.27.

141. The Chapters on intangibles and services were approved by the Committee on Fiscal Affairs in January 1996, and will be published after approval by the OECD Council.

142. *Id.* app. § III.2.

of a global tax war. That almost sounds like a workable plan for peace. To that, we can only commend and encourage the intentions of the member countries and add our own Amen.

