

THE RECOGNITION OF THE EFFECT OF PASSIVE ASSOCIATION ON CONTROLLED TRANSACTIONS FOR TRANSFER PRICING PURPOSES

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UNIVERSITY OF LONDON

**THE RECOGNITION OF THE EFFECT OF PASSIVE
ASSOCIATION ON CONTROLLED TRANSACTIONS FOR
TRANSFER PRICING PURPOSES**

MURRAY CLAYSON

A THESIS SUBMITTED TO QUEEN MARY UNIVERSITY OF LONDON
FOR THE DEGREE OF DOCTOR OF PHILOSOPHY

29 January 2016

London, England

DECLARATION

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A handwritten signature in blue ink that reads "Murray Clayson". The signature is written in a cursive style with a blue circular stamp or mark over the letter 'y' in "Clayson".

Murray Clayson

ABSTRACT

This thesis examines a controversial and unsettled aspect of international tax law in the transfer pricing field: should the effect of “passive association” within a multinational group of companies be taken into account in pricing transactions between group members? The marketplace may assume, typically in a financing context, that (aside from any “explicit” support – the paradigm being a parent company guarantee) a group member experiencing financial distress will be supported by one or more affiliates.

The paradox to investigate is the apparent contradiction between (i) the need, in arriving at an arm’s length price, to postulate a transaction between *independent* parties, and (ii) the possible recognition, in the pricing analysis, of effects deriving from corporate association. How far does the independence hypothesis extend? What features of affiliation must be disregarded in constructing that hypothesis?

An absence of clarity and consistency between national tax systems in this respect presents multinational enterprise groups with legal uncertainty and the threat of international double taxation – a recognised obstacle to cross-border commerce.

This study presents an analysis of supranational guidance; a comparative investigation of national tax laws in selected countries with sophisticated transfer pricing codes; and a critical review of relevant practitioners’ and academic literature. The arguments for and against the recognition of passive association are distilled and evaluated from a legal perspective. The quest is for the most rational, “black-letter” interpretation of existing laws. Alternative solutions based on policy judgments or economic theories are not pursued.

Although the case for disregarding passive association cannot be dismissed casually, the contrary argument – for its recognition, as part of the relevant factual matrix, in pricing controlled transactions – appears convincing.

Therefore, recommendations are made to clarify internationally endorsed guidance, with a view to developing a harmonized approach to what, to date, has remained an unresolved conundrum.

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TABLE OF ABBREVIATIONS/GLOSSARY

ABA	American Bar Association
ACIT	(Indian) Additional Commissioner of Income Tax
AE	Associated enterprise (for Indian transfer pricing purposes)
Associated enterprise	Two enterprises are associated with respect to each other if one of the enterprises meets the conditions of Article 9(1)(a) or (b) MTC with respect to the other enterprise (as defined in the TPG)
ATC	Australian Tax Cases
ATO	Australian Taxation Office
ATR	Australian Tax Reports
BEPS	Base erosion and profit shifting, the subject of the OECD's project of the same name
BEPS 2015 Final Reports	<i>Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports</i> (OECD, 5 October 2015)
BFH	<i>Bundesfinanzhof</i> (German Federal Fiscal Court)
BTR	British Tax Review
CA	(United Kingdom) Court of Appeal
C.B.	(United States) Cumulative Bulletin
CBDT	(Indian) Central Board of Direct Taxation
CFA	The OECD's Committee on Fiscal Affairs
CFR	United States Code of Federal Regulations
CIT(A)	(Indian) Commissioner of Income Tax (Appeals)
CLR	Commonwealth Law Reports
Comparable uncontrolled price (or CUP)	A price derived from the CUP transfer pricing method described in the TPG
Comparable uncontrolled transaction	A transaction between two independent parties that is comparable to the controlled transaction under examination

(or CUT)	(as defined in the TPG)
Controlled transaction	Transactions between two enterprises that are associated enterprises with respect to each other (as defined in the TPG)
CRA	Canada Revenue Agency
CSA	Cost sharing arrangement
CTC	Canadian Tax Cases
CTPA	OECD's Centre for Tax Policy and Administration
CTJ	Canadian Tax Journal
Cl. Ct.	United States Court of Claims
DCIT	(Indian) Deputy Commissioner of Income Tax
DTC	Dominion Tax Cases
ECJ	European Court of Justice, the informal name of the Court of Justice now forming part of the Court of Justice of the European Union (formerly the Court of Justice of the European Communities)
EU	European Union
F.2d	United States Federal Reporter, second series (similarly, F.3d: third series)
FCA	(Canadian) Federal Court of Appeal
Fed. Cl.	United States Court of Federal Claims
FTT	First-tier Tribunal (Tax Chamber)
HL	House of Lords
HMRC	United Kingdom H.M. Revenue and Customs
IBFD	International Bureau of Fiscal Documentation
ICTA	United Kingdom Income and Corporation Taxes Act 1988
IFA	International Fiscal Association
IFZ	<i>Internationale Fiscale Zaken</i> (International Tax Matters) (Netherlands)

IRC	United States Internal Revenue Code of 1986, as amended
IRS	United States Internal Revenue Service
ITA	(Canadian) Income Tax Act, R.S.C., 1985, c.1 (5th Supp); or (Indian) Income Tax Appeal, according to context
ITAT	(Indian) Income Tax Appellate Tribunal
ITLR	International Tax Law Reports
ITPJ	International Transfer Pricing Journal (IBFD)
MNE	A company that is part of an MNE group (as in the TPG)
MNE group	A group of associated companies with business establishments in two or more countries (as defined in the TPG)
MTC	OECD Model Tax Convention on Income and Capital, updated to 2014
OECD	Organisation for Economic Cooperation and Development
OECD 1979 Report	Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises (1979)
OECD 1987 Thin Capitalisation Report	The thin capitalisation section of Thin Capitalization, and Taxation of Entertainers, Artists and Sportsmen in Issues in International Taxation Series, No.2 (1987)
OECD PEs Report	Report on the Attribution of Profits to Permanent Establishments, OECD (2010)
PE	Permanent establishment
Regs.	United States Treasury Section 482 Regulations Title 26 CFR
SCC	Supreme Court of Canada
STC	Simon's Tax Cases
TCC	Tax Court of Canada
TC	United States Tax Court (and "Dkt" = docket)
TCM	(United States) Tax Court Memorandum
T.D.	United States Treasury Decision (published in the Internal

	Revenue Bulletin and the Cumulative Bulletin)
TFEU	Treaty on the Functioning of the European Union incorporating amendments made by the Treaty of Lisbon signed 13 December 2007
TfS	<i>Tidsskrift for Skatter og Afgifter</i> (Danish Journal of Tax Law)
TIOPA	United Kingdom Taxation (International and Other Provisions) Act 2010
TMTPR	Bloomberg BNA's Tax Management Transfer Pricing Report
TPIJ	Bloomberg BNA's Transfer Pricing International Journal
TPG	The OECD's Transfer Pricing Guidelines (July 2010 edition as amended by the BEPS 2015 Final Reports: see note 82 below)
TPO	(Indian) Transfer Pricing Officer
TR	(Australian) Taxation Ruling
UN	United Nations
UN Model	The UN Model Tax Convention on Income and Capital (January 2011)
UN Transfer Pricing Manual	The UN's Transfer Pricing Manual for Developing Countries (October 2012)
Utv.	<i>Dommer, uttalelser m.v. i skattesaker</i> (Norwegian periodical)

1. INTRODUCTION

“The expressions ‘arm’s length’ and ‘non-arm’s length’ are creations of law. They are not words of ordinary language from which a plain meaning can be easily distilled.”¹

Background, key questions, scope of research and justification

1.1 This study considers a detailed technical, but nonetheless controversial, aspect of transfer pricing in international tax law: the effect of “passive association” on the transfer pricing treatment of “controlled” transactions². My conclusion is that passive association/implicit support should indeed be taken into account in pricing controlled transactions.

1.2 Long-established international convention applies the “arm’s length principle” to transactions between associated enterprises. This is the foundation of international transfer pricing, having originated in international tax law through the work of the League of Nations³. It now finds expression in Article 9(1) of the

¹ Justice Hogan in *General Electric Capital Canada Inc v The Queen* 2009 TCC 563, paragraph [188].

² Transactions between two enterprises that are associated enterprises with respect to each other, according to the TPG glossary.

³ League of Nations (1927): a report with a draft model treaty was issued in 1927, followed by a revised series of models in 1928, establishing the separate entity approach (or “separate accounting”) for the first time. Mitchell B. Carroll, an adviser to the US Treasury, undertook a survey of relevant law and administrative practices in 35 countries, leading to a new draft multilateral treaty in 1933 which included at Article 3 authority to the Contracting States, in the context of permanent establishments, “to re-establish the prices or remuneration entered in the books at the value which would prevail between independent persons dealing at arm’s length”. Article 5 contained a forerunner of Article 9(1) MTC, referring to “commercial or financial relations” of controlled enterprises and the diversion of profits. Article 5 was derived from Article IV of the 1932 US-France tax treaty, which itself was based on section 45 of the US Revenue Act of 1928. In 1935 the arm’s length principle was included as a rule in US transfer pricing regulations: Treasury Regulation 86, Article 45-1(b): “The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer.” See Hamaekers (2002), Wittendorff (2010a) chapter 3 and Vögel (2015) page 605, for historical accounts of the adoption of the principle.

Model Taxation Convention of the Organisation for Economic Co-operation and Development⁴:

“Where

(a) *an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*

(b) *the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,*

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of the enterprise and taxed accordingly.”⁵

1.3 The expression “arm’s length”⁶ does not appear, but it is implied by the comparison with what independent enterprises would have done. “Even though Article 9(1) does not explicitly lay down a comparability requirement, there is no doubt that there is such a requirement.”⁷ My aim is not to challenge the arm’s length model and so I will not dwell on alternative tax policy approaches⁸.

⁴ Also see the essentially identical Articles 9(1) of the UN and US Models. Article 9(1) OECD MTC is adopted *verbatim* by the 1987 Intra-ASEAN Model Double Taxation Convention and also in essence in the multilateral 1994 CARICOM Income Tax Treaty, the 1996 Nordic Convention and the 2004 Andean Community Income and Capital Tax Treaty.

⁵ Despite the permissive “may” towards the end of Article 9(1), sometimes viewed as an authority to contracting states to impose transfer pricing adjustments, Article 9(1) may be seen as having a primary purpose of preventing double taxation by restricting adjustments under domestic laws: see e.g. Wittendorff (2010a) page 147 and sources cited, and pages 196-198; Marres (2015); paragraph 2.7 below.

⁶ The *Oxford English Dictionary* (on-line edition, accessed 23 June 2015) offers “a sale or transaction in which neither party controls the other”, and also cites *Webster’s 3rd New International Dictionary of the English Language* (1961): “the condition or fact that parties to a transaction or negotiation are independent and that one does not dominate the other”.

⁷ Wittendorff (2010a) page 314, and the discussion at section 3.3.6.5; see also paragraphs 1.6 and 1.7 TPG. Vann (2010), pages 149-150, entertainingly draws a comparison between what the language of Article 9 literally indicates, and what the TPG suggest.

⁸ For some modern advocacy in support of an alternative “unitary” or formulary apportionment scheme, including by reference to the EU proposal for a Common Consolidated Corporate Tax Base, see e.g. Avi-Yonah (2015) chapter 13. However, “[t]he G-20 should not

Instead, I offer an in-depth legal exploration of an important aspect of the existing arm's length pricing convention on which international norms have not yet clearly been established⁹. The controversy was described in 2007 as follows:

“[t]he more important debate is emerging at the conceptual level with respect to whether the determination of the credit quality should factor in any implicit support due to the affiliate being a ‘member of a group’ or whether this should be based solely on a ‘stand-alone’ basis. A noticeable demarcation on the approach taken by taxing authorities can be observed”.¹⁰

1.4 For some commentators, the recognition of passive association goes against the grain¹¹. Certainly law and tax authority practice is far from settled in many countries. The result, as matters still stand, is cross-border inconsistency,

waste its political capital to explore an option that is conceptually flawed and stands little chance of success, and NGOs should use their newfound political influence to focus on improving, rather than replacing, the arm's length principle”: Owens (2013), standing by his earlier prediction that “the arm's length principle will remain the international consensus for the foreseeable future”: Owens (2005) page 101. The UN also supports the arm's length principle: see e.g. UN *Practical Manual on Transfer Pricing* paragraph 1.4.3. Antipathy to unitary taxation has been widespread and long-standing, even provoking “retaliation” in the UK's Finance Act 1985 section 54. For a measured critique of the arm's length principle, with some suggested adjustments, see e.g. Feinschreiber and Kent (2012), and for a proposal to “recalibrate” the principle with an adaptation of the profit split method, see Wilkie (2012). The main thrust of the academic debate on the concept of the arm's length standard refers to its compatibility with the very rationale for the existence of large firms: see e.g. Schön (2011) page 3 and papers cited at footnote 4. See in particular discussion of the “continuum price problem” (referring to the efficiencies of MNE groups relative to independent enterprises, and thus the difficulty of pricing intra-firm transactions in a way which recognises those efficiencies), notably Langbein (1986), and the Bloomberg BNA Special Report *The Globally Integrated Multinational, the Arm's Length Standard and the Continuum Price Problem* (2000). A recent alternative perspective was offered by the International Monetary Fund, asserting that Ronald Coase's 1937 work *The Nature of the Firm* “does not undercut the [arm's length principle] but, to the contrary, rationalizes it”: IMF (2014) paragraph 48. Kane (2014) (Introduction) argues for a “fractional” interpretation of Article 9 i.e. that it “does not purport to allocate synergy value that could not have been earned at arm's length and thus by its terms purports to allocate only a fraction of the profit earned by commonly controlled enterprises”, or in other words (section 3.1) “does not require allocation of total profits”. See paragraph 2.23 below regarding paragraph 1.10 TPG's apparent acknowledgement of this.

⁹ A wide range of national views was apparent in Bloomberg BNA's *International Forum Examines Pricing of Related-Party Guarantees in 27 Countries*, 19 TMTPR 764, Moses (2010b). For a more recent account of divergent national views, see paragraphs 3.5-3.6 below.

¹⁰ Van der Breggen *et al* (2007). Even the Canadians, who have led the way with their jurisprudence (paragraph 3.163.16ff below), have said “[t]he ambit of the implicit support doctrine ... remains to be determined”: Bakker and Levey (2012), Canada chapter by members of Osler, Hoskin & Harcourt LLP, page 172.

¹¹ E.g. Bakker and Levey (2012), introduction by Antonio Russo and Omar Moerer, who express the view that the recognition of implicit support “appears to run counter to the very essence of the arm's length principle” (page 5).

significant tax uncertainty for MNE groups and potential international double taxation. My objective is enhanced clarity, and harmonized understanding, as regards the operation of existing rules, to be sought through the interpretation and construction of those rules. A nice formulation of that aim is that –

*“[t]he art and method of international tax rules seek systematic, principled and institutionalized compromises that can be relied on and applied to avoid overlapping tax claims and gratuitous distortions of trade.”*¹²

1.5 By “passive association” I mean the relationship *per se* that exists between members of a multinational enterprise (MNE group). As a matter of ordinary language, the term connotes that relationship *without action*: an *association* which is *passive*. I choose this particular term because it is also *neutral*, in that it does not necessarily imply favour or disfavour to any particular person. It is thus a less loaded starting point than “one-sided” (albeit helpful, where apt) expressions such as “affiliation *benefit*” (or “*privilege*”), “implicit *support*”¹³ and even the angelic “halo effect”¹⁴, though notions of benefit or support may be a consequence of passive association. (It is conceivable that the effects of association could be detrimental¹⁵.) “Passive association” is used in

¹² Wilkie (2009) page 395.

¹³ A definition was offered by Justice Hogan in the *General Electric* case (note 1 above; paragraph [281]): “Implicit support is nothing more than one’s expectation as to how someone will behave in the future because economic reasons will cause the person to act in a certain manner.” Seemingly, the judge agreed with one of the taxpayer’s expert witnesses that “implicit support was simply an extrapolation of someone’s opinion that economic incentives would cause the parent company to act although not legally bound to do so. Implicit support is like a ‘metaphorical wallet’. It is something investors believe exists and may be available to provide financial support if the right circumstances are present, but few investors are foolish enough to believe that it is equivalent to a guarantee” (paragraph [287]). Also, “the level of passive support a subsidiary expects to receive from the parent ultimately stems from the self-serving interests of the parent. For instance, to the extent that a subsidiary’s operations are heavily intertwined with those of the multinational group, in the event of financial distress on the part of the subsidiary, there should be a higher level of implicit support from the parent to limit its financial exposure to operational disruptions. Also, to the extent that the subsidiary shares the same name and sources of finance, it would be in the parent’s interest to support the subsidiary due to the potential reputational and financial impacts it could incur when the subsidiary is facing financial difficulties” (Tarassov and Tsiopoulos (2012)). Nielsen and Holmes (2010) present research suggesting that a subsidiary using a valuable group brand “would immediately receive the group credit rating linked interest rate without any explicit credit support”.

¹⁴ Breen (2010) at section II.C refers to the “‘atmospheric’ effect of membership within the controlled group”.

¹⁵ As Standard & Poor’s note in their *Corporate Credit Ratings – General Criteria: Principles of Credit Rating*, paragraph 35. This was argued by the taxpayer in the Finnish *A Oy*

TPG paragraph 7.13, as is “affiliation alone”. *Passivity* is critical. It provides the basis for the distinction between a *passive* state of affairs (part of the facts and circumstances) and an *activity* which requires some sort of *performance*. These terms feature prominently in the TPG¹⁶. Note the important requirement in Article 9(1) that conditions are “made or imposed”. Either way, this implies some form of action: the conditions between the controlled entities are either the result of some form of negotiation or other consensus, or are dictated through the exercise of control¹⁷.

1.6 There is some linkage between notions of passive association and the rationale for the existence of MNE groups. From an economics perspective, it is said that an MNE exists because the integration of its various associated enterprises mitigates transaction costs and safeguards against market uncertainties; these benefits are absent between independent enterprises, and may be referred to as affiliation or association benefits¹⁸. My line of enquiry is however confined to the special sub-set of benefits which arise passively.

1.7 I observe that *refraining* from undertaking an activity within the power of a putative actor will usually not constitute a transfer price-able event – as it will not entail (in Article 9(1) MTC terms) conditions being made or imposed. But this is not an absolute rule. An example might be refraining from preventing an affiliate’s otherwise unlicensed use of intellectual property, behaviour which would be tantamount to the grant of a licence.¹⁹ One may also argue that

case KHO 2010/3092, see Helminem (2011). Macey-Dare (2014) describes the potential complexity of positive and negative effects of association in vertical and horizontal directions across a corporate group structure. New paragraph 1.157 TPG acknowledges that group synergies may be negative (“dis-synergies” according to the Leiden International Tax Center in its 1 October 2013 comments on the 2013 OECD discussion draft on Intangibles: paragraph 2.80 below; note 163 below for public comments website).

¹⁶ Particularly in the Chapter VII discussion of intra-group services e.g. paragraphs 7.6, 7.9, 7.12-14.

¹⁷ Discussed by Wittendorff (2010a) at 3.3.6.4.

¹⁸ See e.g. Kamphuis (2010). The alleged inability of the arm’s length principle to cope with affiliation benefits is sometimes used by the proponents of formulary apportionment to support their cause.

¹⁹ Wittendorff (2010b), in discussing the possibility that refraining from action may form part of the relevant parties’ “commercial or financial relations”, argues that the US *Bausch &*

refraining from terminating an unfavourable contract, when it lies within the contractual rights of the dis-favoured party to do so (and any rational business person would take that opportunity), amounts to the provision of a gratuitous benefit which should attract remuneration²⁰. Leaving in place a loan which is repayable on demand and where the interest rate now looks unappealing or where the borrower has begun to look shaky is an example. Yet refraining from repudiating a particular state of affairs which might confer upon an affiliate some benefit from passive association surely does not amount to making or imposing conditions. If the benefit of passive association is, according to paragraph 7.13 TPG, not compensable, the absence of any repudiation of such association is an *a fortiori* case.

1.8 Given the *passivity* premise, I leave aside the spectrum of “soft” but active corporate support (falling short of binding formal guarantees) seen in the form of “comfort” or “keep-well” letters, or statements of intention or policy as to maintenance by a parent of ownership of, or capital in, its subsidiary, whether or not legally binding. All these require some form of *action* by the putative supporter²¹; they are all forms of “explicit” support, even where not legally binding²². That shifts the transfer pricing framework significantly: it entails a

Lomb case (paragraph 3.223 below) “can be seen as support for the proposition that, in principle, omissions may be subject to adjustment under Sec. 482”.

²⁰ See e.g. Wittendorff (2010b) for other cases of omissions as “commercial or financial relations” within the scope of Article 9(1) MTC; Bullen (2011b), suggests that Article 9(1) authorises the “imputation of a hypothetical renegotiation or termination”, in the light of the “realistically available options standard”. *Claymont Investments, Inc v Commissioner* TCM 2005-254 (US Tax Court) was a case where the IRS failed in its argument to recast a fixed rate loan transaction as a repayment and a new advance, but also failed to run the argument that the borrower, which had a no-penalty prepayment right, should have prepaid the loan and borrowed afresh at a lower rate.

²¹ Contrast the view expressed by the ATO in their June 2008 discussion paper *Intra-group finance guarantees and loans* (paragraph 3.94 below) at paragraph 121 to the effect that “the benefits of implicit support from letters of comfort or similar non-binding statements of intent should be treated similarly to any creditworthiness benefits a subsidiary incidentally obtains from its group or parental affiliations”. Burgers and Bierlaagh (1998) provide a review of the distinctions between guarantees, comfort letters and related instruments, including some comments foreshadowing the tax thinking in the *General Electric* case (paragraph 3.16 below). See also the ABA Guarantees Paper (2012) pages 13-24.

²² Despite being legally non-binding, “comfort letters” may nonetheless have an effect on a risk rating. See e.g. United States Office of the Comptroller of the Currency (2001), page 28.

transaction, or at least an action, which may well merit compensation in its own right.²³

1.9 “Association” can be taken to have its ordinary meaning e.g. the action of combining together for a common purpose; the condition of such combination²⁴. In the context of an MNE group it will usually mean the relationships between a parent company and its subsidiaries; in the transfer pricing context one most naturally thinks of the control, or common control, concepts articulated in Article 9(1) MTC²⁵. But the term is capable of looser meaning; “association” does not necessarily connote any particular level of ownership of shares, stock or other legal instrument, or any particular level of voting control. Conceivably (though unusually) a controlled transaction between, say, a parent and a subsidiary could be influenced by the subsidiary’s association with a third party.

1.10 Thus, to reiterate and re-emphasise, the objective of this study is to test the legal significance of passive association on controlled (usually cross-border and intra-group) transactions. The question is: where a transaction or activity falls to be evaluated for transfer pricing purposes, is passive association to be heeded as a relevant factor in that analysis?

1.11 The significance of passive association raises a fundamental question as regards the application of the arm’s length principle. The test to be applied by Article 9(1) MTC postulates a hypothetical comparator transaction, and asks “what would have occurred between independent parties?” But what exactly is

²³ “[I]t might be contended that such instruments [*comfort letters etc*] represent mere incidents of passive association ... The short answer here, we think, is that execution and delivery of instruments by a corporation, upon request from a lender, do not constitute ‘passive association’ or the ‘mere incidents’ of passive association. Rather, definite activity is undertaken by a member of a controlled group in each case. It is not the affiliation status alone that constitutes the transaction, but the affirmative and purposeful act of the controlled group member.” (ABA Guarantees Paper (2012) page 24.)

²⁴ *Oxford English Dictionary* (on-line edition, accessed 23 June 2015).

²⁵ I do not analyse further the meaning of the control relationships contemplated by Article 9(1). The discussion of passive association does not depend on an exhaustive definition of all the cases within the provision’s scope. See paragraph 2.6 below. A *pro forma* definition is volunteered however in the OECD’s June 2011 paper *Transfer Pricing Legislation – A Suggested Approach*, draft section 2. See also Vögel (2015) pages 633-634: “control seems indeed to be the dominant requirement for association”.

required by the “independence” hypothesis in Article 9(1)? What precisely is to be assumed, or what part of the factual matrix is to be disregarded, in constructing that comparator?

1.12 These questions can be refined in several ways. In applying the “separate entity” concept mandated by the TPG²⁶, to what extent is the actual affiliation between the parties, or the consequences or effects of that affiliation, to be put aside? In assessing a comparable uncontrolled price (CUP)²⁷, to what extent is the *control* relationship to be disregarded? This presents the paradox: one must construct an arm’s length comparator, but take into account all economically relevant circumstances, some of which may be consequent upon group affiliations. Does a borrower’s attribute of being a beneficiary of passive association “merge” into the transaction when the (supporting) parent is the lender? All these questions amount to enquiring “How far does one go in postulating a hypothetical?” To what extent must we “rein in the hypothetical by reference to economic reality”?²⁸ To draw from an application of English law statutory construction, “the hypothetical must not be allowed to oust the real further than obedience to the statute compels’. ... A statutory hypothesis, no doubt, must not be carried further than the legislative purpose requires, but the extent to which it must be carried depends upon ascertaining what that purpose is”²⁹.

²⁶ TPG paragraph 1.6.

²⁷ Even Langbein (1986) recognised that the “continuum price problem” exists only where satisfactory CUPs are unavailable (page 666).

²⁸ Thanks to David Southern QC for this imagery.

²⁹ Millett LJ in *Bricom Holdings Ltd v CIR* [1997] STC 1179, 1193j, the initial quotation being taken from Megarry V-C in *Polydor Ltd and RSO Records Inc v Harlequin Record Shop Ltd and Simons Records Ltd* [1980] 1 CMLR 669, 673. As to the purpose of Article 9(1) MTC, see paragraph 2.6ff below. More generally on the construction of statutory deeming provisions, for the UK perspective see e.g. the decision of the Supreme Court in *DCC Holdings (UK) Limited v HMRC* [2010] UKSC 58, endorsing the principles enunciated by Peter Gibson J in the Court of Appeal in *Marshall v Kerr* 67 TC 56 and developed by Neuberger J in *Jenks v Dickinson* [1997] STC 853. For a perspective in the Australian transfer pricing context, see *Commissioner v SNF (Australia) Pty Ltd* [2011] FCAFC 74, paragraph 95: statutory fictions erected by deeming provisions are to be strictly construed, and one should not travel beyond the hypothesis erected by the statute. A review of the Canadian approach is offered by Davies Ward Philips & Vineberg LLP (2012).

1.13 It is axiomatic that international double taxation obstructs global commerce and investment and thus economic development. The asymmetric application of transfer pricing rules is a particularly pernicious and widespread cause of double taxation. These notions are the foundations of the harmonising work of the OECD³⁰, the UN, the EU and other multilateral organisations and blocs in the tax field. Progress towards a uniform understanding and treatment of passive association in the transfer pricing context will contribute to harmonization and thus the lowering of fiscal hurdles to cross-border trade. At present, a common understanding is missing, this contributing to significant uncertainty (and the potential for disputes) in the international tax arena, thus erecting a barrier to international business³¹.

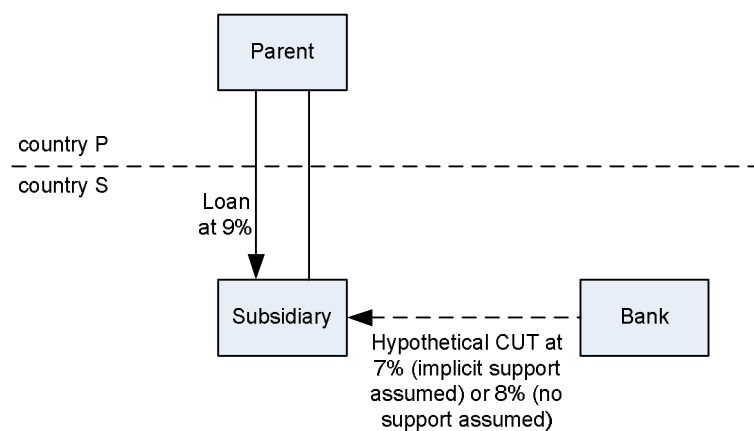
1.14 It may be useful to scene-set with a simple example of a passive association case. Imagine, as in Fig. I below, a MNE group comprising Parent company in country P and Subsidiary company in country S. Parent makes a loan to Subsidiary at an interest rate of 9%. It is established evidentially that Subsidiary could have borrowed an equal amount on equivalent terms from an independent bank (a) upon the strength of its own creditworthiness but *without* regard to its affiliation with Parent at 8%, or (b) in its own right *but also* having regard, as part of the complete factual matrix, to a degree of hope or expectation, on the bank's part, that (despite the absence of any formal guarantee or indeed softer assurances from Parent) Parent would in fact support Subsidiary if the latter experienced financial distress – at 7%. The country S tax authority invokes transfer pricing rules to challenge interest deductibility for Subsidiary: should the disallowance be 1% or 2%?³²

³⁰ “The OECD, with its mission to contribute to the expansion of world trade on a multilateral, non-discriminatory basis and to achieve the highest sustainable economic growth in member countries, has continually worked to build a consensus on international taxation principles, thereby avoiding unilateral responses to multilateral problems” (TPG preface, paragraph 7).

³¹ See e.g. Wittendorff (2012) on the damaging effects of mismatched domestic law interpretations of the arm's length principle and Price, Rahman and Yohana (2012) discussing differing approaches adopted by tax authorities (and taxpayers).

³² It is conceivable that other outcomes would be justifiable e.g. by reference to the comparability of the parties, requiring other adjustments. The example above stops where it does to illustrate the basic conundrum referable to passive association.

Fig. 1



1.15 Fundamentally, this question depends on the application of the arm’s length standard. Testing what *would have* happened between independent parties is inherently hypothetical. It demands the construction of a counter-factual proposition. The ordinary starting point in testing the pricing of a “controlled” transaction between related parties is to assume away the control relationship. Thus the paradox emerges: in the illustration above, what is the effect of disregarding Parent’s control of Subsidiary? Is the effect of passive association inherently to be ignored so that the correct interest rate is 8%? Or is it legitimate, in arriving at an arm’s length price, to point to the attitude of the unrelated bank who would, as a factual matter, lend at 7%, based upon its view of Parent’s likely support for Subsidiary?

1.16 On embarking upon this study I proposed to accept the proposition, implicit in paragraph 7.13 TPG (in full at paragraph 2.44 below³³), that passive association does not itself merit compensation. Some commentators³⁴ had advocated a departure from that proposition, in part to re-establish taxing equilibrium following the rejection of passive association as a pricing factor. In my opinion, as developed in chapter 4, such an approach is flawed, essentially because (a) it abandons the actual facts and circumstances of the case (Subsidiary

³³ Now backed by new paragraph 1.158 TPG (paragraph 2.81 below).

³⁴ E.g. Blessing (2010), page 164.

in paragraph 1.14/Fig. I above could borrow externally at 7%); and (b) it propounds the remuneration of *non-activity* or of the (in my view) illusory provision of property. My standpoint has now been substantially vindicated by the group synergies material added to Chapter I TPG (paragraph 2.81 below).

1.17 Another objection, occasionally raised in the literature³⁵, to the recognition of passive association in pricing transactions is the supposed trivial effect it may have; that triviality may then present a disproportionate compliance obligation. The effects of passive association are so slight (it is said) that the complexity, difficulty and expense of measurement are not merited by the fiscal outcome. That may be true, of course, in many cases: as a practical matter, many MNEs will adopt highly pragmatic transfer pricing policies where the risks of significant double taxation, or penalties for non-compliance, are perceived to be low. Yet this thesis searches for principle. Suppose that the loan in paragraph 1.14 above was for a gargantuan, but in today's world not at all implausible, \$10bn³⁶. The differential transfer pricing effect, as between a 7% or 8% interest rate, presents a very significant tax consequence. And (to make a BEPS-flavoured point) what if, say, country P is a tax haven? The suspicion of country S's tax authority is, in any event, that the loan is over-priced, but by \$100m or \$200m per year? In such a case, putting significant effort into the pricing analysis may well be worthwhile.

1.18 Moreover, given the quest for principle, it is not proposed to analyse critically national tax systems' so-called "safe harbour" regimes. Worthwhile as these often are³⁷, they represent practical short-cuts to compliant transfer pricing

³⁵ *Ibid.*, page 23.

³⁶ See the numbers involved in the Australian *Chevron* case, paragraph 3.82 below. In that case, the taxpayer's expert Dr Becker asserted that "a single notch which results in moving from non-investment grade to investment grade alone lowers the interest rate by 196 basis points and two notches can result in a 268 basis point bump": taxpayer's Outline of Submissions, file NS569/2012, 11 August 2014, paragraph 164(e). A change of 196 basis points "translates to \$350 million of interest in this case" (paragraph 197). Statistics reproduced by Ledure *et al* (2010) demonstrated a gap between credit spreads on long-term BBB (investment grade) and B rated bonds of approximately 6–7%, depending on tenor.

³⁷ Though see the reservations expressed in TPG Chapter IV section E and e.g. Chapter 9 of the US "White Paper" (1988). The US "total services cost" method is a form of safe harbour, but does not apply to financial transactions including guarantees: paragraph 3.206 below.

reporting, and by definition avoid the issue of principle with which I am concerned.

1.19 A further exclusion from the scope of this thesis: I do not propose to examine the application of quantitative *pricing methodology* to the effects of passive association. In many scenarios a market reaction to the relationships of any particular counterparty (typically a borrower) will be subjective. Practical quantitative techniques are utilised in some contexts, most notably the construction of synthetic credit ratings for entities which lack their own formal credit rating³⁸. The robustness of such techniques, and their proper applicability to situations beyond the issue of transferable debt securities into the capital markets, is open to debate. That aspect could be the subject of significant research in the commercial world (e.g. as to the extent which commercial lending banks would adopt this type of metric in evaluating the creditworthiness of an unrated borrower³⁹). But it is beyond the scope of this thesis.

1.20 In testing the qualitative effects of passive association, I will concentrate on transactions concerned with credit risk. This is the most obvious candidate for analysis – because I am concerned primarily with the impact of perceived likely behaviour within the MNE group that should mitigate a counterparty’s *risk*. Credit risk (including credit risk for damages for non-performance of contracts), i.e. a measure of the probability of default⁴⁰, stands out among the panoply of business risks as one most obviously susceptible to mitigation via helpful intervention by associates of one’s counterparty. Although much of the focus in the literature has been on the effects of passive association on

³⁸ See e.g. Standard & Poor’s material on its *Group Rating Methodology* (2013). General Electric Capital Canada Inc (the subject of the eponymous Canadian case: paragraph 3.16ff below) used S&P’s “Debt Rater” software to calculate its stand-alone credit rating. Standard & Poor’s *Guidelines for Evaluating Corporate Credit Risk: Parent/Subsidiary Relationships* (2014) contemplates the preparation of a notional rating for the entire group, which can then become a reference point for the ratings of various subsidiaries. S&P notes (page 4) that “stand-alone analysis of a subsidiary is an incomplete picture of a firm’s true credit characteristics”. A potential formulaic methodology, utilising S&P criteria, is presented in Tarassov and Tsiopoulos (2012). See also Hales *et al* (2010).

³⁹ Justice Robertson in the Australian *Chevron* case (see paragraph 3.82 below) thought that “a commercial lender would not approach the question of the borrower’s credit-worthiness in the same way as would a credit rating agency” (paragraph 503).

⁴⁰ Discussed in e.g. Guzman-Delgado (2012) page 24ff.

interest rates and guarantee fees⁴¹, the *quantum* of debt which a borrower is capable of raising could plainly be affected by its affiliations⁴². There is thus also a *thin capitalisation* dimension to my enquiry⁴³.

1.21 Intercompany financial transactions have been described as “one of the hottest and most debated fields of transfer pricing”⁴⁴. Aside from loans and guarantees, the pricing of indebtedness and thus counterparty financial risk is potentially relevant to a range of other instruments, including various species of derivative (e.g. prepaid forward contracts and deep in the money options), receivables sales (as in the Canadian *McKesson* case⁴⁵), outstanding receivables (several Indian decisions⁴⁶), and finance leasing. More complex situations may readily arise where – as is common – groups operate highly integrated treasury functions e.g. raising finance under multi-borrower cross-guaranteed debt facilities, or optimising credit and debit balances via cash pooling arrangements⁴⁷.

⁴¹ “These transactions are among the most controversial in the transfer pricing world” and “the role of implicit support in the analysis of intercompany guarantee fees (and, for that matter, intercompany interest on loans) will likely continue to be debated by tax authorities, taxpayers and transfer pricing specialists around the world”: Duff & Phelps’ *Transfer Pricing Times* vol. VIII issue 8 (2011). Also, “the pricing of implicit guarantees ... has been one of the most problematic transfer pricing issues for years”: 1 October 2013 comments of Taxand upon the OECD’s 2013 discussion draft on Intangibles (see note 163 below for public comments website).

⁴² See however paragraph 3.189 below for a contrary view from HMRC. Vögel (2015) at page 603 observes that Article 9(1) MTC “may also be extended to prohibit, for example, thin capitalization rules that would disallow deductions for interest otherwise paid at arm’s length”. Baker (2015) paragraph 9B.11 note 4 cites *Specialty Manufacturing v The Queen* [1999] 3 CTC 82 where the taxpayer argued that US-Canada tax treaty analogues of Article 9(1) MTC precluded the application of domestic thin capitalisation rules where it had a capital structure which would be sustainable at arm’s length. The FCA did not decide the legal question because the 100,000:1 debt:equity ratio was “obviously” (paragraph [23]) not arm’s length.

⁴³ In the *Thin Cap Group Litigation* case (Case C-524/04) the ECJ observed that the arm’s length test focused on whether “had there been an arm’s length relationship between the companies concerned, the loan would not have been granted or would have been granted for a different amount or at a different rate of interest” (paragraphs 83, 92, cited in Vögel (2015) page 671). See notes 234, 255 below as regards divergent country approaches to thin capitalisation.

⁴⁴ Moerer and Russo (2013).

⁴⁵ Paragraph 3.32ff below.

⁴⁶ Paragraph 3.141 below.

⁴⁷ See e.g. Rafiq et all (2010). Cash pooling has led to transfer pricing litigation in several recent cases e.g. *ConocoPhillips* case 12-0189459, Utv. 2010, 199 (Norway); *Anon* (Portugal) case 55/2012-T; *Bombardier Transportation* (Denmark) case LE-1990-574A.

1.22 There may be aspects to passive association which go beyond a hope or expectation of financial support in times of distress. For example, a lender may consider that a borrower will have ready access to valuable group management expertise or other support, even in the absence of any formal/contractual arrangements for this to be provided⁴⁸.

1.23 It is quite conceivable that passive association may influence other types of controlled transaction. A group's pooled purchasing power is sometimes given as an example⁴⁹, but arrangements entered into by MNE groups to organise collective/bulk buying will almost inevitably entail *activity* and thus intra-group conditions being made or imposed⁵⁰. On the other hand, for example, one could imagine that a foodstuffs producer might well attach value to (and thus perhaps adjust prices as a consequence of) the buying entity's mere membership of a renowned supermarket chain group⁵¹. My conclusions could be adapted to apply to such a situation i.e. to contribute to the transfer pricing analysis of controlled supplies of goods within the MNE group. The challenges however lie in the intertwined areas of (a) qualitative research – it seems likely that many such

⁴⁸ See e.g. Hollas and Hands (2014).

⁴⁹ E.g. Blessing (2010) page 165; Kamphuis (2010) page 297. See also Examples 3-5 in new Section D.8 Chapter I TPG (paragraph 2.80ff below); compare the Example given in the US section 482 Regulations: paragraph 3.210(v) below.

⁵⁰ In the Canadian Federal Court of Appeal decision in *Indalex Limited v The Queen* [1988] 1 CTC 60 the group's enhanced bargaining power (vis-à-vis its supplier) arose because of the purchasing power of a number of group members; but as regards the Bermudan buying company the court found "no evidence whatsoever that [it] contributed an iota of that pooled purchasing power" (page 68).

⁵¹ Relative bargaining power is naturally the most potent force at work here, but it could be combined with a more or less conscious willingness to deal with affiliates of the "main" buying group entity, and acceptance of credit or other risks as a consequence, because of an expectation of uniform commercial behaviour from the purchaser group. Passive association may also exist between parties dealing at arm's length. An example is a soft beverage bottler company, which may experience an uplift in its credit rating because of the perception of likely support from the otherwise unrelated (or at least, non-controlling) concentrate producer: see e.g. Moody's *Rating Methodology: Global Soft Beverage Industry* (2013). See also Hickman, Rockall and Hall (2011) section II: "[s]ometimes in third-party situations a supplier is so critical that support may be provided even though there is no contractual requirement to do so". A different but topical area is that of potential governmental support e.g. for banking institutions considered to be of systemic importance, see e.g. the Standard & Poor's publication *Rating Government-Related Entities: Methodology and Assumptions* (2010). An interesting study of the values of implicit guarantees of bank debt is provided by Schich and Kim (2012), noting declining values attributable to the establishment of resolution and recovery structures but also weakening sovereign credits.

suppliers, if asked how they take account of passive association present within their customers, would find it hard to relate the question to their business dealings beyond it being one of many components (including notably relative bargaining power) leading to price; and (b) actual (quantitative) pricing effect which, as mentioned, is beyond the scope of this thesis and, outside the creditworthiness context, is likely to be highly subjective and impressionistic. Even for lenders, it is plain that uniform practices are not applied (at least outside ratings models) and more likely that, as a matter of (e.g.) lender discretion at credit committee stage, a subjective/arbitrary pricing concession may be made⁵².

1.24 Much of the focus of the media/political furore over transfer pricing has been on arrangements concerning intellectual property or other intangibles, or the sale of tangible goods. The passive association concept brings little to bear in these contexts – beyond possible credit support for financial obligations. Thus limiting my enquiry to credit risk seems appropriate, despite the “noise” around globally mobile IP, limited risk distributorships and so on.

1.25 There is no tax avoidance dimension to this study. The investigation is a non-partisan search for the “right” approach to allocating taxing rights between states. Transfer pricing is in the news as never before. It is used as a pejorative, implying a reprehensible strategy to avoid paying a “fair share” of corporate income tax. Put more calmly though, it is simply the science (or perhaps art) of setting inter-company prices as required by international tax laws⁵³.

1.26 Economic theories are outside the scope of my research. Such theories can be relevant to (a) shaping policy, and of course (b) establishing hypothetical arm’s length prices. To reiterate, my concern is to develop and clarify the

⁵² “[L]enders – like bond rating agencies – apply non-quantifiable judgmental factors in practice”: Rosenblum (2004), *Guarantee Fees* section.

⁵³ According to the UN, the term “transfer pricing is ... sometimes used, incorrectly, in a pejorative sense, to mean the shifting of taxable income from a company, belonging to an MNE, located in a high taxing jurisdiction to a company belonging to the same group in a low taxing jurisdiction through incorrect transfer prices in order to reduce the overall tax burden on the group”: UN (2001) page 4, also citing paragraph 3 of the preface to the 1979 OECD Report which instructs that “consideration of transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance”. See now the UN *Practical Manual on Transfer Pricing* at 3.2.1.

interpretation of the law as it stands, not with changing it nor, for the reasons just given, with attempting to construct a framework for pricing the effects of passive association.

1.27 Considerations of national fiscal policy might also enter into particular states' attitudes to the recognition of passive association. Developing countries have traditionally been viewed as net importers of capital⁵⁴ and technology, and thus as enthusiasts for withholding taxes and other forms of source-basis taxation. Where such capital is in the form of debt due to related parties, the local (borrower's) fisc will instinctively prefer lower rather than higher interest rates: such countries should therefore be relatively amenable to recognising the beneficial effects on borrowers' interest costs where passive association is factored into loan and guarantee pricing⁵⁵. But the concept "has served as support for both taxpayers and tax authorities ... to defend their positions"⁵⁶.

1.28 This thesis does not extend to an investigation of the qualitative issues of when or whether, and how, passive association is recognised and accorded pricing significance in arm's length dealings. It is taken for granted in the cases and literature (and empirically applied by the rating agencies⁵⁷), and it seems

⁵⁴ This study does not investigate theories concerning capital import (including ownership or savings) neutrality or capital export neutrality (as to which see Schön (2009-10) Part I pages 79-82 and Part II pages 70-73 for a good summary). The passive association concept potentially performs a function in establishing the tax base, not determining how it should then be taxed.

⁵⁵ The analysis (and thus partisan preferences) may be reversed, however, where passive association supports an enhanced quantum of debt or where a tax system permits relief for the write down of impaired loans.

⁵⁶ Zorzi and Rizzuto (2013) page 432, referring to the *General Electric* case: paragraph 3.16ff below.

⁵⁷ See e.g. Standard & Poor's *General Criteria: Corporate Ratings Criteria – General Criteria: Principles of Credit Rating* (2014) and Moody's Investors Service's *Rating Non-Guaranteed Subsidiaries: Credit Considerations in Assigning Subsidiary Ratings in the Absence of Legally Binding Parent Support* (2003) which includes Coca-Cola and Schlumberger subsidiaries as examples of companies enjoying ratings uplift by virtue of group affiliation. A vivid example is the case of German transportation specialist bank DVB Bank SE, which is accorded a stand-alone credit profile of "bb" by S&P, but which is then uplifted for "group support" (which in DVB's case also had regard to the prospect of support from the German cooperative banking sector) by seven notches to an "issuer credit rating" of A+/A-1: <http://www.dvbbank.com/~media/Files/D/Dvb-Bank-Corp/ratings/sp-dvb-analysis-221214.pdf> (accessed 4 June 2015). Another interesting example is Fitch's notching uplift of Indonesian telecoms operator Indosat by reference to parental support from Ooredoo: "Indosat's 'BBB' IDR [issuer default rating] incorporates a three-notch uplift from its stand-alone credit profile of 'BB'"

logically compelling, that passive association can in appropriate circumstances have an effect on uncontrolled transaction pricing. So I conclude that there is little utility in attempting to “prove” that; to do so convincingly would entail substantial research into the practices of (at least) banks and probably corporate groups.

Research methods

1.29 The approach adopted in this paper is a combination of:

- (a) an application of doctrinal or “black-letter” techniques, including the teleological search for purpose, applied to the law or quasi-law, and international legal vocabulary, represented by the increasingly global standards embodied in OECD or UN guidance as applicable to international tax treaties, and the national laws (including case law) of selected states which implement the arm’s length principle into those laws: thus the search is for *lex lata* (“the law as it is”) and not for *lex ferenda* (“the law as it should be”); and
- (b) a functional comparative law analysis⁵⁸ of those national laws based upon the proposition that a common need for a universal interpretation defines the

based on its strategic and financial linkages with its 65% parent Ooredoo QSC (Ooredoo; A+/Stable)”:

<http://www.reuters.com/article/2015/03/27/idUSFit91805520150327?type=companyNews> (accessed 4 June 2015). Wittendorff (2011) at footnote 179, and Bundgaard at page 88, cite the Danish *Egnsbank Han Herred* case Tfs (2000) 243H, where six savings banks paid the unsecured debt of their joint venture company because the bankruptcy of the company would have had significant adverse consequences for the credit ratings and business affairs of the owners. Wilmhurst (2012) summarises the methodologies applied by the three main rating agencies, S&P, Moody’s and Fitch.

⁵⁸ See e.g. Zweigert and Kötz (1998), who splendidly observe (page 3) upon scholarship’s “ultimate goal of discovering the truth”. They quote Lambert from 1905: “comparative law must resolve the accidental and divisive differences in the laws of peoples at similar stages of cultural and economic development, and reduce the number of divergencies in law, attributable not to the political, moral, or social qualities of the different nations but to historical accident or to temporary or contingent circumstances”; and (at page 17) Jhering from 1955: “The reception of foreign legal institutions is not a matter of nationality, but of usefulness and need. No one bothers to fetch a thing from afar when he has one as good or better at home, but only a fool would refuse quinine just because it didn’t grow in his back garden.” The House of Lords opinions in *T (A.P.) v Immigration Officer* [1996] UKHL 8 display open-mindedness to the use of foreign (US and Canadian) case law authorities and supranational materials (the UN Handbook on Refugee Status) where international treaty obligations (the 1951 Geneva Convention on Refugees) were under consideration. “In a case concerning an international convention it is obviously desirable that decisions in different jurisdictions should, so far as possible, be kept in line with each other” (per Lord Lloyd). See also *Indofood International Finance Ltd v JP Morgan Chase Bank NA* [2006] EWCA Civ 158 paragraph 42 developing the

usefulness (i.e., in the present context, lowering of barriers to commerce by the elimination of international economic double taxation) of such universality. For Wittendorff (2010a):

*“The [comparative] method is particularly important to the subject, in part because the drafting of rules is to a large extent international, and in part because the transfer pricing adjustment of international transactions will normally involve the legal systems of at least two countries. A transfer pricing adjustment can thus lead to negotiations with the tax authorities of other countries who may disagree with the adjustment. ... The case law on the arm’s length principle in relation to MNEs is relatively modest in most countries, so that studies of foreign law can significantly supplement analyses of domestic law.”*⁵⁹

Where a rule based on Article 9(1) MTC is the subject of dispute in one country, the case law of other countries, where it produces well-reasoned decisions, may be of significant persuasive utility given the desirability of a uniform global interpretation. More generally, the drafting of national transfer pricing legislation, and the development of tax authority practices, can be informed by an understanding of other country approaches.

1.30 My research therefore seeks illumination from an exploration of (a) the existing international models, commentaries and guidance which touch upon passive association (chapter 2); and (b) comprehensive consideration of the relevant national laws and practices of six English language common law countries, each of which has a relatively sophisticated transfer pricing regime⁶⁰ (chapter 3). The objective is to construct a synthesis of legislative, juristic and

concept of an “international fiscal meaning” for a tax treaty phrase (“beneficial owner”), including by reference to the OECD MTC Commentary.

⁵⁹ Wittendorff (2010a), pages 13-14; see also Bullen (2011) 1.5.3.2, citing IFA (1993) and OECD MTC, Introduction, paragraph 5.

⁶⁰ India is included as a notable example of a developing economy. Although its transfer pricing laws date back only to 2001, case law is prolific - symptomatic of aggressive tax authority pursuit of revenue and a determined emphasis on source-basis taxation. Zweigert and Kötz (page 8) note that the recognition of “principles of law accepted by the large majority of nations ... is rendered more difficult by the basic differences of attitude between the developed industrial nations and those in process of development”. This difference manifests itself in the international tax world through the somewhat competing model tax treaties, and related interpretations, promulgated respectively by the OECD and the UN. The UK presents, among the selected country studies, the added dimension of EU membership: see paragraph 3.174ff below.

governmental attitudes (including conflicting attitudes) to the question. Then the published literature of academics and practitioners is critically examined, both as regards the specific role of passive association and more generally in relation to the meaning in that respect of the arm's length principle (chapter 4). Others have not to date convincingly proposed a closely-reasoned academic legal analysis leading to a conclusion. I confess to leaving aside non-English language literature⁶¹. A yet deeper dive into my subject could engage with this, as it could with non-English laws (see paragraph 3.237 below).

1.31 My conclusion (chapter 5) draws together the analysis of the international and national material outlined above, and proposes the affirmation of the recognition of the effects of passive association in pricing controlled transactions (not, it is reiterated, the compensation of benefits from passive association in favour of the putative provider). The conclusion reached is based upon the assumed desirability of the arm's length principle as the fundamental global tool for (a) the balanced allocation between states of taxing rights over MNE groups, and thus (b) the minimisation of international economic double taxation. To re-emphasise, the objective is a step towards the elimination of uncertainty and the development of consistency.

Chapter structure

1.32 Thus the chapter structure of this thesis is as follows:

Chapter 1: introduction;

Chapter 2: analysis of guidance from international bodies;

Chapter 3: analysis of relevant legislation, case law and tax authority practices from selected countries;

⁶¹ I acknowledge the possibility of relevant literature in languages other than English not having been identified. However, I believe the risk is somewhat mitigated because (i) the countries where my topic has received most attention are English speaking (not least because of the emerging case law and other relevant sources), and (ii) it is common for non-English commentators in this area to publish in English, including in the main international transfer pricing periodicals.

Chapter 4: critical review of the academic and business literature addressing the significance of passive association in transfer pricing and the meaning, so far as relevant to this study, of the arm's length principle;

Chapter 5: summary of conclusions.

1.33 Finally, the Annex offers proposed guidance for use by taxpayers and tax administrations. The Annex to the TPG records the instruction of the OECD Council to the CFA “to monitor implementation of the TPG in cooperation with the tax authorities of member countries and with the participation of the business community and to recommend to the Council to amend and update, if necessary” the TPG, and “to identify areas where the Guidelines may require amendments or additions” including in relation to “problematic issues”. In my view the function of passive association is one such issue. So the Annex to this thesis proposes some brief new material for inclusion in the TPG. This may be a “courageous” venture, as Sir Humphrey Appleby could have said, but, at a time when the OECD is in the process of establishing new and improved guidance on transfer pricing, including in the financial transactions area, might conceivably contribute to the international debate.

1.34 I have deliberately adopted a numbered paragraph approach, especially to assist with cross-referencing, given the important comparative aspect of this study and the interwoven character of the materials reviewed.

1.35 The law is stated as at 25 January 2016.

2. ANALYSIS OF GUIDANCE FROM INTERNATIONAL BODIES

“Transfer pricing is the modern battleground, the tax Armageddon. No more duelling at dawn with gentlemanly Inspectors.”⁶²

Introduction

2.1 This chapter reviews guidance from international organisations to the extent it bears upon the relevance of passive association in pricing controlled transactions. A forensic review of the materials considered indicates that passive association should indeed be taken into account in pricing controlled transactions. I have identified from each of the instruments addressed below the statements with direct or indirect relevance to the topic of this study, and commented on what those statements mean for my analysis.

2.2 An important question in relation to any international instrument concerns its legal status. The answer may well vary from country to country. Directly effective EU law can apply across the Member States, and tax treaties may take immediate effect in “monist” states. Other instruments may more properly be characterised as “soft” international law which, for example, states agree in principle to observe, but without formally incorporating the relevant rules into national laws. An intermediate class comprises instruments which may be received into national laws by some legal act of ratification or other implementation. Chapter 3 illustrates some different country approaches.

2.3 The key themes emerging from the materials considered below are: (1) the fundamental objective of transfer pricing of establishing tax *parity* between controlled and uncontrolled transactions; (2) the need for a causal connection between the exercise of control and price *distortion*; (3) the arm’s length principle’s reliance upon comparability analysis – to test what would have happened between independent parties; (4) thus the need to take into account the *circumstances* of the parties to the controlled transaction and where necessary to adjust an uncontrolled transaction to align its circumstances (and those of its

⁶² Carroll (2004), page 40, with thanks to François Vincent.

parties) with those of the actual transaction; (5) the requirement to test arm's length behaviour by reference to the *options realistically available* to the parties to the controlled transaction; (6) the express recognition of passive association in paragraph 7.13 TPG and the implication that it is a relevant factor in a comparability analysis – now confirmed by the BEPS project materials.



OECD MTC Commentary

2.4 The OECD's Model Tax Convention is exactly that: a model treaty for use by OECD member states or others who may favour it⁶³. The grand unification of law project promoted by comparative lawyers relies to some extent on the production of model laws⁶⁴: the MTC represents a high achievement towards that goal in the international tax field. The Commentary on the MTC importantly aids interpretation of bilateral double tax treaties which adopt the model form. The OECD has made a non-binding recommendation to member countries to follow the Commentary in applying their treaties⁶⁵.

⁶³ See e.g. Wittendorff (2010a) pages 95 *et seq* for historical background to the OECD, established in 1961 as successor to the 1948 Organisation for European Economic Co-operation, and the adoption of the OECD's first Model Draft Double Taxation Convention on Income and Capital with Commentary in 1963 containing an Article 9 in identical form to that in the current MTC. Paragraph 12 of the Commentary on Article 7 contained reference to "ordinary market prices" for goods, and the Article 9 Commentary referred to "normal open market commercial terms" for transactions between associated enterprises. As an early foray into international tax ethics, the 1976 OECD *Guidelines for Multinational Enterprises* encouraged MNEs to comply transparently with the arm's length principle; this is reiterated in the modern version of the *Guidelines* revised in 2011 (Part I, s. XI, paragraph 106). The MTC was revised in 1977 and again in 1992, 2008, 2010 and 2014.

⁶⁴ See e.g. Zweigert and Kötz (1998) page 25.

⁶⁵ *Recommendations of the OECD Council Concerning the Model Tax Convention on Income and Capital C(97)195/Final*. Under Article 18(b) OECD Rules of Procedure, members are left with discretion to consider whether it is appropriate to implement a recommendation.

2.5 The Article 9 Commentary probably falls short of ranking as customary international law⁶⁶. National tax systems may however explicitly provide for the Commentary to be used as a guide, or judges may be prepared to refer to the Commentary, as a form of “soft law”⁶⁷, to gain insights into what must have been intended by contracting parties in finalising their treaty having full knowledge of the contents of the Commentary. The 1969 Vienna Convention on the Law of Treaties may aid treaty construction⁶⁸. Its rules of interpretation are recognised as customary international law, even where parties to a treaty have not ratified the Convention, though there are a range of views regarding how the MTC Commentary is properly aligned with those rules⁶⁹.

2.6 Detailed guidance on the interpretation and application of Article 9 MTC is provided in the TPG. Therefore the OECD Commentary on Article 9, which adopts by cross-reference the TPG, is extremely brief, especially as regards Article 9(1). The introductory description of Article 9 in paragraph 1 of the Commentary describes “associated enterprises” as “(parent and subsidiary companies and companies under common control)”. However, the notions of “parent”, “subsidiary” and “control” are themselves not defined in the Commentary. As Article 9(1) (recited at paragraph 1.2 above) uses the broader language of “participat[ion] directly or indirectly in the management, control or capital” by one enterprise in another, I doubt significant interpretive assistance can

⁶⁶ See e.g. Wittendorff (2010a) pages 123-124, 290. Compare Kofler (2013) page 646 and materials cited. Vega (2012) page 9, in discussing the TPG, “identifies soft law with legally non-binding instruments which, nonetheless, are created with the intention of having an impact on the behaviour of states”, but also notes (page 12, quoting Rose and Page (2001)), “that soft law could be seen as legislation through the back door, with the corresponding deficiencies in terms of public scrutiny and accountability”. Compare the comment of Boyle J in the Canadian *McKesson* case: note 258 below.

⁶⁷ See e.g. Engelen (2006).

⁶⁸ See e.g. Avery Jones (1984; 2002; 2008); Ward et al (2005); Weiss (2008); Wittendorff (2010a) section 3.3.2.2; Schwarz (2015) pages 93-98, also covering UK principles derived from *IRC v Commerzbank AG* [1990] STC 285. A recent example of the UK approach (though not relying on *Commerzbank*) is *Anson v HMRC* [2015] UKSC 44. For some Australian judicial commentary see e.g. *SNF (Australia) Pty Ltd v Commissioner* [2011] FCAFC 74, paragraphs [107]–[117].

⁶⁹ For detailed coverage of the Vienna Convention and its application to tax treaties see e.g. Engelen (2004) Part II; also Bullen (2011) pages 27 and 33, and materials cited; paragraph 2.16 below regarding the TPG.

be derived from this rather casual parenthetical. The nuances are in any event not relevant to this study.

2.7 Despite the apparently permissive tone of Article 9(1) (“any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, *may be included* in the income of the enterprise and taxed accordingly”), paragraph 2 of the Commentary indicates that a reading *a contrario* is appropriate, i.e. that, if the conditions made or imposed do not differ from those that would have been made between independent enterprises, then no other income may be included⁷⁰. Paragraph 2 states that “[n]o re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm’s length basis).” Thus Article 9 “is designed to avoid economic double taxation” (its *purpose*); “DTCs merely restrict, rather than generate, domestic law”; and “the word ‘where’ must be read to mean ‘only where’ and the word ‘may’, as used in Art. 9(1) in connection with ‘any profits’, must be taken to refer to ‘any profits, and only these’”⁷¹.

2.8 Importantly for this study, it is plain that, for a transfer pricing adjustment to be made, a *causal connection* must exist between the control relationship and a transactional *price distortion*. Paragraph 2 of the Commentary contemplates a re-writing of accounts by a state’s tax authority “if, as a result of the special relations between the enterprises, the accounts do not show the true taxable profits arising in that state”. Thus “adjustments envisaged by Art. 9 may be carried out, **but only** if such interconnection was the **cause** of special

⁷⁰ Vincent and Bloom (2006) prefer a “restrictive” approach to an “illustrative” interpretation. Maisto (1992) pages 60-62 describes varying national approaches to this issue: “[t]he illustrative theory is not convincing” – as effectively depriving Article 9 of effect and being inconsistent with the binding application of the arm’s length principle in Article 7. Baker (2015) paragraph 9B.05 describes a purpose of Article 9(1) as “limit[ing] the methods which may be used in the domestic law of Contracting States for adjusting profits between associated enterprises: only the arm’s length principle is acceptable”.

⁷¹ Vögel (2015) pages 603-604; also pages 597-598 (doubting Article 9(1)’s purpose as anti-avoidance); Wittendorff (2009) pages 109-110. Kane (2014), section 3.1, observes that Article 9 both (a) permits states to make adjustments based on the arm’s length principle, but (b) limits such adjustments to accord with an outcome based on that principle. (He draws the conclusion that, in the context of potential MNE synergy value, Article 9 “does not require allocation of total profits under an arm’s length standard”.)

conditions being made or imposed ... and beyond that only according to arm's length criteria"; "[p]articipation in management, control or capital must be the **cause** of the non-arm's length conditions"; and "[a] profit adjustment may be made **only** if the conditions made or imposed on account of the influence exercised result in a diminution of the profits of one of the two enterprises ... the divergence from the arm's length price must ultimately have been **caused** by the conditions made or imposed"⁷². According to Bullen (2011), Article 9(1):

*"is only concerned with profit adjustments triggered because the amount of profits is distorted as a result of a community of interest existing between the parties to a relation affecting the amount of such profits".*⁷³

2.9 "Conditions" in Article 9 bears a naturally broad meaning, but most obviously focuses on the terms of a transaction. Vögel says:

*"[c]onditions may be either 'made' (i.e. the result of negotiations) or 'imposed' (i.e. the result of the exercise of control)."*⁷⁴

2.10 The object of Article 9(1) is the "commercial or financial relations" between the relevant parties. This is not further defined in the MTC, but "the Commentary uses the term 'transactions', and the OECD Guidelines use the term 'controlled transactions' synonymously with 'commercial or financial relations' in Article 9(1)"⁷⁵. The transactional focus of Article 9(1) is highlighted by paragraph 3.9 TPG which asserts that ideally the arm's length principle should be applied on a transaction-by-transaction basis.⁷⁶

⁷² Vögel (2015), pages 638; author's emphasis.

⁷³ Page 70, my emphasis. But Baker (2015) at paragraph 9B.16 note 1 observes that "[c]uriously enough, the Article does not expressly state that the conditions must be made or imposed by virtue of the participation in the management, control or capital of the other [enterprise]".

⁷⁴ Vögel (2015) page 638, referring to the UK *DSG Retail* case, paragraph 66, see paragraph 3.165ff below. Bullen (2011) pages 109-113 addresses the broad meaning of "conditions".

⁷⁵ Wittendorff (2010b), note 3, citing the Commentary on Article 9 and the Glossary to the TPG.

⁷⁶ Vann (2010b), page 140, suggests that "[i]t is not, however, necessary that the [arm's length] principle be based on transactions, because there is nothing in article 7 or article 9 of the OECD model convention to require it, but it is a deep-seated intuition for separate entities".

2.11 Paragraph 3 of the Commentary notes the interaction between Article 9 and thin capitalisation concepts. In essence, Article 9 does not obstruct domestic thin capitalisation rules provided the outcome is consistent with the arm's length principle.

2.12 The arm's length principle also appears in Article 7 MTC. Under Article 7(2) profits attributable to a PE are taxable in the host state to the extent of "the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions". This "corresponds to the arm's length principle which is also applicable, under the provisions of Article 9, for the purpose of adjusting the profits of associated enterprises"⁷⁷. Wittendorff (2009)⁷⁸ observes that "[a] contextual interpretation of Art. 9(1) should, in particular, take Art. 7(1) into account since Art. 9(1) determines the amount of business profits from transactions between associated enterprises which is covered by the exclusive taxing rights of the two residence states according to Art. 7(1)".

2.13 Note also Articles 11(6) and 12(4) MTC. The arm's length principle is used here to determine the extent to which treaty relieving provisions⁷⁹ are disappplied as regards transactions between parties who enjoy a "special relationship" (a potentially broader test than the Article 9(1) associated enterprises concept). The general view is that Articles 11(6) and 12(4) supplement Article 9(1) to the extent they operate in an overlapping manner⁸⁰.

⁷⁷ Commentary on Article 7, paragraph 16.

⁷⁸ Page 116.

⁷⁹ Commentary on Article 11, paragraph 32; Commentary on Article 12, paragraph 22.

⁸⁰ See e.g. Vögel (2015) pages 627-628: whereas Article 9(1) would permit adjustments to the profits of the payer of interest/royalties to an arm's length level, Articles 11(6)/12(4) permit the source state to tax the recipient on the excessive amount. See also Wittendorff (2010a) page 188.

2.14 See also the brief discussion of non-discrimination in the PEs context (Article 24(3) MTC) at paragraph 2.67 below, which has some relevance to the passive association debate⁸¹.

OECD TPG

2.15 This section provides a comprehensive review of the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*⁸² as they relate to the topic of passive association, including important related aspects concerning the nature of the arm's length standard and the assumptions to be made in arriving at an arm's length price.⁸³

2.16 The legal importance accorded to the TPG by different national tax systems varies. The OECD Commentary on Article 9 MTC paragraph 1 considers the TPG to represent “internationally agreed principles”. In some systems the TPG have little or no persuasive effect, indeed may be officially renounced as a basis for policy and law⁸⁴. Other legal systems accept the TPG as a more or less powerful aid to interpretation⁸⁵. A third group directly applies the TPG into

⁸¹ On the interaction between Article 24(4) (which does not apply where Article 9(1) does), see Marres (2015). As regards the interaction between Article 24(5) (non-discrimination regarding controlled enterprises) and Article 9(1), since the latter forms “part of the context in which [the former] must be read ... adjustments which are compatible with [Article 9(1)] could not be considered to violate [Article 24(5)]”: paragraph 79 OECD Commentary on Article 24.

⁸² TPG paragraph numbers used in this study are those reflecting the BEPS 2015 Final Reports, i.e. anticipating the changes being in (or coming into) effect: “[t]he guidance in this Report takes the form of amendments to the Transfer Pricing Guidelines”: page 10, Executive Summary; “[s]ome of the revisions may be immediately applicable such as the revisions to the [TPG]”: OECD Explanatory Statement to the Final Reports, paragraph 23. However, a pending OECD Council Recommendation formally incorporating the BEPS 2015 Final Reports into the TPG has not, at the date of writing, been made. Mayra Lucas of the OECD's Transfer Pricing Unit told me (by email, 22 January 2016) that such a Recommendation was expected in the first half of 2016, “probably by March”.

⁸³ See e.g. Wittendorff (2010a) chapter 3 on the emergence of the TPG, including the contribution of Working Party No. 6, appointed in 1973 to look into the taxation of MNEs including transfer pricing, and the US influence upon the TPG.

⁸⁴ Brazil is a notable example, see e.g. Tax Justice Network (2012) reacting to Falcão (2012), and KPMG (2013), cited in IMF (2014) footnote 76: “Brazil does not follow the OECD guidelines, rather imposes unique standards for evaluating transfer prices ... with related parties and [other] companies located in low-tax jurisdictions”. But, enigmatically, it will “use the guidance in [the BEPS 2015 Final Reports] in this context” (note 1 to those Reports).

⁸⁵ E.g. Canada. The TPG “are clearly a type of soft law and represent, arguably, the most important source of information on transfer pricing”: Li (2012), page 78. But see the qualified approach in the Canadian courts described at note 258 below. Vögel (2015) says the TPG “have

national transfer pricing laws⁸⁶. The trend is an increasing embrace across the globe of the TPG (even in many states which incline towards the parallel approach promulgated by the UN). Thus the TPG have gradually acquired, and continue to acquire, legal or quasi-legal authority. An Appendix to the TPG replicates the OECD Council's *Recommendation on the Determination of Transfer Pricing Between Associated Enterprises*. This operates on a political level and, having recited "the fundamental need for cooperation among tax administrations in order to remove the obstacles that international double taxation presents to the free movement of goods, services and capital between Member countries", it recommends to Member countries' governments that their tax administrations (i) follow the TPG for arriving at arm's length pricing for transactions between associated enterprises, and (ii) encourage taxpayers also to follow the TPG. It is thus a form of "soft" international law, with "powerful influence"⁸⁷. Bullen (2011)⁸⁸ argues that the Vienna Convention's canons of interpretation can be applied by analogy to the TPG.

2.17 After first summarising the conclusions which I propose may be drawn from the content of the TPG, I review below a number of extracts from the TPG in detail because of their importance to the propositions developed in this study.

virtually the same weight as [the OECD MTC Commentary]": page 612. See also Bullen (2011) page 34 on the possibility of the arm's length principle itself acquiring the status of customary international law, or at least an internationally accepted standard or norm.

⁸⁶ E.g. the UK: section 164 TIOPA. Vega (2012) page 17 refers to several tax treaties where the TPG are adopted by protocol or exchange of notes.

⁸⁷ Li (2012) page 78; see also the discussion which follows (pages 79–86) as to the role of this soft law, and the potential for its development into yet more compelling authority. It seems uncontroversial to view the TPG as the best source of international transfer pricing thinking (see the UK's *DSG Retail* case, paragraph 3.165ff below) on the arm's length principle, despite the colourful but scathing alchemy simile offered by Durst (2012): "The reason for their [the alchemists'] success seems to have been a mixture of greed, embarrassment among those who were deceived, and a large dose of pure humbug. The crowned heads of Europe were desperate for revenues, largely for military purposes; they desperately wanted to believe that they had obtained a rich source of revenues, and they also wanted their competitors to believe this. Also, once a customer had paid the alchemist for work performed, the customer, even if it became clear that the alchemical services were fraudulent, generally did not want to admit that he or she had been deceived. Further, the more successful among the alchemists were adept at using the appearance of scientific terminology to promote themselves; at times, they published lengthy guidelines for how to conduct their work, which looked wonderful on the printed page but, to the apparently few who attempted really to read them, proved to contain nothing but speculation and empty, flowery prose. And the institution of alchemy survived in Europe for hundreds of years."

⁸⁸ Pages 45-49.

Commentary and analysis: TPG

2.18 Several key themes appear in the TPG which bear strongly on the recognition of passive association as a pricing factor. The concept is explicitly described in paragraph 7.13 TPG (paragraph 2.44 below). BEPS-led amendments are directly relevant (paragraph 2.80ff below). Emphasis is given to the central principle that transfer pricing law serves to correct *distortions* caused by the control relationship, and thus restore *parity* between controlled and uncontrolled transactions. Importantly, it is necessary for a controlled transaction to be compared with the “options realistically available” to the parties, and comparability analysis must postulate independent enterprises in “comparable circumstances” and thus take into account the attributes of the parties. Risk is a significant factor in assessing comparability.

2.19 The preface to the TPG introduces the arm’s length principle – thus (paragraph 6) “individual group members must be taxed on the basis that they act at arm’s length in their transactions with each other”. The context is explained by reference to potential distortions in intra-group behaviour:

“the relationship among members of an MNE group may permit the group members to establish special conditions in their intra-group relations that differ from those that would have been established had the group members been acting as independent enterprises operating in open markets. To ensure the correct application of the separate entity approach, OECD member countries have adopted the arm’s length principle, under which the effect of special conditions on the level of profits should be eliminated.”

Chapter I: the arm’s length principle

2.20 Chapter I TPG addresses the fundamentals of the arm’s length principle. It is “the international transfer pricing standard that OECD member countries have agreed should be used for tax purposes by MNE groups and tax administrations” (paragraph 1.1). The BEPS project has emphatically endorsed this, despite its flirtation with “special measures” to counteract forms of avoidance where transfer

pricing seemed an inadequate remedy⁸⁹. When independent enterprises transact with each other, the conditions of their commercial and financial relations ordinarily are determined by market forces (paragraph 1.2). The tax position can be “distorted” when pricing does not reflect *market forces*, so the solution is that “for tax purposes the profits of the associated enterprises may be adjusted as necessary to correct any such distortions and thereby ensure that the arm’s length principle is satisfied” (paragraph 1.3). Even where autonomous MNE group members bargain hard between themselves, “it may occur that the *relationship* between the associated enterprises may *influence* the outcome of the bargaining” (paragraph 1.5)⁹⁰.

2.21 TPG paragraph 1.6 promulgates the “separate entity approach”. This lies at the heart of the controversy concerning passive association. Paragraph 1.6 provides, importantly:

“By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances (i.e. in ‘comparable uncontrolled transactions’), the arm’s length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the transactions between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions. Such an analysis of the controlled and uncontrolled transactions, which is referred to as a ‘comparability analysis’, is at the heart of the application of the arm’s length principle.”⁹¹

⁸⁹ See Actions 8-10 in the 2013 BEPS Action Plan: “... special measures, either within or beyond the arm’s length principle, may be required with respect to intangible assets, risk and over-capitalisation to address these flaws [in the current system]”. Various potential special measures were described in the December 2014 discussion paper on Actions 8-10. See e.g. Boidman and Kandev (2015) pages 841-842 proposing that the way in which certain (“brazen”) changes promoted by OECD as arm’s length measures do not stand up as such.

⁹⁰ Emphasis added. This is a potential weakness of the “negotiated price method” promoted by Hamaekers (2002): paragraph 4.19 below.

⁹¹ Emphasis added.

2.22 Paragraph 1.6 TPG is a foundation for any discussion of the recognition of passive association in pricing controlled transactions. Comparability analysis is at the heart of the arm's length principle. The emphasis is on *transactions*. Not only must comparable transactions be identified, but equally an analysis of *circumstances* is required. In my view, the effect of passive association upon a party to a transaction is as clearly a "circumstance" as any other. The question is then whether such effects should be pushed aside by reference to the concept of *independence*. MNE group members are to be treated as "operating as separate entities rather than as inseparable parts of a single unified business" and "as if they were independent entities". Traditionalists (and, where it suits them, litigants) have taken the view that this requires all consequences of affiliation to be disregarded⁹². But on closer inspection (with some illumination from case law and other developments in recent years), this is not what paragraph 1.6 prescribes. The very essence of transfer pricing requires the separateness of corporate entities within an MNE group to be respected. The rejection of a "single unified business" approach requires (in contrast to application of the arm's length principle) that notions of the integrated multinational "firm" are ignored. "Operating as separate entities" simply respects legal actuality (even though businesses which are in fact integrated or divisionalised frequently behave without much regard to the legal personality of group members). There is no fundamental inconsistency between treating group members "as if they were independent entities" and respecting their actual characteristics, including those which are a consequence of group membership. What is required, however, to arrive at an independent treatment, is to disregard distortions to pricing caused by the exercise of control.

2.23 TPG paragraph 1.8 offers as a major reason for adoption of the arm's length principle that it "provides broad parity of tax treatment for members of MNE groups and independent enterprises", achieving a non-distortive "more equal footing for tax purposes". Hamaekers (1992) calls this the *neutrality principle* (paragraph 4.21 below). Indeed, it has been said that the TPG "give pride of place

⁹² See e.g. Wilmshurst (2012): "Ignoring the impact of implicit support may seem appropriate if the statement of the arm's length principle in paragraph 1.6 of the OECD Guidelines is interpreted narrowly and the members of a group are treated as entirely separate entities. Indeed, to do so has been the norm in the analysis of debt for transfer pricing purposes."

as a justificatory matter to the claim that the arm's length standard gives parity of treatment to commonly controlled enterprises and non-commonly controlled enterprises"⁹³. The lending of money is considered to be a case where arm's length prices from comparable transactions "may readily be found" (paragraph 1.9). Paragraph 1.10 notes, but brushes over, criticism from some quarters of the arm's length principle because "the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses"⁹⁴. This just touches on passive association in the sense that MNE group synergies may benefit group members in some respects without there necessarily being transactions or other activities which create the relevant benefits.⁹⁵ On group synergies, see paragraph 2.80ff below.

2.24 TPG paragraph 1.14 defends the arm's length principle as "the closest approximation of the workings of the open market" and "reflects the economic realities of *the controlled taxpayer's particular facts and circumstances*" (my emphasis).

2.25 Newly-revised Chapter I Part D.1 explains the process of comparability analysis. Various amendments and expansions of Part D have now been made by the BEPS 2015 Final Reports. There are two key parts of the analysis (paragraph 1.33) –

"the first aspect is to identify the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated; the second aspect is to compare the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions

⁹³ Kane (2014) section 3.1. The *parity* concept finds express articulation in US legislation: Regs. §1.482-1(a)(1): paragraph 3.197 below.

⁹⁴ Schön (2011) page 38 says: "[t]he arm's length standard is rather a legal than a commercial concept, trying to grant equal treatment to group companies and independent companies, but it cannot be defended as a business concept as it generically misses the efficiency requirements within the firm." Also literature cited, *ibid.*, footnote 96.

⁹⁵ Wittendorff (2010a) at page 335 considers that what is now paragraph 1.10 TPG "implies that economies of integration should be taken into account for transfer pricing purposes."

and the economically relevant circumstances of comparable transactions between independent enterprises”.

2.26 The economically relevant characteristics to be considered include “the economic circumstances of the parties”/“the circumstances of the associated enterprises” (paragraphs 1.36-37)⁹⁶.

2.27 Independent enterprises will compare a potential transaction to the “other *options realistically available* to them, and they will only enter into the transaction if they see no alternative that offers a clearly more attractive opportunity to meet their commercial objectives”. Such enterprises “would generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk) when valuing those options ... [and it is important that] the transaction adopted offers a clearly more attractive opportunity to meet commercial objectives than *alternative options realistically available*” (paragraph 1.38, my emphasis, see also Chapter IX discussed below).

2.28 Paragraph 1.40 robustly asserts that “[a]ll methods that apply the arm’s length principle can be tied to the concept that independent enterprises consider the options realistically available to them and in comparing one option to another they “consider any differences between the options that would significantly affect their value”; “before purchasing a product at a given price, independent enterprises normally would be expected to consider whether they could buy the equivalent product on otherwise comparable terms and conditions but at a lower price from another party”. The comparable uncontrolled price (CUP) method, described as comparing “a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative”, becomes less reliable “if not all the characteristics of these uncontrolled transactions that significantly affect the price charged between independent enterprises are comparable”. And “[w]here

⁹⁶ TPG paragraph 2.16 alludes to the determination of comparability adjustments “where differences exist between the controlled and uncontrolled transactions *or between the enterprises undertaking those transactions*” (emphasis added).

there are differences between the situations being compared that could materially affect the comparison, comparability adjustments must be made, where possible, to improve the reliability of the comparison” (all per paragraph 1.40). Reference to realistically available alternatives is an aspect of comparability analysis, including the way in which comparability adjustments should be undertaken. It is not a justification for recharacterising the actual controlled transaction⁹⁷.

2.29 An important post-BEPS theme is a more acute focus on the conduct of the parties beyond merely taking into account contractual terms. “Where there are material differences between contractual terms and the conduct of the associated enterprises in their relations with one another, the functions they actually perform, the assets they actually use, and the risks they actually assume, considered in the context of the contractual terms, should ultimately determine the factual situation and accurately delineate the transaction” (paragraph 1.46). Sometimes “the actual outcome of commercial or financial relations may not have been identified as a transaction by the MNE, but nevertheless may result in a transfer of material value, the terms of which would need to be deduced from the conduct of the parties. For example, ... synergies may have been created through deliberate concerted action ...” (paragraph 1.49).

2.30 The assumption of *risk* is highly relevant in a comparability study: it will “influence the prices and other conditions of transactions between the associated enterprises ... The level and assumption of risk, therefore, are economically relevant characteristics that can be significant in determining the outcome of a transfer pricing analysis” (paragraph 1.56). “Where an associated enterprise contractually assumes risk but does not exercise control over the risk or does not have the financial capacity to assume the risk, the risk will be allocated to the enterprise exercising control and having financial capacity (paragraph 1.98)⁹⁸. However, whereas an *evaluation* of risk is naturally intrinsic in the financing context to an assessment of creditworthiness and thus pricing (such that passive

⁹⁷ See e.g. Wittendorff (2009) page 127. Compare the US approach: paragraph 3.202 below.

⁹⁸ Compare Schön (2014), who urges that the importance of control should not be overstated, in contrast to the important capacity to bear risk.

association may have an effect), that should not be confused with arrangements which *allocate* risk (or purport to allocate risk, perhaps implausibly) across an MNE group – which is more the focus of concern in the BEPS project⁹⁹.

2.31 Chapter I Section D.2 addresses “Recognition of the accurately delineated transactions”. This authorises tax authorities to disregard the character of a controlled transaction “where 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 in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to each of them at the time of entering into the transaction” (paragraph 1.122). But this controversial¹⁰⁰ rule (and its fascinating interaction with purported risk allocations) does not have a significant bearing on the passive association topic.

2.32 Importantly for this study, the BEPS 2015 Final Reports introduce a new¹⁰¹ Chapter I Section D.8 TPG dealing with “MNE group synergies”. See paragraph 2.80ff below.

Chapter II: transfer pricing methods

2.33 The modern TPG abandoned the traditional “hierarchy” of transfer pricing methods¹⁰² in favour of “finding the most appropriate method for a particular case” (paragraph 2.2). Nonetheless, “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” (paragraph 2.14). In the case of straightforward lending transactions, it should ordinarily be possible to locate

⁹⁹ Paragraph 1.56ff TPG contains substantial new material on risk.

¹⁰⁰ See e.g. Wittendorff (2009), challenging the proposition that Article 9 permits transactional adjustments.

¹⁰¹ Albeit trailed since July 2013.

¹⁰² Paragraph 2.49 of the 1995 TPG, explicitly stated that “traditional transaction methods are preferable to other methods”.

comparables of good quality, or at least comparables which are readily susceptible to adjustment¹⁰³.

Chapter III: comparability analysis

2.34 TPG Chapter III provides guidance on comparability analysis. “By definition, a comparison implies examining two terms: the controlled transaction under review and the uncontrolled transactions that are regarded as potentially comparable ... the process of identifying comparables is dependent upon a prior analysis of the taxpayer’s controlled transactions and of the relevant comparability factors” (paragraph 3.1). Thus empirical transactional comparison is at the heart of the arm’s length principle. To price straightforward loan and guarantee transactions, in applying the CUP method, one should search for evidence of comparable transactions in comparable circumstances.

2.35 TPG paragraph 3.4 offers a stepped summary of a “typical process” for comparability analysis. Step 2 is a “broad-based analysis of the taxpayer’s circumstances” which *inter alia* considers all “elements that affect the taxpayer and its environment” to “understand the conditions in the taxpayer’s controlled transaction as well as those in the uncontrolled transactions to be compared, in particular the economic circumstances of the transaction” (paragraph 3.7).

2.36 Step 4 prescribes a “review of existing internal comparables, if any” (ahead of Step 5 which is an assessment of sources of external comparables where they “are needed, taking into account their relative reliability”). An “internal” comparable is a comparable transaction between one party to the controlled transaction and an independent party. In applying the CUP method to a purchase (or, by analogy, a borrowing) transaction, an internal comparable would be the purchase price (or cost of finance) paid by the taxpayer for comparable goods or services (loan) obtained from an unrelated party in comparable circumstances.¹⁰⁴ An “external” comparable is a transaction between two independent enterprises,

¹⁰³ The Indian case law repeatedly resorts to the CUP method: paragraph 3.117ff below.

¹⁰⁴ This formulation is drawn from the OECD’s 2006 paper on comparability CTPA/CFA(2006)31, paragraph 16.

neither of which is party to the controlled transaction (paragraph 3.24). Paragraph 3.28 observes that “[o]ne obvious and forceful aspect of internal comparability is that the taxpayer will self-evidently itself have constant characteristics whoever it is dealing with”¹⁰⁵.

2.37 Comparables may need to be adjusted to enhance accuracy: examples include adjustments for differences in capital, functions, assets and risks (paragraphs 3.47 and 3.48). Adjustments must be made to the reference transaction i.e. the candidate comparable, not the controlled transaction.¹⁰⁶

Chapter IV: administrative approaches

2.38 The significance of a borrower company’s credit rating is acknowledged in the TPG’s discussion of advance pricing agreements for loans: paragraph 4.125.

Chapter VI: intangibles

2.39 New paragraph 6.60 TPG notes the integral connection between funding and risk-taking, and hence the connection with credit-worthiness. The updated guidance on intangibles further emphasises the “options realistically available”, both generally (e.g. paragraphs 6.112-113 TPG) and specifically in relation to “financing options” (paragraph 6.62). Funding decisions and the ability to evaluate and monitor risk are given prominence (e.g. paragraph 6.64).

Chapter VII: intra-group services

2.40 Chapter VII TPG addresses “Special Considerations for Intra-Group Services”. Two core issues are identified: (a) whether intra-group services have been provided, and (b) if so, what the charge should be (paragraph 7.5). The BEPS 2015 Final Reports introduce new material on low value-adding services. The changes are not material for the purposes of this study. In particular, financial

¹⁰⁵ Proponents of the “lender as guarantor” viewpoint (see e.g. HMRC’s position, paragraph 3.188 below) might argue otherwise.

¹⁰⁶ This is apparent from paragraph 3.47 and also the working capital example in the Annex to Chapter III.

transactions are not to qualify for the simplified approach proposed in the draft (paragraph 7.47).

2.41 Chapter VII emphasises the need for the *performance of an activity* in order to constitute the provision of a service: paragraphs 7.6, 7.9, 7.12 and 7.14. This fits with the dynamic terminology “made or imposed” in Article 9(1) MTC. It may also follow from the use in Article 9(1) of “commercial or financial relations”: thus Wittendorff (2010a) observes that the TPG “use the term ‘controlled transactions’ synonymously with ‘commercial or financial relations’” and argues that “[a]ccordingly, the arm’s length principle of Article 9(1) only relates to the valuation of transactions which qualify as commercial/financial relations under domestic law”¹⁰⁷.

2.42 Usually a service will confer upon the recipient a *benefit*. Thus (paragraph 7.6):

“Under the arm’s length principle, the question whether an intra-group service has been rendered when an activity is performed ... should depend on whether the activity provides a respective group member with economic or commercial value to enhance or maintain its business position. This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself ...”

2.43 Activities (on the part of a member of an MNE group) may “produce economic benefits for other group members not directly involved in the potential decision”; but such “incidental benefits ordinarily would not cause these other group members to be treated as receiving an intra-group service because the activities producing the benefits would not be ones for which an independent enterprise ordinarily would be willing to pay” (paragraph 7.12).

¹⁰⁷ Section 3.3.6.3.1, footnote 791, page 222; section 16.2.1.2, page 479.

2.44 TPG paragraph 7.13 is the bedrock guidance on passive association¹⁰⁸. It is worth reciting in full:

“Similarly, an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed. For example, no service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member, or where the enterprise benefitted from deliberate concerted action involving global marketing and public relations campaigns. In this respect, passive association should be distinguished from active promotion of the MNE group’s attributes that positively enhances the profit-making potential of particular members of the group. Each case must be determined according to its own facts and circumstances. See Section D.8 of Chapter I on MNE group synergies.”¹⁰⁹

2.45 It is hard to improve upon the American Bar Association’s description of the functioning of paragraph 7.13:

“Paragraph 7.13 provides in effect that if the parties do not do anything, there is no transaction or service that can give rise to a transfer pricing analysis. The mere fact that one company is affiliated with another company is not the performance of a service even if the affiliation is mutually beneficial. It follows that ‘passive association’ (a synonym for ‘affiliation alone’) likewise is not a service or transaction. The objective of paragraph 7.13 is to prevent tax authorities from imposing a transfer pricing adjustment based solely on some notion of relative contribution by members of a multinational group. It makes clear that an adjustment is appropriate only where something has been done – where there is a ‘specific activity’, such as the execution of a guarantee or the performance of a global marketing campaign. There is then an activity that can be subjected to a transfer pricing analysis and a transaction or service that can be priced.”¹¹⁰

¹⁰⁸ “Much of the uncertainty that surrounds the transfer pricing of guarantees can be traced to this paragraph and the competing interpretations that have sprung up around it”: Breen (2010) section II.C.

¹⁰⁹ Emphasis added. Wittendorff (2010a) at page 507 says “[t]his may be explained both by the fact that no specific activity is performed, and that the benefits are solely caused by the association of the group enterprises”.

¹¹⁰ ABA Guarantees Paper (2012) page 9.

2.46 Paragraph 7.13 can itself be proposed as a justification for the recognition of passive association in pricing transactions. The argument is that (in contrast with the case of provision of an explicit guarantee) because no service is received where the beneficiary of implicit support has a relatively higher credit rating due to “affiliation alone”, it must follow that the beneficiary need not pay for any such benefit. Therefore, where an actual guarantee or loan is provided, only a fee or interest reflective of the passive association benefit already enjoyed should be paid. In other words, “this paragraph implies that no interest charge should be made in relation to the improvement in a credit rating due to implicit support”¹¹¹.

2.47 In calculating the arm’s length consideration for a service, “the matter should be considered both from the perspective of the service provider and from the perspective of the recipient of the service ... relevant considerations include the value of the service to the recipient and how much a comparable independent enterprise would be prepared to pay¹¹² for that service in comparable circumstances, as well as the cost to the service provider” (paragraph 7.29). I suggest that the value of a loan to an intra-group borrower can be tested by reference to the cost to that borrower of an identical loan from a third party. That benchmark, where available, demonstrates what the borrower, if transacting with an independent lender “would be prepared to pay”.

2.48 Again, “the economic alternatives available to the recipient of the service also need to be taken into account in determining the arm’s length charge” (paragraph 7.35); and it is relevant to determine “whether the intra-group services represent the same value for money as could be obtained from an independent enterprise” (paragraph 7.36). This recapitulates the “options realistically available” concept (paragraph 2.27 above), which indeed appears expressly at paragraph 7.41. To re-emphasise: if an option realistically available to an intra-group borrower includes a third party loan at a certain price (the third party lender

¹¹¹ Wilmshurst (2012).

¹¹² Or be paid?

taking account of passive association), why should the intra-group loan be any more expensive?

Chapter IX: business restructurings

2.49 Several propositions contained in Chapter IX, while written in the context of business restructurings, are of wide application. For example, “[a]n examination of the allocation of risks between associated enterprises is an essential part of the functional analysis”, and “[u]sually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return” (paragraph 9.10). Risk analysis starts from an examination of the contractual terms between the parties though, reflecting paragraphs 1.98ff, the purported contractual allocation of risk may be challenged if it is inconsistent with the economic substance of the transaction (paragraphs 9.11, 9.166). Where “comparable uncontrolled transactions are found that evidence a similar allocation of risks in uncontrolled transactions ... then the risk allocation between the associated enterprises would be regarded as arm’s length” (paragraph 9.111). For lending transactions, credit-worthiness is the paradigm risk. A question is “whether independent parties would have agreed to a similar allocation of risk”; and “[at] arm’s length the party making the investment might not be willing to assume with no guarantee a risk (termination risk) that is controlled by the other” (paragraphs 9.111-112). In a controlled loan, termination risk is manageable via contractual terms; a variation imposed via the exercise of shareholder control on the other hand would itself be non-arm’s length – as a distortion attributable to the control relationship.

2.50 The concept of “*options realistically available*” also features prominently in Chapter IX - upon which “the application of the arm’s length principle is based” (paragraph 9.59). Importantly, “alternative structures realistically available are considered in evaluating whether the terms of the controlled transactions (particularly pricing) would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances”; and “the consideration in the controlled transaction may be adjusted by reference to the profits that could have been obtained in the

alternative structure, since independent enterprises will only enter into a transaction if they see no alternative that is clearly more attractive” (paragraphs 9.60, 9.175). In assessing intra-group loan pricing, it is surely a powerful fact that the borrower could have borrowed externally on certain terms in circumstances where it would be an “independent enterprise” vis-à-vis its lender.

2.51 “The arm’s length principle requires an evaluation of the conditions made or imposed between associated enterprises, at the level of each of them” (paragraph 9.63). This implies, in the financing context, a need to have regard to the characteristics and circumstances of each of the parties to the controlled transaction (notably the creditworthiness of the borrower).¹¹³

Conclusions: TPG

2.52 Taking all these points together, it seems to me that a compelling case is made out, via a careful application of the TPG (the most influential instrument of international guidance on transfer pricing), to recognise the effect of passive association in pricing controlled transactions. The likely availability of parental/affiliate support to a member of an MNE group is not a pricing distortion caused by the exercise of control in relation to any particular transaction. It is an attribute or characteristic of that member. Thus it is appropriate, in performing a comparability analysis in the financing context, to consider a notionally independent borrower which nonetheless possesses such an attribute. Indeed, whether one considers a notionally independent lender, guarantor or borrower, the notional borrower may be regarded as benefiting from the implicit support of its (notional) parent/affiliate, precisely so as to align its circumstances and characteristics with those of the actual borrower. Nothing in this exercise requires the effect of passive association to be disregarded by reference to the actual connection between the parties to the controlled transaction.

2.53 Moreover, if the borrower under an intra-group loan could instead, with the benefit of group implicit support, have raised funds from a third party at a

¹¹³ See also paragraph 5.4 and note 885 below as regards the characteristics/circumstances of a lender.

certain rate (an option realistically available), based upon such an independent lender's assessment of risk, there should be no reason for the borrower to accept a higher cost of funds on its intra-group funding, *ceteris paribus*.

OECD 1979 and 1984 Reports

2.54 The OECD 1979 Report served as the original guidelines on the interpretation of the arm's length principle¹¹⁴. "The aim in short is, for tax purposes, to adjust the price for the actual transaction to an arm's length price"¹¹⁵. The OECD recommended an approach which bore "a strong resemblance to the United States regulations"¹¹⁶. In 1992 the MTC Commentary effectively made the Report part of the Commentary¹¹⁷. The Report unsurprisingly says little about passive association. It did however include a section on loans, including the remark that "[t]he arm's length interest rate is the rate of interest which is charged, or would have been charged at the time the indebtedness arose, in transactions with, or between, unrelated parties under similar circumstances"; and "[i]deally, in each case, the interest rate to be determined for tax purposes should be set according to the conditions in financial markets for similar loans. In deciding what is a comparable or similar loan, it is necessary to take into account ... the credit-standing of the borrower"¹¹⁸.

2.55 Paragraph 2 in the preface observes (thus focusing on price distortions caused by the control relationship) that "[t]he prices charged for [intra-group transactions] do not necessarily represent a result of the free play of market forces, but may, for a number of reasons and because the MNE is in a position to adopt whatever principle is convenient to it as a group, diverge considerably from the prices which would have been agreed upon between unrelated parties engaged in

¹¹⁴ Though the 1979 Report was not formally adopted by an OECD Council measure, and so cannot be accorded the same legal status: see e.g. Bullen (2011) page 50.

¹¹⁵ Paragraph 23.

¹¹⁶ Langbein (1986) page 651.

¹¹⁷ Paragraph 3 of the 1992 Commentary on Article 9 MTC.

¹¹⁸ Paragraphs 198-199.

the same or similar transactions under the same or similar conditions in the open market (hereafter referred to as ‘arm’s length prices’).”

2.56 The 1979 Report deferred any discussion of loans between enterprises engaged in banking or financing activities as part of their regular business¹¹⁹. That theme was picked up in the second part of the OECD’s 1984 Report *Transfer Pricing and Multinational Enterprises, Three Taxation Issues*, but little is found there which further illuminates the arm’s length principle in general, and nothing in terms touching on passive association. The 1984 Report, which as regards the treatment of bank PEs was largely superseded by the OECD PEs Report, does confirm that “the appropriate arm’s length rate of interest for a loan between associated banking or financial enterprises is the rate which would be charged in similar circumstances in a transaction between unrelated parties”. Also, “[n]ormally the transactions to be used for comparison should be arm’s length transactions between unrelated banks where the amount lent, the term of the loan, the currency involved and the other conditions are the same or similar to those in question”¹²⁰. This does not significantly advance the debate about the approach to passive association, but is at least consistent with recognising the “conditions” surrounding controlled transactions when identifying, or adjusting, comparables. What is plain is that a key consideration in pricing financial transactions is *risk* and thus, as a measure of risk, the creditworthiness of a borrower.

OECD 1987 Thin Capitalisation Report

2.57 The 1987 Thin Capitalisation Report offers a few further observations which bear upon the interpretation of the arm’s length principle. The focus is on the regulation via tax codes of “excessive” amounts of debt – which tend to erode the tax base of the debtor’s home jurisdiction via consequentially excessive interest expense. The 1987 Report focuses upon the size of a loan which would have been made in an arm’s length situation¹²¹. There is also a useful discussion,

¹¹⁹ Paragraphs 181 and 198.

¹²⁰ Paragraphs 35–37 of the part of the Report entitled *The Taxation of Multinational Banking Enterprises*.

¹²¹ Paragraph 25(i).

related to the thin capitalisation context, of Article 9 MTC, generally accepted by the CFA to be relevant to thin capitalisation¹²². In principle, the application of rules designed to deal with thin capitalisation ought not normally to increase the taxable profits of the relevant domestic enterprise to any amount greater than the arm's length profit; and this principle should be followed in applying existing tax treaties¹²³.

2.58 In considering the practical application of thin capitalisation rules, one approach would be to enquire whether an independent person would have provided such a high proportion of the capital of the enterprise as debt, perhaps adopting an approach comparable to that which a banker would adopt, asking whether, considering the borrower's financial and economic condition, an *independent bank* would have provided the funds as a loan on the terms actually agreed between the parties¹²⁴ (sometimes referred to as the "independent lender" test¹²⁵). Again, this points immediately to an evaluation of risk, and hence the borrower's creditworthiness. It seems self-evident that if passive association can enhance the risk proposition for a lender, that may in appropriate circumstances encourage a greater quantum of lending, just as it may the conceding of a lower interest rate. The limitations of the independent lender approach caused by informational asymmetry are recognised by the 1987 Report¹²⁶ e.g. because a parent company might have a better understanding of the profit potential of its own subsidiary than would a banker viewing things from the outside. Detailed informational loan covenants may however go a long way towards neutralising this asymmetry.

2.59 One other possibly useful concept used in the Report is that of "hidden equity capitalisation"¹²⁷. The Report focuses in particular on "hybrid" financing

¹²² Paragraph 48.

¹²³ Paragraph 50. Compare paragraph 2.7 above.

¹²⁴ Paragraphs 75–76.

¹²⁵ E.g. in the ATO's Taxation Ruling 92/11, paragraph 60(g).

¹²⁶ Paragraphs 75-76.

¹²⁷ *Ibid.*, paragraph 11.

such as debt instruments with equity-like features¹²⁸, but this is just “one such manifestation”. It prompts the thought that where a subsidiary might be regarded as the beneficiary of implicit support from its parent, such support might arguably be seen as a form of hidden equity capitalisation i.e. by virtue of the expectation that the parent would inject subordinated capital to support the subsidiary in times of financial stress. Thus conceivably there is an “asset” aspect to this theory, if being the beneficiary of implicit support approaches holding an “asset”. However, the beneficiary does not hold anything in this respect which amounts to a legal/proprietary right. See paragraph 2.80 below on the OECD’s modern rejection of the notion that MNE group synergies should be regarded as intangible assets¹²⁹.

OECD Task Force Reports on US Proposed Regulations¹³⁰

2.60 Alarmed by certain aspects of proposed US transfer pricing regulations (particularly the “commensurate with income standard” for transactions in intangibles), the OECD formed a Task Force to consider the proposals and provide the US Administration with the collective views of other OECD member countries. The Task Force’s first report, derestricted in December 1992 and published in January 1993, offers some observations about the nature of the arm’s length principle and the risk of transfer prices being “manipulated” within an MNE group.¹³¹ It also quotes from the CFA 1989 Report on Tax Treaty Override¹³² which, in noting the purposive approach to treaty interpretation promoted by Article 31 of the Vienna Convention, concluded that “the interpretation of [a tax treaty] on the basis of its object and purpose requires a high degree of coordination between the Contracting States”, such that the typical

¹²⁸ See now the OECD’s final report on BEPS Action 2, *Neutralising the Effects of Hybrid Mismatch Arrangements*, 5 October 2015.

¹²⁹ Also paragraph 4.52(ii) below as regards credit standing as a “group asset”.

¹³⁰ *Tax Aspects of Transfer Pricing within Multinational Enterprises: The United States Proposed Regulations* (January 1993) referred to as the *1992 OECD Task Force Report*, and *Intercompany Transfer Pricing Regulations under US Section 482 Temporary and Proposed Regulations* (April 1993) referred to as the *1993 OECD Task Force Report*. See also CFA *Report on Intercompany Transfer Pricing Under US § 482 Temporary and Proposed Regulations* (December 1993), reproduced in TMTPR News Archive 2 February 1994.

¹³¹ Executive summary, paragraph A.1; Introduction paragraph A.1.20.

¹³² DAFPE/CFA/89.13 (2nd revision).

mutual agreement procedure should be used (quoting directly from Article 25(3) OECD MTC) “to deal with any difficulties or doubts arising as to the interpretation or application of the treaties”. I observe that the use of MAP in this way could indeed be an efficient way to establish consensus between treaty partners as regards the proper recognition of passive association¹³³.

2.61 A follow-up report was issued in December 1993. Some might think that the US approach had not been materially attenuated, but nonetheless the OECD was able to feel “particularly pleased to see a reaffirmation of the arm’s length standard”¹³⁴. Continued support for the CUP method was voiced, even where “differences are material, if their effect on the prices concerned is definite and reasonably ascertainable”.¹³⁵

OECD PEs Report

2.62 The generally excellent PEs Report is concerned with the attribution of profits to PEs under Article 7 MTC. Yet (perhaps unsurprisingly, given the focus on the international tax treatment of a single entity and thus the credit-related aspects discussed below) there is very little directly relevant to the meaning of the arm’s length principle as it relates to passive association.

2.63 It is attractive to apply a degree of consistency to the application and interpretation of Articles 7 and 9 given that they are both concerned with the taxation of MNE businesses. Indeed the arm’s length principle should be regarded as an equivalent concept for the purposes of both rules¹³⁶. But certain conceptual limitations are inescapable.

¹³³ A broadly-based amendment to paragraph 4.29 TPG, designed to develop this proposition, is included in the Annex to this study. On a confidential client matter, I was told on 13 February 2015 that a UK headed MNE group will invoke MAP in a situation where the French tax authority is promoting the implicit support concept to limit interest deductions on a loan from the UK parent to its French subsidiary

¹³⁴ Paragraph 2.1.

¹³⁵ Paragraph 3.14.

¹³⁶ OECD Commentary on Article 7, paragraph 14.

2.64 Article 7(2) OECD MTC contains its own version of the arm's length principle. Where an enterprise has a permanent establishment in a host state, the profits that may be taxed in that state are:

“the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through other parts of the enterprise”.

2.65 Thus the “authorised OECD approach” promotes the concept of a PE as (notionally) a “functionally separate entity”, and thus attributes to the PE the profits it would have earned at arm's length. A comparison of *dealings* between the PE and other parts of the enterprise of which it is part with *transactions* between independent enterprises is required¹³⁷. Thus where dealings are capable of being recognised, they should be priced on an arm's length basis, assuming the PE and the rest of the enterprise of which it is part to be independent of one another – by analogy with the transfer pricing methods in the TPG¹³⁸. In the PE context, some of the “conditions” of the PE as a hypothesised separate and independent enterprise are to be derived from a functional and factual analysis of the internal attributes of the enterprise itself; other “conditions” will be derived from the external environment in which the functions of the PE are performed¹³⁹.

2.66 However, as a noteworthy exception to the notional separateness of the PE, the creditworthiness of the entity as a whole is attributed to each PE¹⁴⁰. “It is an observable condition that PEs generally enjoy the same creditworthiness as the enterprise of which they are a part.”¹⁴¹ Thus there is no scope for the operation of

¹³⁷ OECD PEs Report, Part I paragraph 183.

¹³⁸ Part I paragraph 39.

¹³⁹ Part I paragraph 58.

¹⁴⁰ Part I paragraph 100; Part II paragraph 83; Part III paragraph 230; Part IV paragraph 122. “Creditworthiness is the perception by an independent party, e.g. a credit rating agency, of the likelihood that a company (e.g. a bank) will meet its commitments in respect of any borrowings it has made and investments it has received”: Part II paragraph 29.

¹⁴¹ Part I paragraph 99. Section 21(2)(a) Corporation Tax Act 2009 is the UK statutory articulation of this proposition.

passive association - or indeed explicit support - in favour of (or from) a PE within the entity of which it is part. Accordingly, dealings in respect of guarantee fees between a PE and its head office, or between the PE and another PE, are not to be recognised¹⁴². Equally, it makes sense, in relation to pricing an intra-entity “dealing” in the nature of lending (e.g. from head office to a PE), to “equalise” the credit-standing of the respective parts of the enterprise: all of the capital of the entity is available to all parts of the entity¹⁴³. Of course, a business carried on through a PE may itself be a beneficiary of passive association with other members of the MNE group - just not from the entity which is “itself”.

2.67 The “authorised OECD approach” does not purport to achieve equality of treatment between PEs and subsidiaries where there are economic differences between them: “the legal form chosen, PE or subsidiary, may have some economic effects that should be reflected in the determination of taxable profits” e.g. as regards efficient capital utilisation or risk diversification¹⁴⁴. Thus there is no discrimination between PEs and subsidiaries by virtue of applying transfer pricing principles in different ways – because the legal forms have different economic consequences. An enterprise can guarantee the debts of a second enterprise, but a purported “guarantee” given by one part of an enterprise in respect of “obligations” of another part is not legally meaningful. Thus “PEs in their dealings with other parts of the same enterprise in the context of guarantee fees may not be in similar circumstances to a subsidiary”; and “[i]n general, the factual situation of a PE determines that it necessarily has the same creditworthiness as the enterprise of which it is part. In contrast, a subsidiary may or may not have the same creditworthiness as its parent”¹⁴⁵. Therefore, in my view, there is no room for a taxpayer to invoke a treaty provision modelled on Article 24(3) MTC to assert that a PE has been discriminated against by reference to the unified creditworthiness of the entity (e.g. by alleging that its “separate entity/stand alone”

¹⁴² Part I paragraph 103.

¹⁴³ Save in exceptional circumstances where specific laws or regulations may in some way “ring-fence” particular assets from the entity’s creditors in general. See e.g. Part II paragraph 30; Part III paragraphs 204 and 230; Part IV paragraph 122.

¹⁴⁴ Part I paragraph 55; Part II paragraph 4.

¹⁴⁵ Part I paragraphs 103-104; Part II paragraph 31.

credit has been “dragged down” by the financial weakness of other parts of the entity)¹⁴⁶. The effect on creditworthiness of passive association should be experienced across the entity as a whole, thus sitting comfortably with the unified creditworthiness rule.

2.68 One possible clue to the correct way to hypothesise comparable transactions with independent parties is found in an illustration concerning distribution of goods – where the internal dealing is a “purchase” of goods by the PE from its head office. If the head office also sells the product to third parties operating in circumstances similar to those of the PE, the CUP method might be used to determine the price at which the PE would have obtained the products had it been a “separate and independent enterprise”¹⁴⁷. One can analogise this with the provision of finance: it is relevant to consider the price at which a third party would transact with (lend to) the enterprise – or, by extension, in assessing the arm’s length price of intra-group lending, it is relevant to consider the price at which a third party would lend to a subsidiary. In the PEs context, “the part of the enterprise making such a ‘provision’ should receive the return which an independent enterprise would have received for making a comparable ‘provision’ in a transaction at arm’s length”¹⁴⁸. Of course, where finance is concerned – and as reflected in the PEs Report itself – the price of transacting should, so far as creditworthiness goes, be the same for a PE as for the head office or other part of the enterprise. But the principle of seeking *parity* with uncontrolled transactions is nevertheless manifest in the Report.

2.69 Article 7(2) MTC offers potential support for arguments on both sides of the passive association controversy i.e. for both a stand-alone approach to pricing transactions (“separate and independent enterprise”) or, to the contrary, the recognition of passive association having regard to the “same or similar conditions”¹⁴⁹. It seems to me however that the Article 7(2) context in this respect

¹⁴⁶ Paragraph 42 OECD Commentary on MTC Article 24 confirms that Article 7(2) is part of the context in which Article 24(3) must be read.

¹⁴⁷ Part I paragraph 185.

¹⁴⁸ Part I paragraph 191.

¹⁴⁹ As suggested by van der Breggen *et al* (2007).

is no different to that of Article 9(1) which in its terms applies an independent enterprise hypothesis to evaluate the “conditions” of the transaction (paragraph 1.6 TPG: paragraph 2.21 above). The reconciliation of these two strands lies simply in respecting the separateness of the taxpayer (or deemed notional separate taxpayer in the PE case) while at the same time taking into account all relevant circumstances.

Transfer Pricing Legislation – A Suggested Approach

2.70 In June 2011, the OECD released the above-titled paper containing a suggested approach to the drafting of transfer pricing legislation. Its status is “purely illustrative” and it is without legal force; indeed, it does not necessarily represent the views of any particular OECD member state. Nonetheless, it represented a further assertion of the arm’s length principle as the best available method for preventing artificial profit shifting, providing MNE groups with some certainty, reducing the risk of double taxation, providing a level playing field for international investment and also as between MNEs and independent enterprises. And it is presumably at least “illustrative” of a substantial body of OECD member states’ thinking.

2.71 In the Introduction, reference is made equally to Article 9 in each of the MTC and the UN Model. The proposition that the arm’s length principle is more favourable to developed economies than to developing and transitioning ones is firmly rejected: “transfer pricing is not as much about a tension between developed and developing countries, as about a tension between high and low tax jurisdictions”. Also, importantly:

*“[t]he arm’s length principle simply states that transactions between associated enterprises should not be distorted by the special relationship that exists between the parties.”*¹⁵⁰

2.72 The proposed legislation itself expressly requires that the tax effects of controlled transactions shall be determined “in a manner that is consistent with the arm’s length principle”; and taxable profits “derived by an enterprise that engages

¹⁵⁰ Page 3; my emphasis.

in one or more commercial or financial transactions with an associated enterprise shall be consistent with the arm's length principle if the conditions of those transactions do not differ from the conditions that would have applied between independent enterprises in comparable transactions carried out under comparable circumstances"¹⁵¹.

2.73 There is not too much in this which is radical or new, but the paper is at least a positive recapitulation and global promotion of the arm's length principle, including a legislative formulation of comparability and a purposive focus on the elimination of transactional distortions attributable to control.

Thin Capitalisation Legislation: A Background Paper for Country Tax Administrations

2.74 More intriguing is the above-mentioned "initial draft"/"pilot version for comments" paper released by OECD in August 2012. It remarks that the arm's length approach "involves taking a view on the amount of debt that third party lenders, acting at arm's length, would be willing to lend to the specific company in question, taking into account the specific attributes of that company"¹⁵². But it then describes several perspectives on the "separate enterprise approach", noting that "there is less than full consensus"¹⁵³. Draft legislation is tabled based on "approach 3", which tests borrowing capacity of a company "on the basis that it is not a member of a wider group of companies, and benefits from no explicit or implicit guarantees from group members, but also on the basis of owning the same subsidiary companies". In the Annex, draft clauses are proposed:

"Non-arm's amount of length debt [sic] means the amount of debt that exceeds the amount that the borrower would be able to obtain [or would obtain] from a lender that is not associated, and acts at arm's length.

"The amount of debt that the borrower would be able to obtain [or would obtain] from a lender that is not associated shall be determined on the basis that such a lender takes no

¹⁵¹ Section 1(1).

¹⁵² Page 9.

¹⁵³ Page 10.

account of any guarantees (whether explicit or implicit) provided by an associated enterprise, nor of the borrower's membership of a group of associated enterprises."

2.75 It is interesting that this particular approach was favoured ahead of "approach 2" ("determining the borrowing capacity of [the company] on the basis that it is a subsidiary of a group of companies that enjoys an AAA rating"), despite what was then the fairly recent Canadian *General Electric* judgment (paragraph 3.16ff below). And it is more interesting still that only the following year the OECD Intangibles workstream produced an example adopting "approach 2" (paragraph 2.83 below). Maybe the fingerprints of HMRC can be detected on the 2012 draft (see paragraph 3.160 below)?

BEPS

2.76 As a reaction to a sustained political and media outcry about perceived tax avoidance by MNE groups, and against the background of stressed national budgets in the wake of the global financial crisis, in 2012 the leaders of the world's major economies, represented through the group of G20 finance ministers, called upon the OECD to develop an action plan to address Base Erosion and Profit Shifting ("BEPS") issues in a comprehensive and coordinated manner.

2.77 After an initial report in February 2013 (dramatically: "[w]hat is at stake is the integrity of the corporate income tax")¹⁵⁴, the OECD BEPS Action Plan¹⁵⁵ was published in July 2013. It has been an extraordinarily radical, intense and rapid programme of international tax reform, comprising 15 "Actions", backed by political determination at the highest levels from 44 countries representing the preponderance of global GDP¹⁵⁶. Moreover, the UN established a

¹⁵⁴ *Addressing Base Erosion and Profit Shifting*, page 8.

¹⁵⁵ *Action Plan on Base Erosion and Profit Shifting*. According to Owens (2015) (page 20) "[t]he multilateral instrument [contemplated by Action 15] will not include any provision dealing with transfer pricing, which conceptually means that, although soft law, the transfer pricing guidelines are considered sufficient to implement the changes needed". (I imagine the multilateral instrument may in fact address dispute resolution (Action 14).)

¹⁵⁶ The 44 countries comprise the 34 OECD members plus two OECD accession states (Colombia and Latvia) and the eight members of the G20 which are not OECD members (including the BRICS states). Using figures from IMF (2013), the aggregate of the BEPS countries' 2013 GDP figures was US\$83,681bn out of a global total of US\$101,934bn, or 82.1%.

Subcommittee on BEPS for developing countries and the OECD has developed a programme of active engagement with such countries.

2.78 Unsurprisingly, transfer pricing is a central focus of the BEPS project: it is self-evidently capable of producing base erosion and/or profit shifting! Moreover, “the use of interest (and in particular related party interest) is perhaps one of the most simple of the profit-shifting techniques available in international tax planning”¹⁵⁷. It has emphatically not been the BEPS plan however to abandon the arm’s length principle; instead, several aspects of transfer pricing were identified for investigation, notably in Actions 8, 9 and 10. These have respectively addressed intangibles, risk and capital and “other high-risk transactions”.

2.79 Yet none of this – aside from the materials on group synergies in the updated TPG (see paragraph 2.80ff below) - bears directly on the relevance of passive association. Action 4 promised to “limit base erosion via interest deductions and other financial payments”, and it was announced that “transfer pricing guidance will ... be developed regarding the pricing of related party financial transactions, including financial and performance guarantees”¹⁵⁸. On 5 October 2015 the OECD released its final report *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*. This presents a recommended “best practice” formulaic restriction of interest deductions by reference to a fixed ratio rule limiting deductions to a percentage of EBITDA (possibly supplemented by a worldwide group ratio rule). Developing countries have identified Action 4 as a priority area¹⁵⁹. But the review of transfer pricing for related party financial transactions “will be carried out as a separate project”¹⁶⁰.

¹⁵⁷ OECD’s discussion draft *BEPS Action 4: Interest Deductions and Other Financial Payments*, 18 December 2014, page 6.

¹⁵⁸ From the text of Action 4 in the *Action Plan* (note 155 above).

¹⁵⁹ OECD, *Strategy for Deepening Developing Country Engagement* (2014). www.oecd.org/ctp/strategy-deepening-developing-country-engagement/pdf (accessed 5 June 2015).

¹⁶⁰ December 2014 *BEPS Action 4* discussion draft, pages 8 and 66. See also note 169 below.

BEPS 2015 Final Reports: “MNE group synergies”

2.80 The OECD’s July 2013 discussion draft on the transfer pricing aspects of intangibles, now significantly modified and firmly integrated into the BEPS 2015 Final Reports, included proposed new material for Chapter I TPG¹⁶¹ addressing *inter alia* location savings, other market features, assembled workforce and MNE group synergies. That work was completed in the 5 October 2015 BEPS Final Reports. After some vigorous debate, it was concluded that these phenomena are not to be regarded as intangibles¹⁶² but instead are relevant to comparability analysis. The material on synergies now delivered represents new Section D.8 Chapter I TPG, including Examples 1 to 5.

2.81 Among the group synergies mentioned is “increased borrowing capacity”¹⁶³. It is also noted that while synergies are often favourable to the group, there may be circumstances where synergies have a negative effect¹⁶⁴. New paragraph 1.158 TPG, cross-referring to paragraph 7.13, prescribes that no intra-group service arises when a MNE group member:

¹⁶¹ In evidence to the Australian Senate’s Economics References Committee on 9 April 2015 Pascal Saint-Amans of OECD indicated that once consensus on changes to the TPG was achieved “it will mean that judges in Australia or in the US or in Europe will interpret the cases based on these new interpretations, so it will be implemented immediately – it will not need legislative translation” (transcript available at <http://parlinfo.aph.gov.au> accessed 5 June 2015) i.e. advocating a form of “ambulatory” approach. This is possibly an over-enthusiastic view of a wide range of national law approaches; compare paragraphs 2.84 and 3.157 below.

¹⁶² New paragraph 6.30 TPG. Kane (2014) offers a carefully reasoned rejection of the case for recognition of a form of “synergy intangible”. In 2007, group synergies barely merited a mention in the 2007 IFA General Report on *Transfer Pricing and Intangibles* beyond a passing reference on page 24 to “affiliate structure, not being intangible property for want of substantial independent value”.

¹⁶³ Paragraph 1.157 TPG. The International Alliance for Principled Taxation argued at page 5 of its 30 September 2013 submission to OECD that “if implicit parental support is relevant to the pricing of financial transactions, then it should be taken into account not only in the interest rate but also in the quantum of debt a borrower can support”. Submission signed by Caroline Silberztein (former head of the OECD’s transfer pricing unit) for the IAPT. Public comments available at www.oecd.org/tax/transfer-pricing/comments-intangibles-discussion-draft.htm (accessed 2 December 2015). Despite the new guidance, Andrew Hickman, head of the OECD’s transfer pricing unit, was recently quoted as saying “One of the thorny issues is the different views among delegates about how Article 9 and domestic transfer pricing rules apply to the quantum of debt in evaluating the pricing of the arrangements”: interview with BNA, TMTPR news archive, 14 December 2015.

¹⁶⁴ Paragraph 1.157 TPG; see paragraph 1.5 above. The reference to “increased borrowing capacity” is important in assessing the extent to which passive association may be relevant to questions of thin capitalisation. Paragraph 3.188 below notes HMRC’s current resistance to this.

“obtains incidental benefits attributable solely to its being part of a larger MNE group. In this context, the term incidental refers to benefits arising solely by virtue of group affiliation and in the absence of deliberate concerted actions or transactions leading to that benefit. ... Consistent with this general view of benefits incidental to group membership, when synergistic benefits or burdens of group membership arise purely as a result of membership in an MNE group and without the deliberate concerted action of group members or the performance of any service or other function by group members, such synergistic benefits of group membership need not be separately compensated or specifically allocated among members of the MNE group.”

2.82 A brief discussion of centralised purchasing power is interesting (for the comparison it presents), given the emphasis placed on “affirmative steps” or “deliberate concerted group action”¹⁶⁵, noting the distinction drawn between such arrangements and the effects of purely *passive* association. In the latter category is the case “[w]here a supplier unilaterally offers one member of a group a favourable price in the hope of attracting business from other group members, [where] no deliberate concerted group action would have occurred” (paragraph 1.160 TPG). Examples 3, 4 and 5 illustrate “deliberate concerted group action” in the purchasing power context¹⁶⁶. Observing that group synergies can include “streamlined management, elimination of costly duplication of effort, integrated

¹⁶⁵ “Deliberateness” is criticised by Feinschreiber and Kent (2014) page 37 as “too uncertain from a proof standpoint”, though I do not see it as especially more challenging in evidential terms than the plethora of factual issues in transfer pricing cases. The focus in paragraph 1.158 TPG is on the *absence* of deliberate concerted action. Incidental benefits could of course arise because of unilateral (unconcerted) actions.

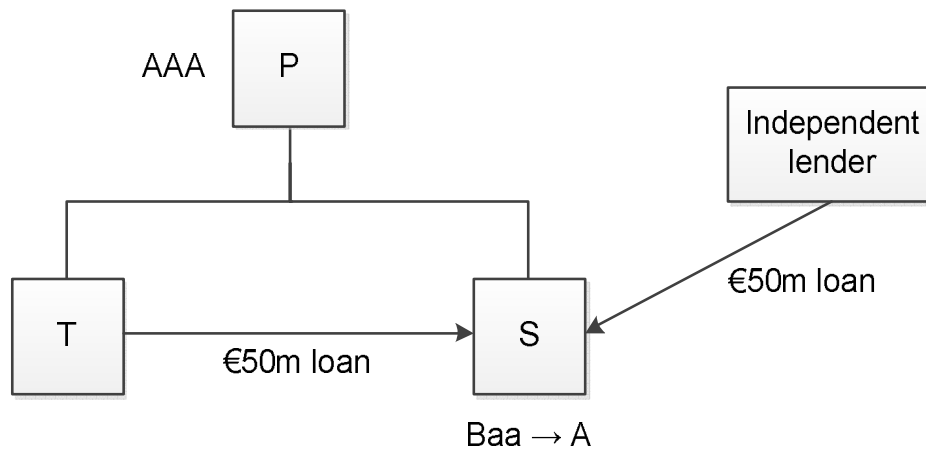
¹⁶⁶ Compare Example 19 in the US section 482 Services Regulations: paragraph 3.210(v) below. The Business and Industry Advisory Committee to OECD expressed concern in its 30 September 2013 comments on the July 2013 paper about the potentially blurred line between benefits of “scale” and cases of “deliberate concerted action” e.g. where a parent with substantial purchasing power merely “allows” a subsidiary to access discount arrangements with a supplier. Deloitte’s comments of 29 September 2013 proposed that “any action solely resulting from a unilateral decision of an unrelated supplier would by default be characterised as an incidental benefit, and therefore should then not deserve a specific comparability adjustment since it is the result of an unrelated party’s decision (which by nature is consistent with the arm’s length principle)”. Deloitte, KPMG and EY also criticised the presumption that the benefit of purchasing discounts should be shared between group members proportionately to purchase volumes as overly simplistic (but this is maintained in new paragraph 1.162 TPG). See note 163 for public comments website.

systems, purchasing or borrowing power ... [s]uch features should be addressed for transfer pricing purposes as comparability factors”¹⁶⁷.

2.83 Most tellingly, two examples, illustrated in Figs. II and III below, and surely inspired by the Canadian *General Electric* case¹⁶⁸ (especially Example 2, which essentially reflects the facts of that case), are provided in the financing area. These are highly relevant to this study.

Fig. II

“*Example 1*”



P is the AAA-rated parent of an MNE financial services group; S is a member of the group engaged in similar business on a large scale in an important market. On a stand-alone basis, S could support a credit rating of Baa but, because of its affiliations, large independent lenders will advance funds at interest rates that would be charged to independent borrowers with an A rating. S borrows €50m from an independent lender at such an interest rate and also borrows a similar amount from its sister company T on the same terms and conditions. Example 1 (paragraphs 1.164-166 TPG) asserts that the intra-group interest rate is arm’s length because it is the same as for the comparable loan from the independent

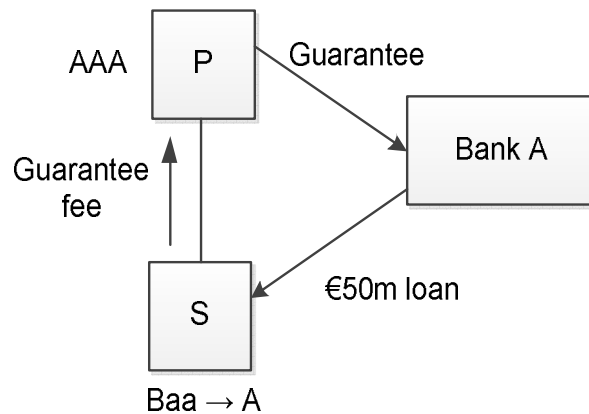
¹⁶⁷ New paragraph 6.30 TPG.

¹⁶⁸ Paragraph 3.16ff below.

lender; no payment is required for the group synergy benefit because it arises from group membership alone (consistent with TPG paragraph 7.13). The Example presents a clearcut utilisation of the CUP method, and an application of the “options realistically available” principle, taking into account an analysis of risk.

Fig. III

“Example 2”¹⁶⁹



Here, similarly-placed S borrows €50m from Bank A; Bank A would be prepared to lend to S at an A-rated interest rate (because of S’s affiliations). However, P guarantees the loan so S accesses an AAA-rated interest rate. S pays a guarantee fee to P. Example 2 concludes that this should reflect the benefit of raising S’s credit-standing from A to AAA (not Baa to AAA). The guarantee is a “deliberate concerted action”. This is manifestly based on *General Electric* and is a clear assertion of the recognition of passive association in pricing the intra-group provision of the guarantee.¹⁷⁰

¹⁶⁹ According to note 6 to the BEPS 2015 Final Reports, “Example 2 should not be viewed as providing comprehensive transfer pricing guidance on guarantee fees in respect of financial transactions. Further guidance will be published on transfer pricing for financial transactions including identifying the economically relevant characteristics for determining arm’s length conditions. This work will be undertaken in 2016 and 2017.”

¹⁷⁰ One potentially interesting extra twist is the possible effect on the *guarantor* of passive association from other affiliates: see e.g. Russo *et al* (2014). In other words, the credit

2.84 The adoption of these amendments to Chapter I TPG will not necessarily or automatically create binding transfer pricing law at the national level in all BEPS participant countries. Yet the changes will surely have a powerful effect in encouraging tax authorities and taxpayers to embrace the passive association recognition proposition.¹⁷¹

2.85 Despite the reference in new paragraph 1.157 TPG to “borrowing capacity”, the Examples themselves do not engage explicitly with the “thin cap” dimension to my enquiry mentioned at paragraph 1.20 above. Perhaps this will be an aspect of the forthcoming “additional consideration” promised by OECD in note 6 relating to Example 2. My Annex proposals include an additional Example on this.

standing of a guarantor entity (which will not necessarily be the ultimate parent company of a group) can be influenced by implicit support from elsewhere in the group. In their 1 October 2013 comments on the 2013 Intangibles discussion draft, Taxand pose an alternative supposedly problematic scenario in which a second subsidiary with an A-rating, rather than the AAA-rated parent, provides the guarantee. It is said that S is then no better off than it was by virtue of the implicit guarantee (which already enhanced S’s credit-standing to A); but the sister subsidiary guarantor will nonetheless require payment. The “true beneficiary” is said to be P, being “relieved of its implicit economic burden”. But this example fails to recognise that some value should attach to the guarantee reflecting the second-string recourse granted to the lender against another A-rated obligor: if S falls on hard times and defaults, its sister guarantor may still be good for the money. See note 163 for public comments website.

¹⁷¹ The continuing divergence of views on the recognition of passive association is apparent from the comments of BDO dated 6 February 2015 (contained at page 126 of the comments received by OECD on BEPS Actions 8-10, published 10 February 2015: <http://www.oecd.org/tax/transfer-pricing/public-comments-actions-8-9-10-chapter-1-tp-guidelines-risk-recharacterisation-special-measures.htm> (accessed 30 December 2015)): “We are concerned that the OECD is recommending the recognition of ‘implicit support’ provided to one company by other companies in the group ... This appears to deviate from the arm’s length principle ... Recognizing any ‘benefit’ from being part of a group of companies is a direct contradiction of the arm’s length principle that is ‘the’ foundation for the OECD Transfer Pricing Guidelines”.



United Nations

2.86 By 2001, the UN had concluded that “[f]rom a financial perspective transfer pricing is probably the most important tax issue in the world”¹⁷². In the tax treaty and transfer pricing fields, the UN has traditionally represented the interests of less-developed and developing economies, as something of a counterweight to the views of the “rich” countries articulated by the OECD¹⁷³. Several emerging world economic powers periodically express the view that their concerns are not fully addressed by ongoing international tax policy debate¹⁷⁴. In 1968 the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries was formed; their work in due course evolved into the UN Model, formally adopted in 1980 and revised in 2001. The Ad Hoc Group was upgraded in 2005 to become the Committee of Experts on International Cooperation in Tax Matters¹⁷⁵. There is a Subcommittee on Article 9, originally established in 2009 to work on the UN Manual (paragraph 2.90 below) and reconstituted in 2013. Its mandate is to “provide draft revised commentary on Article 9 and especially with regard to paragraph 1 of that article [and it] shall, in particular, take into account the common arm’s length principle embodied therein and in the corresponding Article of the OECD Model Convention”¹⁷⁶. A further revised version of the UN Model Double Taxation Convention referred to as the

¹⁷² UN (2001) page 2.

¹⁷³ See e.g. Wittendorff (2010a) page 95 on the origins of the UN Model, including the League of Nations 1943 Mexico Model and the subsequent 1946 London Model, the latter restricting the source state’s taxing rights, and the former representing the basis for the eventual UN Model.

¹⁷⁴ See e.g. Owens (2013), citing, illustratively, a March 2012 letter from the Indian tax authority to the UN regarding the UN Committee of Experts on International Taxation, at 20 TMTPR 1249, 1284 (2012).

¹⁷⁵ At the Financing for Development conference in July 2015, a proposal to replace the Committee with a fully-fledged global tax agency has been debated, though various countries, including the UK, are not supportive, see e.g. *The Guardian* 15 July 2015.

¹⁷⁶ E/C.18/2014/CRP.15, 21 October 2014, available at <http://www.un.org/esa/ffd/tax/tenthsession/index.htm> (accessed 26 July 2015).

2011 Update was issued in 2012, together with a Commentary which is “regarded as part of”¹⁷⁷ the Model. A future update to the Model is expected in 2017¹⁷⁸.

2.87 Article 9(1) of the UN Model is identical in form to Article 9(1) of the OECD MTC. The UN Commentary on Article 9 is substantially based on the OECD Commentary on the MTC, including reciting the OECD position on thin capitalisation (paragraph 2.11 above). Articles 11(6) and 12(3) of the UN Model are also the same as those in the OECD MTC. Yet in applying what one might expect to be a universal principle, several divergences of view emerge; the UN is sometimes criticised for promoting approaches which are hard to reconcile with arm’s length treatment¹⁷⁹. Nevertheless, a commitment to Article 9 and the arm’s length principle were reaffirmed in a call for feedback from developing countries in January 2014¹⁸⁰. The Secretariat to the Committee of Experts produced a note on 15 August 2014¹⁸¹ on the Article 9 Commentary update, standing by the arm’s length principle but shifting the emphasis a little from the previous recommendation that countries should follow the OECD TPG. The proposal was that the Commentary would “recognise the value” of the TPG while noting that they are “not the only source of guidance” and explicitly mentioning the UN Transfer Pricing Manual as providing “authoritative assistance in the field of transfer pricing”¹⁸². New paragraph 4 of the draft UN Commentary noted it to be “highly important for avoiding international double taxation of profits that a common understanding prevails on how the arm’s length principle should be

¹⁷⁷ Introduction to the 2011 version of the Model, paragraph 20.

¹⁷⁸ Economic and Social Council meeting on international cooperation in tax matters, 22 April 2015: E/2015/51 paragraph 19.

¹⁷⁹ See e.g. Liguori and Dicker (2014).

¹⁸⁰ Letter of 14 January 2014 from Stig Sollund, Coordinator of the UN Subcommittee on Article 9.

¹⁸¹ E/C.18/2014/4.

¹⁸² The US Council for International Business wrote on 24 October 2014 to the UN (available at: <http://www.un.org/esa/ffd/tax/tenthsession/index.htm> accessed 26 July 2015) objecting to the proposed changes as a “significant move away from the OECD’s Transfer Pricing Guidelines”, observing that the “broad consistency” proposed by the UN “is not necessarily consistency at all” and criticising “an attempt to retroactively change the status of the Manual”. At least “broad” has now been dropped: see paragraph 2.88.

applied, and that the two Model Conventions provide a common framework for preventing and resolving transfer pricing disputes where they would occur”.

2.88 The 10th session of the Committee in October 2014 decided to delete paragraph 3 of the UN Commentary on Article. This recited the view of the former Group of Experts that “the Contracting States will follow the OECD principles, which are set out in the OECD Transfer Pricing Guidelines”. The deletion of paragraph 3 was “because it could be read as suggesting that countries are bound to follow the [TPG]”. Nonetheless, the revision would confirm that the TPG contained “valuable guidance relevant for the application of the arm’s length principle under Article 9 of bilateral tax conventions”¹⁸³. In referring to the UN Manual, the Commentary will note the desirability of “consistency” with the TPG¹⁸⁴.

2.89 In identifying the origins of transfer pricing laws in both (i) several continental European countries which focused on extraordinary shareholder benefits, and (ii) specific rules introduced in the UK and the US, the UN has observed that:

*“both approaches are based on the concept of equal treatment or in the neutrality principle; shareholders with a controlling interest in a company are placed in the same position as other shareholders and controlled taxpayers are placed on a parity with uncontrolled taxpayers through application of the arm’s length principle which neutralizes the advantage of the former”*¹⁸⁵

2.90 On 29 May 2013 the UN *Practical Manual on Transfer Pricing for Developing Countries*¹⁸⁶ was launched. It significantly draws on the TPG e.g. as regards comparability analysis. The Article 9 Subcommittee is mandated to

¹⁸³ Bell (2014b); formally reported: E/2014/45-E/C.18/2014/6.

¹⁸⁴ *Ibid.*

¹⁸⁵ UN (2001) page 5.

¹⁸⁶ Available at www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf (accessed 23 July 2015).

provide its final updated draft Manual for discussion and adoption at the 12th annual session of the Committee of Experts in 2016¹⁸⁷.

2.91 The 11th session of the Committee, held in October 2015, has presented a draft chapter on intra-group services. It contains a section on passive association¹⁸⁸. The emphasis (like paragraph 7.13 TPG) is on how incidental benefits of association within an MNE group do not arise from the provision of a chargeable service, rather than going to the next step of analysing the effect of passive association on pricing controlled transactions. Nonetheless, it is noted that an “associated enterprise may be viewed by [an] independent supplier as a low risk customer that is unlikely to default on any trade credit”. And “[t]he passive association of an associated enterprise with its MNE group may improve the associated enterprise’s credit rating”. Examples are also given of “incidental follow-on benefits” arising to group members other than the primary beneficiary of a service. This new material should provide a strong foundation for recognising passive association effects in pricing transactions in countries that adhere to the UN approach.

2.92 Chapter 10 of the Manual is innovative, containing the individual country viewpoints on selected transfer pricing matters from Brazil, China, India and South Africa. See paragraph 3.143ff below on certain Indian perspectives relevant to this study.



European Union

2.93 In the direct taxation field, the most striking influence of European law has been exerted by the ECJ. In relatively recent years, the Court has ventured

¹⁸⁷ E/2015/51 paragraph 19.

¹⁸⁸ E/C.18/2015/CRP.12; paragraph 29ff, expected to be finalised in 2016.

into the thin capitalisation and transfer pricing arenas. The arm's length principle has acquired an important status in EU direct tax law. It has been adopted by the Court as a yardstick for testing artificiality and abuse, as well as the proportionality of national measures (see paragraph 2.103ff). Thus arriving at a consensus on the relevance of passive association to pricing will have an impact on these threshold issues. The jurisprudence of the Court has not, however, itself engaged with the passive association topic.

2.94 Despite the formulary apportionment inspired Common Consolidated Corporate Tax Base ("CCCTB") project¹⁸⁹, the EU has in general long been a supporter of the arm's length principle, and has concerned itself with the distortive or obstructive effects of asymmetric transfer pricing adjustments. According to the "Ruding Report":

*"[t]he establishment of the single market will involve ... expansion of cross-border flows of intermediate products and services within groups of firms ... transfer pricing within the Community is bound to assume greater importance. In this regard, the Committee supports the arm's length principle as the basis for determining transfer prices."*¹⁹⁰

2.95 The Ruding Committee expressed concern about divergent country practices:

"diversity of treatment within the EC could not only lead to distortions, but also to disputes between tax administrations on what is the appropriate transfer price to accept"

¹⁸⁹ Refreshed enthusiasm for which has been apparent following the Commission's Action Plan of 17 June 2015 *A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action* COM(2015) 302 final, which contemplates making CCCTB mandatory; a public consultation launched on 8 October 2015: http://europa.eu/rapid/press-release_IP-15-5796_en.htm (accessed 10 January 2016); and a European Parliament resolution of 16 December 2015 proposing a common corporate tax base as a first step towards a CCCTB: <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P8-TA-2015-0457+0+DOC+PDF+V0/EN> (accessed 11 January 2016).

¹⁹⁰ *Report of the Committee of Independent Experts on Company Taxation*, Chapter 10, Part III (page 205), Policy Recommendations, March 1992, Commission of the European Communities. The Committee saw the arm's length principle as "essentially a fair market value criterion that requires the hypothetical determination of prices" (page 40); compare e.g. Wittendorff (2011).

for the purposes of reaching a taxable base. This underlines the need for ... greater uniformity of transfer pricing practices under the arm's length principle."¹⁹¹

2.96 The arm's length standard is recognised explicitly in the 1990 multilateral Arbitration Convention¹⁹². Article 4 demands that "the following principles shall be observed in the application of this Convention", and Article 4(1) reproduces virtually *verbatim* Article 9(1) OECD MTC¹⁹³, while Article 4(2) reproduces in essential respects Article 7(2) OECD MTC in its pre-2010 format. The TPG are not referred to, but "[a]doption of OECD language means that interpretation is facilitated by reference to the OECD Commentary on these articles, and the various OECD studies on transfer pricing are implicitly recognised. In furtherance of this, a Code of Conduct¹⁹⁴ requires the arm's length principle 'as promulgated by the OECD' to be applied. Under Article 3(2) of the Convention, undefined terms are to take their meanings from the relevant bilateral tax treaty between the states concerned, which in turn, as far as transfer pricing is concerned, will take their meaning by reference to Article 9(1) MTC and thus, to the extent that the MTC Commentary and the TPG provide interpretative guidance, from those instruments. In principle, the Vienna Convention may also be brought to bear (paragraph 2.5 above and materials footnoted). The Arbitration Convention is expressed "to give effect to" Article 220 of the Treaty Establishing the EEC¹⁹⁵ (later Article 293 of the EC Treaty) which has now disappeared because that provision was not replicated in the TFEU. But this "is probably of no consequence for the validity of the Convention, as it is an instrument of ordinary international public law, for which (Member) States do not need any EU law

¹⁹¹ *Ibid.*, page 129.

¹⁹² Convention of 23 July 1990 on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises (90/436/EEC).

¹⁹³ There is a further echo of Article 9(1) MTC in Articles 78 and 79 of the European Commission's proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) (COM(2011) 121/4) which, although generally based upon the formulary apportionment model, must engage with conventional arm's length pricing for non-consolidated group members.

¹⁹⁴ See paragraph 2.109 below.

¹⁹⁵ "Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals ... the abolition of double taxation within the Community."

basis. ... [T]he Arbitration Convention is not an EU law instrument, but an ordinary, though multilateral, international public law instrument”¹⁹⁶. The ECJ is not competent to interpret the Convention¹⁹⁷, the Convention does not have direct effect, there is no deadline for implementation, and a State could unilaterally withdraw¹⁹⁸.

2.97 The Arbitration Convention could clearly play a role in a case where two Member States disagree over the recognition of passive association e.g. in relation to a parent company’s loan to a subsidiary. If the parent’s country refused to recognise such effects, but the subsidiary’s tax authority insisted that passive association should be taken into account to lower what would have been an interest rate based on stand-alone creditworthiness, the parent jurisdiction would be taxing more interest income than the subsidiary country permits the borrower to deduct - a classic form of economic double taxation.

2.98 Article 4(2) of the Interest and Royalties Directive¹⁹⁹ contains a “special relationship” rule essentially modelled on Articles 11(6)/12(4) OECD MTC²⁰⁰. Thus the arm’s length principle is applied in the same way to payments potentially within the Directive; so notions of passive association should equally be brought to bear in that context.

ECJ case law

2.99 The case law of the ECJ has engaged with transfer pricing and also on multiple occasions specifically with thin capitalisation. The arm’s length principle has become an important component in the Court’s jurisprudence on these topics. It has not however touched expressly upon the passive association concept.

¹⁹⁶ Terra and Wattel (2012) pages 367-368.

¹⁹⁷ Though query whether the Court might accept jurisdiction to ensure the Convention’s uniform application.

¹⁹⁸ Terra and Wattel, *ibid*, note 196 above.

¹⁹⁹ 2003/49/EC.

²⁰⁰ Implemented, for example, by the UK in section 763 Income Tax (Trading and Other Income) Act 2005.

2.100 In the direct tax field, the ECJ's principal task is to assess the compatibility of domestic law rules with the fundamental freedoms of the TFEU²⁰¹. It is plain that cross-border thin capitalisation and transfer pricing rules have the potential to operate as a restriction²⁰² on the fundamental EU freedom of establishment (Article 49 TFEU, companies or firms established in the EU being assimilated to individual nationals by Article 54), or conceivably the freedom to provide (lending) services (Article 56) or the free movement of capital (Article 63)²⁰³. Alternatively, transfer pricing/thin capitalisation rules could present discrimination on grounds of nationality.

2.101 Where national transfer pricing rules operate truly without regard to the location of the transaction parties, no unlawful restriction or discrimination will be present. But such cases demand a forensic analysis to determine whether in fact unjustifiable procedural or evidential disadvantages are still imposed upon cross-border situations, possibly resulting in indirect or covert discrimination or at least a restriction²⁰⁴ (see paragraph 3.173ff regarding the UK position). The freedom of establishment principle requires that foreign nationals and companies are treated

²⁰¹ But not generally to police the prevention of double taxation: see e.g. Case C-298/05 *Columbus Container Services BBVA v Finanzamt Bielefeld-Innenstadt*, paragraph 46; Case 513/04 *Kerckhaert & Moores v Belgium*, paragraph 20; Case C-128/08 *Damseaux v Belgium*, paragraphs 30, 33.

²⁰² “[N]ational measures that apply indiscriminately to all persons but which in fact hinder intra-Union trade”: HJI Panayi (2013) page 152.

²⁰³ Where national legislation is premised on a control relationship, and thus the ability to influence financing decisions, it is primarily freedom of establishment that is affected; thus restrictive effects on freedom to provide services and free movement of capital “must be seen as an unavoidable consequence of any restriction on freedom of establishment and do not justify an independent examination” of the legislation under Articles 56 or 63: see e.g. Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Inland Revenue Commissioners*, paragraphs 33-34. In Case C-282/12 *Itelcar*, free movement of capital was engaged because the Portuguese thin capitalisation rules under review encompassed situations beyond shareholding relationships. In Case C-492/04 *Lasertec*, the German national rules only applied to cases of “definite influence” and thus freedom of establishment was the relevant freedom, to the exclusion of free movement of capital. Compare Case C-452/04 *Fidium Finanz*, involving consumer loans from Switzerland to German borrowers: freedom to provide services was predominant so free movement of capital displaced; Case C-433/04 *Commission v Belgium*, where withholding on payments to contractors restricted freedom to provide services. See e.g. HJI Panayi (2007), and (2013) page 148ff, on identifying the relevant freedom.

²⁰⁴ See e.g. Tryfonidou (2014) on the separate notions of, and relationship between, “discrimination” and “restriction”: “‘discrimination’ can include discriminatory measures which do not lead to restrictions that are contrary to the free movement provisions, and ‘restriction’ can cover national measures that are not discriminatory” (page 386).

in the host Member State in the same way as nationals of that Member State; it also prohibits a Member State “of origin” from hindering (restricting) the establishment in another Member State of one of its nationals or a locally incorporated company²⁰⁵. Restrictions on such freedoms can, however, be justified if the national rules are aimed at wholly artificial arrangements designed to circumvent national tax rules, or by reference to securing the balanced allocation of taxing rights combined with the prevention of tax avoidance; but those rules must be *proportionate* to securing such objectives.

2.102 The leading modern ECJ authority on transfer pricing is the Court’s decision in *Société de Gestion Industrielle SA v Belgium*²⁰⁶ - the “SGI” case. The case concerned the legality, in light of the exercise of the freedom of establishment, of Belgian tax code provisions which served a transfer pricing function²⁰⁷ – expressed in terms of adjustment to a Belgian company’s income where it had granted an “unusual or gratuitous advantage” to a person outside Belgium. The Belgian company, SGI, had made an interest-free loan available to its French subsidiary and had paid allegedly excessive director’s fees to a significant Luxembourg shareholder. Advocate-General Kokott’s opinion noted²⁰⁸ that transfer pricing rules and treaty rules like Article 9 MTC can be tested for legality under [what is now] Article 49 TFEU. The Belgian rules, which only applied in a cross-border setting, were readily found by the ECJ to constitute

²⁰⁵ See e.g. Case C-196/04 *Cadbury Schweppes*, paragraph 42 and cases cited there.

²⁰⁶ Case C-311/08, representing a development of the earlier jurisprudence of the Court including Case C-347/04 *Marks & Spencer*; Case C-324/00 *Lankhorst-Hohorst* (where the German thin capitalisation rules were held unlawful despite a saving for cases where the taxpayer could have obtained the loan capital from a third party under similar conditions; the German and UK Governments argued that the relevant domestic law was an expression of Article 9 OECD MTC, but – other than to reject this as a basis for the “coherence” justification - the ECJ did not react in any detail to that argument: see e.g. Cordewener (2003)); the *Thin Cap* decision, note 203 above (where the ECJ at paragraphs 36-63 recognised that application of the arm’s length principle can be justified by overriding public requirements, and “accepted the arm’s length test as an objective and verifiable test of absence of artifice, the failing of which may give rise to a presumption that the loan arrangement is artificial”: Terra and Wattel (2012) page 383); and Case C-231/05 *Oy AA*. *Thin Cap* was recapitulated in Case C-105/07 *Lammers & Van Cleeff*, and in Case C-282/12 *Itelcar*.

²⁰⁷ Article 26 *Code des Impôts sur les Revenus* 1992.

²⁰⁸ Paragraph 52.

restrictions on both inward and outbound investment²⁰⁹. Nonetheless, the Court, noting the basis for *justification*²¹⁰ of a national measure where it specifically targets “wholly artificial arrangements designed to circumvent [national] legislation”, considered that the objective of preventing tax avoidance taken together with preserving the “balanced allocation” of the power to tax, could be a justification for a restriction on the freedom of establishment. The Belgian legislation in question was suitable to prevent “artificial arrangements [facilitating] income transfers ... within companies having a relationship of interdependence”.²¹¹

2.103 To be *proportionate* (and thus satisfy the Court that the legislation in question did not go beyond what was necessary to achieve justifiable objectives), the tax measure in question had to be confined to what was necessary to establish a result that companies would have agreed if acting “under fully competitive conditions”²¹² – apparently synonymous with, or approximating to, “at arm’s length”²¹³. Thus if arm’s length pricing is applied by a taxpayer, there is no room for the national legislation to impose an adjustment because the national measure must not go beyond the part of the price which exceeds what would have been agreed absent interdependence²¹⁴. The ECJ in effect accepted the arm’s length principle as a relevant indicator of whether “wholly artificial arrangements” were

²⁰⁹ *SGI* judgment, paragraphs 44-55.

²¹⁰ In Case 55/94 *Gebhard*, at paragraph 37, the ECJ summarised four conditions for justification of restrictive national measures, which must: (1) be applied in a non-discriminatory manner; (2) be justified by imperative requirements in the general interest; (3) be suitable for securing the attainment of the objective which they pursue; (4) not go beyond what is necessary in order to attain it.

²¹¹ Paragraphs 65-69. In *Cadbury Schweppes* (note 205 above) the UK CFC legislation was “suitable to achieve the objective for which it was adopted” (paragraph 59). In *Itelcar*, note 206 above, the Portuguese thin capitalisation rules were “capable of preventing practices the sole purpose of which is to avoid tax that would normally be payable on profits generated by activities undertaken in the national territory. It follows that such rules are an appropriate means of attaining the objective of combatting tax evasion and avoidance” (paragraph 35). Similarly, an unregulated ability to transfer tax losses across borders could be liable “to jeopardise a balanced allocation between Member States of the power to impose taxes”: Case C-446/03 *Marks & Spencer*, paragraph 46.

²¹² *SGI* judgment paragraph 71.

²¹³ The ECJ’s ruling in *Thin Cap* permitted interest disallowance “only so far as [the interest] exceeds what would have been agreed upon at arm’s length”.

²¹⁴ *SGI* paragraph 72.

targeted (satisfying the arm's length principle may itself demonstrate commerciality and thus displace the notion of "wholly artificial arrangements"²¹⁵), and as a limiting agent upon the extent of transfer pricing adjustments²¹⁶. "Clearly the judgment confirms that such cross-border transfer pricing provisions may be justified, even if they operate only cross-border and even if they have a restrictive effect, provided that they secure the balanced allocation of tax jurisdiction and they are necessary for combating tax avoidance."²¹⁷

2.104 In my view it follows (given the conclusion I reach in this thesis regarding the recognition of passive association as part of the arm's length principle) that if the tax law of EU country X restricts a borrower's interest deduction by refusing to accept that passive association effects may support a relatively high level of debt (i.e. refusing to take passive association into account in determining acceptable capitalisation), then this presents a *potential* claim for TFEU infringement where some difference of treatment between cross-border and domestic cases is apparent²¹⁸. Conversely, if an EU taxing jurisdiction attempts to impute an excessive interest rate to a lender by reference to an assumed borrower's (lower) credit rating on the basis of disregarding passive association (contrary, I say, to the arm's length principle), then equally its laws might contravene the TFEU. In short, national thin capitalisation and transfer pricing

²¹⁵ Thin capitalisation and transfer pricing legislation will not generally "have the specific purpose of preventing wholly artificial arrangements ... but [will apply] generally": *Lankhorst-Hohorst*, paragraph 37; *SGI* at paragraph 66 reflects this.

²¹⁶ This is all consistent with the thin capitalisation judgment in *Lammers & Van Cleeff*, note 206 above, which (citing *Thin Cap*, paragraph 80) noted that anti-abuse legislation may be justified where it renders interest non-deductible "only if, and so far as, it exceeds what those companies would have agreed upon on an arm's length basis", and that terms not corresponding to those which would have been agreed upon at arm's length constitute an objective and verifiable element in identifying a purely artificial arrangement" (paragraph 29). In *Thin Cap* the Court acknowledged that companies can structure their capital as they wish, but "this possibility reaches its limit when the company's choice amounts to abuse of law" (paragraph 69).

²¹⁷ Baker (2010). Note also that lack of legal certainty in national tax provisions may make them disproportionate: see Case C-318/10 *SIAT*, paragraphs 57-59, cited in Case 282/12 *Itelcar*, paragraph 44, where reliance on governmental extra-statutory practice left the Portuguese thin capitalisation rules disproportionate for lack of legal certainty.

²¹⁸ An ECOFIN resolution of 8 June 2010 noted that "thin capitalisation rules which observe the arm's length principle are capable of preventing tax avoidance, or maintaining the balanced allocation of taxing powers, or both": www.register.consilium.europa.eu/doc/srv?l=EN&f=ST_10597_2010_INIT (accessed 17 December 2015).

laws which require passive association effects to be left out of account²¹⁹ fail adequately to permit taxpayers to rely upon the arm's length standard in justifying a level of interest expense, so may go beyond what is proportionate, and are thus potentially (subject to the cross-border dimension) unlawful in the EU context.

2.105 A possible additional ingredient of proportionality is that, under the relevant national legislation, taxpayers must be given an opportunity to demonstrate the commerciality of their arrangements. One can argue from the ECJ case law that, even where a taxpayer's arrangements fall short of arm's length pricing, the national law must, to be proportional, permit the taxpayer to demonstrate a commercial justification for the arrangement²²⁰. *Lankhorst-Hohorst* is an example: the Dutch parent's loan to its German subsidiary was a "rescue attempt ... with the sole objective of minimising the expenses of [the subsidiary] and achieving significant savings in regard to bank interest charges"²²¹.

2.106 For the ECJ, the arm's length principle is perhaps not therefore the be-all-and-end-all. The blending of the principle into the justification recognised by the Court of the anti-abuse notion (which is to some extent dependent on the taxpayer's subjective motives) may translate into a permission to taxpayers to challenge justification by reference to their genuine commercial reasons for – or

²¹⁹ Such as the UK's sections 152(5) and 153(5) TIOPA: paragraph 3.160 below.

²²⁰ See e.g. *SGI*, paragraph 71. Section 13 Taxation of Chargeable Gains Act 1992 was found to fail to allow the taxpayer to demonstrate the economic reality of a shareholding: Case C-112/14 *Commission v UK*, paragraph 28. Henderson J at paragraph 60 of the High Court decision in *Thin Cap* describes how the abuse concept in the *Halifax* case (Case C-255/02) inspires the discussion: the arm's length principle is a "valid starting point". In Case C-103/09 *Weald Leasing*, the terms of the leasing transactions would be particularly likely to be contrary to the Sixth Directive if the rent was "unusually low or did not reflect any economic reality" (paragraph 39) i.e. "not at arm's length ... [the case] is important as the Court openly embraced the arm's length principle as a means of delineating elements that could go towards establishing the abusive nature of a transaction": HJI Panayi (2013) page 336.

²²¹ *Lankhorst-Hohorst*, paragraphs 14-15. Yet the majority in the UK Court of Appeal decision in *Thin Cap* thought that adherence to the arm's length principle was the only relevant test. O'Shea (2012-13) criticises HMRC's 2011 consultation document on CFC reform which, in Annex I, assumes that "wholly artificial arrangements" equate with that beyond what would have been agreed between parties at arm's length. O'Shea endorses the approaches of Henderson J in the High Court in *Thin Cap GLO* at paragraph 70 (arm's length test not a complete "proxy" for determining whether there was abusive tax avoidance) and of Arden LJ dissenting in the Court of Appeal (even where transaction not on arm's length terms, taxpayer must be given the opportunity to demonstrate commerciality: paragraph 108): see paragraph 3.172 below.

the “commercial rationality” of - a transaction²²². However, in the context of an MNE firm, “‘commercial rationality’ of related-party transactions – as pronounced by the ECJ in the afore-mentioned judgments - is not necessarily related to the arm’s length pattern. To the contrary, commercial rationality of transfer prices within firms has to follow the rationality of the firm itself, i.e. the specific reasons why the founders of the firm have put together a hierarchical and integrated entity in order to beat the operations of competitors in the open market”²²³. As regards the Court’s approach to the arm’s length principle it has been said that –

“[o]ne of the most striking features of Lankhorst is that the ECJ took into account the relevant commercial reasons behind the loan granted to the German subsidiary, even if, from an arm’s length point of view, a third party (for example, a bank) would not have granted the same loan to the German company. This conclusion, in itself, amounted to a significant departure from the OECD’s transfer pricing logic ... [I]f what the ECJ means by ‘commercial justification’ is that the subjective business reasons of the taxpayer (or its group) should be taken into account in the evaluation of transfer pricing policies, this would mean a significant departure from the OECD principles as established in the 1995 OECD TP Guidelines (or the 2009/10 OECD Draft TP Guidelines).”²²⁴

2.107 But I doubt that the ECJ should be accused of a “departure from logic”. The arm’s length principle, as informed by the OECD’s approach to transfer pricing, seems now clearly to be a reference point for non-discriminatory and non-restrictive national measures. Schön (2015) sees the ECJ viewing the OECD MTC

²²² See e.g. Boone et al (2010) page 187. Compare HJI Panayi (2013) page 356 expressing some uncertainty. Arguably, *SGI* does blur the analysis. Although at paragraphs 71-72 the Court enumerates (“first”) the taxpayer’s opportunity to demonstrate “any” commercial justification, and (“second”) the requirement that the legislation should only counteract excess expenditure beyond arm’s length conditions, it also accepted the proportionality of the legislation based on the Belgian Government’s position (paragraph 73) that the taxpayer had the opportunity to establish that no unusual or gratuitous advantage was involved (which somehow blends the two points together). Jiménez (2010) suggests (page 277) that “in *SGI*, the ECJ failed to make it clear whether the ‘commercial justification’ the taxpayer can provide as a defence for the prices used in transactions with associated entities is part of the arm’s length analysis (as one of the comparability factors) or is more a justification of the kind considered in *Lankhorst* (a non-tax reason for the transaction)”.

²²³ Schön (2011) page 35.

²²⁴ Jiménez (2010) page 276.

“as a sort of ‘gold standard’ for international tax allocation”²²⁵. “Commercial justification” has emerged as a potential taxpayer defence i.e. an escape-clause which must be available under national laws for the relevant rule to be sustainably proportionate. Although commerciality may of course overlap conceptually with arm’s length pricing to some extent, the concepts are not perfectly coincident. Instead, “commerciality” is at most an overlay which should be seen primarily as a limb of the Court’s formulation of proportionality rather than as an attempt to redefine the arm’s length standard.

2.108 Whether or not the jurisprudence of the ECJ “has moved transfer pricing control within the European Union into a corner where the arm’s length standard will gradually be eroded and has to be refined or replaced by another model”²²⁶, the recognition of passive association as a component of the application of the arm’s length principle of itself in no way generates any friction with EU law principles. Such recognition is, I contend, merely one component in the computation of an arm’s length price. It will thus operate in an even-handed way as between the respective taxing jurisdictions concerned with a cross-border transaction. Possibly the proposition favours the tax-take in countries in which borrowers rather than lenders are preponderantly situated (see paragraph 1.27, though compare paragraph 5.13), but, as between legal systems, the point of principle cuts both ways, fairly and without discrimination. It should therefore be seen as a refining element of objective transaction pricing which can be common to all national transfer pricing systems based upon the Article 9(1) OECD MTC format. From there, one can readily conclude that a failure to recognise the pricing effects of passive association, at least where any difference between national and cross-border cases is present, may itself deprive an EU government of the ability to justify national transfer pricing rules which could otherwise operate as a restriction on EU fundamental freedoms.

²²⁵ Page 275, and cases cited at note 43. Meussen (2010) at page 249 says “[t]he *SGI* case ... demonstrates that the ECJ accepts that the arm’s length principle is indeed a principle of EU law that gives Member States the tools to secure their tax bases in cross-border transaction [sic] between related companies”.

²²⁶ Schön (2011) page 8.

EU Joint Transfer Pricing Forum

2.109 The EU Joint Transfer Pricing Forum (JTPF) was created in 2002 with terms of reference focusing on practical problems rather than fundamental matters of principle. However, the brief as originally conceived extended to considering “the scope for improving and rendering more uniform transfer pricing methodologies within the OECD guidelines”²²⁷. The Commission has observed that variations in the interpretation and application of the arm’s length principle between countries, and between businesses and tax administrations, “can result in uncertainty, increased costs and potential double taxation or double non-taxation. These aspects impact negatively on the smooth functioning of the Internal Market”²²⁸. A recommendation of the JTPF led to the European Council adopting a Code of Conduct for the effective implementation of the Arbitration Convention²²⁹, which noted that “profit adjustments arising from financial relations, including a loan and its terms, and based on the arm’s length principle are to be considered within the scope of the Arbitration Convention”²³⁰, and “the arm’s length principle shall be applied, as advocated by the OECD, without regard to the immediate tax consequences for any particular Member State”²³¹. Still in 2014 “the approach adopted by EU Member States to correctly evaluate the price of [associated enterprises’ cross-border] transactions is that of the arm’s length principle”²³². The most recent report on the JTPF’s work programme²³³ focuses on the use of comparables in the EU, profit split methods, economic valuation methods and effective transfer pricing administration. Relevantly for this study, one important point identified by the JTPF’s work is the continued lack of

²²⁷ Commission Communication COM(2001) 582, 23 October 2001.

²²⁸ *Ibid.*

²²⁹ First adopted in 2004, then revised in 2009: 2009/C 322/01.

²³⁰ Paragraph 1.2.

²³¹ Paragraph 6.1(b).

²³² Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the work of the EU Joint Transfer Pricing Forum in the period July 2012 to January 2014 COM(2014) 315 final, page 2.

²³³ JTPF Program of Work 2015-2019 (“Tools for the Rules”), meeting of 25 June 2015 JTPF/005/Final/2015/EN. The OECD’s BEPS work on financial transactions will be “monitored and evaluated” to determine whether further work on this should be done by the JTPF (page 8).

uniformity concerning Member States' application of the Convention to thin capitalisation cases²³⁴.

2.110 There has not to date been any deeper JTPF investigation into the meaning of the arm's length principle. In any event, Wittendorff (2010a) notes that such an initiative may be problematic: “[f]irst, the value, as a source of law, of the JTPF's interpretation of the arm's length principle must be considered modest in relation to the Member States' tax treaties and, in most cases, in relation to transfer pricing provisions in domestic law. Second, it would not be appropriate to develop a consensus on arm's length rules in the EU which departed from the OECD Guidelines.”²³⁵ However, at the 42nd JTPF meeting in Brussels on 12 March 2015, a proposed topic for the future work programme was “financial transactions”²³⁶.

Other EU work

2.111 The Commission's 2007 Communication *The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries*²³⁷ summarised various propositions to be drawn from ECJ case law. In relation to financing arrangements, emphasis is laid upon whether terms and conditions “deviate from those that would have been agreed upon between independent persons”²³⁸ in testing whether a purely artificial arrangement is present. As an aspect of proportionality:

“adjustment to the taxable income as a result of the application of the anti-abuse rules should be limited to the extent that is attributable to the purely artificial arrangement.

²³⁴ The JTPF identified certain Member States excluding thin capitalisation from Convention resolution on the basis that such rules represented general anti-avoidance concepts (discussion paper JTPF/002/2013/EN section B.1) and recently noted “application of the AC to issues of thin capitalisation” as a “possible issue for consideration” (*Final Report on Improving the Functioning of the Arbitration Convention* JTPF/002/Final/2015/EN), and as an “open item” (“Tools for the Rules” report, page 11, note above).

²³⁵ Page 283.

²³⁶ Doc: JTPF/004/2015/EN.

²³⁷ COM(2007) 785 final.

²³⁸ Page 4, citing the *Thin Cap* case.

With regard to intra-group transactions, this means adherence to the arm's length principle".²³⁹

2.112 *Thin Capitalization Rules and Multinational Firm Capital Structure* (2014)²⁴⁰ is a report examining the impact of thin capitalisation rules limiting the deductibility of interest on the capital structures of foreign affiliates of US multinationals. It does not address passive association effects, but does interestingly distinguish between tax codes which apply an "automatic", or formulaic, approach and those which operate on a "discretionary" basis, said to mean a system based on comparisons with corporate indebtedness in arm's length situations. The "automatic" approach does not sit easily with the restriction in Article 9(1) MTC (where applied by a tax treaty) upon governments tempted to tax a greater amount of profits than those which would arise according to the arm's length standard (paragraph 2.7 above).

2.113 A newsworthy modern EU intervention into the transfer pricing world has been the invocation of concepts of unlawful state aid, particularly with regard to the rulings practices of certain national tax authorities. 2014 saw decisions from the Commission to initiate the procedure in Article 108(2) TFEU as regards the treatment by Ireland of Apple, Luxembourg²⁴¹ of Fiat and The Netherlands of Starbucks and Amazon²⁴². Decisions finding selective tax advantages have now

²³⁹ Page 5.

²⁴⁰ Commission Taxation Working Paper N.42-2014.

²⁴¹ See also the "LuxLeaks" company rulings revelations: <http://www.icij.org/project/luxembourg-leaks>, which may provide the Commission with further ammunition.

²⁴² C(2014) 3606 final (Apple); C(2014) 3626 final (Starbucks); C(2014) 3627 final (FFT) (all of 11 June 2014); C(2014) 7156 final (Amazon) (7 October 2014). The Commission brings to bear the concept of a "prudent independent operator acting under normal market conditions", stating that "market conditions can be arrived at through transfer pricing established at arm's length" (e.g. Starbucks, paragraphs (75)-(76)). The precise relationship between the prudent independent operator concept (which appears to have roots in the "market economy investor principle": see e.g. Slocock (2002)) and the arm's length principle remains unclear. Somewhat earlier Commission forays into transfer pricing are listed in Micheau (2014) page 198 and footnotes, including the *Forum 187* decision (Case C-217/03), where it was found that "the transfer prices do not resemble those which would be charged in conditions of free competition" (paragraph 96).

been made in the Fiat and Starbucks cases²⁴³. An investigation regarding McDonald's was announced on 3 December 2015²⁴⁴. None of these cases touches on the passive association topic however.

2.114 But the issue has arisen in the Commission's investigation into the Belgian "excess profit" rulings system. This allowed Belgian members of MNE groups to reduce their taxable profits by amounts attributable to the synergetic advantages of being a member of the group. The Commission has said that "[a]ccording to the Belgian authorities, this tax provision²⁴⁵ only implements the OECD 'arm's length' principle. However, at this stage the Commission doubts that this interpretation of the OECD principle is valid"²⁴⁶. Belgium referred to paragraphs 1.10, 7.12, 9.57 and 9.58 TPG to argue that "the attribution of synergies to individual group entities, which are only realised because a group entity is part of a larger group, is a very difficult exercise. Therefore, when analysing the tax situation of a 'tested party', Belgium adopted a stand-alone approach, leaving out the profits from synergies or economies of scale which are only realized not because of the activity itself but because the tested party is integrated in a larger group"²⁴⁷. The Commission for its part asserted that "Belgium does not apply the arm's length principle properly by excluding from the tax base profits resulting from synergies and economies of scale"²⁴⁸. The Commission appeared, therefore, to be promoting the notion that a company benefiting from group synergies should retain such benefits in an application of the arm's length principle.

²⁴³ Decisions of 21 October 2015 available at www.europa.eu/rapid/press-release_IP-15-5880_en.htm (accessed 8 November 2105).

²⁴⁴ www.europa.eu/rapid/press-release_IP-15-6221_en.htm (accessed 17 December 2015).

²⁴⁵ Article 185§2,b *Code des Impôts sur les Revenus* 1992, which authorises a form of unilateral downward adjustment.

²⁴⁶ Commission press release 3 February 2015 available at http://europa.eu/rapid/press-release_IP-15-4080_en.htm (accessed 12 June 2015) and letter of the same date C(2015)563 (final).

²⁴⁷ Letter of 3 February 2015, paragraph (36).

²⁴⁸ *Ibid.*, paragraph (71).

2.115 Translating the Commission’s stance into the passive association/debt financing context, a Belgian subsidiary which the market would expect to be the beneficiary of parental support should enjoy a commensurately reduced financing cost (the 7% rate in Fig. I, paragraph 1.14 above). It will be interesting to see how far the Commission presses this argument. Their attitude is presumably coloured to some extent by the way that “the deductions granted through the excess profit ruling system usually amount to more than 50% of the profits covered by the tax ruling and can sometimes reach 90%”. On 11 January 2016 the Commission announced its decision that the Belgian scheme illegally granted selective tax advantages to at least 35 MNEs. The press release²⁴⁹ observes that the scheme departed from “the ‘arm’s length principle’ under EU state aid rules” because excess profits generated by group synergies should be shared according to economic reality, not “discounted unilaterally from the tax base of a single company”. This suggests that the Commission stands by the arm’s length principle in general, and in doing so maintains that profits attributable to a Belgian enterprise’s share of group synergies should indeed remain within the Belgian tax net. This appears supportive of the proposition that passive association should be taken into account in pricing transactions, i.e. that, where passive association benefits are present, the consequent economic effect on the profile of the beneficiary company should be respected as part of the factual matrix. At the date of writing the formal decision is unavailable.

Conclusions

2.116 The OECD’s BEPS 2015 Final Reports, including material on group synergies added to Chapter I TPG, have clearly articulated the appropriateness of recognising passive association in pricing a controlled transaction. The *General Electric Capital Canada* case is obviously the inspiration. Other more long-standing pillars of the arm’s length principle (tax parity, the counteraction of price distortions caused by the exercise of control, options realistically available) on a careful analysis all militate in favour of the recognition of passive association.

²⁴⁹ At: http://europa.eu/rapid/press-release_IP-16-42_en.htm (accessed 11 January 2016); decision under case number SA.37667 to follow.

One might reasonably be quite surprised therefore at the extent of ongoing controversy surrounding the topic²⁵⁰, and the divergence of national opinions.

²⁵⁰ E.g. HMRC's persistent position that implicit support cannot affect borrowing capacity.

3. ANALYSIS OF RELEVANT LEGISLATION, CASE LAW AND TAX AUTHORITY PRACTICES FROM SELECTED COUNTRIES

“The question asked by the ‘arm’s-length’ method is whether, if you had a brother, he would like cheese.”²⁵¹

Introduction

3.1 This chapter reviews in detail the legislation, case law and tax authority practices that bear on the effects of passive association in transfer pricing in six common law countries (Australia, Canada, India, New Zealand, the United Kingdom and the United States²⁵²). While some introductory exploration of the basic workings of the respective countries’ transfer pricing rules is necessary, it is beyond my scope to provide comprehensive narrative on the workings of national codes.

3.2 The object is to learn from a comparative study. To the extent that transfer pricing laws are founded on tax treaties, especially where the format of Article 9(1) MTC, or its analogues, is adopted, and in any event where laws require the application of the arm’s length principle, one is dealing with the interpretation of a form of “uniform” law.

“Such laws result from international conventions, governmental cooperation, or supranational or international legislation, and since the underlying aim is to unify law, their construction and development must be geared to this goal. This means that when a national judge is faced with a uniform law, he must not simply deploy his trusty old national rules of construction but modify them so as to arrive at an internationally acceptable result which promotes legal uniformity. This often calls for a comparative law interpretation: the judge must look to the foreign rules which formed the basis of the provision to be applied, he must take account of how courts and writers abroad interpret

²⁵¹ Rosenbloom (2004) page 28, alluding to the US “cheese examples” in Regs. §1-482-4(f)(3)(iv) 68 FR 53447, examples (2), (3) and (4), prior to rewriting of the regulations governing services, now at Regs. §1.482-9. See paragraph 3.210 and note 705.

²⁵² In the case of Canada and the US, analysis is confined to federal income taxes, not state or provincial taxes.

it, and he must make good any gaps in it with general legal principles of law which he has adduced from the relevant national legal systems."²⁵³

3.3 The discussion below begins with Canada because of the singularly developed state of case law there bearing on passive association. The Tax Court's 2009 decision in *General Electric Capital Canada* (paragraph 3.16ff below) served as catalyst for the international debate. The other common law jurisdictions are then considered alphabetically²⁵⁴. All the selected countries are OECD members, other than India, which provides contrast in being a leading, but developing, world economy which resists unquestioning and wholesale acceptance of OECD norms; instead it has traditionally preferred the international tax constructs promoted by the UN – which tend somewhat to favour “source”-based taxation. India is nonetheless an “observer” at OECD, regarded as a “key partner” and is an active participant in the BEPS project.

3.4 It is apparent from this comparative research that (i) there is a high degree of consistency between the selected countries as regards statutory implementation of the arm's length principle in general; (ii) Canada and Australia aside, the courts have yet to engage with the task of recognising passive association as a factor in the proper pricing of controlled transactions; (iii) none of the countries considered explicitly rejects the recognition of passive association; and (iv) in most, regulation or tax authority practice support recognition to a greater or lesser extent.

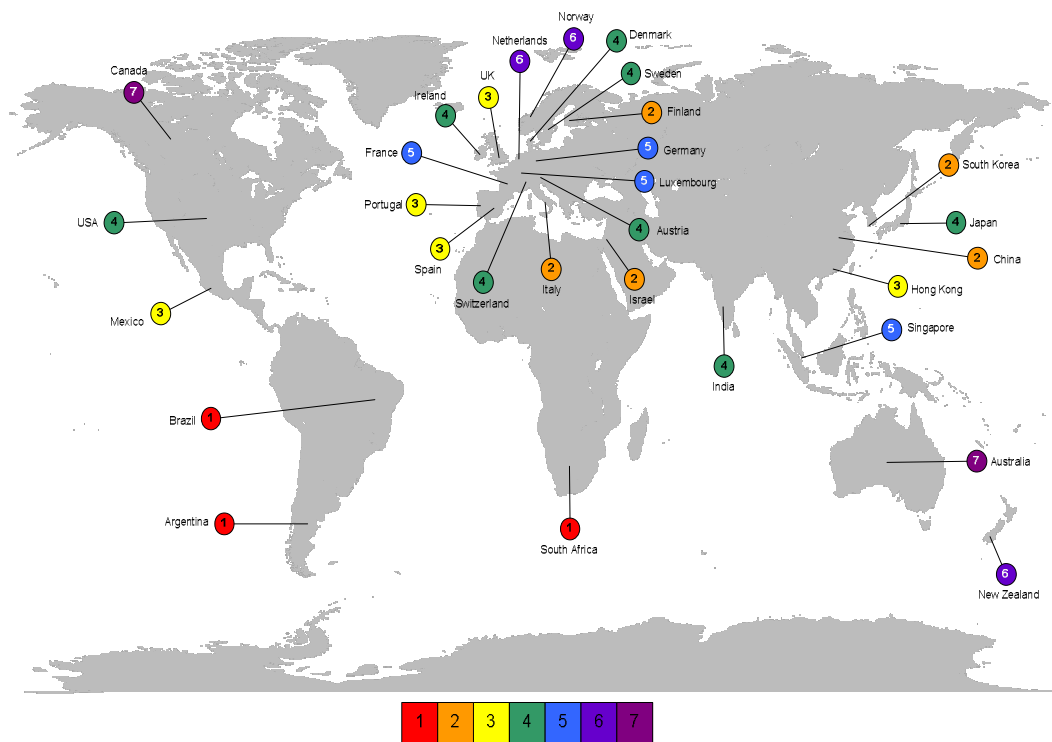
3.5 Fig. IV illustrates in a very high level manner the degree of recognition, in national tax systems, of passive association in the transfer pricing context. The

²⁵³ Zweigert and Kötz (1998) page 21. Avery Jones (1984, page 101) observes that foreign case law can rank as a supplementary means of interpretation under Article 32 of the Vienna Convention.

²⁵⁴ Also, Zweigert and Kötz, page 19: “Courts in England, Australia, Canada, and other commonwealth countries have long made reciprocal reference to each other's decisions and are now invoking continental law to a remarkable degree.” Moreover, “decisions of foreign courts on the interpretation of a convention or treaty text depend for their authority on the reputation and status of the court in question”: Lord Diplock in *James Buchanan & Co Ltd v Babco Forwarding & Shipping (UK) Ltd* [1987] AC 141, 295, cited in *CIR v Commerzbank AG* [1990] STC 285. See also the *T (A.P.) v Immigration Officer* case, note 58 above. In the transfer pricing context see e.g. the Canadian Federal Court of Appeal decision in *GlaxoSmithKline Inc v The Queen* 2010 FCA 201 paragraph [80] referring to the Australian *Roche* case (paragraphs 3.30, 3.73 below respectively) .

indicators are numbered (1 to 7) and colour-coded to represent the state of development of tax systems to accommodate passive association in this way: 1 = least degree of recognition, including rejection of passive association as a pricing factor; 4 = little or no developed law or practice or official ambivalence; 7 = full recognition. This scoring is inherently impressionistic, but attempts a fair evaluation based upon the selective country survey in this chapter and, for other countries, summary narratives contained in BNA Bloomberg's *Transfer Pricing Forum* on the topic of implicit support, and PwC's *Navigating the Complexity* survey (2013)²⁵⁵.

Fig. IV



²⁵⁵ As regards divergent country approaches to thin capitalisation see e.g. Lund, Korsgaard and Albertsen (2008), the IFA 2008 *Cahiers*, vol. 93b and Zielke (2010).

3.6 The *Transfer Pricing Forum* survey was reported²⁵⁶ as finding that, of the 23 countries reviewed, 11 (Australia, Austria, Germany, Ireland, Luxembourg, Mexico, the Netherlands, Portugal, Singapore, the USA and the UK) would usually reduce a guarantee fee, paid by a subsidiary to a parent, to the extent an arm's length lender would assume a level of implicit support for the borrower. Six (Argentina, Denmark, Japan, South Africa, South Korea and Switzerland) would assess a borrower's creditworthiness on a stand-alone basis. And the positions of another six countries (France, Hong Kong, India, Israel, Italy and Spain) are unsettled. I have tried in the world map diagram above to adopt a slightly more nuanced evaluation.



Canada

3.7 For a comprehensive survey of Canadian transfer pricing law and practice, see François Vincent's excellent *Transfer Pricing in Canada*²⁵⁷. What follows attempts to pick out key elements of the jurisprudence relevant to the passive association controversy.

3.8 Canada has led the world in developing law on this topic. The *General Electric* case (paragraph 3.16ff below) ignited the debate, and subsequent decisions of the courts have entrenched the reasoning adopted. In essence, passive association, or the implicit support that may be considered to be derived from passive association, must be recognised as an economically relevant circumstance in a comparability analysis when pricing controlled transactions.

²⁵⁶ Bell (2014a).

²⁵⁷ Carswell (2013).

Legislation

3.9 The transfer pricing provisions in the legislation govern and are determinative of the approach to be taken by a court, not any particular methodology or commentary from the TPG²⁵⁸. The TPG have nonetheless been referred to and relied upon by the Canadian courts to inform the application of domestic legislation²⁵⁹.

3.10 The central modern Canadian transfer pricing rule is section 247 Income Tax Act²⁶⁰ (*ITA*). It is heavily influenced by the 1995 version of the TPG²⁶¹. The key operative rules are in subsection (2), set out below (omitting material relevant to partnerships, and also the statutory transaction

²⁵⁸ Opinion of the Supreme Court per Rothstein J in *GlaxoSmithKline Inc v The Queen* 2012 SCC 52 at paragraph [20]: “The Guidelines are not controlling as if they were a Canadian statute and the test of any set of transactions or prices ultimately must be determined according to S.69(2) rather than any particular methodology or commentary set out in the Guidelines”. Per Boyle J in *McKesson* at paragraph [120] (also citing *GlaxoSmithKline*): “I would add that the OECD Commentaries and Guidelines are written not only by persons who are not legislators, but in fact are the tax collection authorities of the world. Their thoughts should be considered accordingly.” Boidman and Kandev (2013) at footnote 62 note that it is conceivable that a different approach might be taken to the modern Canadian transfer pricing rule in section 247 ITA. In *Marzen Artistic Aluminium Ltd v The Queen* 2014 TCC 194 it was said of the TPG that they “do not have the force of law but rather are intended as tools to assist in determining what a reasonable business person would have paid if the parties to a transaction had been dealing with each other at arm’s length” (paragraph [177]). Outside the transfer pricing arena, in *Prévost Car Inc v The Queen* 2009 DTC 5721 the Federal Court of Appeal was willing to recognise the potentially persuasive effect of the MTC Commentaries even where changes occurred subsequent to adoption of the treaty in question if the material could be regarded as clarifying or better informing the relevant provision (see on this Wilkie (2009) page 399). Nat Boidman pithily put the point to me as follows: “The SCC in *Glaxo* post-dates all prior FCA comments on OECD and basically tells the courts below that they can look at OECD if they would like, but they are not bound by it.”

²⁵⁹ Bakker and Levey (2012), Canada chapter by members of Osler, Hoskin & Harcourt LLP, page 142. Indeed this is true (by reference to the 1995 version of the TPG) in *GlaxoSmithKline* itself. See also Rip ACJ’s approbation, in *GlaxoSmithKline* before the Tax Court, of the Federal Court of Appeal’s confirmation in *SmithKline Beecham Animal Health Inc v Canada* 2002 FCA 229 that the OECD Commentary should inform the interpretation and application of section 69(2). The Supreme Court of Canada in *Crown Forest Industries Ltd v The Queen* [1995] 2 CTC 64 used the MTC Commentaries to determine the proper interpretation of the Canada-US tax treaty. Given the adoption by paragraph 1 of the Commentary on Article 9 MTC of the TPG, it is possible that, where a tax treaty applies to a particular case, the TPG may even prevail over the ITA via the application of the legislation which implements the relevant treaty: Vincent (2013) page 147.

²⁶⁰ R.S.C. 1985, c.1 (5th Supp).

²⁶¹ Bloom and Vincent (2012), section A.1(a), citing the Supplementary Information to the 1997 Federal Budget: one of the Government’s objectives was to “harmonize the standard contained in section 69 of the Act with the arm’s length principle as defined in the [1995] revised OECD Guidelines”.

recharacterisation rule in section 247(2)(b) and (d), neither of which is needed for present purposes²⁶²):

“Where a taxpayer ... and a non-resident person with whom the taxpayer ... does not deal at arm’s length²⁶³ are participants in a transaction or a series of transactions and

(a) the terms or conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm’s length ...

any amounts that, but for this section and section 245, would be determined for the purposes of this Act in respect of the taxpayer ... for the taxation year or fiscal period shall be adjusted (in this section referred to as an ‘adjustment’) to the quantum or nature of the amounts that would have been determined if,

(c) where only paragraph 247(2)(a) applies, the terms and conditions made or imposed, in respect of the transaction or series, between the participants in the transaction or series had been those that would have been made between persons dealing at arm’s length ...”.

3.11 It is worth also noting the predecessor rule – dating from 1972 - in section 69(2) ITA. Some of the case law relates to that provision²⁶⁴. Taking the 1985 version²⁶⁵ of the provision for comparison:

“Where a taxpayer has paid or agreed to pay to a non-resident person with whom the taxpayer was not dealing at arm’s length as price, rental, royalty or other payment for or

²⁶² There is also a no charge safe harbour for loans to foreign subsidiaries engaged in active business and guarantees of third party loans to such subsidiaries: sections 247(7) and 247(7.1).

²⁶³ Paragraph (a) of section 251 ITA deems related persons (including those in a *de jure* control relationship) not to be dealing at arm’s length with each other. In *Highland Roofing Ltd v MNR* 1998 TCC 310 at paragraph [20] the court referred to Revenue Canada’s use of the notion of a “common mind which directs the bargaining for both parties to the transaction” in Interpretation Bulletin IT-419 as an indicator of not dealing at arm’s length. The court noted that *MNR v Sheldon’s Engineering Ltd* 55 DTC 1110 (SCC) and *MNR v Merritt Estate* 69 DTC 5159 (Ex. Ct.) “basically stated that where the same mind that directs the negotiations or bargaining for one party is the same mind that controls negotiations for the other party, then the Court must conclude that there is a common mind and that the parties do not deal with each other at arm’s length”. Note here the flavour of pricing being distorted by the exercise of control.

²⁶⁴ Notably *GlaxoSmithKline*, paragraph 3.30 below.

²⁶⁵ If only because this was the version under consideration in *The Queen v GlaxoSmithKline* 2012 SCC 52.

for the use or reproduction of any property, or as consideration for the carriage of goods or passengers or other services, an amount greater than the amount (in this subsection referred to as ‘the reasonable amount’) that would have been reasonable in the circumstances²⁶⁶ if the non-resident person and the taxpayer had been dealing at arm’s length, the reasonable amount shall, for the purpose of computing the taxpayer’s income under this Part, be deemed to have been the amount that was paid or is payable therefor.”

3.12 Section 69(3) then provided the converse rule to cover cases where the non-arm’s length non-resident had not paid to the Canadian taxpayer an amount equal to or greater than the “reasonable amount”, adjusting the taxpayer’s income to reflect the reasonable amount.

3.13 In *Alberta Printed Circuits Ltd v The Queen*²⁶⁷ it was said by the judge that the Federal Court of Appeal in the *General Electric* case confirmed “there is no meaningful difference between paragraphs 247(2)(a) and (c) and subsection 69(2) of the Act”. In fact the Federal Court of Appeal in *General Electric* merely observed that the parties had agreed, and the Tax Court judge had accepted, that “for present purposes” there was no meaningful difference. Bloom and Vincent (2012)²⁶⁸ note that the Australian Federal Court in the *SNF* case²⁶⁹ considered that subsections 69(2) and (3), in contrast to the Australian transfer pricing rules, posited an arm’s length price between the actual parties to the controlled

²⁶⁶ The “reasonable in the circumstances” component does not appear in section 247(2), but it has been suggested that this is implicit in the comparative exercise mandated by the adoption of the arm’s length principle in that provision: Tobin (2012); Bloom and Vincent (2012) section A.1(b). See also Wilkie (2009) page 397: “The reference to ‘reasonable in the circumstances’ imported the possibility that the particular circumstances of a taxpayer might well explain and justify an outcome for that taxpayer almost in spite of what strict transactional pricing, as now understood, might recommend and despite how other seemingly similar taxpayers might be treated.” Boidman (1987) considers that “reference in the provision to arm’s length dealing ... seems to contemplate the price which a reasonable person would have agreed to in the same circumstances and in order to maximise his own profit where he has a separate economic or profit interest” (page 451).

²⁶⁷ 2011 TCC 232 at paragraph [147] citing paragraph [12] in *General Electric* 2010 FCA 344.

²⁶⁸ At section 2(b).

²⁶⁹ Paragraph 3.74ff below.

transaction rather than as between undefined arm's length persons (as in paragraphs 247(2)(a) and (c))²⁷⁰.

3.14 The question normally asked by paragraphs 247(2)(a) and (c) has been described as: “[a]ssuming all of the (non-price) terms and conditions remain constant, what would have been the price or results of the controlled transaction had it been concluded by persons dealing at arm's length with each other?” – also referred to as a “*ceteris paribus* approach”²⁷¹.

3.15 Canada operates a separate statutory code governing thin capitalisation²⁷². This is essentially formulaic, applying a debt:equity ratio limit of 1.5:1, rather than relying on the arm's length standard to determine borrowing capacity²⁷³, and so is beyond the scope of this study.

Case law

3.16 It is not the chronologically first important Canadian transfer pricing case²⁷⁴, but *General Electric Capital Canada Inc v The Queen*²⁷⁵ deserves – internationally - pole position in the collection of case law relevant to the recognition of passive association as a pricing factor²⁷⁶. I hesitate to assume, regarding the facts, that “only aliens from other galaxies could possibly be unfamiliar with them”²⁷⁷, so briefly scene-set here by noting that the case concerned the deductibility in Canada of 1% p.a. fees (amounting to C\$136.4m) paid to the taxpayer company's AAA-rated US parent for the provision of a

²⁷⁰ Though this seems at least arguable given the hypothetical “would have been” and “if [the parties] had been dealing at arm's length”.

²⁷¹ Bloom and Vincent (2012), section 2(a).

²⁷² Section 18(4)–(8) ITA.

²⁷³ Other quantitative rules may be relevant to the tax treatment of interest e.g. section 80.4(2) ITA, which operates by reference to a “prescribed rate” rather than the arm's length standard.

²⁷⁴ Some early cases are summarised in Baistrocchi and Roxan (2012) page 122ff.

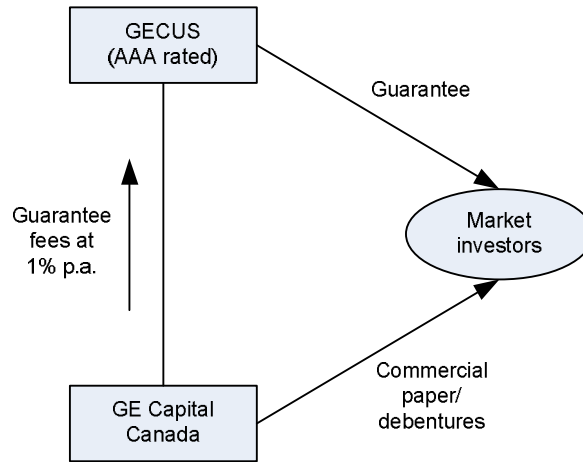
²⁷⁵ 2009 TCC 563, affirmed 2010 FCA 344.

²⁷⁶ The Australian *Chevron* case notwithstanding: paragraph 3.82ff below.

²⁷⁷ Tremblay (2011).

formal guarantee in favour of third party holders of the Canadian company's debentures and commercial paper.

Fig. V

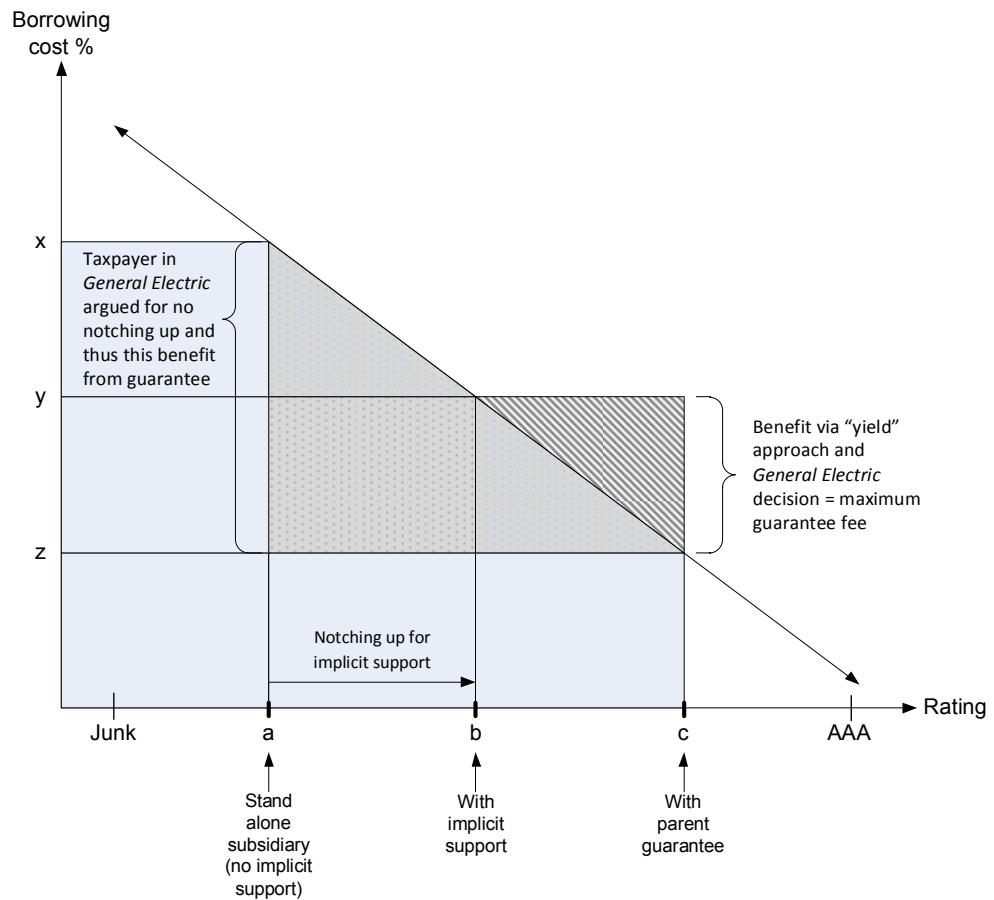


3.17 The Canadian subsidiary did not have its own formal credit rating but, after hearing and evaluating substantial expert testimony, the Tax Court concluded that its rating absent the guarantee would be in the range BBB/BB+. This represented an uplift from its “stand-alone/status quo” rating to take account of implicit support of three notches on a standard scale of the type operated by Standard & Poor’s²⁷⁸. Of the various pricing methodologies put before it, the court preferred a “yield” approach under which the interest cost savings to the appellant attributable to the parent guarantee based on a ratings differential between BBB-/BBB+ and AAA (the parent’s rating) was approximately 1.83% (y – z, in Fig. VI below). Accordingly the 1% p.a. fee did not exceed an arm’s length price as the appellant enjoyed a significant net economic benefit from the arrangement; thus the taxpayer’s deduction for the fee was upheld²⁷⁹.

²⁷⁸ 2009 TCC 563, paragraph [301].

²⁷⁹ The yield approach in principle only provides an upper bound for the fee a borrower would pay.

Fig. VI²⁸⁰



CRA in *General Electric* argued for notching up to point “c”, thus equalisation of ratings, thus no benefit/value in guarantee.

3.18 “At the centre of the dispute was the issue of whether, in determining an arm’s length price, taxpayers should disregard altogether the factors which are particular to the relationship between them or whether those factors form the framework in which an arm’s length price is determined.”²⁸¹ The Court found it straightforward to dismiss the CRA’s contention that the economic effect of passive association was so strong that the creditworthiness (and thus rating) of the Canadian subsidiary should be equalised with that of its US parent. Also

²⁸⁰ Intended as a general illustration. In fact the correlation between rating and borrowing cost will not be linear as depicted. And in the *General Electric* case, as described above, point “c” was in fact the AAA rating of the US parent company.

²⁸¹ Brooks (2013) page 135.

dismissed was the Crown's alternative argument that the Court should make adjustments to any interest rate differential to take account of benefits flowing to the US parent under the arrangement. The taxpayer, on the other hand, had argued that passive association should be disregarded: "[a]ll distortions that arise from the parties' relationship must be eliminated to arrive at an arm's length result"; and that the Crown's argument, based upon parent company benefits, should similarly be dismissed because such benefits, e.g. the prospect of higher dividend income, arose because of share ownership and again therefore should be ignored²⁸².

3.19 Justice Hogan articulated the choice between two opposing positions:

*"Do all of the economically relevant factors have to be considered in the definition of an arm's length price for the transaction in order to arrive at a meaningful comparison, as suggested by the Crown? Does the scheme of paras 247(2)(a) and (c) suggest that all factors which are particular to the non-arm's length relationship must be discarded, as suggested by counsel for the appellant?"*²⁸³

3.20 After observing that "dealing at arm's length" refers to how independent parties negotiating in the marketplace would behave, such that the arm's length principle is tied to modern economic theory, including cost-benefit analysis, considering available alternatives and seeking out relevant information²⁸⁴, the judge found that what was required was "identifying the economically relevant characteristics of the transaction that may influence the arm's length parties in their negotiation". Thus, counsel for the appellant "misapplied the arm's length principle when he suggested to me that the concept of 'implicit support' should be ignored because it is rooted in the non-arm's length

²⁸² 2009 TCC 563, paragraphs [173]-[175]. Al Meghji, counsel for GE, asserted in argument that "[t]he real question here is: Should [GE] Canada have to pay for accessing the parent's balance sheet, or should they [have a] free ride?" (Quoted from the trial transcripts in Menyas (2009a).) I would say, and the court concluded, that the answer is (1) "yes" of course it must pay as regards the express guarantee, but (2) "no" it need not pay as regards the benefit already conferred by parental implicit support. Whatever one feels as a policy matter, the "free ride" is a fact of business life. See further paragraph 4.49(v) below.

²⁸³ *Ibid.*, paragraph [187].

²⁸⁴ The judge also cited paragraph 1.6 TPG as the basis for adjusting profits "by reference to the conditions which would have obtained between independent enterprises in comparable transactions in comparable circumstances", and paragraph 1.15 TPG as "reinforcing" this principle: TCC decision, paragraph [204].

relationship. That concept has nothing to do with the exercise of *de facto* or *de jure* control which defines a non-arm's length relationship. The reputational pressure is exerted by GECUS' debt holders. It is GECUS' debt holders that would react negatively if the appellant was allowed to default on its debt"²⁸⁵.

3.21 The statement that implicit support has “nothing to do with” the phenomenon of control is controversial, or at least, as one prominent commentator archly put it, “the logic in this part of the judgment is hard to follow”²⁸⁶. In fact there is not really any articulation in the judgment of the logic of the proposition, beyond the judge's view that counsel for the appellant over-simplified the corporate law applicable to the appellant because, despite a general power to appoint and remove directors, a shareholder did not have power to run the business of the company²⁸⁷. But this cannot sensibly be taken as judicial opinion that the limitations on shareholder control over a company's day-to-day management neuter the shareholder's control over the subsidiary to the extent that those parties should be regarded as independent. Actually the key to this important aspect of the case is that “implicit support was simply a fact that existed independently of whether one of the parties could exercise control over the other party and did not emanate from the *exercise* of control”²⁸⁸.

3.22 Another interesting aspect of the Tax Court's analysis was the connection made with “modern economic theory” (there is a link here to the OECD's articulation at paragraph 1.38 TPG of the importance of the “options realistically available” to a taxpayer):

“In the final analysis, the ‘arm's length’ principle in the transfer pricing context is tied to modern economic theory, which is based on observations of how parties act in the marketplace. Economic theory assumes that individuals in the marketplace will employ a

²⁸⁵ *Ibid.*, paragraphs [196]-[199].

²⁸⁶ David Ward QC's commentary in 12 ITLR 508, at page 513.

²⁸⁷ 2009 TCC 563 at paragraphs [240]-[246].

²⁸⁸ Bloom and Vincent (2012), section A.1(c). Vincent cites the Tax Court decision at paragraph [199]: “... nothing to do with the exercise of *de facto* or *de jure* control which defines a non-arm's length relationship”: *Transfer Pricing in Canada* (2013) page 99.

cost benefit analysis in choosing among the alternatives available for achieving their commercial objectives.”²⁸⁹

3.23 The Federal Court of Appeal emphatically endorsed the judgment of the Tax Court²⁹⁰. The Court accepted the taxpayer’s invitation to rule on the implicit support aspect of the litigation, even though it was not necessary to do so to dispose of the case - the FCA’s observations on the topic may thus be regarded as *obiter*. (If the Tax Court’s recognition of implicit support was overruled, that would tend to suppress the taxpayer’s creditworthiness and thus increase the credibility of the guarantee fee it had paid, so in that sense a finding that implicit support had the effect perceived by the judge was unnecessary to reject the CRA’s appeal.) In its submissions to the FCA²⁹¹, the taxpayer opposed the Crown’s contention that the trial judge had misapplied the “business judgment rule” which requires deference to business decisions that lie within a range of reasonable alternatives²⁹². On that, the FCA observed that the trial judge considered there was in fact no need to rely on “business judgment” because he had already found that the taxpayer’s unguaranteed debt would not be rated close to AAA. Accordingly, based on objective factors, the guarantee was necessary²⁹³. The taxpayer also asserted that “as a matter of law, the arm’s length standard required the trial judge to situate the parties to the transaction (here, GECUS and GECCI) as persons unaffiliated with each other”. Thus implicit support would not arise because “the concept of implicit support is rooted in the familial relationship between affiliated companies”²⁹⁴. Various case law authorities were given for this proposition, though in fact these mostly address the question whether or not

²⁸⁹ 2009 TCC 563 at paragraph [197].

²⁹⁰ 2010 FCA 344.

²⁹¹ Taxpayer’s Memorandum of Fact and Law, filed 2 June 2010, court file A-1-10.

²⁹² *Ibid.*, paragraph 43, citing *Gabco Limited v Minister of National Revenue* (1968) 68 DTC 5210, 5216 per Justice Cattanaach.

²⁹³ 2010 FCA 344 paragraphs [80]-[82]. The Crown had also argued that, if the FCA refused to equalise the taxpayer’s credit standing with its AAA-rated parent, the taxpayer should nonetheless be regarded as “strategically important” and thus uprated to AA+.

²⁹⁴ *Ibid.*, paragraph [44].

parties were *dealing at arm's length*, rather than the (pricing) consequences of not doing so²⁹⁵.

3.24 Referring to the Tax Court's formulation of the dispute (paragraph 3.19 above), the FCA perceived the issue as a "pure question of statutory construction"; and "[t]he only question is whether implicit support is a factor that can be considered when applying subsection 69(2) and paragraphs 247(2)(a) and (c), given that it arises by reason of the non arm's length relationship"²⁹⁶. In the Court's view, it was necessary to take into account "all the circumstances which bear on the price whether they arise from the relationship or otherwise". Evidently this proposition is to be coloured by the Court's view of the statutory objective, namely "to prevent the avoidance of tax resulting from *price distortions which can arise in the context of non arm's length relationships by reason of the community of interest shared by related parties*. The elimination of these distortions by reference to objective benchmarks is all that is required to achieve the statutory objective. Otherwise all the factors which an arm's length person in the same circumstances as the respondent [the taxpayer] would consider relevant should be taken into account"; and "it is common ground that in the context of the yield method implicit support is a factor which an arm's length person would find relevant in pricing the guarantee"²⁹⁷.

3.25 Paragraph 1.6 TPG, and the FCA's own decision in *GlaxoSmithKline*²⁹⁸ (to the effect that all relevant circumstances are to be taken into account in a transfer pricing analysis), were regarded as supporting the Court's conclusion. There was "no doubt that the existence of the implicit guarantee is relevant to the inquiry and must be considered in identifying the arm's length price"²⁹⁹. Thus the

²⁹⁵ Taxpayer's Memorandum of Fact and Law paragraph 55, citing e.g. *Swiss Bank Corp. et al v Minister of National Revenue* [1974] SCR 1144: parties found to be not dealing at arm's length, although (at 1152) "[t]he fact that the interest actually authorized or paid is consistent with arm's length dealing is not enough in itself to avoid this conclusion". Essentially the same question arose in e.g. *Peter Cundill & Associates Ltd v The Queen* [1991] 2 CTC 221 and *The Queen v Remai* 2009 FCA 340.

²⁹⁶ 2010 FCA 344 at paragraphs [51]-[52].

²⁹⁷ *Ibid.*, paragraphs [54]-[56]. My emphasis.

²⁹⁸ 2010 FCA 201.

²⁹⁹ 2010 FCA 344, paragraphs [57]-[59].

case “supports the concept of a holistic approach seen in other cases and the need to take into account the circumstances of the parties when interpreting CUPs and other market data”³⁰⁰.

3.26 The FCA’s focus on “eliminating distortions which arise by reason of the parties’ community of interest” is central to the decision³⁰¹. Arguably, implicit support arises for that reason. But it seems convincing that it is not, in this context, a *distortion* in the sense intended – because independent parties would have regard to implicit support. Moreover, it is not a phenomenon which arises from the *exercise* of control. The prime target of transfer pricing rules is the case where a controlling party *imposes* conditions on its affiliated counterparty; but the “condition” which reflects affiliation benefits is not something which is imposed (or perhaps affiliation is not a “condition” at all in the sense of a transactional term). Rather, it is part of the factual matrix within which examination of pricing must take place³⁰².

3.27 One further feature of *General Electric* which continues to cause potential conceptual difficulties is the fact that both the implicit support and the transaction being priced (the explicit guarantee) emanated from the same person, namely GECUS. This is the “lender as guarantor” paradox mentioned at paragraphs 4.49(i) and 4.52(v) below. The response is surely that, in constructing a hypothetical comparable transaction, the dimensions of ownership and control should be disregarded. In other words, while the characteristics of the parties should be respected and translated into the hypothetical transaction (such as a borrower being a member of a group of companies with certain attributes), the hypothesis must move away from the proposition that the borrower is controlled by the actual parent. See further the discussion of this aspect in relation to the *McKesson* case, paragraph 3.32ff below. To put this another way, the pricing test must proceed by reference to a *hypothetical* counter-factual – the question is: what

³⁰⁰ Hickman, Rockall and Hall (2011) section II.

³⁰¹ Cited in *Marzen Artistic Aluminium Ltd v The Queen* 2014 TCC 194 paragraph [178].

³⁰² I commented at the time, in an article entitled *GE Verdict Will Set International Precedent*, that “[t]his need not be regarded as an erosion of the arm’s length principle or abandoning respect for separate legal personality: it is just part of the factual matrix” (Clayson (2010)).

would have happened between hypothetical unrelated parties albeit in similar circumstances (including having the same economic characteristics of the actual parties), thus eliminating price *distortions* arising because of the control relationship?

3.28 Further litigation is pending against the GE group in which the CRA assert both the recharacterisation rule in paragraphs 247(2)(b) and (d) ITA and the unlimited liability nature of the taxpayer company to resist deductions for guarantee fees. A preliminary hearing resulted in the Tax Court rejecting (in December 2011) the group's allegations that the CRA was improperly attempting to relitigate the subject-matter of the original *General Electric Capital Canada* dispute³⁰³.

3.29 Two other cases on very similar facts, *Burlington Resources Finance Company v The Queen* and *Conoco Funding Company v The Queen* are pending before the Tax Court. It is apparent from the report of a preliminary motion³⁰⁴ that again the Crown is arguing that, because the Canadian borrower company in each case was a Nova Scotia unlimited liability company (having issued billions of dollars of bonds supported by its US parent's guarantee, and having paid a 0.5% p.a. guarantee fee to its respective parent), the parent/guarantor was ultimately liable for the borrower's debts in any event i.e. without the need for a guarantee – so that the guarantee was valueless.³⁰⁵

3.30 *The Queen v GlaxoSmithKline*³⁰⁶ is the Canadian transfer pricing case of the highest authority, having reached the Supreme Court in 2012. The case concerned the pricing of the purchase by the Glaxo Canada company of active pharmaceutical ingredient from its Swiss affiliate. The relevant law was section

³⁰³ *General Electric Canada Co v The Queen*, 2011 TCC 564, summarised in Menyas (2012).

³⁰⁴ 2015 TCC 71.

³⁰⁵ See also *HSBC Bank Canada v The Queen* 2011 TCC 37 (preliminary motion for determination of questions of law or fact) where it is apparent that the case concerned the transfer pricing of guarantee fees paid by the Canadian taxpayer to its Hong Kong, Netherlands and UK parent companies.

³⁰⁶ 2012 SCC 52. For a detailed review of the facts of the case, and the decision in the Tax Court 2008 TCC 324, see e.g. Vidal (2009).

69(2) ITA and thus the test being applied was of “the amount ... that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm’s length”. In the FCA³⁰⁷ (with whose decision the Supreme Court did not disagree), Nadon J.A. had relied upon *Gabco Limited v Minister of National Revenue*³⁰⁸ in which it was held that “it is not a question of the Minister or this Court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or Court coming to the conclusion that no reasonable business man would have contracted to pay such an amount having only the business consideration of the appellant in mind”. Thus the test “requires an inquiry into those circumstances which an arm’s length purchaser, standing in the shoes of the appellant³⁰⁹, would consider relevant in deciding whether it should pay the price paid by the appellant ... In other words, the test mandated by subsection 69(2) [now paragraphs 247(2)(a) and (c)] does not operate regardless of the real business world in which the parties to a transaction participate”³¹⁰.

3.31 The Supreme Court observed that “the challenge is to find an arm’s length proxy that replicates the circumstances of Glaxo Canada as closely as possible in respect of its acquisition of ranitidine”³¹¹. The statutory requirement to consider the “circumstances” meant that “transactions other than the purchasing transactions must be taken into account”³¹². Support for this conclusion was drawn from the TPG (1995 version, paragraph 1.5) on the basis that “economically relevant characteristics of the situations being compared” may make it necessary to consider other transactions; and enquiring into the price that would be reasonable in the circumstances “necessarily involves consideration of all circumstances of the Canadian taxpayer relevant to the price paid to the non-

³⁰⁷ 2010 FCA 201, paragraph [69].

³⁰⁸ (1968) 68 DTC 5210, 5216. *Gabco* was a case on section 67 ITA, which also contained the phrase “reasonable in the circumstances”.

³⁰⁹ And, I would add, wearing the appellant’s clothes generally i.e. assuming its broader characteristics.

³¹⁰ 2010 FCA 201, paragraphs [73]-[74].

³¹¹ Supreme Court decision, paragraph [19].

³¹² *Ibid.*, paragraph [38].

resident supplier ... the objective is to determine what an arm's length purchaser would pay for the property ...³¹³. Moreover, the "economic and business reality of Glaxo Canada" had to be taken into account, although "prices between parties dealing at arm's length will be established having regard to the independent interests of each party to the transaction"³¹⁴. Thus neither the CRA nor taxpayers may "under the guise of a strict technical transfer pricing approach or fictitious business world, perform an artificial analysis disregarding factors and circumstances which would otherwise be important to arm's length parties acting in the real business world"³¹⁵. It followed that the taxpayer's basic pricing structure, which entailed paying its Swiss affiliate multiple times the open market price for the API on the basis that this was a component of a "package deal" under which it also enjoyed an intellectual property licence from its UK parent, was potentially in accordance with the "reasonable in the circumstances" test³¹⁶. The decision has been described as "recognition from Canada's highest court that the reasonableness of transfer prices must be assessed using a holistic approach that takes into account all of the economically relevant circumstances"³¹⁷.

3.32 *McKesson Canada Corporation v The Queen*³¹⁸ concerned the cross-border factoring, under a C\$900m facility, of trade receivables³¹⁹ by the Canadian taxpayer to its Luxembourg parent. The case does not directly address passive

³¹³ Paragraphs [42] and [44].

³¹⁴ Paragraphs [53] and [63].

³¹⁵ Vincent, *Transfer Pricing in Canada* (2013), page 194.

³¹⁶ Albeit a cause of indignation in some quarters of the tax community e.g. Schön (January 2013): "[t]his is outright profit shifting." See also the articles cited by Schön at footnote 67. I rather agree. This is not a case of intentionally offsetting transactions (where mutuality exists between two parties who "give and take", as contemplated by paragraphs 3.13-17 TPG). Put bluntly, the API was bought for an above market price on terms that the taxpayer received a cheap IP licence. Could royalty withholding tax planning, as well as a low effective tax rate in Switzerland, have influenced the structure? Nat Boidman colourfully observed to me "lest anybody prematurely pop the champagne or raise the crying towel, the taxpayer has won nothing yet because all the SCC did was order a re-hearing by the TCC but this time taking into account the licence". The case has now been settled without further recourse to the TCC: see e.g. taxanalysts *Worldwide Tax Daily* 8 January 2015.

³¹⁷ Wang (2013) page 193. Cf. Hickman *et al*, note 300 above.

³¹⁸ 2013 TCC 404.

³¹⁹ New paragraph 7.39 TPG addresses debt factoring and indicates that a CUP method could be appropriate in such cases.

association, but is nonetheless interesting for its exposition of the application of the arm's length principle, and in particular the assumptions or fictions required to arrive at the hypothetical arm's length analysis. The CRA made adjustments to the taxpayer's taxable income under section 247(2)(a) and (c) ITA.

3.33 In dismissing the taxpayer's appeal against the CRA's downwards reassessment of the factoring rate, the judge observed that: "[w]ithin a transfer pricing review, the question arises whether factors that exist only because of the non-arm's length relationship are assumed away in the notional arm's length analysis or remain relevant characteristics and circumstances"³²⁰. As the taxpayer's counterparty was its direct parent company, should the court assume that a notional arm's length counterparty would still have the power e.g. to change the taxpayer's name, sell the taxpayer or do something else to trigger a termination event under the receivables sale agreement at will? Or cause the taxpayer to agree to change terms for future transactions, or have access to all relevant financial information concerning the taxpayer?

3.34 Pizzitelli J in *Alberta Printed Circuits Ltd v The Queen*, himself referring to the *General Electric* decision, was cited with approval on this issue:

*"It is important to note that factors or circumstances that exist solely because of the non-arm's length relationship of the parties should not be ignored, otherwise the reasonable businessman would not be standing entirely in the Appellant's shoes ... In *General Electric*, the Federal Court of Appeal confirmed that no error of law was made in taking into consideration the Appellant in that case, as a sub of its larger parent company, stood in the position of having an implicit guarantee by its parent of its bank debts. ...*

"In short, all circumstances means 'all' the circumstances an Appellant finds himself in before a reasonable businessman steps into his shoes."³²¹

3.35 Thus the Court in *McKesson* concluded that "all circumstances, including those that arise from, derive from or are rooted in the non-arm's length relationship should be taken into account"; and "the better view is therefore that

³²⁰ *McKesson.*, paragraph [128].

³²¹ 2011 TCC 232 paragraphs [160]–[163], my emphasis.

the court can and should consider notional continued control type rights in appropriate circumstances when looking at term or executory contract rights. Not to do so would be to not look at all of the relevant characteristics and circumstances of the relationships”³²². It was necessary to consider the position of a “notional arm’s length MIH” (the Luxembourg parent/receivables purchaser) and a “notional arm’s length McKesson Canada” (the subsidiary/taxpayer/receivables seller)³²³. This required that all the characteristics of the respective parties are taken into account.

3.36 With relevance to a comparability analysis (and relevance to review of lender’s circumstances in a lending case – different lenders will have different circumstances and thus attitudes to pricing, as with any commodity supplier e.g. costs of capital, regulation, portfolio diversity and risk appetite, markets etc – see paragraph 5.4 and note 885 below), the judge considered that³²⁴:

“As a general rule, the value of an asset to be sold is not generally affected by a particular purchaser’s cost of funds. Generally, a business or an investor with cash or a low cost of funds can profitably make less risky investments with a lower nominal return on investment than can a person with a high cost of funds. A purchaser’s cost of funds does not decrease the value of the asset it wishes to buy or the investment it is considering. Rather, it simply determines whether that particular purchaser can make the purchase or investment profitably, and if so, how profitably.”

3.37 On 11 June 2014 the taxpayer filed a Memorandum of Fact and Law with the Federal Court of Appeal. This launched a withering attack on the trial judge, for “losing sight of his role in the trial process”. The trial judge (who regarded the appellant as accusing him of untruthfulness and impartiality) recused himself from further consideration of the outstanding issues in the case³²⁵, and the taxpayer sought a retrial.

³²² 2013 TCC 404 paragraphs [131]-[132].

³²³ *Ibid.*, paragraphs [330]-[331].

³²⁴ *Ibid.*, paragraph [347].

³²⁵ Order dated 4 September 2014; Reasons at 2014 TCC 266.

3.38 Aside from the (admittedly transfixing) procedural criticism of the judge, the important aspect for this study is the debate around the approach to be taken to the control relationship in constructing comparables. The judge was criticised by the taxpayer for “wrongly concluding that the [transaction] was a riskless transaction to MIH” (the foreign counterparty to the receivables sale), doing so by reference to MIH’s control of the taxpayer and thus its ability to “terminate the transaction at will as a result of its status as McKesson Canada’s sole shareholder”³²⁶. This was said by the taxpayer to be “a critical misconstrual of the arm’s length principle and a clear error of law”³²⁷. The taxpayer contented that the arm’s length principle required:

“a comparison of the terms and conditions – such as price – of the actual transaction between non-arm’s length persons to those of a hypothetical transaction between arm’s length persons. The hypothetical transaction is the same in all respects as the non-arm’s length transaction – except it takes place between persons dealing at arm’s length. ... The over-arching purpose of the arm’s length principle is to eliminate, for purposes of determining tax liability, distortions in pricing that may arise from the non-arm’s length relationship between parties to the actual transaction. ... [T]he trial judge disregarded the consensus view of the taxpayer and the Crown and made a critical error: in his hypothetical transaction, he believed that he was required to assume that the hypothetical purchaser somehow would control the supposedly unrelated hypothetical seller. In so doing, the trial judge turned transfer pricing on its head”.³²⁸

3.39 The taxpayer then rounded on the judge’s conclusion that “all circumstances, including those that arise from, derive from or are rooted in the non-arm’s length relationship should be taken into account” so as thus to “consider notional continued control type rights in appropriate circumstances when looking at term or executory contract rights”³²⁹. However, this “is antithetical to the arm’s length principle. It is an unwarranted extension of the principles set out by [the FCA] in *GE Capital*, and is wholly inconsistent with the

³²⁶ Appellant’s Memorandum paragraph 10.

³²⁷ *Ibid.*, paragraph 44.

³²⁸ *Ibid.*, paragraphs 71-73.

³²⁹ *Ibid.*, paragraph 75, citing paragraphs [131]-[132] of the TCC decision.

Supreme Court of Canada's guidance in *GlaxoSmithKline*". The recognition of implicit support in the *GE Capital* case is reconciled with the requirement to disregard the control relationship on the basis that the former is a "factor which an arm's length person in the same circumstances ... would consider relevant" whereas "the concept of independent enterprises is similar to the arm's length concept in that both presuppose that neither party controls the other or is subject to common control"³³⁰. Thus, said the taxpayer in *McKesson*:

"[78] Two things are apparent from the above excerpt of this Court's reasoning in GE Capital. First, a particular factor must be considered if it would be relevant to an arm's length person pricing the same transaction. Second, in the hypothetical transaction to be considered by the Court, neither party controls the other or is subject to common control.

"[79] In other words, the membership of each party to a non-arm's length transaction in a corporate group just like the corporate group to which it actually belongs may be a factor that an arm's length party would consider in pricing a transaction with that person, in which case it properly informs the transfer pricing of the non-arm's length transaction. But in no case should the fact that the parties belong to the same corporate group, much less the fact that one controls the other, inform the application of transfer pricing rules to the dealings between them. That would be the antithesis of the arm's length principle, the object of which is to determine an arm's length price as if the related parties were in fact unrelated and entered into the same transaction.

"[80] In this regard, GE Capital is consistent with the reasoning of the Supreme Court of Canada in GlaxoSmithKline. In that case, Justice Rothstein (speaking for the Court) held that the requirement, found in a license agreement with its parent, that the taxpayer purchase its active pharmaceutical ingredient from an approved source, was a factor to be considered in pricing the active pharmaceutical ingredient because it 'was not the product of the non-arm's length relationship between Glaxo Canada and [its parent] or [its affiliate]' and an arm's length party 'might well be faced with the same requirement'.

*"[81] In summary, both GE Capital and GlaxoSmithKline are clear that circumstances must inform the arm's length pricing of a transaction if an arm's length party would have considered them. An arm's length party in *MIH's shoes* would not have considered that it*

³³⁰ *Ibid.*, paragraph 77, citing paragraphs [55], [57] from the FCA decision in *General Electric*.

controlled McKesson Canada, because an arm's length party in MIH's shoes would not have controlled McKesson Canada: in the properly articulated hypothetical, the arm's length person in MIH's shoes does not control McKesson Canada, and someone else does control McKesson Canada."³³¹

3.40 It was reported in June 2015 that the case had settled³³², so the litigation will not now provide further judicial elucidation of the arm's length principle. Nevertheless, the Tax Court's endorsement of the need to take into account all relevant circumstances and characteristics, including those attributable to group affiliations, and the taxpayer's (more limited) acceptance that affiliation may be an arm's length pricing factor, present a solidifying of the recognition of passive association in Canadian tax jurisprudence.

3.41 The *Alberta Printed Circuits* case³³³ is mentioned above in the discussion of *General Electric*. It offers a somewhat helpful general statement of the "parity" policy underlying transfer pricing rules:

*"The underlying policy concern behind the transfer pricing rules is, of course, leakage from the Federal Treasury due to profits being shifted from one country to another or, expressed in more conventional terms, the object is to ensure that parties not at arm's length report substantially the same amount of income in the jurisdiction in which they are located as would parties dealing at arm's length."*³³⁴

3.42 The case is interesting also because of the judge's citation of paragraph 2.6 TPG and the use of internal and external comparables³³⁵. In the loan context, the paradigm internal comparable would be where the intra-group borrower has in fact also borrowed in a comparable manner (terms, quantum, circumstances, etc) from a third party e.g. bank lender (as in Fig. II above, paragraph 2.83). In

³³¹ *Ibid.*, paragraphs 78-81.

³³² 24 TMTPR 132, quoting McKesson's Form 10-K filed with the US Securities and Exchange Commission.

³³³ 2011 TCC 232.

³³⁴ *Ibid.*, paragraph 152.

³³⁵ *Ibid.*, paragraph [172]. See paragraph 3.24 TPG; paragraph 2.36 above. The court found that internal CUPs existed and were inappropriately ignored by the CRA (paragraph [200]).

principle, although evidentially more challenging, the outcome should be the same in the absence of such an internal comparable - if it is possible to prove, hypothetically, what *would have* happened had the intra-group funding instead been raised from an independent lender.

3.43 Vincent, in *Transfer Pricing in Canada*, identifies a collection of cases which did not make it to trial and final court decision. One of these, *HSBC Bank Canada v The Queen*, entailed a Tax Court decision at interlocutory stage, under which the court provided an observation relevant to “informational asymmetry”:

*“The arm’s length fee cannot be determined on the basis of information that an arm’s length party would not have. This does raise the intriguing question of whether the third party is deemed to have knowledge that the parent would have had notwithstanding in the real world it could not get that knowledge. My view is that one has to take the real world approach.”*³³⁶

3.44 This concept of informational asymmetry is in my view somewhat analogous to, but separate from, the effect of passive association. It is probably best perceived as a comparability factor. In other words, in assessing the comparability of a transaction involving a third party, it may be appropriate to adjust pricing by reference to informational asymmetry. In the financing context, information about the borrower goes to the heart of the evaluation of credit risk. Thus an inadequacy of relevant information would logically be regarded as increasing risk and thus pricing, or diminishing a lender’s appetite for lending. But in the arm’s length lending context, the problem is typically ameliorated by disclosure (as in public debt issues) or by covenants requiring the periodic delivery of financial information to the lender. Thus the lender’s understanding of the affairs of the borrower, so far as relevant to the risk proposition, may be significantly approximated to the knowledge of (say) the borrower’s parent company, such that informational asymmetry is largely dissipated.

³³⁶ TCC file number 2006-3579(IT)G; [2011] 1 CTC 2025 paragraph [38].

Tax authority practice

3.45 Canada has been described as “a relatively aggressive jurisdiction with regard to cross-border transactions”³³⁷. In the financial transactions context, guarantee fees have attracted particular (and inconsistent as between inbound and outbound cases) attention³³⁸. The principal CRA publication on transfer pricing is Information Circular IC 87-2R (1999) which replaced and updated IC 87-2 (1987). The CRA broadly embraces OECD principles including pricing methodologies. Neither the Circular nor its predecessor have engaged with the topic of passive association; the publications are in the nature of general transfer pricing guidance. This is unsurprising given that they significantly pre-date the case law which has been the catalyst for the debate. Of course one must anyway be careful not to defer to tax authority guidance as if it were a statute³³⁹; indeed, the CRA acknowledges (paragraph 3) that the Circular “is not to be construed as a formal interpretation of the law”. It is said nonetheless (paragraph 9) that “the arm’s length principle treats a group of parties not dealing at arm’s length as if they operate as separate entities rather than as inseparable parts of a single unified business”. But this statement is no more than a reiteration from paragraph 1.6 TPG and should not be regarded as a repudiation of the recognition of passive association or other group synergy effects (especially given the CRA’s enthusiastic adoption of the implicit support proposition in *General Electric*).

3.46 Otherwise, of passing interest are paragraphs 159–163 in the intra-group services section. Paragraph 159 notes that the arm’s length charge is a function of the price at which a supplier is prepared to perform a service, and also a function of the value to the recipient. Thus “the determination of an arm’s length charge must take into consideration the amount that an arm’s length entity is prepared to pay [*or, I suggest, be paid*] for such a service in comparable circumstances”. Moreover, “where a service is rendered by arm’s length parties, or the service

³³⁷ Zorzi and Rizzuto (2013) page 426.

³³⁸ Dujic and Billings (2004), section 2.5.

³³⁹ Interpretive publications by the CRA are not binding in law, but may in certain circumstances be of persuasive value in interpreting ambiguous provisions: see Vincent (2013) pages 60-65 and cases there cited.

supplier, as part of its ordinary and recurring activities, renders the service for arm's length parties, the price charged in those circumstances is a good indication of the arm's length price". And "one must also take into account the economic alternatives available to the recipient of the service". All these statements are at least consistent with the proposition that, in arriving at an intra-group charge, it is appropriate to enquire what the service recipient (or, by analogy, borrower) would have paid to an arm's length service provider (or lender/guarantor).

3.47 In January 1994, the CRA and Department of Finance released a statement criticising various aspects of the US section 482 Regulations. Aside from the US dimension, the release is interesting from a Canadian-domestic perspective (albeit at a time when section 69 ITA governed) given the emphasis on use of "a pricing method unrelated parties would negotiate" to arrive at "amounts that would be reasonable if the parties were not members of the same economic group".

3.48 The CRA's Transfer Pricing Memorandum TPM-14 (31 October 2012) provided an overview of changes made in the 2010 TPG, and revised certain cross-references to the TPG in IC87-2R. The CRA aligned its practice with the need to find the "best" method and endorsed the OECD's 9-step comparability analysis. It was also confirmed that the revised TPG would be applied to pre-2010 transactions and treaties, on the basis that the changes were a "clarification and elaboration". TPM-15 (29 January 2015) addresses intra-group services. It touches on interest payments and notes that "if an arm's length amount is not otherwise deductible under the Income tax Act, it does not become deductible simply because section 247 of the Income tax Act and Article 9 of a tax treaty are applied"³⁴⁰.

3.49 In summary, Canada has led the way, through its case law, to the recognition of passive association in pricing controlled transactions. The *General Electric* case is now cited around the world, though with mixed impact. It provides the basis for resolution of the paradox: the effects of passive association should be

³⁴⁰ Paragraph 44, citing *Utah Mines v The Queen* 92 DTC 6194.

recognised, despite inherently emanating from group affiliation; but they should not be regarded as factors which distort pricing due to exercise of the control relationship. The *Glaxo* case indicates that “all the circumstances” of the case must be taken into account to arrive at an arm’s length price, and the taxpayer’s argument in *McKesson* provides a neat reconciliation of the acceptance of that proposition with the need, in testing the independent transaction hypothesis, to disregard the distortive effects of the control relationship.



Australia

3.50 The recognition of passive association as a factor in pricing controlled financing transactions has long been aired in Australian tax circles, including official publications. It established a legislative toe-hold in the 2013 re-write of Australia’s transfer pricing laws, and is clearly supported in official practice through ATO/governmental statements, although in my view the statutory position is not as clear as some commentators seem to assume³⁴¹. In the thin capitalisation context, legislative clarification has recently been recommended (paragraph 3.67 below). At least for periods prior to the update of the legislation however, the relevance of implicit support was vigorously challenged by the taxpayer in the *Chevron* case, but approved in principle by the Federal Court: paragraph 3.82 below.

Legislation

3.51 Australia’s modern transfer pricing laws, introduced in 1982³⁴², were substantially rewritten pursuant to the Tax Laws Amendment Act (Countering Tax

³⁴¹ Professional advisory opinion seems to have embraced parental affiliation as a required step in loan pricing. See e.g. the Australia chapter by members of Ernst & Young at page 57 of Bakker and Levey (2012).

³⁴² Applicable to income arising after 27 May 1981. From 1921 Australia had enacted laws based on the UK’s section 31 Finance (No 2) Act 1915: see note 579 below.

Avoidance and Multinational Profit Shifting) Act 2013. A new detailed code³⁴³, contained in Subdivisions 815-B to 815-D of Division 815 of the Income Tax Assessment Act 1997, was introduced by the 2013 Act, and the formerly applicable Division 13 of Part III of the Income Tax Assessment Act 1936 has been repealed; interim rules contained in Subdivision 815-A of the 1997 Act (introduced by the Tax Laws Amendment (Cross-Border Transfer Pricing) Act (No.1) 2012) no longer have effect. Thin capitalisation rules are contained in Division 820.³⁴⁴

3.52 Subdivisions 815-C and 815-D, respectively, are about the arm's length principle for PEs and special rules for trusts and partnerships. I will focus therefore on Subdivision 815-B, titled "Arm's length principle for cross-border conditions between entities".

3.53 Section 101 of Subdivision 815-B applies "if an entity would otherwise get a tax advantage in Australia from cross-border conditions that are inconsistent with the internationally recognised arm's length principle". In such cases, "the entity is treated for income tax and withholding tax purposes as if arm's length conditions had operated". This is to be achieved by determining "the conditions that might be expected to operate between entities dealing at arm's length", so that if the actual conditions differ from the arm's length conditions, and – in a cross-border context³⁴⁵ – an entity gets a transfer pricing benefit (e.g. its taxable income would have been greater under arm's length conditions), the arm's length conditions are taken to operate³⁴⁶. There is taken to be a difference between the actual conditions and the arm's length conditions if (a) an actual condition exists

³⁴³ Available at http://www.austlii.edu.au/au/legis/cth/consol_act/itaa1997240/ (accessed 27 August 2015).

³⁴⁴ A report of 18 August 2015 on corporate tax avoidance by the Senate Economics References Committee proposes a final report on 30 November 2015 (now extended to 26 February 2016) including a focus on transfer pricing and "excessive debt loading".

³⁴⁵ See the table at subsection 815-120(3). The rules are designed to ensure that Subdivision 815-B does not apply to purely domestic arrangements: Explanatory Memorandum paragraph 3.60.

³⁴⁶ Paragraph 815-105(1)(b) and subsection 815-105(2); paragraph 815-115(1)(b); subsection 815-120(1).

that is not one of the arm's length conditions, or (b) a condition does not exist in the actual conditions but is one of the arm's length conditions³⁴⁷.

3.54 "Arm's length conditions" are "the conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances". To identify the arm's length conditions, it is necessary to use the "most appropriate and reliable" method, "having regard to all relevant factors" including "the circumstances"³⁴⁸. Then, in identifying comparable circumstances, "regard must be had to all relevant factors" including "the economic circumstances". "[C]ircumstances are comparable to actual circumstances if, to the extent (if any) that the circumstances differ from the actual circumstances, (a) the difference does not materially affect a condition that is relevant to the method; or (b) a reasonably accurate adjustment can be made to eliminate the effect of the difference on a condition that is relevant to the method"³⁴⁹.

3.55 The identification of the arm's length conditions must (a) be based on the commercial or financial relations in connection with which the actual conditions operate; and (b) have regard to both the form and substance of those relations³⁵⁰. Transactions may be disregarded/recharacterised in certain cases³⁵¹. Arm's length conditions are to be identified "so as best to achieve consistency with" the TPG³⁵². In thin capitalisation situations (where Division 820 applies), the interest rate is to be determined as if the arm's length conditions had operated and applied to the debt actually issued; but Division 820 may reduce or further reduce the debt deductions³⁵³.

³⁴⁷ Subsection 815-120(2).

³⁴⁸ Subsections 815-125(1) and (2).

³⁴⁹ Subsections 815-125(3) and (4).

³⁵⁰ Subsection 815-130(1).

³⁵¹ Subsections 815-130(2)-(4). Taxation Ruling TR 2014/6 provides guidance on the ATO's approach. But passive association and its financial consequences are just relevant facts for analysis and should have no particular interface with recharacterisation principles.

³⁵² Section 815-135, emulating the UK statute: paragraph 3.157 below.

³⁵³ Section 815-140.

3.56 In the Explanatory Memorandum accompanying the 2013 Bill³⁵⁴ the required “arm’s length conditions” hypothesis in section 815-125 is described thus:

*“The identification of arm’s length conditions involves hypothesising what independent entities would have done in the place of the actual entities. This process requires the postulation of how independent entities in comparable circumstances would have dealt with one another had they been dealing at arm’s length.”*³⁵⁵

3.57 Thus the enquiry is into how two independent entities would have behaved. There is no suggestion that one of the entities in the counter-factual is the actual taxpayer; it is implicit in the reference to “independent entities ... in place of the actual entities”, that the required hypothesis relates to two hypothetical parties.

3.58 However, regard must be had to the *characteristics* of the actual entities in postulating the independent entities. The Explanatory Memorandum notes significant increases in recent years in the volume and complexity of cross-border intra-firm financing transactions. Importantly for this study of passive association, it is said:

*“In the more complex cases involving these financing facilities, determining the arm’s length conditions could include factors that relate to an entity’s relative financial strength, and how the market would perceive the entity’s financial strength with explicit consideration given to the fact that the entity is part of a larger financial group.”*³⁵⁶

³⁵⁴ With effect from 1984, section 15AB of the Acts Interpretation Act 1901 provided for the use of extrinsic material in the interpretation of an Act of Parliament. Included in the list of relevant material is: “any explanatory memorandum relating to the Bill containing the provision, or any other relevant document, that was laid before, or furnished to the members of, either House of Parliament by a Minister before the time when the provision was enacted”. See: www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/Browse_by_Topic/law/explanmem/wasthereanEM (accessed 20 August 2015).

³⁵⁵ Explanatory Memorandum on the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013, paragraph 3.77, my emphasis.

³⁵⁶ *Ibid.*, paragraph 3.78, my emphasis.

3.59 Accordingly, “[t]his means that the concept of implicit parental support is now enshrined into Australian transfer pricing law.”³⁵⁷ It strikes me though that, while the pronouncements of the ATO (paragraph 3.93ff below) have built a strong impression that that is the appropriate approach, the words of the statute, even when taken with the interpretative influence of the Explanatory Memorandum, do not go quite that far.

3.60 As to comparability:

*“The term ‘comparable circumstances’ relates to the profile of each of the hypothetical independent entities. By requiring that the independent entities be in ‘comparable circumstances’ to the actual entities, the nature of the actual entities and the context within which they operate is directly relevant in constructing the profile of the hypothetical entities.”*³⁵⁸

3.61 Thus “the relevant question for the purposes of Subdivision 815-B is whether the conditions which operate between the entities would make commercial sense if the entities were dealing wholly independently with one another”, i.e. whether the parties “have acted as independent parties would in comparable circumstances, so that the outcome of the dealing is a matter of real bargaining”³⁵⁹. In determining the degree of comparability with circumstances being compared, “consideration must be given to the range of options that would be realistically available to an independent enterprise in comparable circumstances”³⁶⁰. The OECD’s five comparability factors are then listed, with summary material derived from the TPG.

3.62 Division 820 of the Income Tax Assessment Act 1997³⁶¹ addresses thin capitalisation cases. Its operation is preserved in transfer pricing cases by a rule

³⁵⁷ Australia chapter (Fone and Hainsworth) in Bloomberg BNA’s *Transfer Pricing Forum*, vol. 4, no. 4 (December 2013) on Implicit Support; “[i]t is expected that the ATO will release further guidance on its views as to the acceptable treatment of both explicit guarantees and implicit parental support” (page 9). At the date of writing they have not done so.

³⁵⁸ Explanatory Memorandum, paragraph 3.79.

³⁵⁹ *Ibid.*, paragraphs 3.88, 3.89, citing *Trustee for the Estate of the Late AW Furse No.5 Will Trust v Federal Commissioner of Taxation* (1990) 21 ATR 1123, 1132.

³⁶⁰ *Ibid.*, paragraph 3.125, echoing e.g. TPG paragraphs 1.38 and 9.59.

³⁶¹ Inserted by the New Business Tax System (Thin Capitalisation) Act 2001.

which requires that where, in applying arm's length conditions, a rate is applied to a debt interest, the rate is to be worked out as if the arm's length conditions had operated. However, that rate is to be applied to the debt interest the entity actually issued instead of the debt interest that would have been issued in arm's length circumstances. Division 820 can then operate.³⁶²

3.63 The thin capitalisation rules are extremely detailed and it is not my intention to examine them beyond noting that one available method for calculating a tax-allowable amount of debt³⁶³ is the so-called "arm's length debt amount",³⁶⁴. This has been described by the ATO as a "modified" arm's length approach³⁶⁵. The determination includes both "would" and "could" dimensions, namely (i) an amount of debt that the entity "would reasonably be expected"³⁶⁶ to have" (which is attributable to its Australian business), and (ii) an amount of debt that would be provided by unaffiliated commercial lenders – i.e. what the taxpayer "could" have borrowed. Several factual assumptions are required, including that "any guarantee, security or other form of credit support" provided to the entity in relation to the Australian business by its associates is disregarded³⁶⁷. These words appear to refer only to formal or legal obligations, not to implicit credit support (although the reference to "other form of credit support" muddies the water).

³⁶² Subsection 815-140(2); Explanatory Memorandum paragraphs 3.143–3.149. This approach is said to maintain the administrative approach in TR 2010/7 (paragraph 3.100 below), which was confirmed in Subdivision 815-A.

³⁶³ Division 974 Income Tax Assessment Act 1997 provides a mechanism for characterising instruments as debt or equity, including for thin capitalisation purposes. Division 974 is itself subject to a review by the Board of Taxation: http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/debt_and_equity/default.htm&pageid=007 (accessed 17 August 2015).

³⁶⁴ Section 820-105 for outbound investment and section 820-215 for inbound. However, most entities subject to thin capitalisation rules make use of the alternative safe harbour test: Board of Taxation, *Review of the Thin Capitalisation Arm's Length Debt Test* (December 2013), paragraph 3.12.

³⁶⁵ Taxation Ruling TR 2010/7 paragraph 63.

³⁶⁶ In Taxation Ruling TR 2013/1 paragraph 33, the ATO cites *Commissioner v Peabody* [1994] HCA 43 paragraph 31 (a High Court case on Australia's general anti-avoidance rule): "a reasonable expectation requires more than a possibility. It requires a prediction as to events which would have taken place ... and the prediction must be sufficiently reliable for it to be regarded as reasonable". There is a possible read-across here to the UK's section 154(4)(b) TIOPA: paragraph 3.161 below.

³⁶⁷ Subparagraphs 820-105(2)(e)(i), 820-215(2)(e)(i).

3.64 The Board of Taxation³⁶⁸ issued a discussion paper in December 2013, *Review of the Thin Capitalisation Arm's Length Debt Test*. One of the issues on which stakeholder comments were sought was “whether credit support from related parties could be recognised in particular circumstances when they correspond to ordinary commercial dealings and do not represent integrity concerns, and how to determine those circumstances”³⁶⁹. Noting the uncertainty as to whether implicit support is currently addressed by the statute, the Board observed that “[n]ot excising implicit parent or group support could undermine the purpose of isolating the stand-alone business”³⁷⁰. Stakeholders were invited to comment on the extent to which lenders would take into account implied support³⁷¹, it being noted that “[a]ccordingly there is some uncertainty as to whether the policy of identifying and excising the support provided to the stand-alone Australian business should also extend to implicit credit support that can arise from parent entities or other group entities”³⁷².

3.65 And –

“[a]rguably, parent or group affiliation is directly relevant to the amount of debt an Australian business can borrow”³⁷³. The strategic position of the entity in the context of the group’s business directions, reputation, the economic benefit to the Australian business of using the parent’s name and other factors can result in implicit support being provided ... For example, consider a situation where an Australian company is rated on its own as sub-investment grade, but is considered core to its parent. This could result in a significant uplift to the Australian company’s rating, and as a result, it could be argued by the taxpayers that the company would be able to borrow significantly more debt”³⁷⁴. The

³⁶⁸ A non-statutory advisory body charged with contributing a business and broader community perspective to improving the design of taxation laws and their operation: <http://www.taxboard.gov.au> (accessed 20 August 2015).

³⁶⁹ Page 28, question (g).

³⁷⁰ Paragraph 4.58.

³⁷¹ Page 36 question (e).

³⁷² Paragraph 4.56.

³⁷³ Contrast the attitude currently (but in my view misguidedly) adopted by HMRC: paragraph 3.189 below.

³⁷⁴ Paragraph 5.38 acknowledges that “the transfer pricing rules also factor in credit support, which the thin capitalisation rules exclude” and “if the operations of the subsidiary are core to the group, the credit rating of a subsidiary could be ‘notched’ up such that it has the same

*fact that the Australian company is making losses would not affect the uplifted 'core' rating, as the taxpayer could simply argue that, despite the Australian company's losses, the ultimate parent will continue to fund the Australian company's debt obligations (for example, through equity injections which cover the interest payments)."*³⁷⁵

3.66 Noting that "adjustments to credit support to comply with thin capitalisation rules could be complex and require detailed analysis to be performed" (against its terms of reference of reducing compliance costs and making the arm's length debt test easier for the ATO to administer), the Board of Taxation asked "whether there is a need to better define and provide guidance on the identification and exclusion of certain types of credit support to avoid inappropriate outcomes and, if so, how this could be achieved?"³⁷⁶.

3.67 The Board reported on 19 December 2014; the document was released on 4 June 2015. Submissions from Chartered Accountants Australia and New Zealand and PwC had contended that "for transfer pricing purposes, implicit credit support is a relevant factor in determining arm's length rates" and proposed that "only explicit credit support is to be excluded from the ALDT analysis [as this] would provide certainty to taxpayers, would be consistent with commercial lending practices, and would better harmonise the thin capitalisation and transfer pricing regimes"³⁷⁷. The ATO interestingly acknowledged the dual effects of implicit support as tending to (i) reduce arm's length interest rates, and (ii) increase borrowing capacity³⁷⁸. The Board concluded, and has recommended to

credit standing as its foreign parent, resulting in the subsidiary paying the same interest rate that the parent would be expected to pay for its debt". Moreover, in the transfer pricing context, "[i]n considering the arm's length interest rate for a given loan arrangement, all the relevant commercial and financial conditions surrounding the two entities need to be taken into account" (paragraph 5.40). Thus the Board asked "whether there is scope for placing greater reliance on the analysis undertaken under the transfer pricing rules in applying the ALDT and, if there is scope, how this can be achieved while preserving the intended outcomes of both regimes". (Q 5.2 Issues/Questions, (b).)

³⁷⁵ *Ibid.*, paragraphs 4.57-58.

³⁷⁶ *Ibid.*, paragraph 1.6 and Q 4.2 Issues/Questions, (g).

³⁷⁷ Paragraph 5.17. Presumably the comment about implicit support in the transfer pricing context relates to the modern law in Subdivisions 813-B to 815-D: paragraphs 3.50 to 3.58 above.

³⁷⁸ Paragraph 5.18. See the diagrammatic representation at paragraph 5.14, Fig XI, below.

the Government, that implicit support should not be excluded (so could be recognised) in the ALDT analysis. However, this appears to be based on the view that implicit support “tends to affect the price of debt but not the amount of debt available in commercial dealings” (the latter being “the crucial question in an ALDT context”³⁷⁹).

3.68 Mention should be made of the formerly applicable law in Division 13 Part III (sections 136AA-136AG, introduced in 1982 to “overcome difficulties” in the former Division 13 exposed by *Commissioner v Commonwealth Aluminium Corporation Ltd*³⁸⁰) of the Income Tax Assessment Act 1936. This legislation was under consideration in the case law discussed below at paragraphs 3.72ff. Section 136AC defined “international agreements” as, essentially, cross-border agreements involving an Australian taxpayer for the supply or acquisition of property, “property” itself broadly defined to include services³⁸¹. Where the Commissioner was satisfied that the parties were not dealing at arm’s length, section 136AD deemed the consideration received or receivable by a taxpayer who had supplied property to be that consideration which is “equal to the arm’s length consideration”. Section 136AD(2) addressed the situation where no consideration (rather than inadequate consideration) was received by the taxpayer. Section 136AA(3)(c) explained “the arm’s length consideration” as what “might reasonably be expected to have been given ... under an agreement between independent parties dealing at arm’s length with each other”. Section 136AD(3) provided the converse rule for acquisitions of “property” by an Australian taxpayer, again imputing “arm’s length consideration”.

3.69 Detailed guidance was provided by Taxation Ruling TR 94/14, but little is to be found there of relevance to the recognition of passive association, and nothing directly engaging with the topic. Indeed, TR 94/14 was concerned primarily with transactions in goods and other tangible assets. One interesting

³⁷⁹ Paragraphs 5.27–5.29, citing discussions with an unnamed Australian lending institution and with the Australian Prudential Regulation Authority.

³⁸⁰ (1980) 143 CLR 646; see TR 94/14 paragraph 155.

³⁸¹ Subsection 136AA(1), the definition encompassing transactions for royalties and loans.

comment though is that, in discussing the importance of bargaining power, the ATO decided to “go further” than the OECD³⁸² to “add that where [conditions similar to those existing between unrelated parties] do exist, failure by the members [of an MNE group] to exercise that autonomy and operate as separate profit centres, would be unlikely to lead to a result that is consistent with the arm’s length principle”³⁸³. TR 94/14 also observes that “independent parties who were dealing at arm’s length would each compare the options realistically available to them and seek to maximise the overall value of their respective entities from the economic resources available to or obtainable by them”, and “minimise the consideration to be given in respect of the acquisition of property”³⁸⁴. The ATO’s glosses upon these related concepts (relative bargaining power and options realistically available) lend support to the view that a borrower which could raise funds externally at a certain price, or in a certain quantum, should not be required to report a less favourable transaction with its parent or other affiliate.

3.70 Subdivision 815-A (no longer applicable) was introduced by the Tax Laws Amendment (Cross-Border Transfer Pricing) Act 2012, controversially with application to income years beginning on or after 1 July 2004³⁸⁵, in part as a statutory response to governmental dissatisfaction with the *SNF* case (paragraph 3.74ff below). The legislation recited its equivalence to, but independence of, the “transfer pricing rules in Australia’s double tax agreements”, and its object as ensuring that “amounts are appropriately brought to tax in Australia, consistent

³⁸² See paragraph 1.5 TPG.

³⁸³ TR 94/14 paragraph 55.

³⁸⁴ *Ibid.*, paragraphs 66, 68(b).

³⁸⁵ The new legislation was considered to be “consistent with Parliament’s view that treaties provided a separate basis for making transfer pricing adjustments” according to the Explanatory Memorandum on the 2012 Bill, page 3, despite the “contrary argument [which] relies on a general argument that tax treaty rules cannot be used to extend taxing rights beyond the limits of domestic law”: paragraph 1.21. However, “tax treaties do not generally apply to restrict the right of states to tax their own residents”: paragraph 1.34, citing paragraph 6.1 OECD Commentary on Article 1 MTC. Australia’s tax treaties are incorporated into domestic law by the International Tax Agreements Act 1953. In *Case 53* (1963) 11 CBTR (NS) 261, 279, the Board considered that a forerunner of Article 9 (Article IV in the then applicable UK-Australia treaty) was “not a formula for determining taxable income; it is a directive to be observed in the course of determining taxable income ... the Commissioner could, in our view, take into account in the course of determining taxable income profits ... calculated in accordance only with Article IV”. See now the *Chevron* case (paragraph 3.82ff below) at paragraph 61 for the Federal Court’s conclusion that Article 9 does not confer a separate and independent power to tax.

with the arm's length principle", namely "profits which would have accrued to an Australian entity if it had been dealing at arm's length, but by reason of non-arm's length conditions operating between the entity and its foreign associated entities, have not so accrued"³⁸⁶. The key operative provision, section 815-10, permitted the "negation" of a transfer pricing benefit, but only in cases where a tax treaty with an associated enterprises provision equivalent to Article 9 of the Australia/UK treaty applied to the entity.

3.71 For Australian resident entities, a "transfer pricing benefit" would arise if the requirements of a treaty associated enterprises article are met; "an amount of profits which, but for the conditions mentioned in the article, might have been expected to accrue to the entity, has, by reason of those conditions, not so accrued"; and, had that amount of profits so accrued to the entity, its taxable income for the income year in question would be greater than its actual amount³⁸⁷. Thus, in effect, "the transfer pricing articles contained in Australia's tax treaties are able to be applied independently of Division 13 through explicit incorporation into the ITAA 1997"³⁸⁸. Determining whether a transfer pricing benefit had been obtained, and interpreting a treaty provision, were to be done consistently with the MTC and its Commentaries and the TPG³⁸⁹.

Case law

3.72 Before the important *Chevron* case (paragraph 3.82ff below), which bears directly on the passive association topic, Australia had provided just two significant substantive³⁹⁰ transfer pricing cases, *Roche Products Pty Ltd v*

³⁸⁶ Paragraph 815-5(a).

³⁸⁷ Subsection 815-15(1).

³⁸⁸ Explanatory Memorandum paragraph 1.52.

³⁸⁹ Section 815-20. The TPG were described as "the international consensus on transfer pricing" containing "authoritative know-how on the application of transfer pricing rules", citing the view expressed in the UK's *DSG* case (paragraph 3.165 below) that the TPG were "the best evidence of international thinking" on the topic: Explanatory Memorandum paragraph 1.93.

³⁹⁰ *Syngenta Crop Protection Pty Ltd v Commissioner* [2005] FCA 1646 and *W R Carpenter Holdings Pty Ltd v Commissioner* [2008] ATC 20-040 focused on procedural issues; *Daihatsu Australia Pty Ltd v Commissioner* [2001] ATC 4268 was an unsuccessful attempt by the taxpayer via judicial review under the Judiciary Act 1903 to invalidate Division 13 assessments; *San Remo Macaroni v Commissioner* [1999] FCA 1468 concerned the application of Division 13 to an unrelated party transaction. See the Australia chapter by Richard Vann in

*Commissioner*³⁹¹ and *Commissioner v SNF (Australia) Pty Ltd*³⁹². Both cases were concerned with sales of goods to Australian taxpayer companies by their foreign affiliates, and in both cases the relevant law was primarily Division 13 of Part III of the Income Tax Assessment Act 1936.

3.73 The *Roche* case has little to say of general importance about interpretation of the arm's length principle. The focus was on the "arm's length consideration" demanded by section 136AD of the 1936 Act, though the Commissioner also invoked Article 9 of the Australia-Switzerland double tax treaty and the equivalent provision in the Australia-Singapore treaty. However, the parties "spent little time dealing with the words of either set of provisions and effectively accepted that the same result would obtain whichever was applied", it being "pointed out that the concepts of 'independence' and 'arm's length' are almost interchangeable"³⁹³. The judge did not find it necessary to rule on the applicability of the treaties, but thought that "there is a lot to be said for the proposition that the treaties, even as enacted as part of the law of Australia, do not go past authorising legislation and do not confer power on the Commissioner to assess. They allocate taxing power between the treaty parties rather than conferring any power to assess on the assessing body"³⁹⁴. The case was decided on the basis of the expert evidence on pharmaceutical market pricing, rather than delving into the significance of the economic characteristics of the parties.

3.74 The *SNF* case, on the other hand, contains some significant discussion of the arm's length test, as well as opining upon the legal effect of the TPG. *SNF* also concerned the application of section 136AD. The Australian company had

Baistrocchi and Roxan (2012) at page 397ff for a review of these cases. *Case 53* (note 385 above) engages with the interaction of the early UK-Australia tax treaty and the then applicable domestic law in section 136 of the 1936 Act.

³⁹¹ [2008] ATC 10-036; [2008] AATA 639.

³⁹² (2011) 13 ICLR 954.

³⁹³ *Roche*, paragraph 17.

³⁹⁴ *Ibid.*, paragraph 191. The ATO released a Decision Impact Statement asserting that the Commissioner was not bound by the observations of the judge on the treaty aspect and would continue to adhere to the position that a treaty may provide a separate basis for assessing transfer pricing adjustments. Also the "decision is confined to the facts of the case": <http://law.ato.gov.au/atolaw/view.htm?DocID=LIT/ICD/NT2005/7/00001> (accessed 17 August 2015).

purchased polyacrylamides from French, Chinese and US affiliates. It had been consistently loss-making. The Commissioner determined that the prices paid by the taxpayer exceeded arm's length prices.

3.75 *SNF* has been controversial for two reasons. First, it rejected (in the context of a dispute about the relevance of the Commentaries/TPG to the application of Australia's treaties with France, China and the US) the applicability of the TPG – on the basis that the Commentaries were an aid to construction only where the states concerned had agreed that they should be so, or it was the practice of the states to do so. The guidelines were no more than that: guidelines³⁹⁵. Secondly, and partly in view of the conclusion on the relevance of OECD principles, it was not necessary for comparable transactions – in the context of a comparability examination - to reproduce all the circumstances of the taxpayer apart from the lack of independence: instead, as reflected in OECD thinking, it was acceptable to have regard to similar cases where adjustments could reasonably be made³⁹⁶.

3.76 The latter point is relevant to this study. In *SNF* the ATO argued that “the transfer pricing exercise requires the change of only one fact – the relationship of the parties – and that otherwise the taxpayer was to be regarded as

³⁹⁵ “It is plain from that statement [*paragraph 16 of the preface to the TPG*], however, that the guidelines are just that – guidelines. Under art 31(3) [*of the Vienna Convention*] they can be examined only if they reflect the subsequent agreement of the states in question or, under art 31(3)(b), ‘any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation’. ... There was no evidence that any of the states in question had adopted the practice of applying the guidelines to any of the circumstances in which art 9 of the model law might obtain in their jurisdictions. ... The guidelines are not a legitimate aid to the construction of the double taxation treaties. ... There is no principle of statutory interpretation which requires domestic legislation of the present kind to be read as if it were itself an international agreement”: *SNF*, Full Federal Court at paragraphs [116]–[118].

³⁹⁶ The Full Federal Court approved – at paragraph [121] - the trial judge's approach (at [2010] FCA 635 paragraph [44]) to identifying arm's length consideration: “I do not accept the Commissioner's submission that the test is to determine what consideration an arm's length party in the position of the taxpayer would have given for the products. The essential task is to determine the arm's length consideration in respect of the acquisition. One way to do this is to find truly comparable transactions involving the acquisition of the same or sufficiently similar products in the same or similar circumstances, where those transactions are undertaken at arm's length, or if not taken at arm's length, where suitable adjustment can be made to determine the arm's length consideration that would have taken place if the acquisition was at arm's length.” The judge's reference to the “position of the taxpayer” should not, in my view, be taken to mean that the taxpayer's position (circumstances) is irrelevant, but rather that adjustments could be made to align a putative comparable with that position.

having all its other characteristics, including in this case that the taxpayer was in perennial loss”³⁹⁷.

3.77 As in the *Roche* case, a large portion of the *SNF* decision is preoccupied with the quality of the competing evidence on comparables. Much attention is paid to comparability of contractual terms, comparability of product, differences in markets and the functional analysis of buyers. Aside from the taxpayer losses issue, none of this touches on the economic circumstances of the buyer in a way relevant to this study’s discussion of passive association. The Court did however set out the fundamental interpretive challenge in assessing what is meant by a transaction between “independent parties at arm’s length” (as postulated by section 136AA(3)(d)). The possibilities contemplated by the Court were: (a) a purchase by the taxpayer from a hypothetical arm’s length supplier; (b) a purchase by a hypothetical purchaser from the taxpayer’s actual supplier; (c) a purchase by a hypothetical purchaser from a hypothetical arm’s length supplier³⁹⁸. This can be analogised into the loans/credit context: (a) a borrowing from a hypothetical arm’s length lender; (b) a borrowing by a hypothetical borrower from the actual lender (e.g. the parent company in a simple parent company lending scenario); (c) a borrowing from a hypothetical borrower from a hypothetical arm’s length lender.

3.78 At first sight surprisingly, the Court in *SNF* took exception to the Commissioner’s advocacy of the proposition that “[o]ne simply removes the fact of interdependence and non-arm’s length dealing, but otherwise the exercise involves taking into account all the circumstances which bear on the price” - in other words, the arm’s length principle requires an enquiry into what a purchaser in identical circumstances to those of the taxpayer would have paid, but for its membership of the group, with reliance being placed on paragraph 1.6 TPG. Leaving aside the particular context of the loss-making Australian taxpayer, as a general proposition this does not seem extravagant. However, the Court grumpily complained that “[t]he deeply impractical nature of this submission is manifest from the outset” – and regarded the consequence of the Commissioner’s position

³⁹⁷ (2011) 13 ITLR 954, 958d.

³⁹⁸ Paragraph [91].

as “requiring a strict norm of operation inflexibly requiring one kind of comparable and forbidding all others and it refuses to admit the possibility of making adjustments for differences”³⁹⁹. It seems however that the Court’s irritation was with the Commissioner’s insistence that the only comparable situations which could lawfully be examined under section 136AD(3) were those sharing the same characteristics as the taxpayer’s (apart from its non-independence from the group)⁴⁰⁰, rather than with the formulation above:

*“but what is to occur, one may ask, if no such comparables are available; what if there exists no other business sharing all the same features of the taxpayer bearing on price so that the crystalline perfection the Commissioner submits is demanded by s136AA(3)(d) cannot be achieved? The Commissioner’s submission necessarily means that a taxpayer, who bears the onus in tax appeals, can never succeed in such a case for the bar will be set at an unattainable height.”*⁴⁰¹

3.79 This feels like quite an extreme way of rejecting the Commissioner’s basic formulation of the arm’s length hypothesis. Moreover, the rejection is not in terms applied or addressed to the taxpayer’s loss-making history. The Court went on to explain how the TPG contemplate comparability adjustments by reference to the five comparability factors (which of course include the “economic circumstances of the parties”). Referring to the UK *DSG* case (paragraph 3.164ff below), the Court concluded that when there were material differences between the taxpayer and any proposed comparable, such differences should, where possible, result in adjustment and not the exclusion of the comparable⁴⁰². The ATO placed some reliance on the Special Commissioners’ comments about the relevance of the actual characteristics of the parties: paragraph 3.165 below. But “on no reading did [the TPG] support the Commissioner’s submission that one was required to examine only putative purchasers who were in the same

³⁹⁹ Paragraph [102]f. There is an echo here of the US Tax Court’s approach in the *US Steel* case, paragraph 3.220 below.

⁴⁰⁰ Paragraphs [9]-[10].

⁴⁰¹ Paragraph [102].

⁴⁰² Paragraph [105].

circumstances as the taxpayer”⁴⁰³. Clearly this is correct where credible adjustments can be made.

3.80 Given the Court’s tantalising formulation of the interpretive meaning of “independent parties acting at arm’s length” (paragraph 3.77 above), the decision is disappointing because, having formulated the question about the hypothesis to be applied, it fails to answer it. The judgment philosophises about the notion that independence is a relative concept: “[a] requirement, for example, that two businesses be more than 20km apart says nothing about where either business is situated.” In looking at section 136AD –

*“it would be unsound to read it as requiring any more than that the two parties in question should be independent of each other; that is, the ordinary meaning is not as the Commissioner contends ... There is no doubt that section 136AD(3) is, as the Commissioner submits, about the taxpayer; however, it does not follow from acceptance of all those features that arm’s length consideration – which does not, in general, refer to the actual position of either party – must be treated as overlaid by a further requirement that the consideration not only be at arm’s length but that the arm in question be attached to the taxpayer.”*⁴⁰⁴

3.81 Thus, at least prior to the legislative modernisation described above, “[t]he decision suggest[ed] that the arm’s length principle of Australian tax law must be characterized as an objective, market-based standard that deviates from the arm’s length principle of Article 9(1) of the OECD model tax treaty”⁴⁰⁵.

3.82 With judgment delivered in October 2015, *Chevron Australia Holdings Pty Ltd v Commissioner*⁴⁰⁶ has been the first Australian transfer pricing case to address loan pricing, and represents a significant step in the development of international jurisprudence on the recognition of passive association. The taxpayer in the case was an Australian subsidiary (“CAHPL”) of the merged Chevron/Texaco group. CAHPL borrowed funds from its own US subsidiary

⁴⁰³ Paragraphs [104]–[106].

⁴⁰⁴ Paragraph [99].

⁴⁰⁵ Wittendorff (2012) page 1132.

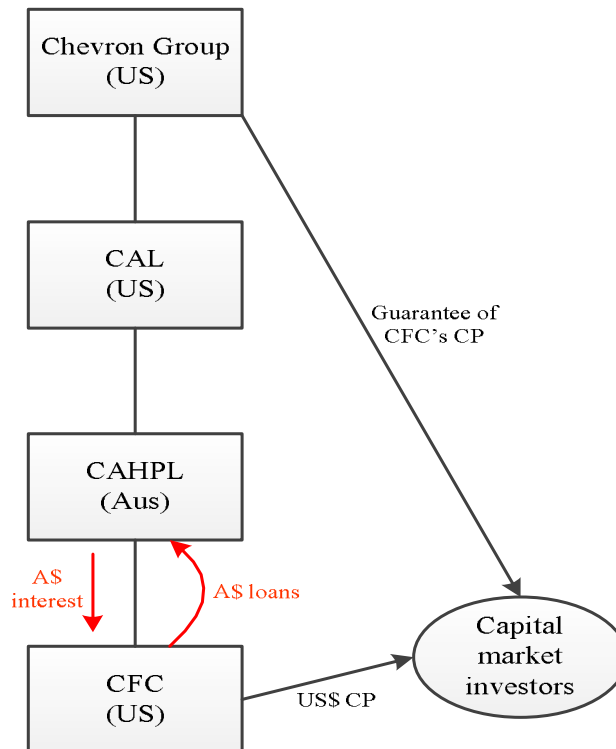
⁴⁰⁶ [2015] FCA 1092.

(“CFC”) which had been formed to raise finance by issuing US\$ commercial paper to the market, guaranteed by Chevron Corporation (no guarantee fee being charged to CFC). CFC lent substantial amounts to its parent CAHPL in Australian dollars. See Fig. VII below, including the red highlighting of the loans/interest which were contentious⁴⁰⁷. Over five years, CAHPL paid CFC approximately A\$1.47 billion of interest. For the most part, the interest rate charged was A\$ LIBOR + 4.14%, totalling about 9% p.a. By contrast, CFC’s commercial paper carried rates at or around US\$ LIBOR (around 1.2%). Of the interest paid by CAHPL, the ATO sought to disallow A\$601 million, invoking section 136AD Income Tax Assessment Act 1936 and alternatively Subdivision 815-A and asserting interest and penalties of around A\$88 million. The ATO argued that the rate of interest payable by CAHPL should be suppressed by implicit support available to it from within the Chevron group. In addition, the ATO considered that Article 9 of the Australia-USA double tax treaty provided a separate and independent basis for making an adjustment to the taxable income of CAHPL. Whereas the ATO’s expert witnesses suggested that a standalone rating for CAHPL of “BB” should be increased by even as much as 6-9 notches to A/AA, the taxpayer denied the legal recognition of implicit support, failing which “at a stretch the most that the parent company, Chevron Corporation, would be taken to affect the risk rating of the subsidiary borrower, CAHPL, is one notch on the risk rating scale”⁴⁰⁸.

⁴⁰⁷ Chevron’s arrangements have been portrayed by the media and NGOs as an alleged tax avoidance scheme: see e.g. *Sydney Morning Herald*, 9 October 2014, referring to the interest rate differential, and dividends flowing back to the taxpayer in tax-free form, quoting academic censure of “effectively eroding the tax base in Australia”.

⁴⁰⁸ Taxpayer’s Outline of Submissions, file 569/2012, 11 August 2014, paragraphs 180 and 195.

Fig. VII



3.83 The case has addressed multiple complex and inter-related issues, including the validity and interaction of assessments under Division 13 and Subdivision 815-A; the effect of Article 9 of the Australia-US tax treaty, both as a separate and independent taxing provision and as an “associated enterprise article” within section 815-10(2); the ability of the tax authority to recharacterise or reconstruct the transaction undertaken (e.g. as regards currency, loan terms, seniority, security); and the constitutional validity of Subdivision 815-A. Importantly for this study, one particular battlefield was the significance of implicit support from Chevron Corporation in the pricing of the intra-group lending from CFC to CAHPL.

3.84 Specifically, the taxpayer contended that the legislative phrase “consideration that might reasonably have been expected to have been given ... [by] ... independent parties”⁴⁰⁹ “is one that necessarily requires the removal of all

⁴⁰⁹ Section 136AD(3)(d) Income Tax Assessment Act 1936.

the connections between the actual parties in the hypothesis or comparison mandated by the provision. Unless all connections are removed, parties will not be independent of each other. That includes common ownership by a single person”; and “the legislation ordinarily requires one to exclude the particular attributes of the parties in question, and to focus instead upon the intrinsic value of the property or services in question. As a consequence, s 136AD should be construed as requiring the specific circumstances of the taxpayer to be disregarded”⁴¹⁰. The taxpayer then drew the analogy with property valuation where the actual attributes of the seller (e.g. actual willingness to sell) are said to be irrelevant. On the other hand, the taxpayer (correctly, of course) accepted that -

“the general rule against introducing [attributes of the parties] to the Division 13 hypothetical inquiry needs to be qualified. The provision of financial accommodation is an example of such a transaction. From an economic perspective the characteristics of the borrowing entity are of utmost importance in determining an interest rate on a loan”.⁴¹¹

3.85 However, the taxpayer maintained that -

“the assets, risk and functions of CAHPL to be attributed to the hypothetical inquiry are those of CAHPL as a standalone entity. This is the point of disagreement with the Commissioner. ... That would require the exclusion (if such a thing exists as a legal concept) of what ratings agencies refer to as ‘implicit support’, namely the assumed existence of a willingness (or the perception of the existence of a willingness) of a parent of the borrower to provide the borrower with credit support in the event of default on the obligation to repay the loan, in the absence of any legally enforceable obligation to do so. The concept of ‘implicit support’ or credit benefit obtained by reason of the taxpayer’s affiliation with Chevron Corporation is the very product of the non-arm’s length relationship. To take account of so called implicit support requires a preservation of a key aspect of the non-arm’s length relationship between CAHPL and CFC, which is

⁴¹⁰ Taxpayer’s Outline of Submissions, file NSD569/2012, 11 August 2014, paragraphs 132(b) and 140.

⁴¹¹ *Ibid.*, paragraph 151.

contrary to, and incompatible with, the concept of ‘independent parties’ prescribed by s 136AD(3)”.⁴¹²

3.86 Moreover, in testing the conditions on which paragraph 815-15(1)(c) operates, i.e. the conditions “which might be expected to operate between independent enterprises dealing wholly independently with one another” –

“[t]he relationship between the lender and the borrower must therefore be eliminated in order to undertake this task, and in a situation where they are sister companies, so too must the relationship between each of them and their common parent. ... The OECD Guidelines provide that two enterprises are ‘independent’ if they are not ‘associated enterprises’. It follows therefore that all and any attributes that give rise to entities being ‘associated’ within the meaning of Article 9 must be disregarded in determining the attributes of the independent parties. ... The terms of Article 9 thus require one to hypothesise a standalone borrower and a standalone lender. There is no room for implicit parental support which of necessity derives from the common owner, Chevron Corporation.”⁴¹³

3.87 It is notable also that the taxpayer took the position that –

“in most cases the attribution of the characteristics of the supplier of financial accommodation (including their cost of funds) is not required because those characteristics do not, ordinarily, impact on the pricing of the financial accommodation. What is priced is the likelihood of default by the borrower which, in turn, depends on the characteristics of the borrower. ... On that basis, ... the characteristics of the actual lender, and in particular CFC’s own funding costs, are irrelevant to the statutory hypothesis. ... The only attributes of the actual parties that are removed in determining the attributes of the hypothetical independent parties are those that arise from the relationship between the actual borrower and the actual lender (and their common parent) which result in those actual parties not being ‘independent’.”⁴¹⁴

3.88 The Commissioner on the other hand argued that a ratings agency would have attributed to CAHPL a rating “having regard to, among other factors,

⁴¹² *Ibid.*, paragraphs 153–154.

⁴¹³ *Ibid.*, paragraphs 236-239.

⁴¹⁴ *Ibid.*, paragraphs 155-156. Compare paragraph 5.4 below.

the implied support CAHPL enjoyed by virtue of its position as a prominent subsidiary of [Chevron Corporation], rather than as if CAHPL was an orphan with no parental support”⁴¹⁵. In particular, the legislation “(a) [did] not authorise the artificial assumption that CAHPL was not 100% owned by [Chevron Corporation] (or a hypothetical equivalent parent); (b) [did] not authorise the determination of the arm’s length price to be made on the false hypothesis that CAHPL enjoyed no parental support”⁴¹⁶. Moreover, “[i]mplied support is no different to any other factor which might influence a lender’s view of the creditworthiness of the borrower and the terms on which it might be prepared to lend. ... In this way, parental support influences a subsidiary’s arm’s length borrowing cost”⁴¹⁷. The ATO also disagreed that the lender’s cost of funds and risks assumed were irrelevant⁴¹⁸, and argued that it is erroneous to permit a taxpayer simply to “enter into a related party loan on such disadvantageous terms to the lender in respect of gearing, covenants, repayments and currency that would inevitably lead to a loan that would be unattractive to a lender and would either not be made by an independent party or, if so, would involve a very high rate of interest”⁴¹⁹.

3.89 The Federal Court robustly dismissed the taxpayer’s case⁴²⁰ on the procedural and constitutional issues and indeed has rejected its argument that the quantum of its interest payments was at or below the arm’s length consideration⁴²¹ (though the Court found that the tax treaty could not be relied on by the Commissioner as a taxing power independent of the national legislation⁴²²). Substantial evidence of ratings methodology and rating agency practices was heard and summarised in the decision, but ultimately the judge found that the

⁴¹⁵ Commissioner’s Outline of Submissions, filed 25 August 2014, file number NSD569/2012, paragraph 15(a).

⁴¹⁶ *Ibid.*, paragraph 122.

⁴¹⁷ *Ibid.*, paragraphs 140-141.

⁴¹⁸ *Ibid.*, paragraph 108.

⁴¹⁹ *Ibid.*, paragraph 112.

⁴²⁰ An appeal to the Full Federal Court was filed by Chevron in December 2015: <http://taxinsight.thomsonreuters.com.au/chevron-transfer-pricing-case/> (accessed 9 January 2016).

⁴²¹ [2015] FCA 1092, paragraph 525.

⁴²² *Ibid.*, paragraph 61.

correct comparator for the controlled transaction was commercial (bank) lending⁴²³ and therefore ratings practice was not relevant⁴²⁴.

3.90 On the correct comparability hypothesis, the Court found the exercise to be “to address an agreement between two parties independent of each other, neither being an actual party to the actual loan ... [T]he exercise should [not] depart from reality more than is necessary ... [and] should remain close to undertaking the actual loan ... [including] what has been shown on the evidence to be relevant in the market in question ... [e.g. whether] the hypothetical borrower not being the taxpayer has at the time of the loan certain financial resources which the lender would regard as relevant to the pricing of the loan”⁴²⁵.

3.91 Specifically on the effects of group affiliations, while the Court accepted the requirement to assess conditions between independent parties –

“it by no means follows that where, as here, the entities in question are sister companies⁴²⁶, also to be eliminated is the relationship between each of them and their common parent ... [I]ndependent enterprises dealing wholly independently with one another may still be subsidiaries and may still have subsidiaries ... I therefore accept the respondent’s submission insofar as he contended that there was no legislative warrant for ignoring affiliation between a hypothesised party to a transaction and other members of that party’s group of companies. ... ‘Implicit support’ may be generally relevant when assessing a borrower’s credit rating.”

3.92 Thus *Chevron* presents an endorsement of the requirement to recognise passive association in pricing controlled transactions. In any particular case, the evidential and quantitative aspects may be challenging (in *Chevron* “implicit support had very little, if any, effect on pricing”⁴²⁷), but the principle is clear. Thus the Court has rejected the taxpayer’s view that attributes arising from the group relationship should be excised. This sits comfortably alongside the

⁴²³ *Ibid.*, paragraph 503.

⁴²⁴ *Ibid.*, paragraphs 254, 433, 469.

⁴²⁵ *Ibid.*, paragraphs 499-502.

⁴²⁶ In fact the parties were parent and subsidiary, but the judge’s point is correct to the extent of looking to a common controlling parent i.e. Chevron Corporation.

⁴²⁷ *Chevron* judgment, paragraph 606.

Canadian jurisprudence. It is appropriate to eliminate price-distorting effects of control, but it goes too far to eliminate all effects of affiliation.

Tax authority practice

3.93 Early ATO guidance on Division 13 as it related to loans and credit balances⁴²⁸ confirmed that “all relevant facts and circumstances surrounding an international agreement will be taken into account in determining an arm’s length consideration”; this would include the credit standing of the borrower⁴²⁹. The ATO also confirmed their view that “independent parties when evaluating the terms of a potential deal would compare the deal to the other options realistically available to them and would enter into the deal only if there was no alternative clearly of greater commercial advantage to the individual entity”⁴³⁰; “[i]t would not be expected that a seller would accept less or a buyer pay more than the open market price ... or settle, for example, for less profit ... than would have been available to an uncontrolled enterprise.”⁴³¹ Also as to comparability, “the fundamental principle of the [TPG] and the statutory objective of the Australian rules are the same, namely, what truly independent parties acting independently would probably have done *in the taxpayer’s circumstances*”⁴³². In relation to intra-group services, including the provision of finance, “the position on incidental benefits taken by the OECD in paragraphs 7.12 and 7.13 of its 1995 Report” is adopted by the ATO⁴³³.

3.94 A thoughtful and informative discussion paper was produced by the ATO in June 2008: *Intra-group finance guarantees and loans – Application of*

⁴²⁸ TR 92/11.

⁴²⁹ *Ibid.*, paragraphs 80(a), 83(g).

⁴³⁰ TR 94/14 paragraph 315; TR 97/20 paragraph 2.4. In this context (TR 97/20 paragraphs 2.5 and 2.17) the ATO also posed the question as “what would have happened if the ownership link had been severed and the enterprise was motivated by its own economic interest?” I do not consider that one can infer from this that the ATO was rejecting the recognition of passive association; in any event, subsequent developments are clearly to the contrary.

⁴³¹ TR 97/20 paragraph 2.17.

⁴³² TR 97/20 paragraph 1.23, my emphasis.

⁴³³ TR 1999/1 paragraph 32.

*Australia's transfer pricing and thin capitalisation rules*⁴³⁴, inviting comments from the public on the ATO's "suggested methodology and framework" for arriving at arm's length debt pricing. The paper did not commit the ATO to any particular position, and has since been withdrawn, but nonetheless may be regarded as a fair summary of their thinking at the time. One objective was to build on TR 92/11 which, as noted above, included creditworthiness as a factor in determining an arm's length interest rate, but did not address how creditworthiness is determined.

3.95 The paper observed that "major lenders and the capital markets more generally will have regard to group relationships in evaluating the credit risk they are prepared to assume in respect of any one group or industry", and "a lender may be prepared to lend to a subsidiary of a major multinational, which may not be creditworthy on a strict stand-alone assessment, where the lender judges that the subsidiary is conducting activities that are core to the group's activities and that accordingly the parent is likely to stand behind the subsidiary in the event of difficulty lest its own credit rating be adversely affected"⁴³⁵.

3.96 Four scenarios were discussed in detail: (i) a parent loan to a subsidiary that could not borrow on a stand-alone basis; (ii) a parent loan to a subsidiary that could borrow by itself; (iii) a parent guarantee for the benefit of a subsidiary that could not borrow on a stand-alone basis; (iv) a parent guarantee for a subsidiary that could borrow by itself, but which enables the subsidiary to access a lower interest rate. "Explicit credit support" is distinguished from "implicit credit support", the latter including "credit support obtained as an incidental benefit from the taxpayer's passive affiliation with the multinational group, its parent or another group member"⁴³⁶. In each of the four cases, the ATO was at least amenable to implicit support being taken into account in pricing the relevant instrument. In scenario (i), the arguments for and against are recited: "[s]ome say that to do so would be inconsistent with the arm's length principle embodied in the

⁴³⁴ Cited in the Indian *Micro Ink* case, paragraph 3.139 below.

⁴³⁵ Paragraphs 25-26.

⁴³⁶ *Ibid.*, paragraphs 52-53.

Associated Enterprises Articles of Australia’s double tax agreements and Division 13, which are based on the outcome that would be achieved by independent parties dealing wholly independently with each other. Others argue that since the notching advantage flows from the market and not something the parent company has done or provided, the benefit to the subsidiary should be regarded as incidental and attributable solely to its being part of a larger concern⁴³⁷. The ATO then seemed to lean towards the recognition of passive association:

“There are no widely accepted objective criteria for allocating such economies or diseconomies of scale or benefits and disadvantages of integration and in such circumstances it may be appropriate to determine the outcome by reference to what the subsidiary could achieve itself through dealing directly in the open market, despite the fact that the market will pay some regard to affiliation.

“Accordingly, if on a stand-alone basis the subsidiary had a credit rating below investment grade which dictated an interest rate of 15% but the market was prepared to notch up the credit rating without any further financial support or binding commitment from the parent to a level that allowed the subsidiary to borrow at 12% it could be argued that the 12% interest rate represents the correct arm’s length transfer price.”⁴³⁸

3.97 Similarly in scenario (ii), “it is arguably not appropriate to adjust a market price that includes notching benefits that incidentally arise from the passive association of the subsidiary with the wider group⁴³⁹ (i.e. arguably it is appropriate to recognise passive association). In scenario (iii), independent borrowers would not “be expected to pay fees for benefits that are already available, whether those benefits are available on a cost-free basis or have already been purchased for full value”; and “[w]here a subsidiary derives implicit credit support as an incidental benefit from its parental affiliation, the benefit derives from the market, not from the provision of any service by the parent ... Depending on the facts and circumstances, it may be that a subsidiary that is not creditworthy on a pure stand-alone analysis is able to obtain the debt funding it needs because the market is prepared to notch up the credit rating on the basis of

⁴³⁷ *Ibid.*, paragraphs 74-75.

⁴³⁸ *Ibid.*, paragraphs 75-76.

⁴³⁹ *Ibid.*, paragraph 80.

the subsidiary's group affiliation". An example is given of a subsidiary with a strict stand-alone rating of BB which is nonetheless accorded a rating of A+ by the market based on parental affiliation; the AA-rated parent then provides a guarantee: "[t]he benefit the parent has provided to the subsidiary is the improvement in the credit rating from A+ to AA", thus [t]he benefit to the subsidiary is the marginal saving in interest expense from being able to borrow on an AA rated basis instead of the A+ rating it would have obtained without the guarantee. This is the only benefit for which an independent borrower would be prepared to pay."⁴⁴⁰ Again, in scenario (iv) the value to the credit-worthy subsidiary of an explicit parental guarantee is said to reflect the difference between its rating "after any notching up of the subsidiary's stand-alone rating that the market was prepared to make" and the parent's rating⁴⁴¹. Having provided some rather clear indications that passive association is a relevant factor in pricing controlled lending or guarantee transactions, the ATO slightly muddied the water with the concluding words in the discussion paper:

"[W]here a borrower and a guarantor or lender are related parties, the application of the arm's length principle in determining a guarantee fee or loan interest rate requires that regard be had to the creditworthiness of the borrower considered independently of its parent. Unless an MNE group member is hypothesised as if it were an independent stand-alone entity separate from the group and its other members it is impossible to determine whether conditions operate between the parent and subsidiary that distort what would have occurred if the parties were independent of each other and dealing wholly independently with each other. The essence of the arm's length principle is the reliability of the outcomes produced by independent parties dealing wholly independently with each other in the open market. It is the absence of any organisational influence or impact and the economic tension between the parties in these circumstances in seeking to optimise their economic outcomes that generates reliability ...

"Accordingly, an arm's length creditworthiness can be defined for the purposes of applying the transfer pricing rules as being the level of creditworthiness at which an independent party would regard the risk as acceptable in providing a loan or guarantee

⁴⁴⁰ *Ibid.*, paragraphs 107-114. This 2008 commentary was strikingly prescient of the Canadian *General Electric* case (paragraph 3.16ff above).

⁴⁴¹ *Ibid.*, paragraph 117.

to a borrower company without requiring financial support undertakings from its parent, and which results in a cost to the borrower that allows it to remain viable and obtain an acceptable return from its line of business. Thus, an arm's length creditworthiness for a borrower is appropriately determined using the criteria an independent lender or guarantor would use to determine the probability of default if its only redress were against the borrowing subsidiary."⁴⁴²

3.98 This was less than crystal clear, but probably the ATO's references to "financial support undertakings" and "redress" meant contractually binding recourse, such that passive association still fell to be considered in assessing the borrowing capacity of a subsidiary in applying the arm's length test. The phrase "absence of any organisational influence or impact" has a strong flavour of behavioural distortions caused by a control relationship, not mere passivity. The paper was withdrawn in December 2009.

3.99 At that time the ATO issued draft practice statement PS LA 3187. This offered a "practical rule of thumb" approach, permitting taxpayers to set outbound related party interest flows at a rate reflecting the weighted average cost of debt of the taxpayer's foreign parent company. One commentator thought that this "could amount to an implicit endorsement of the 'notching' concept when analysing intercompany interest, wherein a subsidiary is viewed as having the same credit rating as its parent even in the absence of a formal guarantee"⁴⁴³. The "rule of thumb" was criticised by the Institute of Chartered Accountants in Australia as akin to global formulary apportionment for interest expense and because "it fails to have regard to any factors that might materially impact interest rates on loans between independent parties e.g. security, subordination, term, etc"⁴⁴⁴; the ATO eventually accepted the Institute's representation that the draft practice statement should be withdrawn.

⁴⁴² *Ibid.*, paragraphs 185-188.

⁴⁴³ Duff & Phelps *Transfer Pricing Times* vol. VII issue 3, available at <http://www.duffandphelps.com/services/tax/Pages/TPTimesArchive.aspx?itemid=28> (accessed 6 July 2015).

⁴⁴⁴ Submission dated 19 February 2010.

3.100 Taxation Ruling TR 2010/7 importantly discusses the interaction of the Division 820 thin capitalisation rules and the transfer pricing rules, albeit that coverage of the latter related to the now repealed Division 13. The Ruling focuses only on inbound finance, although “it is expected that the ATO will apply the same principles for outbound transactions”⁴⁴⁵. The ATO emphasises the need for the outcome to make “commercial sense in all the circumstances of the case”⁴⁴⁶. Naturally enough, the CUP method finds favour, both in a worked internal comparable example where transfer pricing rules are found inapplicable because a loan from an independent lender is “sufficiently similar” to the intra-group debt⁴⁴⁷, and in a general statement about determining arm’s length consideration in relation to debt funding: “[i]n practice, the most reliable method is that which uses available data as to the pricing of a comparable loan between comparable independent parties dealing at arm’s length in comparable circumstances ... all the relevant facts and circumstances surrounding the ‘international agreement’ will be taken into account in determining that consideration”⁴⁴⁸.

3.101 The significance of implicit support is acknowledged: “[w]here, for example, the operations of the borrower are core to the group in the sense that its functions were a vital part of an integrated business, it would generally be expected that the borrower company would have the same credit standing as its parent”, and (noting the importance of the credit standing of a borrower) “factors include ... parental affiliation”; and a possible approach is “to consider the circumstances of comparable companies which operated in the particular market which, under their capital structures and/or with the benefit of parental affiliation, were able to borrow from third parties the amounts in question”⁴⁴⁹. Yet more explicitly, in the associated Compendium of stakeholder representations and ATO responses, the ATO stated unequivocally that –

⁴⁴⁵ Duff & Phelps (2014), Australia chapter by Shannon Smit and Adriana Calderon, page 163.

⁴⁴⁶ TR 2010/7 paragraph 50.

⁴⁴⁷ *Ibid.*, paragraph 17.

⁴⁴⁸ *Ibid.*, paragraph 46.

⁴⁴⁹ *Ibid.*, paragraphs 49, 52 and 57.

*“[w]e consider that taking account of parental affiliation is consistent with the arm’s length principle embodied in the transfer pricing provisions where, in determining the creditworthiness of a borrower, it is a feature of the market to take account of any affiliation the borrower has.”*⁴⁵⁰

3.102 In summary, it is plain that the ATO has embraced the notion of implicit support. For some time it has asserted the effect of passive association on related party loan and guarantee pricing⁴⁵¹. *Chevron* vindicates the approach adopted; if anything, the current law in Subdivisions 815-B to 815-E should be clearer still. More specifically, a statutory foundation has been laid for the recognition of such effects in Australia’s modern transfer pricing law at section 815-125 and the accompanying explanatory material. Further engagement with the topic may follow in the thin capitalisation context if the Board of Taxation’s recommendations are followed.



India

3.103 Transfer pricing has become the single most important weapon in India’s international tax armoury and is perceived as “the best policy instrument for securing a fair allocation of taxes and addressing BEPS”⁴⁵². Transfer pricing

⁴⁵⁰ Compendium of responses to issues raised by external parties to draft TR 2009/D6 (the predecessor of TR 2010/7, itself a reissue of draft Tax Determination 2007/D20), issue no. 5. In TR 2009/D6 paragraph 32, the ATO said “[t]aking account of parental affiliation is consistent with the arm’s length principle embodied in the transfer pricing provisions where, in determining the creditworthiness of a borrower, it is a feature of the market to take account of any affiliation the borrower has.”

⁴⁵¹ See e.g. PwC (2013), Australia chapter: “Informally PwC is aware that the ATO has challenged guarantee fees where it has formed the view that they have been priced without regard to passive association or implicit support.”

⁴⁵² Dr Parthasarathi Shome, Chairman, Tax Administration Reforms Commission, Government of India, speaking at the “TP Minds” conference in Singapore on 24 September 2014.

adjustments for 2014-15 have been reported as 46,465 Rs. Crore (c.£4.65 billion)⁴⁵³.

3.104 India's transfer pricing code, introduced in 2001, is a relative youngster. Yet it has spawned more than 700 reported cases⁴⁵⁴, some of those dealing directly with financial transactions including the pricing of intra-group loans and guarantees. However, the jurisprudence which emerges from the cases is sometimes chaotic, and the quality of the logic and reasoning applied, particularly in the several benches of the Income Tax Appellate Tribunal (ITAT), is (given the fertile ground for judicial exposition) often frustratingly thin. Decisions from India's various High Courts are generally of greater rigour, but at that level the case law with even indirect relevance to the topic of passive association is sparse. In short, the subtlety of adjusting pricing of related party transactions to take account of passive association has not yet arrived in Indian transfer pricing law. Yet the seed has been planted and surely a convincing judgment on the topic will emerge soon. One might expect that embracing notions of implicit support should eventually appeal to the tax authority of a net capital importing country (see paragraph 1.27 above).

Legislation

3.105 The Indian Finance Act 2001 introduced transfer pricing rules as sections 92 and 92A-92F Income Tax Act 1961, effective from 1 April 2002, applicable to international transactions between associated enterprises (AEs): arm's length pricing is to govern for tax purposes⁴⁵⁵. The legislation "is broadly in line with the OECD Guidelines"⁴⁵⁶. The Finance Act 2012⁴⁵⁷ made significant amendments. The basic rule at section 92(1) prescribes that "[a]ny income arising from an international transaction shall be computed having regard to the arm's

⁴⁵³ Jindal (2015) page 24.

⁴⁵⁴ Source: discussion with Mukesh Butani of BMR Legal, New Delhi, 16 July 2014 – the figure is now significantly greater.

⁴⁵⁵ For a review of the pre-2001 position, where various statutory provisions afforded scope for tax assessments in the nature of transfer pricing adjustments, see Butani (2007) chapter 2.

⁴⁵⁶ Butani (2007) page 294.

⁴⁵⁷ Available at <http://law.incometaxindia.gov.in/> (accessed 24 August 2015).

length price”. The “arm’s length price” means “a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions”⁴⁵⁸. The transfer pricing rules were extended to certain “specified domestic transactions” in 2012. The arm’s length rule operates as a “one way street” in that it cannot reduce income or increase a loss⁴⁵⁹.

3.106 The meaning of “associated enterprise” is at first sight (section 92A(1)) closely modelled on the relationships described by Article 9(1) MTC, adopting the concept of participation by one enterprise, directly or indirectly, in the management, control or capital of another, as well as enterprises under common control of those types. Then an individualistic list of deemed association cases follows in section 92(2), including 26%+ voting power, loans of at least 51% of the borrower’s book value, guarantors of 10%+ of another enterprise’s debt, board control, various other cases of economic inter-dependency and a sweeper for cases where “there exists between the two enterprises, any relationship of mutual interest, as may be prescribed”.

3.107 Apart from limited classes of “specified domestic transaction”, India’s transfer pricing rules apply to “international transactions”. This means “a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises” (also certain cost contribution arrangements are described). Transactions with unrelated persons are deemed to be between AEs “if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other person and the associated

⁴⁵⁸ Section 92F(ii). “Enterprise” is widely defined to mean a person engaged in any of a long list of business-like activities (including providing a loan) (section 92F(iii)), and “transaction” includes “an arrangement, understanding or action in concert” whether or not formal or written and whether or not legally enforceable (section 92F(v)).

⁴⁵⁹ Section 92(3).

enterprise”⁴⁶⁰. This rule of extension may apply to situations where (a) a borrower subsidiary agrees with a third party lender to procure a guarantee from its (the borrower’s) parent, or (b) the terms of a borrower subsidiary’s third party loan are negotiated by its parent. An “Explanation” was added by the Finance Act 2012 confirming *inter alia* that, with retrospective effect from 1 April 2002, “international transaction” shall include “(i)(c) capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business”.

3.108 Section 92C prescribes methods for arm’s length pricing, including the familiar CUP, as well as “such other method as may be prescribed by the Board”. The “most appropriate” method is to be applied “in the manner as may be prescribed”. These provisions thus cross-refer to the Income Tax Rules 1962, as amended⁴⁶¹.

3.109 Rule 10AB of the 1962 Rules provides that the “other method” within section 92C(1)(c) “shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts”. “Uncontrolled transaction” means a transaction between enterprises other than AEs⁴⁶². Rule 10B(1)(a) elaborates upon the CUP method: “(i) the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified; (ii) such price is adjusted to account for differences, if any, between the [*transaction under review*] and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market; (iii) the adjusted price arrived at under sub-clause (ii) is taken to be an arm’s length price

⁴⁶⁰ Section 92B(1) and (2). Finance (No.2) Act 2014 made clarifying amendments with effect from 1 April 2015.

⁴⁶¹ Made under section 295 Income Tax Act 1961. Section 92CB contemplates safe harbour rules; these were issued by the CBDT on 14 August 2013, and extend to certain intra-group loans and guarantees: paragraph 3.110 below.

⁴⁶² Rule 10A(ab).

in respect of the property transferred or services provided in [*the transaction under review*]”. Rule 10B(2) requires that comparability be judged via several factors strongly redolent of paragraph 1.36 TPG, covering specific characteristics of property transferred or services provided; functions performed; contractual terms, including as to risks and benefits; and conditions prevailing in the relevant markets. Rule 10C dictates that the “most appropriate method shall be the method which is best suited to the facts and circumstances of each [*transaction under review*]”.

3.110 The subsequent Rules are mostly concerned with information and documentation requirements and with India’s advance pricing agreement system, but conclude with provisions governing safe harbours. Eligible transactions include certain intra-group loans⁴⁶³ and corporate guarantees. A “corporate guarantee” means “explicit corporate guarantee extended by a company to its wholly owned subsidiary being a non-resident in respect of any short-term or long-term borrowing”; an Explanation in the Rules confirms that “explicit corporate guarantee does not include letter of comfort, implicit corporate guarantee, performance guarantee or any other guarantee of similar nature”⁴⁶⁴. Here at least is express recognition in the legislation of the distinction between explicit and implicit support. The amount guaranteed must not exceed certain limits (depending on the credit rating of the AE debtor)⁴⁶⁵. A safe harbour minimum guarantee fee of 2% or 1.75% (depending on that credit rating) is prescribed by Rule 10TD. The safe harbour rules are not available when the AE is located in a zero or low tax territory⁴⁶⁶.

3.111 For several years, the Indian Government worked on a new Direct Taxes Code – essentially a form of tax law re-write project. The most recent version of the draft Code was released in April 2014, and Part F Chapter XII

⁴⁶³ Defined by Rule 10TA(f) to be one advanced to a wholly owned non-resident subsidiary, sourced in rupees, not being advanced by a financial enterprise in the ordinary course of business and not being an advance with no fixed repayment term.

⁴⁶⁴ Rule 10TA(c).

⁴⁶⁵ Rule 10TC(v).

⁴⁶⁶ Rule 10TF. A low tax territory is one where the maximum rate of income tax is less than 15%: Rule 10A(i).

contained “Special Provisions Relating to Avoidance of Tax”, in which the transfer pricing rules were found. The rules were however closely modelled on the existing legislation, containing the basic arm’s length pricing rule at clause 119, the most appropriate method rule in clause 120, provision for safe harbour rules (section 120(8)) and broad and extended definitions of “associated enterprise”, “international transaction” and “transaction”. The capital financing heading (paragraph 3.107 above) was specifically legislated at clause 127(11)(a)(iv). Nothing however in the re-write appeared likely to influence the debate regarding passive association in Indian transfer pricing laws. The revised Code was shelved in the 2015 Budget by the Government of India elected in 2014⁴⁶⁷.

3.112 India is not a member of the OECD, but sits as an “observer” at the CFA. In a number of relevant cases discussed below, the TPG are invoked, and tax offices have indicated their intent of broadly following the TPG during audits to the extent not inconsistent with the Indian legislation⁴⁶⁸. In the Supreme Court in *Union of India v Azadi Bachao Andolan*⁴⁶⁹, interpretative reliance was placed on the OECD MTC Commentary. Butani (2007) cites other authorities supporting the need “to give due regard to international conventions and norms for construing domestic laws more so when there is no inconsistency between them and there is a void in domestic law”⁴⁷⁰. See paragraph 3.119 on reference to the TPG and UN Manual.

3.113 India’s double tax treaties typically adopt a provision based on Article 9(1) MTC. If a tax liability is imposed by domestic statute, the taxpayer may

⁴⁶⁷ Speech of Arun Jaitley, Minister of Finance, 28 February 2015 (“... there is no great merit in going ahead with the Direct Tax Code as it exists today”).

⁴⁶⁸ PwC’s *International Transfer Pricing*, 2013/14, page 486.

⁴⁶⁹ (2003) 263 ITR 707.

⁴⁷⁰ Page 395, citing the Supreme Court in *Apparel Export Promotion Council v A.K. Chopra JT* (1999) 1 SC 61. However, official comment (29 June 2007) on the relevance of OECD guidance remains dismissive: <http://www.itatonline.org/info/index.php/relevance-of-oecd-guidelines-departments-view> (accessed 22 December 2015).

invoke an applicable treaty to eliminate or reduce that liability; a treaty cannot itself impose tax not contemplated by the statute⁴⁷¹.

3.114 Butani also notes⁴⁷² that foreign case law from countries with the same system of jurisprudence may, while not being formally binding, be used in interpreting Indian legislation dealing with the same subject matter, subject always to the primacy of the language of the Indian statute.

3.115 India does not have statutory thin capitalisation rules. The importation of debt capital is regulated by exchange control rules concerning “external commercial borrowings” (ECB), including with regard to debt:equity ratio and capping interest payable by Indian residents. However, by analogy with other cases, it seems that permissibility under exchange control regulation will not establish that a payment is at arm’s length from the transfer pricing perspective⁴⁷³.

3.116 A general anti-avoidance rule (GAAR) (proposed Chapter XA Income Tax Act 1961) is anticipated⁴⁷⁴. This will target “impermissible avoidance arrangements” i.e. certain classes of arrangement, the main purpose of which is to obtain a tax benefit. One case is where the arrangement “creates rights or obligations which are not ordinarily created between persons dealing at arm’s length”. Various counteraction mechanisms will be available including treating the impermissible avoidance arrangement as if it had not been carried out, and “reallocating amongst the parties to the arrangement any accrual, or receipt, of a capital nature or revenue nature, or any expenditure, deduction, relief or rebate”⁴⁷⁵. Also, “any equity may be treated as debt or *vice versa*”⁴⁷⁶. Expressly, treaties may

⁴⁷¹ *Azadi Bachao Andolan* at page 733.

⁴⁷² Page 395.

⁴⁷³ *CIT v Nestlé India Ltd* ITA 662/2005; *Coca Cola India Inc v ACIT* 309 ITR 194, cited in Bakker and Levey (2012), India chapter by Mukesh Butani, pages 289-290.

⁴⁷⁴ The 2015 Budget announced that implementation of GAAR will be deferred until 1 April 2017.

⁴⁷⁵ Section 98(1)(b) and (e), the latter perhaps drawing inspiration from the US section 482.

⁴⁷⁶ Section 98(2)(i). An Indian court may be prepared to invoke recharacterisation concepts following what is now paragraph 1.122ff TPG to treat excessive debt as equity, see e.g. the Delhi High Court at paragraph 149 of the *Sony Ericsson* case, citation at note 486 below.

be overridden⁴⁷⁷. Clear transfer pricing and thin capitalisation themes are visible here, but nothing that is likely to bear on passive association more so than the existing legislation.

Case law

3.117 An extraordinary proliferation of cases, mostly at ITAT level, has addressed the arm's length pricing of loans, guarantees and outstanding receivables⁴⁷⁸. The guarantee cases have mostly addressed "outbound" guarantees granted by Indian companies in respect of indebtedness of foreign AEs. Reported litigation has been scarce⁴⁷⁹ in the converse case where an Indian subsidiary pays a guarantee fee for a foreign parent's guarantee to a third party as in the Canadian *General Electric* case: paragraph 3.16ff above. Nevertheless, *General Electric* is now being cited in argument. However, aside from a passing reference to taxpayer argument in the *Nimbus Communications* case (paragraph 3.133 below), the effect on pricing of implicit support has not yet made its way into the Indian financial case law. Perhaps this is partly due to the pattern and process of transfer pricing litigation whereby taxpayers adopt a certain position, the tax authority imputes a higher level of income, and then the appeals process judges whether the tax authority position is sustainable – mostly it has not been⁴⁸⁰. One might expect that invoking the notion of implicit support would favour taxpayers in outbound guarantee cases, because it tends to suppress the quantum of the arm's length price required to be reported by the guarantor.

3.118 Yet it is surely only a matter of time before passive association features as a pricing factor in Indian financial transfer pricing litigation. It has been suggested that the Supreme Court's ruling in *Director of Income Tax v Morgan Stanley & Co. Inc*⁴⁸¹ that no charge was justified for stewardship activities and the

⁴⁷⁷ The Expert Committee's *Final Report on General Anti-Avoidance Rules (GAAR) in Income-tax Act 1961* (2012) recommended (page 44) that where a treaty has specific anti-avoidance provisions these should not be displaced by the GAAR.

⁴⁷⁸ A good summary is provided in chapter 4 of Jindal (2015).

⁴⁷⁹ Compare e.g. the *DSM* case: paragraph 3.140 below.

⁴⁸⁰ The approach to process and onus of proof does not e.g. follow the US model described at paragraph 3.219 below.

⁴⁸¹ Appeal (civil) 2914 of 2007 (9 July 2007).

work performed in India by staff sent there by the taxpayer group's US parent may "be extended to the understated passive association or implicit support in case of financial transactions"⁴⁸². Elsewhere, the concept has appeared expressly in *Knorr-Bremse India Pvt Ltd v ACIT*⁴⁸³ in relation to expenses claimed for various putative intra-group services. The ITAT found that the evidence "only goes to reveal that incidental and passive association benefit has been provided by the associate enterprise. In this view of the matter there could neither be any cost contribution or cost reimbursement nor payment for such services to the AE. The TPO, therefore, has rightly adopted nil value for benchmarking the arm's length price in respect of both these services". Similarly, in *Mitsubishi Corporation India Pvt Ltd v DCIT*⁴⁸⁴, in the context of development of intangibles, the Delhi ITAT ruled –

"[t]he particular business model which gives rise to this edge, assuming that there is indeed an edge, to the assessee is a result of group synergy, and intangibles as a result of such group synergy cannot, therefore, be assigned to the assessee alone. In any event, when the impact of group synergy is taken into account, it is only when it consists of deliberate concerted action⁴⁸⁵ benefits, and not when it merely consists of the passive association benefits. There is no such suggestion of deliberate concerted action benefits in this case."

3.119 The Indian courts are comfortable referring to the TPG and the UN Manual (paragraph 2.90 above) in transfer pricing cases. A good transfer pricing example (addressing local advertising, marketing and promotion expenditure by a distributor) is the Delhi High Court's decision in *Sony Ericsson Mobile Communications India Pvt Ltd v Commissioner of Income Tax* (and joined cases): "[w]e have taken note and liberally referred to the two guidelines as it is found to be conducive and helpful in deciding the issues". Additionally, the High Court in

⁴⁸² Bloomberg BNA Transfer Pricing Forum, *Implicit Support*, India chapter by Rahul Mitra, Aditya Hans and Devendra Gulati (2013).

⁴⁸³ ITA No. 5097/Del/2011 paragraph 14. In *BMW India Pvt Ltd v ACIT* ITA No. 385/Del/2014 the ITAT heard how the TPO had invoked paragraph 7.13 TPG and the *Knorr-Bremse* decision to resist expense deductibility; the case was remitted by the ITAT to the TPO for further consideration upon the evidence.

⁴⁸⁴ ITA No. 5042/Del/11.

⁴⁸⁵ A phrase precisely echoing the BEPS reforms, paragraph 2.82 above.

Sony Ericsson referred to the US section 482 regulations and to ATO guidance, emphasising the arm's length principle's objective "to correct distortion" and "to ensure that the controlled taxpayers are given *tax parity* with uncontrolled taxpayers"⁴⁸⁶.

3.120 Loans. An important modern (2015) authority on the correct approach to loan transfer pricing is the Delhi High Court decision in *Cotton Naturals (India) Private Limited v Commissioner of Income Tax*⁴⁸⁷. This case reviewed the main ITAT judgments (discussed further below), and rejected the TPO's attempt to restructure the transaction (a US\$ loan to the taxpayer's US subsidiary), citing the "exceptionality" standard in what are now paragraphs 1.121-125 TPG, emphasising the need for a careful comparability analysis reflecting the approach in the TPG and the UN Manual. This required consideration of "what an independent distributor and marketer, on the same contractual terms and having the same relationship, would have earned/paid as interest on the loan in question"⁴⁸⁸. The High Court also noted that transfer pricing logic must be applied equally to both inbound and outbound loans, contrary to the Revenue's submission⁴⁸⁹.

3.121 An oddity in some of the cases is the lack of connection made (by the tax authority at least) between arm's length interest rates and the currency of the loan in question. For example, in *Siva Industries & Holdings Limited v ACIT*⁴⁹⁰ the Indian taxpayer had lent US\$ to its foreign AE, but the TPO, referring to the Indian prime lending rate, proposed 14% on the basis that this was required to compensate the lender for adverse foreign currency movement risk. The ITAT rejected this approach, ruling that a LIBOR-based rate should be used, so that the actual (higher) rate charged by the taxpayer was not susceptible to transfer pricing

⁴⁸⁶ ITA No. 16 of 2014, paragraphs 60, 77, 122-123, 125, 127. My emphasis. See also *CIT v EKL Appliances Ltd* ITA Nos. 1068 and 1070/2011 paragraph 19 accepting the TPG as "valid input" regarding recharacterisation, and other cases cited by Jindal (2015) at page 40ff.

⁴⁸⁷ ITA No. 233 of 2014.

⁴⁸⁸ Paragraph 23.

⁴⁸⁹ Paragraph 37.

⁴⁹⁰ ITA Nos. 2148/Mds/2010; 1917/Mds/2011.

adjustment. The tax authority has been curiously persistent with its use of rupee benchmarking of loans which are in foreign currency. It is now clear that this approach is fundamentally flawed: see e.g. *Cotton Naturals*⁴⁹¹ applied in *Hinduja Global Solutions Ltd v ACIT*⁴⁹².

3.122 By contrast, the tax authority prevailed in arguing for the use of US\$ LIBOR plus a 1.64% margin, based on five putative comparables, in *Perot Systems TSI (India) Ltd v DCIT*⁴⁹³, contrary to the taxpayer's position that no interest needed be charged to its Bermudan and Hungarian subsidiaries because the loans in question were quasi-equity. The taxpayer's attempt to recharacterise its own transaction by invoking paragraph 1.37 TPG (1995 edition) was rejected, as was reliance on the applicable Hungarian thin capitalisation rules and an esoteric reference to the UK's tonnage tax manual⁴⁹⁴. The ITAT observed that "[t]he aim is to examine whether there is anomaly in the transaction which arise out of special relationship between the creditor and the debtor"⁴⁹⁵; there is a nod here to the policy underlying transfer pricing being the elimination of distortions attributable to the control relationship⁴⁹⁶.

⁴⁹¹ Delhi ITAT, ITA No. 5855/Del/2012; High Court decision, note 487 above, quoting Vogel (3rd edition) commenting on Article 11(5) OECD MTC.

⁴⁹² ITA No. 254/Mum/2013. Also see e.g. *Mahindra & Mahindra Ltd v ACIT* ITA No. 586/Mum/2013; *Ces Pvt Ltd v DCIT* ITA No. 1445/Hyd/2010; *Apollo Tyres Ltd v ACIT* ITA No. 16/Coch/2011; *Vijay Electricals Ltd v ACIT* ITA No. 1159/Hyd/2013; *Videocon Industries Ltd v ACIT* ITA No. 1728/Mum/2014; *Aditya Birla Minacs Worldwide Ltd v DCIT* ITA No. 7033/Mum/2012; *Prolific Corporation Ltd v DCIT* ITA No.237/Hyd/2014; *Manugraph India Ltd v DCIT* ITA No. 4761/Mum/2013. An alternative tax authority strategy has been to start with the relevant LIBOR rate, but then add extravagant margins for credit risk and transaction costs. That approach was rejected in favour of the Reserve Bank of India's guidance on external commercial borrowings in *Ion Exchange (India) Ltd v ACIT* ITA No. 5109/Mum/2013.

⁴⁹³ [2010] 37 SOT 358. An attempt by the TPO to apply a rate of LIBOR + 0.25% to short-term interest-free advances was rejected in *Wipro Ltd v DCIT* ITA No. 1178/Bang/2007 following an utter failure to present any comparables.

⁴⁹⁴ Probably what is now TTM07500: "[m]any shipping groups use intra-group interest-free loans from one UK company to another as a more flexible alternative to an equity investment. Under the transfer pricing rules, interest is not imputed on loans which cross the ring fence if they are properly regarded as performing an equity function – i.e. where, and to the extent that, the loan renders the debtor company thinly capitalised."

⁴⁹⁵ Paragraph 10 of the decision.

⁴⁹⁶ See e.g. paragraph 1.3 TPG – a central theme of this study.

3.123 In *Aithent Technologies Pvt Ltd v Income Tax Officer*⁴⁹⁷ the ITAT held that the CUP method was applicable for pricing an outbound interest-free loan (the implication of the tribunal's approval of *Perot Systems* being that US\$ LIBOR was the appropriate base) and, in the absence of valid comparables submitted by either party, remitted the case to the Assessing Officer for reconsideration. What was required was "assessment of the credit quality of the borrower and estimation of a credit rating, evaluation of the terms of the loan e.g. period of loan, the amount, the currency, interest rate basis, and any additional input such as convertibility and finally estimation of arm's length terms for the loan based upon the key comparability factors and internal and/or external comparable transactions". The source of the taxpayer-lender's funds, and notions of "commercial expediency", were "wholly irrelevant"⁴⁹⁸.

3.124 Outbound non-rupee loans have been scrutinised by the ITATs in several other cases. The general themes emerging from the decisions are (a) a rejection of the TPO's attempts to apply the familiar 14% rupee rate and approval of relevant currency market rates⁴⁹⁹, (b) scepticism about the relevance of "commercial expediency" as a justification for any particular transaction⁵⁰⁰, and (c) criticism (usually directed at the TPO) of a lack of rigorous comparability analysis⁵⁰¹.

⁴⁹⁷ ITA No. 3647/Del/2007 (2011 Delhi ITAT).

⁴⁹⁸ Paragraph 7. The High Court in *Cotton Naturals* (paragraph 3.120 above) was reluctant to reject "commercial expediency" out of hand, dismissing the argument that "commercial expediency and related benefits have no connection or relationship with the rate of interest" although "this fact could be of marginal significance and effect" (paragraph 27).

⁴⁹⁹ *Tata Autocomp Systems Limited v ACIT* ITA No. 7354/Mum/11; *Mylan Laboratories Ltd v ACIT* ITA No. 1615/Hyd/2010; *Auriopro Solutions Ltd v ACIT* ITA No. 7872/Mum/2011, itself applied in *PMP Auto Components Pvt Ltd v DCIT* ITA No. 1484/Mum/2014; *Tooltech Global Engineering Pvt Ltd v DCIT* ITA No. 273/Pn/2013; *Four Soft Ltd v DCIT*, paragraph 3.129 below.

⁵⁰⁰ *Crest Animation Studios Ltd v ACIT* ITA Nos. 5212 and 5348/Mum/2007, paragraph 2.4.4; compare *Mascon Global Ltd v DCIT* ITA No. 2205/Mds/2010, paragraph 21.

⁵⁰¹ *Maharishi Solar Technology Pvt Ltd v Income Tax Officer* ITA Nos. 4393 and 4561/Del/2009; *The Indian Hotels Company Ltd v DCIT* ITA Nos. 6712/Mum/2008, 2678/Mum/2009.

3.125 *Bharti Airtel Limited v DCIT*⁵⁰² addressed loans made by the taxpayer to its AEs in the US, the UK and Canada. These were in USD, GBP and CAD respectively, and said by the taxpayer to have borne interest at “LIBOR + 160 basis points” resulting in an interest rate of 7.33%⁵⁰³. The TPO tediously imputed interest at 14% by reference to BBB-rated rupee bonds; unsurprisingly the ITAT found such rate to “have no relevance at all”⁵⁰⁴. Nor was it relevant to distinguish between bank and non-bank lenders, or to increase the interest rate for risk on account of the loans being unsecured. On the latter point, the ITAT considered that “the assessee has advanced monies to its subsidiaries which are under its management and control – a factor which substantially reduces the risk rather than increasing it”⁵⁰⁵. (This approach seems dubious given the need to postulate an arm’s length transaction and thus to postulate a dealing between unrelated parties.⁵⁰⁶) One further interesting point (also in my view dubious) is that the ITAT thought that “the proposition that the credit rating of the parent company and subsidiary company will be the same is not of universal application but it is certainly a good indicator, in the absence of anything else to the contrary, of the credit rating of the subsidiary as well”. On that basis, the taxpayer’s own cost of funds (in the relevant currencies) was regarded as a good internal CUP.

3.126 Indeed in *VVF Limited v DCIT*⁵⁰⁷ the ITAT remitted the case for reconsideration by reference to the parent company lender’s own LIBOR-related foreign currency cost of funds (though paid no heed to any difference in creditworthiness between lender and borrower). And in *The Great Eastern Shipping Co Ltd v ACIT*⁵⁰⁸ (where the TPO had “proceeded on an entirely

⁵⁰² ITA No. 5816/Del/2012.

⁵⁰³ Something is awry here given the universal interest rate but the different currencies.

⁵⁰⁴ Paragraph 61.

⁵⁰⁵ Paragraph 66.

⁵⁰⁶ In *Glamour Enterprises (Private) Ltd v DCIT* ITA No. 1114/Jp/2011, disconcertingly, but probably *obiter*, the Jaipur ITAT commented that “[t]he loan given to subsidiary company has a lower risk as the assessee has indirect control on it” (paragraph 2.6): this seems to infringe the principle of disregarding the control relationship in hypothesising a transaction between independent parties. On this, see also the introductory comments on certain European countries at paragraph 3.237 below.

⁵⁰⁷ [2010] TIOL-55-ITAT-Mum, cited in *Bharti Airtel*.

⁵⁰⁸ ITA Nos. 397 and 437/Mum/2012.

erroneous basis”, and on “facts which were not even remotely connected with the facts of the case”, to propose the seemingly standard 14% rate on outbound loans), the taxpayer’s US\$ rates were sustained via an unsatisfactory reliance on its own cost of funds.

3.127 In *Kohinoor Foods Ltd v ACIT*⁵⁰⁹, interest-free loans were, promisingly, evaluated by the TPO by reference to a coherent list of factors, including credit ratings for borrowers with similar standing, financial/credit risk for the lender, risks inherent in the business of the borrower and structural risk; the TPO again invoked *General Electric*⁵¹⁰. From there the TPO sought the advice of CRISIL⁵¹¹, who opined that an interest rate of 13.49% would be appropriate. The Delhi ITAT rejected the proposition that the taxpayer parent company was comparable to a financial institution lender. The CUP method was appropriate, but “multi-national corporate set-up involves creation of subsidiaries and associate enterprises for advancement of their overseas business. They help them in terms of finance by offering soft loans and subsidiary loans; they are primary [*sic*] focused to spread the business of the principal unit. In our view, re-coursing straightaway to CRISIL, which deals in hardcore institutional finance transactions ... is wholly inapplicable”⁵¹². Thus the 13.49% rate proposed by the tax authority was rejected. Instead, the “correct comparable” was LIBOR. (No margin was mentioned.) While one can see that the crude CRISIL rate was not obviously based on the scientific factors first tabled by the tax authority (and was presumably – though not apparent from the report - a rupee rate rather than a rate appropriate for the currency of the loans concerned), such that the applicable LIBOR (for currency and tenor) should provide a starting point, the ITAT did not bother to dwell on any analysis of credit risk and thus margin over LIBOR in the way that an arm’s length lender would do.

⁵⁰⁹ ITA Nos. 3688-3691/Del/2012; 3867-3869/Del/2012.

⁵¹⁰ Paragraph 63.3.E(vi).

⁵¹¹ A Standard & Poor’s company, headquartered in Mumbai.

⁵¹² Paragraph 68.1.

3.128 *Deputy Director of Income-tax (International Taxation) Mumbai v The Development Bank of Singapore*⁵¹³ is unusual in addressing intra-entity “loans” between the bank’s Indian branch and its head office in Singapore and other branches. Thus these “loans” were not actually legal transactions at all, but merely intra-entity arrangements (“dealings” in OECD parlance⁵¹⁴). The decision does not dwell on this fundamental structural aspect at all but instead focuses on the appropriate “interest” charge. This is curious given the threshold condition for application of Indian transfer pricing law of an “international transaction” between two or more associated enterprises. One might have expected that the controversy should just have been concerned with the calculation of profit attributable to the Indian branch. That said, the Indian tax authority considers that “transactions between the head office abroad and a branch in India are ... subject to these transfer pricing regulations”⁵¹⁵. The case in fact addressed the status of LIBOR as an “arithmetical mean” of prices (finding it to be such), so that the taxpayer’s use of that rate, together with a $\pm 5\%$ variance band (under the law then applicable) was sanctioned by section 92C(2). Of course, within a single entity, no question of passive association could arise. Note here the general rule promulgated by OECD (reflecting legal and commercial actuality) that PEs have the same credit rating as the entity as a whole: paragraph 2.66 above.

3.129 Guarantees. In *Four Soft Ltd v DCIT*⁵¹⁶ the Hyderabad ITAT had followed the approach in *Siva* and approved the use of a LIBOR rate for outbound loans to AEs rather than the 14% Indian corporate bond rate proposed by the TPO. In the ITAT’s 2011 decision for the 2006-7 assessment year, the taxpayer’s provision of a parental guarantee to support its foreign subsidiary was found not to be an “international transaction” within the meaning of the transfer pricing legislation; but the changes introduced by Finance Act 2012 to section 92B were

⁵¹³ ITA No. 6631/Mum/2006.

⁵¹⁴ Paragraph 2.65 above.

⁵¹⁵ Circular 14, 22 November 2001. Butani (2007) at page 65 notes that the term “permanent establishment” has been included in the definition of “enterprise” in section 92F. I am not sure that puts the point beyond argument given the requirement for a “transaction” which is “between two or more associated enterprises” (section 92B(1)).

⁵¹⁶ ITA No. 1495/Hyd/2010.

considered to render that argument ineffective in subsequent litigation for the following assessment year⁵¹⁷. In that later case (March 2014), the ITAT distinguished the 3.75% rate proposed by the TPO, based on a standard or “rack” rate charged by ICICI Bank for a bank guarantee, from a corporate guarantee: “[a]s the corporate guarantee is not in the nature of bank guarantee, the rate applicable to bank guarantee provided by the bank cannot be applied to corporate guarantee which is provided by group company”⁵¹⁸. Following *Glenmark Pharmaceuticals v ACIT* (paragraph 3.135 below) and *Infotech Enterprises Ltd*⁵¹⁹, the ITAT remitted the issue back to the TPO to redetermine the quantum of guarantee fee based upon the approach in *Glenmark*.

3.130 *Everest Kanto Cylinder Ltd v DCIT*⁵²⁰ concerned the adequacy of a 0.5% fee paid to the Indian taxpayer parent company by its wholly-owned Dubai subsidiary for a guarantee issued by the parent in respect of the subsidiary’s bank borrowings. The TPO pointed to various arm’s length guarantee fees observable in the market and selected 3%. The Mumbai ITAT however found that the TPO had not presented any evidence of the terms and conditions and circumstances in which banks had been charging such fees; therefore the TPO had not made out comparability.⁵²¹

3.131 The ITAT preferred as a comparable a separate guarantee 0.6% fee paid by the taxpayer itself to the bank which had made the loan to its subsidiary. The TPO had argued that, but for the guarantee by the taxpayer, the bank would not have lent the money, or might have charged a much higher interest rate, “considering the enterprise risk”, citing *General Electric*⁵²². The ITAT rejected the taxpayer’s proposition that there could not be any cost or charge for the guarantee, but felt that the 0.5% actually charged was “quite near” to the 0.6%

⁵¹⁷ The same conclusion was reached by the Mumbai ITAT in *Mahindra & Mahindra v DCIT* ITA No. 8597/Mum/2010, but see paragraph 3.139 below.

⁵¹⁸ ITA No. 1903/Hyd/2011 paragraph 25.

⁵¹⁹ ITA Nos. 115 and 2184/Hyd/2011.

⁵²⁰ ITA Nos. 542/Mum/2012; 7073/Mum/2012.

⁵²¹ Similarly, in *Asian Paints* (note 531 below), the ITAT rejected the TPO’s use of “naked quote from banks”.

⁵²² Paragraph 11; paragraph 3.16ff above on *General Electric*.

paid by the taxpayer itself to the same bank for a guarantee facility. It is unsatisfying that, in arriving at this view, it is not apparent that the ITAT applied any sort of qualitative comparability criteria. There is no trace of the terms of the two guarantees being compared; bizarrely the tribunal felt that the difference of 0.1% “can be ignored as the rate of interest on which [the bank’s Bahrain branch] has given loan to [subsidiary] is at 5.5%, whereas assessee is paying interest rate of more than 10% on its loan taken with [the bank in India]. Thus, such a minor difference can be on account of differential rate of interest”⁵²³. Evidently the taxpayer/assessee was “a prominent and reputed industrial company ... [which] on account of its financial strength has tie up with many large banks ... [whereas] the subsidiary in Dubai, which was newly-formed and unknown, had a low credit rating”⁵²⁴. Thus the 5.5% vs. 10%+ interest rate differential cannot have been down to creditworthiness. It seems likely that the interest rate difference was significantly attributable to the respective currencies of the loans: the subsidiary had borrowed in US\$; I infer that the taxpayer’s 10%+ interest cost was for rupee debt. If correct, that surely crumbles the foundations of the ITAT’s finding in that respect?

3.132 Nevertheless (noting that the TPO appears to have failed to discharge the burden of proof, rather than on issues of legal principle), the decision is useful for its recognition of relevant economic factors including, critically, risk, in evaluating arm’s length guarantee fees. Yet despite the TPO’s citation of *General Electric* and the guarantor’s high credit-standing, the topic of implicit support is absent from the discussion. (Of course, it would not suit the TPO to argue that point, which would tend to suppress rather than augment the guarantee fee.) The Revenue’s appeal to the High Court was dismissed as not raising any substantial question of law⁵²⁵.

⁵²³ Paragraph 21.

⁵²⁴ Paragraph 11.

⁵²⁵ ITA No. 1165 of 2013.

3.133 *Nimbus Communications Ltd v ACIT*⁵²⁶ concerned guarantees given by an Indian parent company taxpayer to a UK bank lender to the taxpayer's UK and US subsidiaries; no guarantee fees were charged. Again the TPO referred to benchmark bank fees in the range 0.15–3%, and selected 1.5% as a point within that range. Tantalisingly, the ITAT rehearsed how the Commissioner of Income Tax (Appeals) had observed that “[s]ometimes taxpayers take the position that a parent company’s support for a subsidiary is to be implied and therefore no specific guarantee fee payment is required”⁵²⁷. The CIT(A) rejected the TPO’s use of a “naked quote” which failed to heed qualitative factors, noting that guarantor banks typically take into account credit rating/risk, financial position of the borrower, guarantee terms including duration and amount, credit history, market dynamics and competition, bank profit margins, negotiation and client relationships. The CIT(A) was attracted to the precedent set by the French *Société Carrefour* case⁵²⁸, and found that a balance was to be struck between the normal commercial practice of charging a fee and “the general rule that a parent company may provide a free services [*sic*] as long as it can justify that the act was in its own interest”. On that basis, the French approach was followed and, as in that case, a 0.25% guarantee fee set.

3.134 The ITAT, drawing support from paragraph 7.13 TPG, found a “clear benefit” to the AEs such that guarantee commissions should have been charged at the arm’s length price. However, because the facts were “materially similar” to those in *Everest Kanto Cylinder*, the ITAT preferred to follow the decision of its co-ordinate bench and impute a 0.5% guarantee fee. The coherence of *Everest* is questioned above, so it is frustrating that *Nimbus* uncritically adopts it as well as

⁵²⁶ ITA Nos. 2359 and 3664/Mum/2010.

⁵²⁷ Paragraph 5 of the ITAT decision, resonant of the CRA’s argument in *General Electric*.

⁵²⁸ Conseil d’État, #81690-82782, 17 February 1992. The taxpayer guaranteed third party loans to its foreign subsidiaries without charging a fee. The tax authority considered this an abnormal act of management and adjusted the taxpayer’s profits by adding the value of the services rendered, set at 1% of the guaranteed amounts. The Court found the taxpayer’s conduct to be an unsound business practice; free services could be justified, but only where that was in the parent’s own interest. The financial strength of the subsidiaries was good and so the parent’s risk was low; it was (questionably?) relevant to take into account the parent’s increased dividend income, but an adjustment was still required, albeit reduced to 0.25%.

according (almost) equivalent respect to *Société Carrefour*, the reported decision in which is itself unburdened by quantitative analysis. In particular, the ITAT passed no comment on the CIT(A)'s "balancing" process which appeared to sanction free services by a parent as long as they were "in its own interest": this notion seems to go way beyond the classes of shareholder activities contemplated by paragraphs 7.9-10 TPG.⁵²⁹

3.135 *General Electric* was cited by the TPO in *Glenmark Pharmaceuticals Limited v ACIT*⁵³⁰, another case on guarantee fees and commissions for letters of credit, though still without reference to the implicit support concept; instead, the TPO seems simply to have cast about for supposed comparables, claiming to have found one in the 1% guarantee fee rate sustained by the Tax Court of Canada. The ITAT rejected the TPO's use of "naked quotes" from banks, and also found a "conceptual difference" between bank and corporate guarantees, though the articulation of this difference is dubious, bank guarantees, unlike corporate instruments, being said to be "foolproof" - default being treated as a "service deficiency" under banking regulation; it is mildly surprising in these post-financial crisis days to hear of bank obligations being regarded as "foolproof". The ITAT upheld the taxpayer's rates by reference to rates sustained or applied in other cases⁵³¹, but without any quantitative or qualitative analysis of the underlying risks bearing upon the taxpayer's own facts and circumstances (thus falling into the same trap as the TPO did with his citation of the 1% rate from *General Electric*).

3.136 In *Bharti Airtel*⁵³² the Delhi ITAT presented a startling decision on guarantees. The taxpayer guaranteed a working capital facility provided to its AE by Deutsche Bank; it appears that no borrowings were in fact drawn under the

⁵²⁹ *Reliance Industries* (note 531 below) is similarly frustrating, with the ITAT adopting a simplistic averaging of ten questionable comparables. *Technocraft Industries (India) Ltd v ACIT* ITA Nos. 7159 and 7990/Mum/2011 also adopted an unsatisfying averaging approach.

⁵³⁰ ITA Nos. 5031 and 5488/Mum/2012.

⁵³¹ *Asian Paints Limited* ITA Nos. 408 and 1937/Mum/2010; ITA No. 7801/Mum/2010; *Everest Kanto Cylinder* (paragraph 3.130 above); *Nimbus Communications* (paragraph 3.133); *Reliance Industries Ltd v ACIT* ITA Nos. 885 and 1725/Mum/2009; *Cox & Kings Ltd v ACIT* ITA Nos. 1354 and 7770/Mum/2014.

⁵³² Paragraph 3.125 above. The Hyderabad ITAT in the 2014 *Four Soft Limited* decision (paragraph 3.129 above) did not refer to *Bharti Airtel*, which had been released only days previously.

facility⁵³³. No fee was charged to the subsidiary, but the taxpayer volunteered a 0.65% transfer pricing adjustment. In appealing against the TPO's assessment of a 4.68% fee (the TPO invoking paragraph 7.13 TPG and *General Electric*), the taxpayer argued that provision of the guarantee was a shareholder activity and anyway entailed no cost, so that no transfer pricing adjustment was permitted. The appeal was allowed on the basis of a clever exercise in statutory construction. The ITAT considered that the section 92B Explanation added by the Finance Act 2012 (paragraph 3.107 above), as it related to guarantees, was merely clarificatory and "for the removal of doubts", so that it had "to be read in conjunction with the main provisions, and in harmony with the scheme of the provisions"⁵³⁴. Explanation (i)(c), dealing with "capital financing", could only be regarded as elaborating upon the part of section 92B(1) which addresses "any other transaction having a bearing on profits, incomes, losses or assets" of the relevant enterprise. Although "future" impacts on profits etc were to be taken into account, the ITAT distinguished "contingent" effects, and concluded that provision of the guarantee did not have any such effect: it did not alter the income, profits, losses or assets of the assessee⁵³⁵. Thus the guarantee did not rank as an "international transaction" as defined in the statute. The decision was welcomed in some quarters⁵³⁶, and the ITAT's approach to construction of the statute is at least tenable, but it is surprising that the absence of (immediate financial) cost to a parent company guarantor should be enough to take cross-border guarantees out of the realm of transfer pricing. Does not failure to charge a guarantee fee have a negative effect on the profits of the guarantor? *Bharti Airtel* was applied in *Videocon Industries Ltd v ACIT*⁵³⁷ and *Redington (India) Ltd v JCIT*⁵³⁸, but see further below.

⁵³³ Paragraph 30.

⁵³⁴ Paragraph 27.

⁵³⁵ Paragraph 32.

⁵³⁶ E.g. Ostwal (2014): a "classic and landmark decision" which it is "important to welcome, admire and follow". Ostwal observes that imputation of guarantee fees would, given net capital import flows, have negative implications for the Indian economy in outbound fee cases; but that does not affect the correct application of the arm's length principle. Compare Jhabakh: the ITAT's conclusion "may not last for long". However, see paragraph 3.139 below.

⁵³⁷ ITA Nos. 6145, 6662/Mum/2012; 1728-9/Mum/2014, expressly distinguishing the *General Electric* case by reference to the different domestic law under consideration (paragraph 35).

3.137 Although *Bharti Airtel* was pleaded by the taxpayer in *Kohinoor Foods Ltd v ACIT*⁵³⁹, that case proceeded on the basis that transfer pricing adjustments could indeed be made in an Indian parent company guarantee situation. The tax authority assessed guarantee fee income based upon a supposedly standard bank commission of 2.25% and added a margin of 2%. The tribunal contented itself with the view that the 1% charge reported by the taxpayer was fair and reasonable by reference to rates used in the *Nimbus* and *Reliance* cases (paragraph 3.133 and note 531 above), rather than undertaking any separate analysis of the creditworthiness of the actual debtors or the comparability of the circumstances in those cases.

3.138 The durability of *Bharti Airtel* did at first indeed seem limited. Apart from *Kohinoor Foods, Hindalco Industries Ltd v ACIT*⁵⁴⁰ and *Aditya Birla Minacs Worldwide Ltd v DCIT*⁵⁴¹, concerned Indian parent company guarantees of foreign subsidiaries' bank borrowings related to corporate acquisitions. In *Hindalco* the taxpayer challenged the tax authority's position that a fee should have been charged, but the Bombay High Court rejected the taxpayer's case on procedural grounds without ruling on the substantive issue. The case proceeded to the Mumbai ITAT where the taxpayer's invocation of *Bharti Airtel* was rejected on the basis that in that case the observations of the tribunal upon the Explanation were "obiter dicta only"⁵⁴². In *Aditya Birla* the ITAT ignored the taxpayer's invocation of *Bharti Airtel*, and preferred a 0.5% guarantee fee on the basis of the supposed precedent in *Everest Kanto* (paragraph 3.130) without the slightest examination of comparability⁵⁴³.

3.139 *Bharti Airtel* has however received significant support in the November 2015 decision in *Micro Ink Ltd v ACIT*⁵⁴⁴. The Ahmedabad ITAT agreed that

⁵³⁸ (2014) 49 taxman.com 146.

⁵³⁹ Paragraph 3.127 above.

⁵⁴⁰ Writ petition no. 2782 of 2011.

⁵⁴¹ ITA No. 7033/Mum/2012.

⁵⁴² ITA No. 4857/Mum/2012, paragraph 29.

⁵⁴³ Likewise in *Manugraph India Ltd v DCIT* ITA No. 4761/Mum/2013.

⁵⁴⁴ ITA No. 2873/Ahd/10.

cases where no guarantee fee had been charged did not have “a bearing on the profits, income, losses or assets” of the taxpayer (mere contingent liability not being enough to have such an effect)⁵⁴⁵. Thus the issue of a corporate guarantee for no fee was not an “international transaction”. On the particular facts of the case, the guarantee was seen (as the taxpayer proposed) as a contribution to “quasi-equity” or a shareholder activity, not amounting to the provision of a service. *General Electric* was cited but (quite properly) distinguished as addressing different statutory language. The case is therefore important, under current Indian law, for situations where (i) the guaranteed entity could not itself raise debt on the basis of its own credit-standing, and (ii) (perhaps consequentially) *no* guarantee fee is charged. In arriving at their decision the ITAT referred to Chapter VII TPG (“international best practices”,⁵⁴⁶), ATO statements⁵⁴⁷ and US literature⁵⁴⁸.

3.140 The debt of the Indian assessee in *DSM Anti-Infectives India Ltd v ACIT*⁵⁴⁹ was guaranteed by its Dutch AE. Counsel for the taxpayer admitted that “there is international practice to pass on 50% of such financial savings” (i.e. due to the guarantee). No forensic examination of the split is offered, but one might think that acceptance of the benefit share principle should open the door to more rigorous discussion of relative bargaining power in future cases.

3.141 Receivables. Several of the Indian cases address situations where trade credit is allowed to an AE, typically without interest⁵⁵⁰. Some have resulted in the

⁵⁴⁵ So the guarantee was not regarded as a service; cf. notes 636, 835 below on the US position.

⁵⁴⁶ Paragraph 34. But it is doubtful whether the facts of the case really fit with TPG notions of shareholder activity. The ITAT quoted paragraph 7.9 TPG (2010 edition, substantially reproduced in the BEPS Final Reports), which refers to an activity “relating to group members even where those group members do not need the activity (and would not be willing to pay for it were they independent enterprises)”.

⁵⁴⁷ Paragraph 32.

⁵⁴⁸ Paragraph 36. Miller (1994) is cited with approval.

⁵⁴⁹ ITA No. 1290/Chd/2012.

⁵⁵⁰ Compare the US safe harbour permitting interest not to be charged on intercompany receivables for approximately 3 or 4 months (depending on whether the debtor is in or outside the US): Regs. § 1.482-2(a)(1)(iii). It is recognised that longer interest-free periods may be used when that is regular trade practice.

imputation of income⁵⁵¹. In *Commissioner of Income Tax v Indo American Jewellery Ltd*⁵⁵² the Bombay High Court found there to be “complete uniformity” in the assessee’s approach to not charging interest on trade outstandings with both AEs and unassociated persons, so the ITAT’s decision to delete the transfer pricing adjustment was upheld.⁵⁵³ But no receivables case has engaged with the passive association topic.

Tax authority practice

3.142 The Indian Central Board of Direct Taxation has been “rather reluctant” to provide national transfer pricing guidance⁵⁵⁴. None at all has been issued regarding the passive association topic⁵⁵⁵. Nonetheless, “[t]he Indian tax authorities are closely following the developments in the international arena, with the higher tax authorities showing some signs of inclination towards global best practices”⁵⁵⁶. As recorded above, the Canadian *General Electric* case has been cited before the ITAT on several occasions, but argument which focuses on the effect of implicit support on financial transactions has not yet been reported.

⁵⁵¹ E.g. *Logix Micro Systems Ltd v ACIT* ITA Nos. 423 and 529/Bang/2009, applied in *Cheil India Pvt Ltd v DCIT* ITA No. 1230/Del/2014; *Tech Mahindra Limited v DCIT* ITA No. 1176/Mum/2010; cf. *Evonik Degussa India Pvt Ltd v ACIT* ITA No. 7653/Mum/2011.

⁵⁵² ITA(L) No. 1053 of 2012 (judgment 8 January 2013), distinguished in *Dania Oro Jewellery Pvt Ltd v Income Tax Officer* ITA No. 6827/Mum/2012.

⁵⁵³ Other receivables cases are *Boston Scientific International BV India v Assistant Director of Income Tax* [2010] 40 SOT 11 (transfer pricing imputation of interest on trade receivables deleted by reference to offsetting payables); *Commissioner of Income Tax v Patri Computer Systems Limited* ITA No. 1148 of 2012 (case remitted to Pune ITAT in view of retrospective addition of the Explanation to section 92B); *Mylan Laboratories Ltd v ACIT* ITA No. 66/Hyd/2013 (taxpayer’s charge of LIBOR + 1% upheld by reference to the 1% guarantee fee approved by the Dispute Resolution Panel); *Bausch & Lomb Eyecare (India) Pvt Ltd v ACIT* ITA Nos. 3861/Del/2010, 4924/Del/2011, 6382/Del/2012 and 6580/Del/2013 (allowing taxpayer’s appeal against the imputation of interest income where taxpayer allowed interest-free credit to both AEs and unconnected persons, applying *Indo American Jewellery*); *Micro Ink Ltd v ACIT*, paragraph 3.139 above (taxpayer’s appeal sustained because time value of money included in goods sale price). The Mumbai ITAT has also ruled that share subscription money left outstanding for a period of “inordinate delay” can attract an imputed interest charge under transfer pricing rules: *PMP Auto Components Pvt Ltd v DCIT*, see note 499 above.

⁵⁵⁴ Dr Parthasarathi Shome, Chairman, Tax Administration Reforms Commission, Government of India, former adviser to the Indian Finance Minister, speaking at the “TP Minds” conference, Singapore, 24 September 2014.

⁵⁵⁵ Aside perhaps from the hint mentioned in paragraph 3.145 below.

⁵⁵⁶ Ahuja (2012).

(However, at least some professional advisers advocate notching up a borrower's credit rating to take account of implicit support⁵⁵⁷.)

3.143 One source of Indian governmental practice is found in the UN *Practical Manual on Transfer Pricing for Developing Countries*⁵⁵⁸. Chapter 10, entitled “Country Practices”, includes a section on “Emerging Transfer Pricing Challenges in India”. In particular, “[t]ransfer pricing of inter-company loans and guarantees are increasingly being considered some of the most complex transfer pricing issues in India. The Indian transfer pricing administration has followed quite a sophisticated methodology for pricing inter-company loans which revolves around: comparison of terms and conditions of loan agreement; determination of credit rating of lender and borrower; identification of comparable third party loan agreement; suitable adjustments to enhance comparability”. For outbound loans, “[t]he Indian transfer pricing administration has determined that since the loans are advanced from India and Indian currency has subsequently converted into the currency of the geographic location of the AE, the Prime Lending Rate (PLR) of the Indian banks should be applied as the external CUP and not LIBOR or EURIBOR rate”⁵⁵⁹. But it will be plain from the case law discussion above that this latter position has now become untenable in most scenarios. Indeed, the statement was expressly disapproved by the Delhi High Court in *Cotton Naturals*⁵⁶⁰.

3.144 The UN Manual also identifies guarantee fees as a controversial issue. Again the focus is on outbound investment and thus guarantees extended by Indian parent companies for the benefit of their foreign subsidiaries. While sensibly asserting that the CUP method is appropriate⁵⁶¹, the position is taken that

⁵⁵⁷ See e.g. Tolia, Mehta and Gajar (2011), section II.

⁵⁵⁸ See paragraph 2.90.

⁵⁵⁹ Paragraph 10.4.10.2.

⁵⁶⁰ At paragraph 42; paragraph 3.120 above.

⁵⁶¹ This is generally consistent with the approach taken in the cases, and also in the *Guidance Note on Report under Section 92E of the Income Tax Act 1961* issued by the Institute of Chartered Accountants of India (August 2013) paragraph 6.5(d). The form of transfer pricing report to be furnished by an accountant under section 92E and Rule 10E (form No.3CEB) requires *inter alia* details of international transactions in respect of lending or borrowing of money and guarantees.

“[i]n most cases, interest rate quotes and guarantee rate quotes available from banking companies are taken as the benchmark rate to arrive at the ALP. The Indian tax administration also uses the interest rate prevalent in the rupee bond markets in India for bonds of different credit ratings. The difference in credit ratings between the parent in India and the foreign subsidiary is taken into account and the rate of interest specific to a credit rating of Indian bond is also considered for determination of the arm’s length price of such guarantee.”⁵⁶² Again, recent case law mostly presents an emphatic rejection of the use of “rack rate” guarantee fees and of rupee rates where foreign currency transactions are concerned.

3.145 Finally, it is acknowledged that “the Indian transfer pricing administration is facing a challenge due to non-availability of specialized database and transfer price of complex cases of inter-company loans in cases of mergers and acquisitions which involve complex inter-company loan instruments as well as implicit element of guarantee from parent company in securing debt”⁵⁶³. This must be intended as a reference to the implicit support phenomenon as an effect upon the pricing of guarantees, just as in *General Electric*, which the Indian tax authority is plainly aware of given the way it has been cited repeatedly in the cases. Thus the point is seen as a “challenge” in a context which is “complex”.

3.146 Notwithstanding the extraordinary proliferation of Indian transfer pricing case law, including in the financial transactions context, and despite increasing citation of the TPG including paragraph 7.13 and *General Electric* and the Indian tax administration’s acknowledgment of the issue, no clear guidance yet exists in Indian tax law and practice regarding the recognition of passive association in pricing controlled transactions. It seems inevitable however that the point will soon emerge, if not otherwise then via litigation, either by the tax authority looking to maximise taxable income or minimise deductible expenditure, or by taxpayers with converse motivations.

⁵⁶² Paragraph 10.4.10.3.

⁵⁶³ Paragraph 10.4.10.4.



New Zealand

Legislation

3.147 New Zealand enacted transfer pricing legislation in 1995 with effect for the income tax year 1996-97 onwards⁵⁶⁴. Its transfer pricing code is now principally contained in Subpart GC of the Income Tax Act 2007. The Act represented the final stage in New Zealand’s rewrite of income tax legislation using plain English techniques. That included rewriting Parts F to Y of the Income Tax Act 2004, which had previously housed Subpart GD addressing transfer pricing. The 2007 Act is not intended to introduce changes in policy save as signalled in Schedule 51; no such changes are listed in relation to old Subpart GD. Section GC6(1) observes that the purpose of the rules is “to substitute an arm’s length consideration in the calculation of a person’s net income if the person’s net income is reduced by the terms of a cross-border arrangement with an associated person for the acquisition or supply of goods, services, or anything else”. Where “the amount of consideration” payable or receivable by a taxpayer is other than the “arm’s length amount”, the arm’s length amount is imputed⁵⁶⁵. Section GC13(1) prescribes that “an arm’s length amount of consideration must be determined by applying whichever one or a combination of the methods listed in subsection (2) produces the most reliable measure of the amount that completely independent parties would have agreed upon after real and fully adequate bargaining”. The methods listed in subsection (2) are the CUP, resale price, cost plus, profit split and comparable profits methods. The hypothesis emphasises the use of “completely independent” parties who must be assumed to have entered into “real and fully adequate bargaining”. It seems doubtful that these aspects of

⁵⁶⁴ With explanatory guidance provided in Tax Information Bulletin vol. 7 no. 11 (March 1996).

⁵⁶⁵ Sections GC7 and GC8.

the meaning of “arm’s length amount” substantively alter the hypothesis posed by Article 9(1) OECD MTC (used in all New Zealand’s double tax treaties⁵⁶⁶). Presumably “independent” in Article 9(1) inherently means “completely” independent; and bargaining power is already recognised as a pricing factor⁵⁶⁷. But if anything the emphasis lends support to the view that the comparator transaction should be one between two hypothetical parties.

3.148 An interesting point of detail in the New Zealand legislation is its active engagement with share capital. The issue of shares is expressly excluded from the operative concepts of acquisition and supply, save in the case of fixed rate shares “because such shares are analogous to, and highly substitutable with, loans. As loans are covered by the transfer pricing regime, it is appropriate that fixed rate shares are also covered”⁵⁶⁸.

3.149 A separate statutory code at Subpart FE of the 2007 Act applies thin capitalisation rules on a formulaic basis rather than by utilisation of the arm’s length principle⁵⁶⁹.

Case law

3.150 There is no transfer pricing case law in New Zealand⁵⁷⁰.

Tax authority practice

3.151 On 10 April 2015, the New Zealand Inland Revenue published its “Transfer pricing focus in 2015 and 2016”: among other things, they promised to “maintain a special focus on ... loans in excess of NZ\$10m principal and guarantee fees”. Less recently, in October 2000, the Revenue issued its own

⁵⁶⁶ The New Zealand Inland Revenue has acknowledged that “in the event of any inconsistency [with the domestic transfer pricing rules], the double taxation agreement provisions will prevail in the normal manner”: Tax Information Bulletin vol. 7, no. 11, page 12.

⁵⁶⁷ Paragraph 1.5 TPG.

⁵⁶⁸ Section GC14; Tax Information Bulletin vol. 7 no. 11, page 2. Compare the UK *Abbey National* case, paragraph 3.179 below.

⁵⁶⁹ Guidance on thin capitalisation is provided in Tax Information Bulletin vol. 7, no 11, from page 13.

⁵⁷⁰ Smith (2013), confirmed by Robyn Rakete of IRD, email of 27 August 2015.

“Transfer Pricing Guidelines”⁵⁷¹. These refer to the application of section GD13 of the Income Tax Act 2004, which differs in various respects from the current section GD13, but crucially the “arm’s length amount” concept is in all material respects identical to that now used. The Guidelines enthusiastically endorse use of the arm’s length principle and the OECD TPG (e.g. to secure “broad parity of tax treatment for multinationals and independent enterprises”⁵⁷²); the Inland Revenue Guidelines “should be read as supplementing” the TPG. It is said that useful reference may also be made to ATO material and the US section 482 regulations⁵⁷³. Also, “the arm’s length principle seeks to remove the effect of any ownership relationship between members of the multinational from the transfer price it adopts”⁵⁷⁴. Taken literally, this might be seen as providing support for the opponents of recognising the effects of passive association in pricing controlled transactions. However, I think it needs to be seen as a rather general statement made in relation to the merits of using the arm’s length approach, at a time when the passive association controversy had not yet begun in earnest.

3.152 Nowadays the Inland Revenue acknowledges that although -

“in determining an appropriate interest rate, we generally evaluate the credit risk of the company in question on the basis that it is a stand-alone entity, rather than an inseparable part of a single unified business”⁵⁷⁵ ... [s]ome subsidiaries in a multinational group are so central (or core) that, even absent any formal guarantees, if the subsidiary should be unable to repay its debt, the parent will intervene with the necessary financial support. This parental intervention will occur either due to reputation concerns or in order for the parent to ensure that its own credit rating is not jeopardised by the rumour mill. ... The arm’s length principle which underpins international transfer pricing practice does not operate in a vacuum. Would bank credit approvals of a subsidiary in

⁵⁷¹ As an appendix to Tax Information Bulletin vol. 12, no. 10, available at www.ird.govt.nz/technical-tax/tib/vol-12/ (accessed 17 August 2015). Inland Revenue has advised that it will not be updating the Guidelines, and instead taxpayers should refer to the practice issues now published on its website.

⁵⁷² Paragraph 64.

⁵⁷³ Paragraph 13. See also IRD’s 2012 Tax Policy Report endorsing international tax policy coordination with Australia.

⁵⁷⁴ Paragraph 63.

⁵⁷⁵ Echoing paragraph 1.6 TPG.

the local New Zealand market take into account the wider multinational group's creditworthiness? If so, this market condition must be factored into the transfer pricing analysis, in just the same way as third party banks and rating agencies do currently in their decision-making.”⁵⁷⁶

3.153 There is no formal guidance from Inland Revenue on how passive association or implicit support should be taken into account in the case of guarantees⁵⁷⁷. Logically, recognition of passive association should follow in the same way as for loan transactions.

3.154 The almost casual cross-reference to – adoption of – ATO guidance and the US section 482 regulations does seem rather significant (though perhaps this is to be understood by reference to such material at the time of the 2000 Guidelines). As noted above, ATO guidance, at least that currently applicable, provides quite strong support for the recognition of passive association (see paragraph 3.93ff above, including the discussion of TR 2010/7); and the US legislation, particularly Regs. § 1.482-9(l)(3)(v) and the Examples at Regs. § 1.482-9(l)(5), provide a powerful indication that passive association is to be taken into account as a comparability factor (paragraph 3.209ff below).



United Kingdom

Legislation

3.155 One might think that firm foundations are present in UK tax law for the recognition of the effects of passive association in pricing controlled transactions. The principal statute requires interpretation in a manner consistent with the TPG,

⁵⁷⁶ <http://www.ird.govt.nz/transfer-pricing/practice/transfer-pricing-practice-financing-costs.html> (accessed 17 August 2015). Robyn Rakete of IRD confirmed to me in an email dated 27 August 2015 that “[i]n practice, IRD does recognise implicit support ... Guidance is usually taken from the rating agencies’ published criteria in assessing cases”.

⁵⁷⁷ PwC (2013), New Zealand chapter.

and it is to be expected that the decisions of foreign (especially common law and Commonwealth) courts of high repute will be accorded a high degree of persuasive influence⁵⁷⁸. Thus e.g. the decision of the Canadian Federal Court of Appeal in *General Electric* and the Australian Federal Court in *Chevron* (paragraphs 3.16 and 3.82 above) should be regarded as influential in the application of UK transfer pricing law. On the other hand, the UK statute presents a serious obstacle (paragraph 3.160 below), and tax authority practice has at best been ambivalent towards the concept of implicit support. Specifically, HMRC consider that its effects should be confined to the quantum of guarantee fees or interest rates, and not to borrowing capacity (paragraph 3.188 below).

3.156 The UK's transfer pricing code is in Part 4 Taxation (International and Other) Provisions Act 2010 (*TIOPA*)⁵⁷⁹. The Article 9(1) MTC concept of "conditions made or imposed" between controlled persons is transposed into UK tax law via the analogous notion⁵⁸⁰ that "the actual provision" which is "made or imposed" between two persons who satisfy a "participation condition" (the test of common control) "differs from the provision ('the arm's length provision') which would have been made as between independent persons"⁵⁸¹. The UK's rules can apply to entirely domestic transactions⁵⁸², though usually the sting is removed via a form of domestic corresponding adjustment⁵⁸³.

⁵⁷⁸ In *Government of India v Taylor* [1955] AC 491, 507, Viscount Simonds was "ever willing to get help from seeing how the law, which is our common heritage, has developed on the other side of the Atlantic".

⁵⁷⁹ UK transfer pricing rules articulating the arm's length rule date back to section 37 Finance Act 1951, the forerunner of section 770 ICTA, but the earliest manifestation of UK transfer pricing legislation can be traced back (at least) 100 years to section 31 Finance (No.2) Act 1915, which in a cross-border control context, focused on "income which might be expected to arise", on which see *Gillette Safety Razor Ltd v IRC* [1920] 3 KB 358. Baistrocchi and Roxan (2012) at page 303ff provide a good historical survey: "[t]he Inland Revenue even regarded the arm's length principle as going back to the agency provisions in section 41 of the 1842 Act". In the modern code, exemptions are provided for small and medium-sized enterprises, subject to certain exclusions (sections 166-168 TIOPA). The diverted profits tax introduced by Part 3 Finance Act 2015 is a unilateral UK response to BEPS. It provides HMRC with a supplemental weapon beyond transfer pricing – but does not bear directly on the passive association topic.

⁵⁸⁰ Finance Bill 1998 explanatory notes to clause 106, paragraph 42.

⁵⁸¹ Section 147(1)(d) TIOPA.

⁵⁸² Though note the comments of Advocate-General Geelhoed in the *Thin Cap* case, finding it "extremely regrettable that ... Member States ... have felt obliged to 'play safe' by extending the scope of their rules to purely domestic situations where no possible risk of abuse

3.157 Part 4 is to be read in such manner as best secures consistency between the effect given to certain specified provisions – including the basic rule described above – and the effect which, in accordance with the 22 July 2010 TPG, is to be given, in cases where double tax treaties incorporate the whole or any part of Article 9 MTC in its form on 9 February 1988 or other rules in equivalent terms⁵⁸⁴. The Special Commissioners have held that this rule applies generally and independently of whether or not there is a relevant double tax treaty between the two jurisdictions in which the parties to a “provision” are located⁵⁸⁵; and “provision” should be given a similar meaning to “condition” in the MTC⁵⁸⁶. Moreover, although reference to the TPG was not to be found in UK tax legislation until the Finance Act 1998, the Special Commissioners considered that, even in relation to prior transfer pricing rules which simply referred to the “arm’s length price”, the TPG could be regarded as a “useful aid” to be applied “in the absence of any other guidance as they are the best evidence of international thinking on the topic”⁵⁸⁷.

3.158 The term “passive association” is not found in the UK transfer pricing legislation, but to an extent finds expression in rules which address cases involving guarantees. In broad terms, section 152 TIOPA applies where a

exists. Such an extension of legislation ... is anathema to the internal market”: paragraph 68 of the opinion reported at [2007] STC 906, 929. This view was reiterated by the Commission in its Communication on anti-abuse measures (page 6): paragraph 2.111 above.

⁵⁸³ Section 174 TIOPA; INTM 412130. This is potentially important in the EU law context: paragraph 3.175 below.

⁵⁸⁴ Section 164 TIOPA. The Treasury may designate an updated or supplementary version of the TPG – to cope with updates produced by the OECD. Such designation is now to be anticipated in view of the BEPS 2015 Final Reports. Previously HMRC said that “the scope of [Part 4] can be no wider than the scope of Art. 9, as informed by the OECD Transfer Pricing Guidelines” (INTM 432040), but now they say, more blandly, “interpretation of transfer pricing legislation must be consistent with Article 9 ... and in accordance with the [TPG]” (INTM 421010). Vega (2012) page 20 observes that “[i]n comparison to other countries, the British legislation is precise when indicating the version of the OECD Guidelines to be considered, which increases legal certainty in this area”.

⁵⁸⁵ *DSG Retail Ltd v CIR* [2009] UKFTT 31 (TC), TC 00001, paragraph 71 (confirming the assumption of both HMRC and the taxpayer).

⁵⁸⁶ *Ibid.*, paragraph 66.

⁵⁸⁷ *Ibid.*, paragraph 77. In *Meditor Capital Management Ltd v Feighan* [2004] STC (SCD) 273 at paragraph 51, the Special Commissioner relied on paragraph 1.21 of the 1995 TPG to ascertain the nature of a required functional analysis that in turn informed the relevance of document production sought by the Revenue.

“security” (ordinarily, a debt security such as a note or bond, but extended in meaning by the statute⁵⁸⁸) is issued by one of the controlled parties to the other; and section 153 applies where a security has been issued to a third party and a guarantee has been provided by the other controlled party. In comparing the actual provision with the arm’s length provision, and specifically in testing (a) the borrower’s overall level of indebtedness⁵⁸⁹, (b) whether it might be expected that the borrower and any particular person would have become parties to the transaction for the issue of a security or making of a loan, and (c) the rate of interest or other terms, in general account must be taken of “all factors”, but *no* account is to be taken of (or of any inference capable of being drawn from) any “guarantee” provided by a company with which the borrower was in a control relationship⁵⁹⁰.

3.159 Section 152 thus addresses intra-group lending cases, and section 153 bites upon the classical “indirect thin capitalisation” situation where a borrower in country X, instead of raising excessive debt from parent in country Y, borrows from an independent lender (ostensibly on arm’s length terms), supported by the guarantee of its country Y parent. Where section 153 is applicable the “guarantee” is to be disregarded, leaving the borrower’s ability to raise debt to be tested by reference to its own financial standing.

3.160 This rule has potential application in passive association situations because of the broad definition in section 154(4) TIOPA of “guarantee”. It includes a “surety” and also “*any other relationship, arrangements, connection or understanding (whether formal or informal) such that the person making the loan to the issuing company has a reasonable expectation that in the event of a default*”

⁵⁸⁸ Interest or other consideration payable or given for other advances of money is treated as payable or given in respect of a security; “references to a security are to be read accordingly”: section 154(7) TIOPA.

⁵⁸⁹ Provocatively, Ghosh, in the IFA 2008 *Cahiers* vol. 93b pages 743-744, remarked that “most creditors, other than banks, could be said to be perfectly happy to lend to any debtor, irrespective of its credit rating or its debt:equity ratio. ... It is arguable that the thin capitalisation provisions are difficult to operate intelligibly to the satisfaction of HMRC at all.”

⁵⁹⁰ Sections 152(5) and (6)/153(5) and (6) TIOPA.

by the issuing company the person will be paid by, or out of the assets of, one or more companies”⁵⁹¹.

3.161 Whereas “arrangements”⁵⁹² or “understandings” are likely to entail some level of *activity* on the part of the putative “guarantor”, or consensus between it and the lender or borrower, the references to “relationship” and “connection” are inherently passive; in the paragraph 3.159 case above the parent and subsidiary are obviously *related* and *connected*. Thus a reasonable expectation of support by (in that example) parent in favour of lender, in circumstances where subsidiary might fall into financial distress, where such expectation is attributable to the parent-subsidiary relationship, can amount to a “guarantee”. As a matter of plain language, a “reasonable expectation” in this context does not mean “any possibility, however slight”, of support. There is no directly applicable authority in this context, but some guidance may be taken from other fields, perhaps indicating that what is required is a “more than 50% likelihood” of support⁵⁹³.

3.162 This very broad definition of guarantee, to the extent it captures mere passive association, is arguably at odds with paragraph 7.13 TPG and indeed the broader application of the arm’s length principle. The argument is based on the proposition in that paragraph that mere passive association does not entail the provision of a service, and (by necessary implication) is not compensable,

⁵⁹¹ Emphasis added. There are identical definitions in sections 191(4)/192(6) TIOPA in the related but distinct context of allowing a form of compensating adjustment to guarantors: paragraph 3.183. See also the Australian *Peabody* case, note 366 above.

⁵⁹² See e.g. *CIR v Payne* (1940) 23 TC 610, 626 per Greene MR and *Crossland v Hawkins* [1961] Ch 537 CA on the meaning of “arrangements” in another context, in each case emphasising the need for “steps”. Also, *British Slag Ltd v Registrar of Restrictive Trading Agreements* [1962] 3 All ER 247, 255: “all that is required to constitute an arrangement not enforceable in law is that the parties to it shall have communicated with one another in some way and that as a result of the communication each has intentionally aroused in the other an expectation that he will act in a certain way” (per Cross J, cited by Diplock LJ in the Court of Appeal).

⁵⁹³ See e.g. *Bradley v Secretary of State for Work and Pensions* [2008] EWCA Civ 36, per Chadwick LJ; also *Atkinson v HMRC* [2013] UKFTT 191 and *Kitching v HMRC* [2013] UKFTT 384 on the objective nature of a “reasonable expectation” test (in another context) and *R (on the applications of SRM Global Master Fund LP and others) v Commissioners of HM Treasury* [2009] EWHC 227 which may be seen as implying a test which approaches the need for some legally binding support. “Implicit support exists along a spectrum, from strong implicit support, akin to a legal guarantee, to weak or no implicit support”: Burnett (2014) page 66.

implying that the party benefiting from passive association is entitled to retain, without payment, affiliation benefits (e.g. lower borrowing costs) which arise from affiliation alone and not from any specific activity of the group⁵⁹⁴. I doubt however that the section 164 TIOPA directive to “read” Part 4 so “as best secures consistency” with the TPG permits the plain words of section 154 to be displaced by reference to what is at most an inference drawn from paragraph 7.13 TPG. Nevertheless, sections 152-154 in my view fall short of scrupulous implementation of the arm’s length principle into UK tax law. On that basis, it may be open to a taxpayer, armed with a UK double tax treaty incorporating the Article 9(1) MTC format, to argue that the arm’s length standard demanded by the treaty can displace the effect of those sections where (as in a thin capitalisation scenario) the taxpayer’s deductions would be suppressed below an arm’s length amount⁵⁹⁵. The observation that “the arm’s length principle is applied, although it is applied to a modified reality”⁵⁹⁶ (i.e. not to the actual facts) is just not good enough.

Case law

3.163 Despite having one of the oldest systems of transfer pricing in the world, the UK has experienced almost no significant transfer pricing litigation. Almost all cases are settled between taxpayer and HMRC.

3.164 At least until the decision in *DSG Retail Ltd v CIR*⁵⁹⁷, the slight volume of UK transfer pricing case law shed no meaningful light on the significance of passive association. Two reported decisions of the Special Commissioners, *Ametalco v CIR*⁵⁹⁸ and *Waterloo plc v CIR*⁵⁹⁹, both concerned legislation (section

⁵⁹⁴ See e.g. ABA Guarantees Paper, 13 September 2012, page 58.

⁵⁹⁵ See paragraph 2.7 above. Compare *Utah Mines Ltd v The Queen* (1991) 92 DTC 6194 (Canadian Federal Court of Appeal) where a domestic restriction on royalty deductibility was held not to contravene the permanent establishment profit attribution rule in the Canada-US tax treaty. But the focus there of the court was on an ambulatory interpretation of the treaty, combined with the inapplicability of the PE non-discrimination rule (not infringed because the restriction applied equally to Canadian residents). The answer in an Article 9 MTC case might be quite different.

⁵⁹⁶ Burnett (2014) page 47.

⁵⁹⁷ [2009] UKFTT 31 (TC), TC 00001.

⁵⁹⁸ [1996] STC (SCD) 399.

770 ICTA) that preceded the UK's modern transfer pricing code, and related to interest-free loans (where one might think that passive association as an element of pricing could be potentially relevant), but did not engage with quantitative issues at all.

3.165 *DSG Retail* is the leading modern UK case in the transfer pricing field, and one of only two cases⁶⁰⁰ on what is now the transfer pricing regime in TIOPA Part 4. Because the periods in dispute straddled the introduction of the modern transfer pricing code⁶⁰¹, the predecessor rule in section 770 was also considered.

3.166 While passive association is not mentioned specifically, the Special Commissioners did rule (“it is clear to us”) that (a) in section 770, in reaching the price which would have been paid if the parties “had been independent parties dealing at arm’s length”, no adjustment was required “to the actual characteristics of the parties other than their independence. The actual assets, business and *attributes* of each party remain constant and may be relevant to the determination of the arm’s length price”; and (b) what is now section 147(1)(d) TIOPA, “should be interpreted as requiring consideration of what provision independent enterprises sharing the *characteristics* of the actual enterprises would have made”⁶⁰². Moreover, the Commissioners appeared to consider that “*the only assumption required* in determining the taxpayer’s profits is that it is *independent of the particular counterparty*”⁶⁰³.

3.167 In my view, these statements support the recognition of passive association in pricing controlled transactions. Surely the references to the attributes and characteristics of the actual parties should be regarded as extending to the empirical fact, if such can be established as a matter of evidence, that (say) a

⁵⁹⁹ [2002] STC (SCD) 95.

⁶⁰⁰ See paragraph 3.179.

⁶⁰¹ By section 108 and Schedule 16 Finance Act 1998, inserting section 770A and Schedule 28AA ICTA, with effect for corporation tax purposes for accounting periods ending on or after 1 July 1999.

⁶⁰² [2009] UKFTT 31 (TC) at paragraph 78, my emphasis.

⁶⁰³ *Ibid.*, paragraph 90 (my emphasis), though this proposition is advanced as a reason for another which the Commissioners then reject, with resulting uncertainty as to the weight it is to be accorded.

lender would have regard to an expectation (albeit one unfounded on any legal rights) that the borrowing company would be supported by its parent? Suppose further that “the only assumption” statement above can indeed be regarded as attracting judicial approval. Then take a case where Subsidiary S1 borrows from sister Subsidiary S2 in circumstances where their common Parent, P, can be expected voluntarily to support S1 in respect of its external debt. If the only assumption required is that S1 is independent of S2, S1’s affiliation with P remains in play as one of its relevant attributes or characteristics. (See further paragraph 4.19.)

3.168 A potential difficulty arises if instead one postulates Subsidiary S borrowing from Parent P where the assumed provider of support would also be P. What then does the “independent of P” assumption entail? On this see the broader discussion of what I have termed the “lender as guarantor” paradox at paragraphs 4.49(i) and 5.10.

3.169 *DSG* is also of interest given the prominence given by the Special Commissioners, in their consideration of comparables⁶⁰⁴, to the concept of *relative bargaining power*. As observed at note 51 above, and as recognised in e.g. paragraph 1.5 TPG, this can be an important comparability factor⁶⁰⁵. A company’s membership of an MNE group with a high-quality reputation (and thus its passive association with that attribute), such that counterparties are in relative terms more desirous of transacting with that company in the group, could result in increased bargaining power for the company, so that it is able to purchase or sell goods or services, at arm’s length, at relatively favourable prices (compared with the position it would have been in absent its affiliation with the group). The Special Commissioners in *DSG* considered it appropriate to seek a result which “replicates the outcome of bargaining between independent enterprises in the free market” (citing paragraph 3.21 of the 1995 TPG)⁶⁰⁶. Passive association as a contributor to bargaining power is not expressly addressed in *DSG*, but the case is important in

⁶⁰⁴ *Ibid.*, paragraphs 96–138.

⁶⁰⁵ The concept featured prominently in the Norwegian *ConocoPhillips* cash pooling case *Utv* 2010 at 199. See Andresen, Pearson-Wood and Jørgensen (2010).

⁶⁰⁶ *DSG*, paragraph 153.

the way it develops the importance of bargaining power in transfer pricing; and if actual bargaining power is respected as a relevant attribute in arriving at an arm's length price, it may fairly be said that the effect of passive association equally should be respected.

3.170 A fly in the ointment is however presented by the Court of Appeal decision in the *Thin Cap* case⁶⁰⁷. That case ultimately upheld the validity of the UK's (now repealed) thin capitalisation legislation when tested against the EU freedom of establishment assured by what is now Article 49 TFEU (paragraph 2.99ff above). As what appears to be a last throw of the dice, Graham Aaronson QC argued for the taxpayers (by way of contingent cross-appeal⁶⁰⁸) that when applying the arm's length test to a subsidiary within a group of companies it was necessary, in order to comply with EU law, for HMRC and the court to take into account the subsidiary's membership of that group. An independent third party, in considering whether to lend to such a subsidiary, would have regard to the fact that its parent company was a reputable and credit-worthy company that was unlikely to allow its subsidiary to fail to meet its liabilities. One of the sets of UK rules in dispute, section 209(2)(da) ICTA, had been found by the ECJ to constitute a restriction on the freedom of establishment⁶⁰⁹. The UK Government argued that the restriction went no further than was necessary, being based on the arm's length principle⁶¹⁰. The Court accepted that justification was possible where the national measure applied only to interest "if, and in so far as, it exceeds what those companies would have agreed upon on an arm's length basis"⁶¹¹. A gloss on the arm's length principle in UK tax law, specifically section 209(8A)–(8F) ICTA⁶¹²,

⁶⁰⁷ *Test Claimants in the Thin Cap Group Litigation v R&CC* [2011] EWCA Civ 127.

⁶⁰⁸ Paragraph [58]ff of the Court of Appeal report.

⁶⁰⁹ ECJ decision, Case C-524/04, paragraphs 59-63. The interest deductibility restriction was effectively disapplied when the lender was a UK resident company: section 212 ICTA.

⁶¹⁰ *Ibid.*, paragraph 71.

⁶¹¹ *Ibid.*, paragraph 80.

⁶¹² These rules contained a forerunner of the TIOPA rules discussed at paragraph 3.160 above, touching on passive association by requiring no account to be taken, in determining borrowing capacity and interest rate, of any "*relationship, arrangements or connection* (whether formal or informal) between the [borrower] and any person": section 209(8A)–(8B), my emphasis.

did not permit the group position to be taken into account; this, Mr Aaronson argued, rendered the rules non-compliant. (See paragraph 2.104 above.)

3.171 HMRC contended that this submission, if accepted, would render the arm's length test ineffective for its purpose, and also noted that Henderson J at first instance had doubted the validity of the claimants' argument in this respect: "I do not think it is open to the claimants in the light of the ECJ's judgment"⁶¹³. In my view the judgment must be taken to have endorsed the use of an arm's length test for this purpose."⁶¹⁴ Stanley Burnton LJ agreed, based upon the ECJ's apparent awareness of the effect of the UK legislation, despite Mr Aaronson arguing⁶¹⁵ before the ECJ that "the OECD test takes into account the borrowing capacity of the group" but the UK statute failed to reflect that. To illustrate the passive association phenomenon, Mr Aaronson before the ECJ had said:

*"If someone is lending to any Volvo company, they will know that Volvo's reputation is at stake. Although Volvo simply cannot allow a subsidiary to default on its loan. If it did so, no one would ever lend money to Volvo again. This is why the OECD test takes into account the borrowing capacity of the group. But this simply cannot be taken into account in the UK context ..."*⁶¹⁶

⁶¹³ In the *Thin Cap* case.

⁶¹⁴ Paragraph [74] of the High Court decision, [2009] EWHC 2908 (Ch), cited at paragraph [59] in the Court of Appeal report.

⁶¹⁵ Graham Aaronson put it this way to me in correspondence of 28 April 2015, which I quote here with his permission: "I remain firmly of the view that what I said in the contingent cross-appeal in *Thin Cap* was not merely right, but blindingly obvious. The fact that a company is a member of a well-established and highly profitable group is empirically something that positively affects that company's terms of trade and creditworthiness vis-à-vis third parties; and the fact that the UK's thin cap rules precluded recognition of the existence of the wider group relationship must mean that they depart from that commercial reality. Stanley Burnton LJ in the Court of Appeal was unsympathetic to the Claimants' arguments in that case; and Henderson J did not pay serious attention to this argument in the High Court because he was absolutely sure that HMRC's case was hopeless on other grounds. So the cursory dismissal of the argument reflects the general state of mind of the respective judges."

⁶¹⁶ Quoted at paragraph [60] of the Court of Appeal decision. Ian Roxan in Baistrocchi and Roxan (2012) page 331 suggests that Henderson J's view may "have been influenced by the argument, made explicitly by a witness in the *IBM* case, that the thin cap restrictions did not reflect the reality of commercial borrowing, since a UK subsidiary would be able to borrow from a third party on terms that would take into account the credit of the whole group": this presumably is the evidence of Ms Bishop, quoted at paragraph 152 of the High Court decision, that "[i]f NRH had been seeking to borrow from an unconnected party, it is inconceivable that such a third party lender would not have taken into account the fact that it was the UK holding company for one of the world's largest multinational corporations".

3.172 Unfortunately the Court of Appeal was unmoved. For Stanley Burnton LJ: “I do not accept Mr Aaronson’s submission that the UK arm’s length test is more stringent than the OECD test. His submission is inconsistent with the ‘functionally separate entity’ approach of the OECD”⁶¹⁷. Rimer LJ agreed⁶¹⁸, and for Arden LJ, who delivered a dissenting judgment, the claimants’ contingent cross-appeal did “not arise”⁶¹⁹. Thus we are left with Court of Appeal statements to the effect that the requirement to ignore passive group association in testing borrowing capacity, in the context of the UK’s thin capitalisation rules prior to the codification of transfer pricing legislation, is not at odds with the arm’s length principle. But these statements are highly unsatisfying given the total lack of reported reasoning. In the High Court, Henderson J observed⁶²⁰ that “Mr Aaronson’s argument was not pursued in his oral submissions”; and the judge’s comment that the ECJ’s judgment “must be taken to have endorsed the use of an arm’s length test” brings us no further forward – the argument was simply that increased borrowing capacity was *part of* the arm’s length test. Then in the Court of Appeal, Stanley Burnton LJ notes that “[t]here is nothing in the [ECJ’s] *Thin Cap* judgment to suggest that UK legislation might have been incompatible because of its failure to take into account a subsidiary’s membership of a non-UK group of companies”; yet this can hardly be equated with a finding to that effect by the ECJ. If there is a *ratio* at all in the Court of Appeal on this point, it is the ten word assertion that the submission was “inconsistent with the ‘functionally separate entity’ approach of the OECD”. But not the slightest attempt is made to justify this conclusion by reference to the TPG or indeed the obvious persuasive authority available by the time of the *Thin Cap* decision from the *General Electric* case (paragraph 3.16 above)⁶²¹.

⁶¹⁷ Paragraph [61].

⁶¹⁸ Paragraph [81].

⁶¹⁹ Paragraph [111].

⁶²⁰ Paragraph [74] in the High Court judgment.

⁶²¹ The Court of Appeal decision is also unsatisfactory as regards its approach to the question of commerciality as a taxpayer defence to pricing adjustments in circumstances where the arrangements in question do not adhere to the arm’s length principle: “the application of an arm’s length test is appropriate and sufficient for this purpose” Stanley Burnton LJ at paragraph 55, which appears to conflate the two separate limbs of proportionality – a commerciality

3.173 Regrettably, one could imagine that a court faced with a case in which sections 152(5)/153(5) and 154(4) TIOPA were in dispute might draw upon *Thin Cap* to form the view that the statutory disregard of “guarantees” as defined is consistent with the arm’s length principle. It would be a brave tribunal to hold otherwise, and it may be necessary to go to the Court of Appeal⁶²² or beyond to revisit the analysis properly.

3.174 Yet EU law might still provide recourse for a UK taxpayer facing HMRC’s rejection of passive association in reliance on those TIOPA provisions. Take the case of a UK parent company lending to a (say) French subsidiary. Assume that the market would expect support from the parent and would accordingly upgrade its view of the subsidiary’s creditworthiness so as to justify a borrowing rate of 5%. HMRC on the other hand denies that economic effect and imputes interest income to the parent of 6%. Alternatively, take the case of a French parent company’s UK subsidiary with a certain market borrowing capacity (based on market expectations of parental support). HMRC however regards the borrower’s debt quantum as excessive, having disregarded passive association effects. Just as with the Belgian rules at issue in the *SGI* case (see paragraph 2.102), a taxpayer may be able to argue that the UK transfer pricing rules in TIOPA represent a restriction on freedom of establishment (or possibly indirect discrimination).

3.175 While it is true that those UK rules apply between UK group members as well as in cross-border cases, on a detailed practical level UK-to-UK transfer pricing may be regarded as a relatively minor compliance irritation. This is because of the corresponding adjustment mechanism available, as of right, only as between UK taxpayers (an obvious EU alarm bell), in section 174 TIOPA. Contrastingly, in a cross-border case, a corresponding adjustment would be achievable only under a double tax treaty’s mutual agreement procedure

defence and a limit on tax adjustments to the arm’s length price – in paragraphs 71-72 of the *SGI* judgment, note 206 above).

⁶²² Subject to the limitations in *Young v Bristol Aeroplane Ltd* [1944] KB 718. Possibly more could be made of the effect of Article 9(1) of an applicable treaty: see paragraphs 2.7 and 2.107 above.

(“MAP”)⁶²³, perhaps including arbitration where that is included in the treaty, or under the EU Arbitration Convention. But the timeline, costs and uncertainties of such processes represent significant disadvantages in cross-border cases. “[A]s far as economic double taxation is concerned, the extent to which this is prevented under EU law depends on whether the home state takes measures to mitigate it domestically but does not extend such measures in a cross-border situation”⁶²⁴.

3.176 MAP does not provide a mandatory binding solution⁶²⁵, and treaty arbitration on the Article 25(5) MTC model is as yet, despite the evangelism of the BEPS programme, available only in a limited number of treaties⁶²⁶. Moreover, complete consensus remains elusive across the EU as regards the Arbitration Convention’s scope for addressing thin capitalisation cases⁶²⁷ (see paragraph 2.96). In these respects, the UK approach may well impose a restriction on (or even indirect discrimination against) cross-border establishment⁶²⁸. In the *SGI* case, the ECJ observed⁶²⁹ that, as regards recourse to the Arbitration Convention:

⁶²³ Authorised by section 124 TIOPA.

⁶²⁴ HJI Panayi (2013) page 249.

⁶²⁵ “[F]or many countries the MAP is a black hole of taxpayers’ rights, where the taxpayer has neither the right to initiate the procedure, nor to participate, no certainty that there will be an outcome and no certainty that the outcome will be implemented”: Baker and Pistone (2015) page 53. In the EU arena, the Commission has acknowledged that “[t]he taxpayer has no guarantee that double taxation will be eliminated, nor that tax administrations will proceed swiftly”: *Double Taxation in the Single Market*, COM(2011) 712 final, page 10. Aspirational improvements to MAP are enumerated in the BEPS Action 14 final report *Making Dispute Resolution Mechanisms More Effective* (October 2015).

⁶²⁶ Within the EU, the UK’s bilateral tax treaties containing an arbitration provision are limited to those with Belgium, Bulgaria, France, Germany, The Netherlands, Spain and Sweden.

⁶²⁷ Or indeed under MAP: see e.g. INTM 423060.

⁶²⁸ A restriction on freedom of establishment is prohibited by Article 49 TFEU “even if of limited scope or minor importance”: Case C-9/02 *Hughes de Lasteyrie du Saillant*, paragraph 43, and cases cited therein. Even being required to keep local accounts was a restriction in Case C-250/95 *Futura Participations SA*. More generally, a parallel may be drawn with the Case C-196/04 *Cadbury Schweppes* decision paragraph 45. The UK parent of a CFC was found to be placed at a disadvantage relative to a UK parent of a UK subsidiary; in the former case, but not the latter, the parent was taxable on the profits of its controlled subsidiary. One might also bring to bear certain other EU law principles: “the detailed procedural rules designed to ensure the protection of the rights which individuals acquire under Community law are a matter for the domestic legal order of each Member State ... provided that they are not less favourable than those governing similar domestic situations (principle of equivalence) and that they do not render impossible in practice or excessively difficult the exercise of rights conferred by the Community legal order (principle of effectiveness)”: Case C-392/04 *i-21 Germany GmbH*, paragraph 57;

“an additional administrative and financial burden is imposed on the company which has submitted its case to such a procedure. Moreover, a procedure aimed at resolution by mutual agreement, followed, if necessary, by an arbitration procedure, may extend over several years. During that period, the company in question must bear the burden of double taxation. Furthermore, it is apparent ... that the legislation at issue in the main proceedings is applicable in certain situations falling outside the scope of the Convention.

“[55] It follows that legislation of a Member State such as that at issue in the main proceedings constitutes a restriction on freedom of establishment within the meaning of Article 43 EC, read in conjunction with Article 48 EC.”

3.177 Put another way, the UK rules, in view of these practical hurdles, may make lending to a foreign subsidiary less attractive than lending to a UK subsidiary, and consequentially less easy for foreign subsidiaries to raise capital from the UK (first case in paragraph 3.174 above). Similar reasoning applies in the reverse situation where a UK subsidiary contemplates raising capital from its EU parent (second case above)⁶³⁰. To the extent that the UK fails to apply the arm’s length principle, it will be liable to “cause” double taxation: “in relation to double taxation caused by a single Member State, it is clear from the Court’s jurisprudence that the Member State in question may have to give relief in situations where relief of economic double taxation is granted domestically”⁶³¹.

3.178 Aside from pointing to UK-to-UK transfer pricing, the UK Government would doubtless argue that the TIOPA transfer pricing rules should be justified by reference to securing the balanced allocation of taxing powers and the need to prevent avoidance. But a failure to apply the arm’s length principle itself fails to adopt an adequately “balanced” approach. “The corrective tax measure must be confined to the part which exceeds what would have been agreed if the companies

Case C-362/12 *Test Claimants in the Franked Investment Income Group Litigation*, paragraph 32.

⁶²⁹ Paragraphs 54-55.

⁶³⁰ Compare a version of this “two-way” analysis (in the context of dividend taxation/free movement of capital) in Case C-319/02 *Manninen*, paragraphs 20-24.

⁶³¹ O’Shea (2013) page 106, citing Case C-315/02 *Lenz*; Case C-319/02 *Manninen*; Case C-374/04 *ACT IV GLO* and Case C-170/05 *Denkavit International*. But EU law does not in general preclude double taxation: see notes 201 above and 633 below.

did not have a relationship of interdependence”⁶³². The taxpayer may also be able to assert that, freedom of establishment having been engaged, the lack of legal certainty in the UK tax code, given the need to resort to MAP/arbitration, itself prevents the UK rules from being proportional⁶³³.

3.179 In *Abbey National Treasury Services Plc v HMRC*⁶³⁴ the First-tier Tribunal was prepared to apply Schedule 28AA ICTA to a share issue in the context of a tax avoidance scheme, and then to disregard the share issue, applying the principles in paragraph 1.37 of the 1995 TPG, as a step which was not “commercially rational” and which “impeded the tax administration from determining the appropriate transfer price”, to arrive at a comparator situation in which the shares had not been issued at all. The case does not offer any profound commentary on the nature of the arm’s length principle.

Tax authority practice

3.180 Long before the publication of their official manuals, the Inland Revenue (as it then was) expressed the view that the “arm’s length price” meant “the price which might have been expected if the parties to the transaction had been independent persons dealing at arm’s length i.e. dealing with each other in a normal commercial manner unaffected by any special relationship between them”⁶³⁵. Extensive guidance on transfer pricing is nowadays provided in

⁶³² *SGI*, paragraph 72; see also the ECJ judgment in *Thin Cap*, paragraph 92.

⁶³³ See Case C-318/10 *SIAT*, paragraphs 57-59, cited in Case 282/12 *Itelcar*, paragraph 44, note 206 above. In *SIAT* the Court disapproved of the fact that “the assessment concerning the applicability of the special rule is carried out on a case-by-case basis by the tax authority” (paragraph 26). Aside from the arguments above, it might even be open to a taxpayer to argue that a transaction priced with regard to passive association satisfied the “commerciality” test which should be regarded as a separate limb of proportionality: see paragraph 2.105 above. Taking the case to the ECJ might of course be unnecessary if the UK court could be persuaded that a proper application of the arm’s length principle required passive association to be taken into account and Article 9(1) of an applicable tax treaty displaced sections 152(5)/153(5) and 154(4) TIOPA. See paragraphs 2.7 and 2.107 above. The UK has bilateral tax treaties containing a provision based on Article 9(1) OECD MTC with all other EU Member States. It would not be for the ECJ to rule on a possible infringement of a bilateral tax treaty: Case C-298/05 *Columbus Container Services BVBA & Co v Finanzamt Bielefeld-Innenstadt*, paragraph 46, cited e.g. in Case C-128/08 *Damseaux v Belgium*.

⁶³⁴ [2015] UKFTT 341 (TC) paragraphs 99–106.

⁶³⁵ Notes by the UK Inland Revenue, *The Transfer Pricing of Multinational Enterprises*, published in *Intertax* 1981/8, paragraph 2.

HMRC's International Manual⁶³⁶. An introductory formulation of the arm's length principle is that "transactions between connected parties should be treated for tax purposes by reference to the amount of profit that would have arisen if the same transactions had been executed by unconnected parties"⁶³⁷.

3.181 HMRC do acknowledge⁶³⁸ the concept of an "implicit guarantee", but what this means is not explained in a precise way. They say:

"If a guarantee is only implicit, the lender will not be able to sue the guarantor in the event that the borrower defaults on a loan. The guarantor may not have taken on a risk to which a price can be attached. Even a comfort letter from the UK parent may not be sufficient to create a measurable guarantee, unless it binds the issuer in the event of its subsidiary's default. Expectation in such circumstances may count for as much as a legally binding commitment.

"Seeking to impute a fee in relation to the effect of simple membership of a group is inappropriate [TPG paragraph 7.13 is cited].

"It may come down to what evidence there is that the guarantor will make good its implicit guarantee. It may have a track record of supporting or abandoning subsidiaries which get in trouble; it may have a reputation for defending its name and standing by its subsidiaries. A lender is not going to set much store by an unenforceable 'letter of comfort' unless it can have confidence that the signatory keeps their word. It is a matter of weighing up the likelihood of an implicit guarantee being honoured and the effect that it would have on the borrowing terms of the borrower."

3.182 Interestingly, HMRC then comment on the pricing of explicit guarantees, saying that "under OECD guidelines" (and thus, it would seem they consider, UK tax law) a fee may be imputed if the guarantee provides a benefit to the borrower "after taking into account any implicit support"⁶³⁹. The implicit support aspect is not in fact found expressly in the TPG, but the statement

⁶³⁶ Available at www.gov.uk/government/collections/hmrc-manuals (accessed 15 July 2015).

⁶³⁷ INTM 412040.

⁶³⁸ INTM 501050.

⁶³⁹ *Ibid.*

represents HMRC acceptance that implicit support is a relevant factor in pricing an explicit guarantee. This is followed by the lukewarm comment that “there is an argument” that an arm’s length guarantee fee “should be reduced if it is found that the borrower already has the benefit of implicit guarantees”; and: “to charge for the explicit guarantee without taking account implicit support could be regarded as charging for something that was, to some extent at least, already in place”. Reference is made to that being the line taken in the Canadian *General Electric* case⁶⁴⁰. Elsewhere, HMRC acknowledge specifically that “all relevant factors should be considered ... [including] consideration as to whether the guarantee brings the borrower something beyond the implicit parental or group support provided by passive association with fellow group members”⁶⁴¹.

3.183 It is understood from professional experience that HMRC draw a distinction, as a matter of terminology, between “implicit guarantees” and other forms of implicit support. The former represents something falling within the statutory definition of “guarantee” in section 154(4) TIOPA but which falls short of a contractually binding guarantee or surety. Other forms of (perhaps yet lesser quality) implicit support may not, in HMRC’s view, influence a borrower’s ability to raise debt⁶⁴². In the related but distinct context of allowing guarantor companies a form of compensating adjustment, HMRC say⁶⁴³:

“The term ‘implicit guarantee’ is also used in [section 192 TIOPA]⁶⁴⁴ ... Where affiliated companies make such claims on the basis that a guarantee is implicit because of the relationship between the thinly-capitalised and the claimant company, that should not of itself be taken as evidence of the existence of an actual guarantee that requires pricing.”

3.184 More generally in the context of guidance on thin capitalisation, HMRC assert that, because the arm’s length provision is that which would have been made as between independent enterprises, “the arm’s length borrowing capacity of

⁶⁴⁰ See paragraph 3.16ff.

⁶⁴¹ INTM 413130.

⁶⁴² This is a position which, in professional practice, I have seen HMRC adopting: see paragraph 3.189.

⁶⁴³ INTM 501050.

⁶⁴⁴ Actually it is not.

the borrower is therefore the debt which it could and would, as a stand-alone entity, have taken on from an independent lender. To establish this, it is necessary to consider the borrower separately from the other members of the same group of companies. This is the ‘separate entity’ or stand-alone basis for determining borrowing capacity... no account is taken of any guarantees, explicit or implicit, from connected companies”⁶⁴⁵. Paragraph 1.6 TPG is then cited: “... treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business”. However, equating the “separate entity” approach (mandated by the TPG) with the “stand-alone” concept (used by rating agencies) seems misconceived; the separateness required by the OECD demands respect for the separate legal corporate existence of the company in question rather than viewing things from the perspective of the MNE “firm” as a whole or on some sort of consolidated basis. The rating agencies themselves recognise that, in determining creditworthiness, the stand-alone position may then be adjusted for group affiliation⁶⁴⁶.

3.185 While it is unobjectionable that mere implicit support or passive association does not amount to “the existence of an actual guarantee” (at least in the legal sense), in my opinion HMRC’s broad approach is inconsistent with the statute. The sections 154(4)/191(4)/192(6) definitions are *inclusive*: instruments that would, as a matter of ordinary legal terminology, be recognised as guarantees will clearly fall into the definition; other lesser forms of assurance are then, by extension, brought within the term “guarantee”. The statutory test on its terms embraces *inter alia* any “relationship” or “connection” that may produce a “reasonable expectation” of payment. Let us accept (as seems reasonable) the proposition that “reasonable expectation” implies a prospect something in excess of 50%⁶⁴⁷. It is in my view logically irrefutable that there may exist cases where the implicit support from which a putative borrower may benefit may (a) produce a prospect of payment for a lender of less than 50% - let us say “40%”, but nonetheless (b) favourably influence the pricing of, or willingness to advance, a

⁶⁴⁵ INTM 413070.

⁶⁴⁶ See the S&P *Group Rating Methodology*, note 38 above.

⁶⁴⁷ See paragraph 3.161 above.

loan to the borrower. True, the quantitative effect may not be large, or easy to determine, but the principle seems plain.

3.186 Some sections touching on passive association have been removed from INTM⁶⁴⁸. Unsurprisingly, this archived material does not resolve any uncertainties. HMRC themselves acknowledged that “the issues of whether and to what extent passive association improves a borrower’s credit rating and at what point group support becomes more than passive association are difficult and complex”⁶⁴⁹. HMRC do however seem to consider that the existence of an implicit guarantee depends on behaviour of the parties, and that passive association can have an effect on the terms of a loan⁶⁵⁰.

3.187 HMRC facilitates occasional discussions on financial transfer pricing with professional practitioners through a “Joint Thin Cap Forum”. Implicit support in financing cases has been the subject of debate in that group, first at a meeting on 15 October 2013, and then on 27 January and 14 October 2014. The group generally operates subject to the Chatham House Rule, but I can say that at the earlier of these two meetings (illustrating the uncertainty in this area) the opinions of the six major UK accounting firms and the law firm present were split fairly evenly as to the appropriateness of making implicit support adjustments in lending scenarios; at the latter meeting views were no further advanced. The main perceived difficulty is the broad UK statutory definition of “guarantee” (paragraph 3.160 above): some were of the opinion that implicit support can only be meaningful if it creates the “reasonable expectation” referred to in section 154(4) TIOPA, at which point it must be disregarded. Reference was made to the two examples included in the OECD’s July 2013 discussion draft on Intangibles (see paragraph 2.80ff), which have been retained in the updated Section D.8 Chapter I TPG. However, HMRC did indicate in the October 2014 meeting that its competent authority work included a number of challenges from other tax

⁶⁴⁸ Archived HMRC manual material is available from various sources including e.g. CCH’s *HMRC Tax Manuals Archive* service available by subscription from www.cch.co.uk.

⁶⁴⁹ INTM 542090. See now INTM 413110.

⁶⁵⁰ *Ibid.* “Where there are intra-group guarantees, explicit or implicit, the effect that the guarantee has on the terms of the loan need to be separated from any effect that can be attributed to passive association.”

authorities in the context of interest rates and guarantees, and that many countries seemed to have accepted the concept of implicit support⁶⁵¹. At that time HMRC “had no policy” on implicit support, but were firmly of the view that it could not increase borrowing capacity.

3.188 In confidential correspondence with a client taxpayer, HMRC at first persisted with the view that implicit support from a parent company to its borrower subsidiary cannot be taken into account in pricing a loan from that parent to that subsidiary. “The HMRC view is that while the provision, that is the arrangements, between [parent] and [subsidiary] must be compared with the provision that would have taken place at arm’s length this does not change the fact that [parent] is the lender. We need to consider on what terms [parent] would lend at arm’s length but [parent] remains the lender and would not, at arm’s length, provide support for its own loan in the case of a default.”⁶⁵² Subsequently, HMRC accepted “that implicit support is a relevant concept but only to the extent that it affects the pricing of debt”⁶⁵³; they have maintained (and reaffirmed in a letter of 19 June 2015) the position that implicit support is not relevant to borrowing capacity.

3.189 Consistent with that position, at a meeting with HMRC on 12 August 2014, an HMRC officer indicated that consideration of the significance of implicit support had developed within HMRC in recent months and that revised guidance could be expected. He also said that HMRC would be imminently providing proposed language to OECD for inclusion with the group synergies material in the September 2014 paper on Intangibles (see paragraph 2.80ff above). As trailed at the August meeting, HMRC are understood to have proposed to OECD that implicit support should indeed be recognised as a market phenomenon, but that its

⁶⁵¹ That might be thought to imply that other countries were invoking the notion of implicit support to argue for a lower interest rate (or guarantee fee) payable by a local borrower to a UK lender or guarantor.

⁶⁵² Confidential letter (quoted with client permission) from HMRC dated 9 May 2014 to a UK corporate taxpayer in the course of a dispute regarding the application of section 447 Corporation Tax Act 2009 under which exchange gains or losses must be left out of account for tax purposes by reference to loans to the extent that, under section 147 TIOPA, profits or losses are computed as if all or part of the loan had not been made.

⁶⁵³ Confidential letter from HMRC dated 22 September 2014 in the same matter.

effects should be limited to the *rate of interest* charged on a borrowing (or, one assumes, as in the *General Electric* case⁶⁵⁴, the quantum of a guarantee fee), but should *not* be regarded as having an impact on borrowing capacity i.e. the thin capitalisation aspect of the debate. This seems logically flawed: if the presence of implicit support is accepted as enhancing (relative to the pure stand-alone position) the creditworthiness of a company, surely it is self-evident that a putative arm's length lender would be prepared to advance relatively more funds (or advance funds in circumstances where, with a stand-alone credit analysis perspective, it would not do so at all)? For the moment, the *examples* reiterated by OECD in the BEPS 2015 Final Reports (paragraph 2.83 above) have not expressly developed the analysis beyond the position apparently favoured by HMRC. However, paragraph 1.157 TPG does now contemplate "increased borrowing capacity" in the group synergies discussion, contrary to HMRC's position. Perhaps additional clarification will be forthcoming by the time the BEPS project comes to a conclusion (see paragraph 2.85 above).

3.190 In summary, while the UK's transfer pricing legislation explicitly (but guardedly) adopts the OECD TPG for interpretative purposes, and HMRC are vocal supporters of the arm's length principle, only a rather limited and grudging acceptance of the effects of passive association in pricing controlled transactions is so far apparent. In many cases, the statutory requirement to disregard "guarantees" will serve as a serious obstacle to recognition of such effects, despite this being somewhat at odds with paragraph 7.13 TPG and the arm's length principle generally.

⁶⁵⁴ Paragraph 3.16ff above.



United States

*“We can simply interpret arm’s length to mean what we think it should mean, and if we say it correctly, that’s what it means”.*⁶⁵⁵

Legislation

3.191 The United States must be credited with the first statutory expression of arm’s length pricing; “the United States has been the standard-setter for the development of the arm’s length principle.”⁶⁵⁶ Legislative antecedents date back to 1917⁶⁵⁷. To support section 45 Revenue Act 1928, which provided authority to the government to “distribute, apportion or allocate” income to reflect the taxpayer’s income, regulations were published in 1935 which recited the objective as placing “a controlled taxpayer on a tax parity with an uncontrolled taxpayer” and included the rule that “the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer”⁶⁵⁸. The US’s first double tax treaty – with France, 1932 – applied the arm’s length principle for income allocation purposes in a provision which resonates with today’s Article 9(1) MTC⁶⁵⁹. The US has been a formative influence on international transfer pricing thinking, its regulations significantly affecting the development of the TPG. Indeed, there has been “a long-standing US tax policy to export the Sec. 482 regulations to other countries with a view to

⁶⁵⁵ Edward Kleinbard, Chief of Staff of the Joint Committee on Taxation, with citations, including an Alice in Wonderland allusion, in Wittendorff (2009) note 211.

⁶⁵⁶ Wittendorff (2010a) page 14.

⁶⁵⁷ War Revenue Act of 1917, Regulation 41, Articles 77-78 referenced by Wittendorff (2009) note 21. For historical accounts see Avi-Yonah (1995) and Wittendorff (2010a) chapter 2. It is hard to over-state the importance of the US in the development of modern transfer pricing thinking.

⁶⁵⁸ US Treasury Regs. 86, Art. 45-1(b) (1935), reflecting some slightly earlier cases on section 45: see Oates and O’Brien page 12.

⁶⁵⁹ Article IV: “the first of its kind in a tax treaty”: Avery Jones *et al* (2006).

creating an international consensus on the application of the arm's length principle”⁶⁶⁰.

3.192 However, although one might expect the US to have developed sophisticated thinking on the topic of passive association, significant uncertainty and professional disagreement persists on that topic⁶⁶¹. The concept appears to be firmly recognised as an element of comparability analysis in the services context⁶⁶², but its effect on risk, and thus on financing transactions, remains controversial. Nonetheless, the emphasis placed in case law on the principle that transfer pricing rules are there to ensure *parity* of treatment between controlled and uncontrolled transactions, and the focus on pricing *distortions* attributable to a control relationship⁶⁶³, together provide a springboard for deeper recognition of the effects of implicit support.

3.193 The foundation for US transfer pricing law is section 482 of the Internal Revenue Code 1986:

“In any case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion or allocate gross income, deductions, credits or allowances between or among such organizations, trades or businesses, if he determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses. In the case of any transfer (or license) of intangible property (within the meaning of Section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.”

⁶⁶⁰ Wittendorff (2009) page 109, citing at note 27 US Assistant Treasury Secretary Stanley Surrey from 1966. Langbein (1986) (page 627) described an “‘export campaign’ undertaken by United States officials and experts during the 1960s and 1970s, the process by which those officials sought to ‘internationalize’ ideas novelly developed by the United States during the 1960s.”

⁶⁶¹ Lowell, Burge and Briger (on-line service) paragraph 6.07[4][e] say that “the extent to which membership in an MNE group is a benefit requiring arm’s length compensation” is an issue “that arises frequently in transfer pricing examination and controversy contexts”.

⁶⁶² Paragraph 3.206ff below.

⁶⁶³ Both found e.g. in the Supreme Court’s decision in *Commissioner v First Security Bank of Utah*: paragraph 3.218 below.

3.194 Regulations under section 482 were published in 1968 in response to an invitation by the Conference Committee Report on the Revenue Act of 1962 to “explore the possibility of developing and promulgating regulations under the [authority of section 482] which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income”⁶⁶⁴. The regulations “for the first time imbued the arm’s length standard with practical meaning by formulating the three classical methods of Comparable Uncontrolled Price (CUP), cost plus and resale price, all of which depended on finding comparable uncontrolled transactions to those engaged in by the related parties”⁶⁶⁵. The internationalization of the regulations was achieved via the OECD:

*“The United States initiated a targeted campaign with the aim of creating an international consensus behind the United States’ reading of the arm’s length principle, and the need for rules on corresponding adjustments. The OECD Fiscal Committee was seen as being the key to the resolution of this problem. After their publication, the section 482 regulations were put before the OECD Fiscal Committee. The campaign culminated in the 1979 OECD Report, which largely adopted the section 482 regulations.”*⁶⁶⁶

3.195 The US has also exercised a formative influence on the introduction, content and periodic updating of the TPG, including their issue in 1995 and the abandoning in 2010 of the traditional hierarchy of methods – reflecting the emerging acceptance of profit-based methodology and the US “best method” concept⁶⁶⁷. On the other hand, the US “has been less explicit in terms of

⁶⁶⁴ H.R. Rep. No. 2508, 87th Cong. 2d Sess. 18-19 (1962), cited in the Statement of Robert S McIntyre and Michael J McIntyre before the Senate Committee on Government Affairs, 25 March 1993, available via Citizens for Tax Justice at <http://www.ctj.org/html/multimjm.htm> (accessed 18 August 2015).

⁶⁶⁵ Avi-Yonah (2009) page 1.

⁶⁶⁶ Wittendorff (2010a), pages 38-39. Thanks to Nat Boidman for the entertaining remark that “the OECD should have paid a royalty to the US for basically copying, in ’79, the US 482 Regs written in 1968”.

⁶⁶⁷ Regs. §1.482-1(c)(1), i.e. “the most reliable measure of an arm’s length result”. According to the IRS’s *Report on the Application and Administration of Section 482* (1999) at page 8 “[t]he central guidance for taxpayers and IRS examiners on the application of the arm’s length standard is set forth in the final regulations under section 482 issued in July 1994. ... These regulations were developed at the same time as, and are fully consistent with, the 1995 OECD Transfer Pricing Guidelines” (though some might differ regarding “fully consistent”).

recognizing the Guidelines' relevance as a means of interpreting the arm's length principle. A primary reason for this is presumably that the Treasury Regulations ... provide for an even more detailed interpretation ... As a result, there is not the same need to resort to the Guidelines in the United States as in countries with less detailed transfer pricing law. In line with this, the US courts rarely refer to the OECD Guidelines."⁶⁶⁸

3.196 Section 7805 IRC empowers the US Secretary of the Treasury to promulgate regulations to enforce the Code. The IRS is a bureau of the Treasury; its tax regulations constitute the Treasury's interpretations of the Code. Typically, regulations are first published in "proposed" (non-binding) form for consultation. "Temporary" regulations are effective upon publication in the US Federal Register and can be valid for up to three years from issue⁶⁶⁹. Regulations which are of an interpretive nature may be found to be *ultra vires* the primary legislation: the validity of regulations may be tested under a two-step approach enunciated by the Supreme Court in *Chevron, USA Inc v NRDC*⁶⁷⁰ whereby the court first considers whether Congress has "directly spoken to the precise question at issue" and then, if not, analyses whether the relevant agency action is based on a permissible or reasonable construction of the statute⁶⁷¹. Recent challenges to the validity of regulations include the *Altera*⁶⁷², *Amazon*⁶⁷³ and *3M*⁶⁷⁴ cases. The US Government considers the section 482 regulations to be consistent with treaty

⁶⁶⁸ Bullen (2011) page 40 and note 177, noting the *Xilinx* case (paragraph 3.224 below) as an exception. Similarly, Vega (2012) page 24: "the existence of detailed regulations on transfer pricing has made circulars referring to the OECD Guidelines unnecessary".

⁶⁶⁹ Section 7805(e)(2).

⁶⁷⁰ 467 U.S. 837 (1984).

⁶⁷¹ Jones, Roberson and Yoder (2013). An alternative basis of challenge lies with *United States v State Farm Mutual Auto Insurance Co* 463 US 29 (1983), invoked successfully by the taxpayer in the *Altera* case: note 672 below.

⁶⁷² TC Dkt Nos. 6253-12 and 9963-12, decision reported at 145 TC No. 3 (US Tax Court 27 July 2015) finding Regs. §1.482-7(d)(2) invalid. *Altera* is now challenging subsequent versions of the regulations: TC Dkt No. 31538-15.

⁶⁷³ TC Dkt No 31197-12. See also *Dominion Resources, Inc v United States* 681 F.3d 1313; *Cohen v United States* 650 F.3d 717; *United States v Home Concrete & Supply LLC* 132 S.Ct. 1836 (2012).

⁶⁷⁴ TC Dkt No. 5186-13.

obligations and the OECD TPG⁶⁷⁵. Section 1.482-1 introduces the arm's length principle and the conditions for its application, and subsequent sections address different transaction categories. Proposed regulations on global dealing have been published.

3.197 Regs. §1.482-1(a)(1) expresses the general objective of the US transfer pricing code (echoed in paragraph 1.8 TPG) that “[s]ection 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer”.

3.198 Regs. §1.482-1(b)(1) provides that –

“In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result will generally be determined by reference to results of comparable transactions under comparable circumstances.”

3.199 The use of the abstract “a taxpayer” and “uncontrolled taxpayers” is noteworthy: like Article 9(1) OECD MTC, it signposts price testing against the behaviour of hypothetical taxpayers (undertaking the same transaction under the same circumstances), rather than postulating a transaction between a third party and the actual taxpayer.

3.200 Despite promulgating the best method rule, as regards comparability the CUP method “will generally be more reliable than analyses obtained under other methods if the analysis is based on closely comparable uncontrolled transactions, because such an analysis can be expected to achieve a higher degree of comparability and be susceptible to fewer differences than analyses under other methods”⁶⁷⁶. Where a simple internal comparable is available, the CUP method

⁶⁷⁵ Advisory Memorandum 2007-007, issue 5.

⁶⁷⁶ Regs. §1.482-1(c)(2)(i).

will be preferred. On the other hand, “in accordance with the best method rule, a method may be applied in a particular case only if the comparability, quality of data, and reliability of assumptions under that method make it more reliable than any other available measure of the arm’s length result”⁶⁷⁷.

3.201 Five comparability factors are adopted, along essentially similar lines to those in the TPG, including contractual terms, risks and economic circumstances. Contractual terms will generally be respected if they are consistent with economic substance of the underlying transactions⁶⁷⁸. And the allocation of risks will usually be determined as specified or implied by the taxpayer’s contractual terms, if consistent with that substance⁶⁷⁹. Relevant risks naturally include “credit and collection risks”⁶⁸⁰. For comparability purposes, the “alternatives realistically available to the buyer and seller” are among the significant economic conditions to be taken into account⁶⁸¹.

3.202 The concept of “true taxable income” as used in the regulations is defined as “the taxable income that would have resulted had [the controlled taxpayer] dealt with the other member or members of the group at arm’s length”⁶⁸². Under the heading “allocation based on taxpayer’s actual transactions” the Commissioner is directed to respect the “transaction as actually structured by the taxpayer unless its structure lacks economic substance”. In this context however the Commissioner “may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances”⁶⁸³. An Example which follows shows

⁶⁷⁷ Regs. §1.482-8(a) (Examples of the best method rule), and Example (1) at paragraph (b).

⁶⁷⁸ Regs. §1.482-1(d).

⁶⁷⁹ Regs. §1.482-1(d)(3)(iii)(B).

⁶⁸⁰ Regs. §1.482-1(d)(3)(iii)(A)(4). In the Proposed Regulation on global dealing the creditworthiness of the counterparty is listed: Prop. Reg. §1.482-8(a)(iii)(D).

⁶⁸¹ Regs. §1.482-1(d)(3)(iv)(H).

⁶⁸² Regs. §1.482-1(i)(9).

⁶⁸³ Regs. §1.482-1(f)(2)(ii)(A). In response to the *Bausch & Lomb* case (paragraph 3.223 below), “the reaction of the US tax authorities ... has been to incorporate the concept of realistic alternatives in the 1994 Sec. 482 regulations, under which such alternatives may serve both as

an intra-group IP licence being respected “if it has economic substance”, but notes that the licensor’s ability itself to manufacture product may be taken into account in the pricing analysis. Thus the US regulations juxtapose the notions found in the TPG of recharacterisation (or derecognition) for want of economic substance and the need to consider options realistically available in a comparability analysis. Some have worried that “the authority left in the IRS’s hands to consider alternatives available to the taxpayer and to base transfer pricing adjustments on those alternatives, seems no less potent than the authority to actually restructure”⁶⁸⁴. Also, the provision does not require the “alternative” to be “realistic”, unlike other methodological rules e.g. Regs. §1.482-3(e)(1) which refers to the “general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it”⁶⁸⁵. However, the IRS have said:

*“It is a longstanding principle under § 1.482-1(f)(2)(ii)(A) and in the valuation field, generally, that, although the Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless it lacks economic substance, the Commissioner may consider alternatives available in determining the arm’s length valuation of the controlled transaction. The realistic alternatives principle does not recast the transaction. Rather, it assumes that taxpayers are rational and will not choose to price an arrangement in a manner that makes them worse off economically than another available alternative.”*⁶⁸⁶

3.203 Regs. §1.482-2(a)(1)(i) provides specifically that “[w]here one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm’s length rate of interest (as defined in paragraph (a)(2) of this section) with respect

independent criteria for price determination and as a factor in the comparability test”: Wittendorff (2009b) page 208.

⁶⁸⁴ Insley and Ackerman (1995).

⁶⁸⁵ Regs. §1.482-2(a)(2)(i). See also Regs. §§1.482-3(b)(2)(ii)(B), 1.482-4(d)(1), 1.482-7(g)(2)(iv)(A), 1.482-7(g)(4)(i) and (ii)(A), and 1.482-9(h).

⁶⁸⁶ T.D. 9456 section C.

to such loan or advance, the district director may make appropriate allocations to reflect an arm's length rate of interest for the use of such loan or advance". Under paragraph (a)(2), "an arm's length rate of interest shall be a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances". Moreover, "all relevant factors" must be taken into account, "including the principal amount of the loan and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor⁶⁸⁷ for comparable loans between unrelated parties". Particular transfer pricing methods are not specified for loans⁶⁸⁸ and in practice "the principles of the transfer pricing methods established in the section 482 regulations are relied upon to benchmark intercompany debt"⁶⁸⁹.

3.204 The ABA has recommended that guidance on guarantees should be placed in Regs. §1.482-2 as a "specific situation" alongside the loans and advances guidance⁶⁹⁰. More specifically, the ABA notes that advocates of the "no affiliation" approach (i.e. to ignore passive association: see paragraph 4.64 below) "submit that the reference to the 'borrower' explicitly distinguishes the borrowing entity from all other affiliates, thus prohibiting consideration of affiliation benefits in determining an arm's length rate"⁶⁹¹. But surely the answer to this is that the borrower's credit standing "is what it is" i.e. having regard to passive association if indeed that has an empirical effect; to disregard that association would entail a departure from taking into account "all relevant factors" including the "credit standing of the borrower". Indeed, the ABA notes that advocates of the "market/affiliation" model (paragraph 4.65 below) also cite Regs. §1.482-2(a)(2)(i) in support of their case.

⁶⁸⁷ Regarding the position of the lender see paragraph 5.4 and note 885 below.

⁶⁸⁸ Other than a "situs of the borrower" rule under which a loan out of proceeds of a loan raised by the lender at the situs of the borrower may be priced at the rate paid by the lender plus the lender's costs (Regs. § 1.482-2(a)(2)(ii)) and a safe harbour for certain US dollar bona fide debt based on a monthly published "applicable federal rate" (Regs. § 1.482-2(a)(2)(iii)).

⁶⁸⁹ Bakker and Levey (2012), US chapter by Mac Calva, Krishnan Chandrasekhar and Mike Gaffney, page 534.

⁶⁹⁰ ABA Guarantees Paper (2012) page 3.

⁶⁹¹ ABA Guarantees Paper page 56.

3.205 Regs. §1.482-3(e) addresses “unspecified methods” in the context of transfers of tangible property. It recites the “general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it”. Thus it is appropriate to compare “a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price to which the parties would have agreed had they resorted directly to a market alternative”⁶⁹². Regs. §1.482-3(e)(2) presents an Example – illustrating the application of a bid comparison in an export/distributorship context. Similar enlightenment may be available if there are prevailing rates for a particular product quoted on a public market⁶⁹³. It should follow that loan pricing may be informed by analogy where a bank is prepared to lend (at least if a firm quote based on proper credit analysis is available). Moreover, this approach seems to me to confirm consistency between the propositions that:

(a) the correct comparison required by the arm’s length standard in Regs. § 1.482-1(b)(1) is between the controlled transaction and a hypothetical transaction between hypothetical parties; and

(b) the hypothetical borrower in a lending scenario must have all the same characteristics as the actual borrower in the controlled transaction, including its ability to secure certain pricing had it “resorted directly to the market”.

3.206 Recognition of the passive association concept has to date been most visible in the “Services Regulations”, found in their final form at Regs. §1.482-9, effective from 31 July 2009, but electively applicable back to 2003⁶⁹⁴. The regulations permit certain services to be charged for at cost i.e. with no mark-up: the arm’s length price is deemed to be the “total services costs”⁶⁹⁵. However,

⁶⁹² Regs. §1.482-4(d)(1) provides a parallel rule for transfers of intangible property.

⁶⁹³ Subject to various qualifications: Regs. §1.482-3(b)(5).

⁶⁹⁴ Summarised e.g. by DeNovio (2007), Feinschreiber and Kent (2008) and Green and Jenn (2009).

⁶⁹⁵ Regs. §1.482-9(j).

financial transactions including guarantees are excluded from application of this method⁶⁹⁶.

3.207 In general, under Reg. §1.482-9(l)(1), a “controlled services transaction includes any *activity* (as defined in paragraph (l)(2) of this section) by one member of a group of controlled taxpayers (the renderer) that results in a *benefit* (as defined in paragraph (l)(3) of this section) to one or more other members of the controlled group (the recipients)” [my emphasis]. “Activity” includes performance of functions, assumption of risks, use of property, capabilities or knowledge, and making available property or resources of the “renderer”⁶⁹⁷. Despite the apparently non-exhaustive definition (“includes”), there is a strong sense here of positive action rather than the mere passivity with which this study is concerned. “Benefit” is provided “if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient’s commercial position, or that may reasonably be anticipated to do so”. And benefit will generally be presumed where an uncontrolled taxpayer would be willing to pay another to *perform* the same or a similar activity or if the recipient would have done it for itself⁶⁹⁸.

⁶⁹⁶ Regs. §1.482-9(b)(4)(viii). When the Services Regulations appeared in proposed form, IRS Deputy Associate Chief Counsel (International) Steven Musher confirmed that the *character* of loan guarantees had not been taken on as part of the project (see Ryan *et al* (2004) note 1). General Counsel Memorandum 38499 (September 1980) took the position that a guarantee should be characterised as a service and thus under the regulations then in force an arm’s length charge could be equal to the costs incurred by the provider – typically zero. Field Service Advice FSA 1995 WL 1918236, 1 May 1995, indicated that in certain circumstances a guarantee may be treated as a service. That position was abandoned in 2006, the preamble to the temporary regulations including the comment that “no inference is intended ... that financial transactions (including guarantees) would otherwise be considered the provision of services for transfer pricing purposes”: T.D. 9278, 21 August 2006, Explanation of Provisions paragraph 11(d) (confirmed in 2009 by T.D. 9456). One view is that loans are not services (see e.g. Blessing (2010) page 164), possibly putting paragraph 7.13 TPG out of play (but cf. Vögel (2015) page 647, where it is assumed that “financial services e.g. loans” are indeed covered by Chapter VII TPG), though the “no inference” statement above is perhaps rather neutral on the point. Lowell, Burge and Briger (on-line service) paragraph 7.01[5][e] view the characterisation of guarantees as “a longstanding area of uncertainty”. *Container Corporation v Commissioner* 134 TC No. 5 (2010), albeit in a different (withholding/sourcing) context, supports the view that guarantees entail services. Breen (2015) at note 4 cites Miller (1994) as “the definitive study of US tax issues associated with guarantees”. But Miller at section III.A incorrectly asserts that an arm’s length guarantee fee should be equal to the value of the benefit to the debtor (whereas this in fact represents the upper bound of the range).

⁶⁹⁷ Regs. §1.482-9(l)(2).

⁶⁹⁸ Regs. §1.482-9(l)(3)(i).

3.208 This “moved the United States closer to the OECD in this area of law”⁶⁹⁹ – in fact the benefit concept is clearly modelled on TPG paragraph 7.6 (including the version in place when the Services Regulations were first proposed). “The perspective of the buyer prevails under the benefit test ... [*but*] benefits that result from passive association are among the exceptions to the benefit test.”⁷⁰⁰ The Regulations abandoned a “general benefit” concept under the predecessor regulations (which dated back to 1968) “under which certain activities in a corporate group are presumed to generate a benefit to the controlled group as a whole”⁷⁰¹. Moreover, with a broad parallel in TPG paragraph 7.13, Regs. §1.482-9(l)(3)(v) confirms that:

“[a] controlled taxpayer generally will not be considered to obtain a benefit where that benefit results from the controlled taxpayer’s status as a member of a controlled group.”

3.209 And then, importantly:

“[a] controlled taxpayer’s status as a member of a controlled group may, however, be taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions”⁷⁰².

3.210 The confirmation that (mere) membership of a group may be taken into account in a comparability analysis is a powerful pointer towards the recognition of passive association as a relevant factor in pricing controlled transactions. In response to the 2003 proposed regulations, concern was expressed that “virtually any uncontrolled transaction could potentially be considered unreliable, because it

⁶⁹⁹ Zollo et al (2006), page 39.

⁷⁰⁰ Wittendorff (2010a), page 776. The point is that a benefit from passive association is inherently in place prior to (or independently from) any activity by the renderer. Thus “benefit” from “activity” cannot include benefits from passive association.

⁷⁰¹ Wood and Canale (2004), page 32. Also, “[i]n direct contrast to the [then] Current Services Regulations’ general benefit test, the OECD Guidelines provide that an activity whereby an associated enterprise receives only an incidental benefit solely due to the fact that it is part of a larger concern, and not to any specific activity being performed, does not support a charge for the intercompany service”: Hill (2006) referring to TPG paragraph 7.13.

⁷⁰² This is now echoed in paragraph 1.163 TPG: “Comparability adjustments may be warranted to account for group synergies.” See also Regs. §1.482-1(f)(2)(i) Example 3 where controlled transactions of another MNE group involving economies of integration are apparently (but surprisingly) regarded as a more reliable reference transaction than uncontrolled transactions.

would not generally reflect the same efficiencies and synergies as controlled services transactions”⁷⁰³. But see the discussion of *Bausch & Lomb, Inc v Commissioner*⁷⁰⁴ below (paragraph 3.223) and, of special interest, the series of Examples⁷⁰⁵ provided at Regs. §1.482-9(l)(5), including Examples 15 to 19 which address passive association (described in T.D. 9278⁷⁰⁶ as “an increment of value that a controlled party obtains on account of its membership in the controlled group”). “These examples draw a contrast between the cognizable benefit conferred upon a subsidiary through the parent’s performance of an affirmative act and the non-cognizable benefit enjoyed by the subsidiary by virtue of its passive association or mere affiliation with the parent. Although phrased in terms of the absence of a cognizable benefit to the subsidiary, this ‘passive association’ principle can be expressed equally well in terms of the absence of an affirmative act by the parent”⁷⁰⁷. The Examples represent an advanced quasi-statutory recognition of passive association⁷⁰⁸, and each deserves a mention:

(i) Example 15 “stands for the proposition that a benefit enjoyed by an affiliate does not constitute a ‘benefit’ for purposes of section 482 if the benefit arises solely from affiliation with its parent”⁷⁰⁹. The Example concerns a newly-acquired subsidiary (“Y”) of a major IT group (“X”) which manages to win a contract for a new project which is significantly bigger than anything it has done before due to its membership of the acquirer’s group, but without active support from the X

⁷⁰³ T.D. 9278 paragraph 11(c); Wittendorff (2010a), page 505.

⁷⁰⁴ 933 F.2d 1984 (1991). Wittendorff (2010a) page 505 says “the IRS unsuccessfully argued that economies of integration in a controlled transaction meant that uncontrolled transactions identified by the taxpayer did not satisfy the comparability requirement; the question therefore is whether the new regulations seek to negate the effect of that judgment”.

⁷⁰⁵ It is hard to resist a mention of the so-called “cheese examples” from the 1994 regulations (Regs. (1994) §1.482-4(f)(3)(iv)), featuring the “Fromage Frere” group, even though, being mostly concerned with the development of marketing intangibles, they are not very relevant to the current study.

⁷⁰⁶ Paragraph 11(c).

⁷⁰⁷ ABA Guarantees Paper (2012) page 6. Compare the OECD’s use of “deliberate concerted action”: paragraph 2.82 above.

⁷⁰⁸ Australia’s Explanatory Memorandum on its modern transfer pricing law is a worthy competitor: paragraph 3.56 above.

⁷⁰⁹ ABA Guarantees Paper page 6.

group or utilisation of marketing intangibles⁷¹⁰. No benefit is considered to be obtained by Y from the broader group because winning the contract is not attributable to any specific activity by X.

(ii) Example 16 uses the same facts as Example 15 except that X provides a performance guarantee. This clearly constitutes the active provision of a benefit to Y.

(iii) Example 17 again uses those facts except that X had itself started to negotiate the contract with the customer before acquiring Y. Thus Y obtains a benefit from being able to step into the contract, necessarily with X's acquiescence.⁷¹¹

(iv) Example 18: same facts again, except that X sends the customer a letter confirming its ownership of Y and intention to maintain that state of affairs; this allows Y to obtain the contract on more favourable terms than it would otherwise have achieved. Interestingly, this is not considered to confer a benefit on Y because the letter "simply affirmed Company Y's status as a member of the controlled group and represented that this status would be maintained until the contract was completed". That seems to me an odd outcome as X has actively provided support and indeed what may be a contractually binding stipulation potentially to its detriment. The Example has been criticised by the ABA⁷¹², who nonetheless speculate that perhaps the underlying rationale is that the letter is legally unenforceable or because the benefit derived by the subsidiary was insubstantial; neither of these are satisfactory explanations.

(v) Example 19 (inserted, in response to commentators' requests for clarification of the treatment of passive association, to illustrate a situation in which group membership would be taken into account in evaluating comparability⁷¹³) uses a different and slightly more complex fact pattern involving comparables.

⁷¹⁰ Wittendorff's criticism (2010a, page 504) that the example may be "pointless" unless Y uses its new group name seems unfair: the simple fact of its ownership may be enough to induce a counterparty to offer favourable terms without the need for a corporate name change.

⁷¹¹ "Examples 16 and 17 seem to be inspired by the *Hospital Corp of America v Commissioner* case" 81 TC 520 (1983): Wittendorff (2010a), page 504.

⁷¹² ABA Guarantees Paper (2012) page 7.

⁷¹³ T.D. 9278, 21 August 2006, Internal Revenue Bulletin 2006-34.

Company X and its subsidiary Y respectively buy 1 million and 100,000 units of goods from supplier S. There is no active negotiation and S applies a volume discount so as to charge \$0.95 per unit, separately billing X and Y. X charges Y a fee of \$5,000 representing Y's supposed benefit from the arrangement. Unrelated singleton company U is comparable to Y and buys 100,000 units at \$1 each. Similar taxpayers R1 (parent) and R2 (subsidiary) have a purchasing pattern from S which is identical to that of the X-Y group, but no intra-group fee is charged. The Example concludes that the combined purchasing power advantage enjoyed by Y is "entirely due to Company Y's status as a member of the Company X controlled group and not to any specific activity by Company X or any other member of the controlled group. Consequently Company Y is not considered to obtain a benefit from Company X or any other member of the controlled group." Thus the \$5,000 fee is inappropriate. This Example interestingly (and in my view sensibly) "takes group membership into account for comparability (i.e. determining which vendor price levels can be passed through), while simultaneously viewing group membership as not conferring a compensable benefit"⁷¹⁴. (The relevance of the controlled arrangement between R1 and R2 seems dubious unless it is simply being presented as correct practice.) Example 19, taken together with the Preamble, is said to demonstrate that benefits from affiliation should be taken into account, but do not qualify as services⁷¹⁵.

3.211 The ABA Guarantees Paper (2010) observes that Example 19 is cited by proponents of the view that credit-standing should in some way be regarded as a "group asset". That concept is however given short shrift (e.g. because it would "seemingly compel the conclusion that all intercompany debt be priced at cost"). And it is denied that Example 19 supports the argument that an affiliate should get a related party guarantee for free or at a discount to market price:

"At most, the example stands for the principle that affiliation is a comparability factor, so if a third party would price a good at 95c per unit taking affiliation into account, the

⁷¹⁴ Lewis (2006), page 346.

⁷¹⁵ Wittendorff (2010a) page 506. Compare the Canadian *Indalex* case, where the offshore purchasing company was found not to have contributed anything to the group's purchasing power, note 50 above. See also Examples 3-5 in Section D.8 Chapter I TPG, paragraph 2.80 above.

*related party transaction should be priced similarly. Nothing in the example suggest or supports the view that the related party transaction should be priced below the market, at 90c or 85c per unit or that the good should be given away for free.”*⁷¹⁶

And:

*“[t]he comparability issue would have been presented better in Example 19 if Company X or another affiliate had purchased the 1.1 million containers itself and sold 100,000 of the units to Company Y. Then the question would arise regarding the arm’s length price for that sale (a related party sale) and whether it would have to reflect the same 5c per unit volume discount that would have attached if Company Y purchased them directly from Company S. We anticipate the Government may have answered this question in the affirmative, insisting that Company Y not be denied the volume discount on the sale from the related party that would have been available to it on the sale from Company S but even if this is the intended lesson of Example 19, neither this lesson nor any other lesson from this example supports the notion that an affiliate is entitled to acquire a good or service from a related party at a price below which it could have acquired the good or service from a third party in the marketplace taking account of its affiliations.”*⁷¹⁷

3.212 Thus it seems plain, from the text of Example 19 and informed commentary, that at least in the purchasing power context, the benefits of passive association are to be taken into account as a comparability factor and thus as a characteristic of a purchaser of goods under a controlled transaction. By extension the same principle should apply in financing situations.

3.213 On 6 March 1998 the US Treasury released proposed regulations regarding global dealing operations⁷¹⁸. The proposed rules, which include various illustrative examples of different permissible transfer pricing methodologies (including a “comparable uncontrolled financial transaction” or “CUFT” method), do not contribute to the passive association discussion, despite some expectation that guarantees would be addressed (the topic may be included in an eventual reissue of the global dealing regulations).

⁷¹⁶ Page 67.

⁷¹⁷ Footnote 150, page 68, my emphasis.

⁷¹⁸ Federal Register vol. 63, no. 44; 63 FR 11177.

3.214 A first draft version of the US Model Income Tax Convention was issued in 1976, based on the then current OECD Model. It was revised in 2006. It is supplemented by a US Treasury Technical Explanation. Article 9(1) is identical in form (but for the inconsequential positioning of one word and use of “that” rather than “which”) to Article 9(1) MTC. Article 9(3) does however qualify Article 9(1), with language strongly redolent of section 482:

“The provisions of paragraph 1 shall not limit any provisions of the law of either Contracting State which permit the distribution, apportionment or allocation of income, deductions, credits or allowances between persons, whether or not residents of a Contracting State, owned or controlled directly or indirectly by the same interests when necessary to prevent evasion of taxes or clearly to reflect the income of any of such persons.”

3.215 In a sense, therefore, the US Model heads off potential accusations of treaty override by preserving the right (albeit within the terms of section 482) to depart from the arm’s length standard. See further paragraph 3.233 below in relation to the Technical Explanation.

3.216 Section 385 of the Internal Revenue Code separately addresses thin capitalisation (beyond the scope of this study).

Case law

3.217 “The IRS lost every single major transfer pricing case it litigated between 1980 and 1995, including cases against all the US pharmaceutical companies and many other US multinationals.”⁷¹⁹ There has to date been a surprising lack of sophistication in the analysis and evidence presented to the US courts in many transfer pricing cases, even modern ones, both by taxpayers and by

⁷¹⁹ Avi-Yonah (2009) page 2; (2015) page 71. A useful summary of key cases is contained in Avi-Yonah (1995) pages 98–129. This is perhaps a slightly sweeping statement as some decisions rejected the taxpayer’s analysis too, such that the court increased assessable income via its own determination. An example is *Sundstrand Corporation v Commissioner* 96 TC 226 (1991), where both parties were criticised for the poor quality of the record, “obfuscation” and “antagonism”, so that for the court “[o]ur task was not easy but we have shouldered the yoke, and the parties now must reap what they have sowed” (96 TC at 375). In Avi-Yonah (2015) the *DuPont* case (1979) (note 722 below) is described as “the last unequivocal IRS victory in the transfer pricing area”.

the IRS⁷²⁰, especially when one reflects upon the US’s leading role in formulating global transfer pricing law and the many decades over which arm’s length pricing legislation has been in place. “There have been hundreds of cases decided under section 482 and its predecessors”⁷²¹, of which a good number have become internationally well-known to transfer pricing practitioners⁷²², including the

⁷²⁰ A *schadenfreude*-inducing example is *Westreco, Inc v Commissioner* 64 TCM (CCH) 849, 866 (1992), where, in haranguing the IRS for its expert’s uncritical attachment to SIC codes, the Tax Court observed that “[w]e cannot see how architectural services, nuclear power plant construction and operation, map making and oceanographic services, tire making, breeding of research primates and canines, and packaging material development can be compared with petitioner’s food research.”

⁷²¹ Duff & Phelps (2014), US chapter by Mark Madrian and Jill Weise, page 829.

⁷²² E.g. *Young & Rubicam Inc v United States* 410 F.2d 1233 (1969) (IRS allocation of income attributable to employee services to subsidiaries rejected); *Lufkin Foundry and Machine Company v Commissioner* 468 F.2d 805 (1972) (reallocation of commissions and discount on sales of oil field machinery; intra-group transactions inadmissible as comparables); *R T French Co v Commissioner* 60 TC 836 (1973) (royalty payments to recipient corporation with only partially common ownership found to be arm’s length); *Engineering Sales Inc v United States* 510 F.2d 565 (1975) (reallocation of revenues from sales of cooling towers between commonly controlled US corporations); *E I DuPont de Nemours & Co v United States* 608 F.2d 445 (1979) (reallocation of Swiss sales subsidiary’s income to taxpayer); *Hospital Corp of America v Commissioner* 81 TC 520 (1983) (allocation to US parent of 75% of income of Cayman subsidiary from Saudi hospital management contract); *Ciba-Geigy Corporation v Commissioner* 85 TC 172 (1985) (taxpayer’s royalty rate to Swiss parent for licence to manufacture and sell herbicides upheld); *G D Searle & Co v Commissioner* 88 TC 252 (1987) (transfer of pharmaceutical/medical intangibles to Puerto Rican subsidiary in exchange for stock sustained – allocation to taxpayer of 25% of subsidiary’s net sales); *Central Bank of the South v United States* 834 F.2d 990 (1987) (reallocation of unpaid equipment lease rent sustained); *Eli Lilly and Company v Commissioner* 856 F.2d 855 (1988) (pharmaceutical intangibles transferred to Puerto Rican subsidiary in exchange for stock sustained; sale of product into the US susceptible to re-pricing); *Sundstrand Corporation* (see note 719 above) (intangibles licensing to Singapore manufacturing subsidiary, sales of product to US taxpayer, both reassessed); *Merck & Co, Inc v United States* 24 Cl. Ct. 73 (1991) (rejecting IRS allocation of royalty income to taxpayer from Puerto Rican pharmaceutical manufacturing subsidiary); *Westreco, Inc v Commissioner* 64 TCM (CCH) 849 (1992) (rejecting IRS’s allocations of income to US contract research services subsidiary of Swiss group); *Perkin-Elmer Corp v Commissioner* 66 TCM (CCH) 634 (1993) (court’s reallocations of parts prices and royalties between taxpayer and Puerto Rican subsidiary); *Seagate Technology, Inc v Commissioner* 102 TC 149 (1994) (court’s reallocation of component/disk prices charged by taxpayer’s Singapore subsidiary to taxpayer and royalties charged by taxpayer to Singapore; services charge sustained); *National Semiconductor Corporation v Commissioner* 67 TCM (CCH) 2849 (1994) (reallocation by the court of income of taxpayer’s Asian component packaging subsidiaries based on an adaptation of the “least unacceptable” expert proposal); *Pikeville Coal Co v United States* 37 Fed. Cl. 304 (1997) (taxpayer’s sales of coal to Canadian parent; IRS offered section 482 downwards adjustment of income; taxpayer sought a greater reduction and tax refund); *Compaq Computer Corporation v Commissioner* 78 TCM 20 (1999) (Singapore manufacturing subsidiary selling printed circuit assemblies to US parent: found to have satisfied CUP method); *DHL Corp v Commissioner* 285 F.3d 1210 (2002) (trademark disposition and licensing; pricing of services); *Veritas Software Corporation, Symantec Corporation v Commissioner* 133 TC 297 (2009) (adequacy of buy-in payment by taxpayer’s Irish subsidiary for pre-existing intangibles under a cost sharing arrangement). Significant further cases are pending e.g. *Eaton Corp* TC Dkt 5576-12 (cancellation of advance pricing agreements covering component production by Cayman

famous US\$3.4 billion settlement in 2006 between the IRS and GlaxoSmithKline relating to the value of product and marketing intangibles⁷²³. But these cases provide only infrequent insights into the character of the arm's length principle. Perhaps this is in part due to the highly codified regulatory approach in the US – leaving less room than in some other jurisdictions for interpretative argument. In any event, as yet, no clear judicial statement has yet emerged as to the recognition of passive association.

3.218 The US Supreme Court, in *Commissioner v First Security Bank of Utah*, has at least emphasised the keystone principle that “the purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer”⁷²⁴. The Commissioner allocated insurance premium income from a reinsurance company to its affiliated banks which had arranged sales to customers. The Supreme Court affirmed the Tenth Circuit’s judgment for the taxpayers because it was illegal under federal banking law for them to receive insurance sales commissions. Thus there was no shifting or distortion of income because the banks simply could not receive insurance premium income. It was only where the “controlling interest” had power to shift income between affiliated companies, and where that power had been exercised in such a way that the “true taxable income” of a taxpayer had been understated, that the Commissioner was authorised to reallocate under section 482 (that power “hardly includes the power to force a subsidiary to violate the law”). Thus the holding company “did not utilize its control over the banks and Security Life to distort their true net incomes”⁷²⁵. So

affiliates); *Amazon.com Inc* TC Dkt No. 31197-12 (value of intangibles contributed to cost sharing agreement with Luxembourg subsidiary); *Guidant LLC v Commissioner* TC Dkt 5989-11 (transfers of goods, intangibles and services); *Microsoft* TC Dkt 2:14-mc-00117-RSM (cost sharing buy-in payment); *Medtronic* TC No. 6944-11 (valuation of intangibles and resulting royalties); *Henry Schein Inc* TC No 6862-15 (alleged under-charging for executive services). *Bray International v Commissioner* TC No. 7347-14 filed 1 April 2014 involves allegedly excessive interest on intra-group loans, so could conceivably include argument regarding passive association.

⁷²³ 117 TC No.1 (filed 5 July 2001) TC No. 5750-64 (filed 4 February 2004).

⁷²⁴ 405 U.S. 394, 400 (1972), rehearsing Regs. § 1.482-1(b)(1).

⁷²⁵ *Ibid.*, paragraph 23, applied in *Proctor & Gamble Co v Commissioner* 95 TC 323, 335 (taxpayer unable to exercise control over Spanish subsidiary in circumstances where remittances of royalties were effectively proscribed by Spanish laws), also citing *Hospital Corp of America v Commissioner* 81 TC 520, 594. See Jones, Roberson and Yoder (2013) on 3M’s challenge to the validity of Regs. § 1.482-1(h)(2) in the light of the *First Security Bank of Utah* case. Paragraph

this case, of the highest authority, presents two important themes: (i) the objective of *parity* with uncontrolled transactions; and (ii) the need for a pricing *distortion* which is *caused* by the exercise of control. The latter point finds further support in the *dictum* that “[s]ection 482 is not designed to punish the mere existence of commonly controlled entities nor the unexercised power to shift income among them”⁷²⁶.

3.219 A useful summary of the US transfer pricing rules of engagement is found (for example) in *H Group Holding Inc v Commissioner*⁷²⁷, a case concerning the Hyatt hotel group and the use of trademarks/trade names and the provision of management services:

*“Section 482 determinations are to be sustained absent a showing that the Commissioner’s discretion was abused. ... Consequently, taxpayers bear a heavier than normal burden of proving that the Commissioner’s section 482 allocations are arbitrary, capricious or unreasonable. ... In reviewing the reasonableness of the Commissioner’s allocation under section 482, we focus on the reasonableness of the result, not the details of the methodology employed. ... The applicable standard is arm’s length dealing between taxpayers unrelated either by ownership or control. See sec. 1-482-1(b)(1), Income Tax Regs [the 1968 regulations]. Taxpayers bear the burden of showing that the standard they used or that they proposed is arm’s length. ... If it is established that there was an abuse of the Commissioner’s discretion and a taxpayer fails to show that questioned transactions met an arm’s length standard, then the Court must decide the amount of an arm’s length allocation.”*⁷²⁸

1.75 TPG addresses cases where a country “blocks” payments of amounts owed between associated enterprises.

⁷²⁶ *Merck & Co v United States* (1991) (note 722 above) citing *Your Host Inc v Commissioner* 58 TC 10, 24 (1972) affirmed 489 F.2d 957 (1973).

⁷²⁷ TCM 1999-334 (1999).

⁷²⁸ Pages 59–60. The picturesque “arbitrary, capricious or unreasonable” formulation first comes as a surprise to the uninitiated. As the “abuse” notion suggests, however, it is somewhat akin to the UK standard for judicial review of administrative action sometimes referred to as “Wednesbury unreasonableness” (after *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1948] 1 KB 223).

3.220 A now fairly distant case, which appears to adopt a rather simplistic approach, but which has nonetheless been subsequently cited with approval⁷²⁹, is *United States Steel Corporation v Commissioner*⁷³⁰. In essence, the taxpayer's Liberian shipping subsidiary Navios charged the same rates to all its US customers, including the taxpayer, for the transportation of ore to US ports from Venezuela. The Tax Court ruled for a significant allocation of additional income to the taxpayer having regard to the substantial volumes transported for the taxpayer and the companies' continuing relationship. The decision was reversed on appeal. The Second Circuit considered that "[w]here, as in this case, the taxpayer offers evidence that the same amount was actually charged for the same service in transactions with independent buyers, the question resolves itself into an evaluation of whether or not the circumstances of the sales to independent buyers are 'similar' enough to sales to the controlling corporation under the circumstances, 'considering all relevant facts'"⁷³¹. The Court was unimpressed by the alleged effect of the long-term relationship, or by the fact that the subsidiary's ore-carriers were the largest of their kind in the world, such that the transportation for the parent "had never been done before" so that the comparability tests in the Regulations could not be relied upon:

*"We are constrained to reject this argument. ... To say that [the independent] Pittsburgh Steel was buying a service from Navios with one set of expectations about duration and risk, and Steel another, may be to recognize economic reality; but it is also to engraft a crippling degree of economic sophistication onto a broadly drawn statute, which if 'comparable' is taken to mean 'identical', as Judge Quealy would read it, would allow the taxpayer no safe harbour from the Commissioner's virtually unrestricted discretion to reallocate."*⁷³²

⁷²⁹ E.g. in *Bausch & Lomb Inc v Commissioner* 933 F.2d 1084 (1991) at paragraph 48; *Perkin-Elmer Corp v Commissioner* 66 TCM (CCH) 634, 666; *Seagate Technology, Inc v Commissioner* 102 TC 149, 239 (1994). Reuven Avi-Yonah in Baistrocchi and Roxan (2012) page 52 comments on the "continued vitality and extensive effect" of *US Steel*.

⁷³⁰ 36 TCM (CCH) 586 (1977); 617 F.2d 942 (1980).

⁷³¹ Paragraph 26. There is a loose parallel here with the taxpayer's win in the Canadian case involving an offshore purchasing entity: *The Queen v Irving Oil Limited* 91 DTC 5106 (FCA); cf. the Crown's victory in the *Indalex* case, note 50 above.

⁷³² Paragraph 43. "The *US Steel* case gave rise to the detailed rules on the comparability analysis in the 1994 Sec. 482 regulations addressing other matters than the products (functional

3.221 The Second Circuit accepted that certain transactions between Navios and unrelated customers were with “independent” parties because the taxpayer -

*“had no ownership or control interest in any of these firms and thus was not in a position to influence their decision to deal with Navios. To expand the test of ‘independence’ to require more than this, to require that the transaction be one unaffected by the market power of the taxpayer, would be to inject antitrust concerns into a tax statute. But in § 482, a tax statute, it is appropriate to limit the concept of what is not ‘independent’ to actions influenced by common ownership or control.”*⁷³³

3.222 This comes close to a rejection of relative bargaining power as a potential component of comparability analysis, a view which seems unlikely to attract favour today⁷³⁴. The case does however provide clear recognition of the essential target of transfer pricing law: “actions influenced by common ownership or control”. Despite the continued recognition of *US Steel* by the US courts, it seems highly likely now that an ever-increasing degree of “economic sophistication” will be brought to bear in assessing transfer pricing cases. Certainly the time, trouble and expense spent by both adversaries nowadays on expert economic evidence results in sophisticated (albeit often misdirected) economic arguments being presented to the courts.

3.223 *Bausch & Lomb Inc v Commissioner*⁷³⁵ entailed the provision of technology and trademark licences by the US taxpayer to its Irish subsidiary and sales of manufactured contact lenses from the Irish subsidiary to the taxpayer. It is important regarding the comparability hypothesis. The IRS was “indifferent as to whether the royalty is increased or the transfer price [*for the sales to the US*] is decreased as long as the result is that B&L Ireland receives only its costs of production and a reasonable mark-up”⁷³⁶. Regarding product sales into the US,

analysis, contractual terms, economic circumstances and business strategies). In 1995, the US rules found their way to the OECD Guidelines, which are based on the same comparability factors”: Wittendorff (2009b) page 205.

⁷³³ Paragraph 37.

⁷³⁴ See the discussion of relative bargaining power in the context of the UK *DSG* case: paragraph 3.169 above.

⁷³⁵ 933 F.2d 1084 (1991).

⁷³⁶ *Ibid.*, paragraph 33.

the Commissioner contended that the standard for comparability had not been met. In particular, the Commissioner argued that the taxpayer's relevant functions included the provision of knowhow, trademarks, regulatory approval, R&D and ready-made markets. But the Court considered these attributes relevant to the intangibles licensing arrangement, not the separate sales of product, and criticised the IRS because "the position urged by the Commissioner would preclude comparability precisely because the relationship between B&L and B&L Ireland was different from that between independent buyers and sellers operating at arm's length. This, however, will always be the case when transactions between commonly controlled entities are compared to transactions between independent entities"; the *US Steel* case was cited with approval.⁷³⁷

3.224 The US Court of Appeals for the Ninth Circuit rather extraordinarily rendered its decision and then changed its mind about the outcome in *Xilinx, Inc v Commissioner*⁷³⁸. The case represents a reaffirmation of the central importance of the arm's length principle in US transfer pricing law. Indeed, the withdrawal and reissue of the Court's opinion followed an international chorus of protest from business and commentators, concerned to preserve the integrity of the arm's length principle. The US taxpayer was party to a cost sharing arrangement with its Irish subsidiary, but had not, within that CSA, recognised costs in respect of employee stock options. It was established as factual matter (which the IRS did not contest on appeal) that parties at arm's length would not have included such costs in a CSA. On the other hand, Regs. § 1.482-7(d) required that "all" costs be taken into account. This presented an apparent conflict between the specific requirement of the cost sharing rules and the general principle in Regs. § 1.482-1(a)(1) that the "standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer". The choice for the Court was therefore to "1. apply a rule of thumb: the specific controls the general; 2. Resolve the ambiguity based on the dominant purpose of the regulations ... The first alternative presents a simple solution. It is plausible. But it is wrong. It converts

⁷³⁷ *Ibid.*, paragraphs 47–48.

⁷³⁸ 598 F.3d 1191 (2010), reversing the decision of an identically constituted court at 567 F.3d 482 (2009) (withdrawn on 13 January 2010), and thus affirming the decision of the Tax Court 125 TC 37 (2005).

a canon of construction into something like a statute. ... Purpose is paramount. The purpose of the regulations is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions.” Weight was also given to the use of the arm’s length standard in the US-Ireland tax treaty and the US Treasury’s Technical Explanation of that treaty which noted, as regards Article 9, that the treaty incorporates “the arm’s length principle reflected in US domestic transfer pricing provision, particularly Code section 482”⁷³⁹.

Tax authority practice

3.225 There is no specific IRS guidance in the context of intercompany financial arrangements addressing the effects of passive association on the pricing of controlled transactions.

3.226 In 1988 the IRS and U.S. Treasury published their paper *A Study of Intercompany Pricing under Section 482 of the Code*, often known as the “White Paper”⁷⁴⁰. The paper was produced in the wake of the “commensurate with income” standard added in 1986 to section 482 (i.e. that the income from a transfer or licence of intangible property must be commensurate with the income attributable to the intangible). It is a seminal work on the transfer pricing of intangibles, so is mostly directed at issues beyond the scope of this thesis. It is nonetheless interesting for the comments made about the general nature of the arm’s length principle. On one rather extreme view, it “played a major part in the demise of the traditional ALS” [*arm’s length standard*]⁷⁴¹ and (less extravagantly) was “a turning point for the arm’s length principle”⁷⁴². However, in the face of international criticism of the commensurate with income rule, the White Paper

⁷³⁹ Ninth Circuit opinion (2010) paragraphs 2, 5 and 6. Judge Noonan delivered the revised opinion, repeating *verbatim* this aspect of his 2009 dissent. See now the *Altera* case on the validity of the regulations: note 672 above.

⁷⁴⁰ 1988-2 C.B. 458.

⁷⁴¹ Avi-Yonah (1995) page 91, who considered that, at least measured against the traditional ALS with its reliance on CUPs, and despite the language used, the White Paper advocated a significant broadening of the ALS, in fact a “revolution in the United States’ approach to transfer pricing” (page 135), noting also the new emphasis on results rather than pricing e.g. by the adoption of the “comparable profits method” (page 144) so that “the traditional ALS is defunct in practice” (page 147).

⁷⁴² Wittendorff (2010a) page 43.

robustly asserted that “the arm’s length standard is the accepted international norm for making transfer pricing adjustments”, and reaffirmed that “Congress intended the commensurate with income standard to be consistent with the arm’s length standard, and that it will be so interpreted and applied by the Internal Revenue Service and the Treasury Department”⁷⁴³.

3.227 As regards comparability, the notion of “exact” comparables is described as “the best evidence of what unrelated parties would do in a related party transaction”. The intangibles context of the White Paper naturally enough means that an exact comparable is said to entail that “the comparable transaction involves the same intangible property transferred under substantially similar circumstances”; but the concept would seem to be (even more) readily adaptable to financing transactions – where the property provided is money. For exact comparability, the comparable transaction and the related party arrangement must take place in “similar economic environments” and “must contain substantially similar contractual features”⁷⁴⁴.

3.228 Some comments are also offered on risk-bearing in the context of comparability. For example:

“In general, in a related party transaction, the market reward for taking risks must be allocated to the party truly at risk. Companies take risks in all dealings in the marketplace, and are rewarded for doing so. Some of this risk disappears in related party transactions. The legislative history of the Tax Reform Act of 1986 noted: ‘In addition, a parent corporation that transfers potentially valuable property to its subsidiary is not faced with the same risks as if it were dealing with an unrelated party. Its equity interest assures it of the ability ultimately to obtain the benefit of future anticipated profits, without regard to the price it sets. ... [Risk] allocation should be based on the risks arising out of the true economic activities undertaken by parts of the enterprise, not on mechanisms that merely shift risks within the group. ... [I]n searching for appropriate comparables, one should look for situations in which an unrelated party contracted to

⁷⁴³ White Paper at 1988-2 C.B. 458. Rollinson and Frisch (1988) present some supplemental theoretical issues reinforcing the approach taken in the White Paper.

⁷⁴⁴ *Ibid.*, pages 485-6.

*perform an economic activity that is about equal in riskiness to the activity done by the affiliate ...*⁷⁴⁵.

3.229 Prior to the decision of the Canadian Federal Court of Appeal in the *General Electric* case, panellists at an ABA Tax Section meeting on 7 May 2010 discussed the pricing of related-party guarantees. Treasury Associate International Tax Counsel David Ernick criticised the view that the arm's length standard required implicit support to be ignored. It was, in his view, inappropriate to hypothesize the group companies "as if they were completely unrelated and not part of a group"; rather, the arm's length standard "requires you to reach the price that unrelated parties would". Thus in pricing an (explicit) parental guarantee, it was relevant to recognise how the market would "bump up" the creditworthiness of the borrowing subsidiary on account of implicit support, and thus appropriate to calculate the benefit of the guarantee against the benchmark of the subsidiary's borrowing cost on that basis⁷⁴⁶.

3.230 It is understood that the IRS applies the concept of implicit support in determining intra-group financing charges under advance pricing agreements⁷⁴⁷. However, despite a 2006 suggestion that guidance would be made available⁷⁴⁸, and despite indications from 2010 that the IRS was studying transfer pricing issues involving financial guarantees⁷⁴⁹, no guidance has yet emerged; and no formal response from the IRS or the US Treasury has been issued in response to the

⁷⁴⁵ *Ibid*, page 491.

⁷⁴⁶ Reported by Moses: 19 TMTPR 58; see also Stewart (2010), in which Steven Musher, IRS Associate Chief Counsel (International) was quoted, with Ernick, as suggesting that "future guidance may seek to value guarantees in terms of the reduction in borrowing costs relative to borrowing costs of an affiliated company absent a guarantee rather than the cost of debt for the subsidiary as if it had been an unaffiliated company"; Ernick also said that "the arm's length standard does not require 'hypothesising' related companies as if they were completely unrelated", and Musher pointed to Example 19 in the Services Regulations to support this view (see paragraph 3.210(v) above).

⁷⁴⁷ Blessing (2010) page 158.

⁷⁴⁸ T.D. 9278 paragraph 11(d).

⁷⁴⁹ Musher, quoted in Duff & Phelps' *Transfer Pricing Times* vol. VII issue 2 (2010).

detailed analysis and call for such guidance in the 2012 ABA Guarantees Paper (discussed at paragraph 4.62ff below)⁷⁵⁰.

3.231 The IRS's Internal Revenue Manual⁷⁵¹ is essentially concerned with organisation, governance and process matters and does not represent a technical advisory manual in the way that the HMRC manuals function. It does not contain commentary on substantive transfer pricing law.

3.232 The IRS has also issued a number of "International Practice Units", designed as IRS staff "job aids and training materials on international tax issues"⁷⁵². Of several on transfer pricing topics, one addresses the "Arm's Length Standard"⁷⁵³ but the content is of a very general nature and does not touch on the passive association topic.

3.233 Article 9(1) of the US Model Income Tax Convention of 15 November 2006 is essentially identical to Article 9(1) OECD MTC. The Treasury Department Technical Explanation is an official guide to the Model, though its coverage of Article 9 is very general. Its preamble states that it "reflects the policies behind particular Convention provisions, as well as understandings reached with respect to the application and interpretation of the Convention". In relation to Article 9 it is said that "[t]his Article incorporates in the Convention the arm's length principle reflected in the US domestic transfer pricing provisions, particularly Code section 482". Article 9(1) addresses situations where enterprises are related "and there are arrangements or conditions imposed between the enterprises in their commercial or financial relations that are different from those that would have existed in the absence of the relationship". The "commensurate

⁷⁵⁰ My New York colleague Dennis Caracristi commented: "The IRS and Treasury are notorious for saying that they are studying issues, and for taxpayers to be ready for regulations or other pronouncements, only to do either absolutely nothing or to promulgate rules after many, many years. From my reading, it looks like they were probably looking to issue guidance in the form of regulations. Unfortunately, that kind of project usually takes the longest. It isn't uncommon for regulations to be 'just around the corner' for 5, 10 or 15 years or even longer."

⁷⁵¹ Available at www.irs.gov/irm/ (accessed 3 August 2015).

⁷⁵² Available at <http://www.irs.gov/Businesses/Corporations/International-Practice-Units> (accessed 3 September 2015).

⁷⁵³ DCN ISI/9422.09_06(2013).

with income” standard (see paragraphs 3.193, 3.225 above) is self-servingly said to have been “designed to operate consistently with the arm’s length standard”. But at least if the conditions of a controlled transaction “are consistent with those that would be made between independent persons, the income arising from that transaction should not be subject to adjustment under this Article”. This at least fits with the notion that (say) a subsidiary should not be expected to pay more to its parent under a financial transaction than it would pay to a third party, including where the third party offers pricing based upon assumed implicit support. On the other hand, Article 1(4) of the US Model “relieves the residence state from its obligations to comply with the arm’s length principle when it makes primary adjustments”⁷⁵⁴. The US Government is working on a revision to the Model and plans to release a final revised version in early 2016⁷⁵⁵, but changes to Article 9 are not proposed⁷⁵⁶.

3.234 In summary, while the US has undoubtedly led the world for several decades regarding the development of transfer pricing law and practice, and while transfer pricing litigation has been prolific, there remains a curious dearth of legislative or indeed tax authority guidance on the recognition of passive association in pricing controlled transactions, despite promises (still unfulfilled after some years) of clarification of the treatment of guarantees. The Services Regulations at least provide a firm basis for accepting group affiliation as a comparability factor, and senior government officials appear to have endorsed that approach at least informally.

Conclusions







3.235 Here is a high level tabular summary of the degree of recognition of passive association in pricing controlled transactions under the laws and tax authority practices of the countries surveyed.

⁷⁵⁴ Vögel (2015) page 598.

⁷⁵⁵ TMTPR 18 December 2015.

⁷⁵⁶ The proposed changes, released on 20 May 2015, are available at www.treasury.gov/resource-center/tax-policy/treaties/Pages/international.aspx (accessed 5 August 2015).

Fig. VIII

 Canada	<p>Firmly established via the <i>General Electric</i> case in the Federal Court of Appeal.</p>
 Australia	<p>Apparently established in legislation and expressly acknowledged in ATO guidance. The <i>Chevron</i> case now provides conceptual endorsement.</p>
 India	<p>No clear position developed, despite prolific case law, but TPG and <i>General Electric</i> cited regularly.</p>
 New Zealand	<p>Inland Revenue recognition that group membership may affect pricing.</p>
 United Kingdom	<p>Legislation expressly rejects taking into account “expectations” of support; otherwise, limited HMRC recognition of passive association concept (but not so as to affect borrowing capacity). <i>Thin Cap</i> case presents a negative view of recognition of passive association.</p>
 United States	<p>Group membership recognised in section 482 regulations as a comparability factor. Otherwise, no legislative or case law engagement with the issue.</p>

3.236 A range of approaches – in other words, some degree of inconsistency, can be observed. But strong recognition, in case law and/or in tax authority

practice, of the pricing effect of passive association is established in Canada, Australia and New Zealand; limited acceptance of the principle can be seen in the UK; there is the potential for acceptance in India; and a clear signpost is present in the US transfer pricing regulations.

3.237 It is beyond the scope of this study to discuss the approaches taken in countries other than those mentioned above. But it is apparent that other countries too have moved in the direction of recognising passive association. One striking case is The Netherlands, where modern governmental practice⁷⁵⁷ expressly recognises implicit support in the financing context and approves guarantee pricing by reference to a “derivative rating” i.e. one derived by reference to perceived group support (resonating with *General Electric*). In Norway, the *Bayerngas Norge AS* case provides authority for recognition⁷⁵⁸. Singapore’s 4 January 2016 Transfer Pricing Guidelines note that “IRAS may accept a credit rating of the borrower based on the overall group credit rating if it can be substantiated that an independent lender will similarly accept such group credit rating”⁷⁵⁹. Malaysian legislation prescribes that “any charge made by a person in a controlled transaction in respect of the intra-group services shall be disregarded if it involves ... services that provide incidental benefits or passive association benefits”⁷⁶⁰. In France, recent case law⁷⁶¹ indicates that the fact that a borrower belongs to a group of companies can be taken into consideration if this affects its borrowing capacity. Interestingly, a different but somewhat analogous approach has evolved in Germany⁷⁶² and Sweden⁷⁶³. This at first sight appears to be at odds with the arm’s length principle because it adjusts pricing to take account of control

⁷⁵⁷ Decree of 14 November 2013 no. IFZ 2013/184M, section 10.

⁷⁵⁸ Utv. 2012 s 1411, Oslo District Court.

⁷⁵⁹ Paragraph 13.24, page 82.

⁷⁶⁰ Income Tax (Transfer Pricing) Rules 2012, P.U.(A) 132 rule 9(2).

⁷⁶¹ *Sté Stryker Spine*, Bordeaux Court of Administrative Appeals, 2 September 2014, #12BX01182.

⁷⁶² E.g. BFH decision 17 December 2014 I R 23/13.

⁷⁶³ *Diligentia AB*, Supreme Administrative Court, 28 June 2010, Case 2483-2485-09. Contrast the *Cambrex* case, Administrative Court of Appeal (Gothenburg), Case 2481-2485-03 (2005) where the court applied a stand-alone assessment of creditworthiness in the case of a loan to the Swedish taxpayer from its foreign sister company (cited by Wittendorff (2010a) page 509).

(rather than eliminating the effects of control on pricing). In that sense, regarding a parent company's loan to a controlled subsidiary as effectively secured on the subsidiary's assets – because the parent can, by the exercise of control, gain access to those assets and more generally inhibit default – seems itself to be an adjustment to pricing attributable to the ability to exercise control. The approach seems to represent a leap beyond the recognition of passive association as a comparability factor. I expect that further comparative research to analyse and test the logic of this aspect of these and other legal systems will be rewarding.

4. CRITICAL REVIEW OF THE LITERATURE ADDRESSING THE SIGNIFICANCE OF PASSIVE ASSOCIATION IN TRANSFER PRICING

“One man’s arm’s length principle is not necessarily another man’s arm’s length principle.”⁷⁶⁴

Introduction

4.1 This chapter surveys the academic and professional literature which discusses, or touches upon, the recognition of passive association or implicit support in the pricing of controlled transactions. The Canadian *General Electric* case in 2009 was the catalyst for significant debate, so most of the literature engaging directly with my topic post-dates that decision. However, because passive association is itself merely one facet of the arm’s length principle, I have selected various (pre- and post-2009) items which discuss that principle more generally to bring out some key themes which inform the analysis.

4.2 I start with a high level summary of the arguments emerging from the literature respectively for and against the recognition of passive association. Although this thesis represents a legal study, I have mentioned below certain policy arguments advanced by commentators. To the extent these amount to pleas for change, they are not of course instructive as to what the law currently means; to the contrary, they may imply that the law does not currently fit with the policy that is promoted. They are interesting though for that latter reason, and indeed intrinsically.

4.3 *Proponents of the recognition of passive association* consider it to be entirely consistent with the separate entity approach; if an entity in fact benefits from passive association, that is an attribute of that entity. In other words, all economically relevant characteristics of the parties (including the effects of passive association) must be taken into account. In a comparability analysis, the

⁷⁶⁴ Joseph Andrus, head of the OECD’s Transfer Pricing Unit, speaking at a Bloomberg BNA conference in Paris on 1 April 2014: 22 TMTPR 1447.

correct comparator is a hypothetical buyer (or borrower) with all the characteristics (including the effects of passive association) of the actual buyer, dealing with a hypothetical seller (or guarantor/lender) with all the characteristics of the actual seller. It is therefore inappropriate to eliminate the passive association attribute from the analysis.

4.4 Moreover, the appropriate way to recast the pricing of a transaction to arrive at an arm's length outcome is to eliminate pricing distortions caused by the exercise of influence or power, but not to disregard all features of affiliation. Passive association is a matter of fact. The parties to a controlled transaction do not distort pricing because of or by reference to passive association; it is not a price-distorting aspect of the control relationship.

4.5 The OECD TPG are regarded as strongly supportive of the recognition of passive association. Paragraph 7.13 TPG implies that passive association should be taken into account in pricing controlled transactions. The important concepts of relative bargaining power, and "options realistically available", in arriving at an arm's length price are themselves powerful indicators that a subsidiary which can borrow on certain terms from a third party will not pay more to its parent. If an internal comparable exists, this presents evidence of the arm's length price; it follows logically that a hypothetical comparable should be constructed on the same basis.

4.6 On the other hand, the instinct of *those opposed to the recognition of passive association* is that the separate entity approach inherently requires passive association to be disregarded. In principle, comparability adjustments should be applied to the uncontrolled reference transaction, not the controlled transaction. Therefore, an arm's length lender's recognition of passive association should be "reversed out" of the pricing of an uncontrolled transaction to arrive at a proper CUP. The requirement to take into account, in a comparability analysis, the risks assumed by the parties means that a parent-to-subsidary loan cannot be analogised with a transaction between independent parties. Where a parent company is lender/guarantor, its status as creditor displaces the relevance of implicit support because it is oxymoronic to propose that it should deserve less

interest or fee by assuming that it would support the credit of the obligor subsidiary (“lender as guarantor paradox”). Recognising passive association is seen as inconsistent with the requirement to focus on the legal rights of the parties and the recognition of the actual transaction undertaken.

4.7 Then various economic objections are raised: (1) recognising passive association so as to suppress financing costs produces a windfall benefit or a “free ride” for a borrower; (2) recognition of passive association is “directionally inappropriate”: where a subsidiary relies on passive association, an “asset” of the parent (its credit rating) is eroded, but so would be its remuneration; (3) ratings agency methodology represents a flawed basis for the application of transfer pricing rules e.g. because of the use of a “deemed consolidation” approach.

4.8 The disagreement described above about the impact of the separate entity approach goes to the heart of this study. However, it seems clear to me that one can respect the separateness of the actual parties to a controlled transaction and indeed do so rigorously by imputing all their qualities into a comparable transaction.

4.9 As regards the proper conclusions to be drawn from paragraph 7.13 TPG⁷⁶⁵, what is evident is that (i) benefits arising from mere affiliation are expressly recognised as an empirical matter, but (ii) are not to be remunerated. I see nothing there to require that passive association be disregarded; instead its recognition by OECD as a factual state of affairs plays naturally into a comparability analysis. The alleged inconsistency between recognising passive association and respecting the actual legal rights of the parties under the transaction undertaken is to my mind a flawed “apples versus pears” argument – because passive association is inherently not part of the legal construct; rather, it is a “background” circumstance or characteristic of one or more of the parties.

4.10 Unless regarded as an economics-based policy proposal, it seems misplaced to regard a parent company’s creditworthiness as an “asset” which is “eroded” by a subsidiary’s “use” in borrowing for its own account. First, there is

⁷⁶⁵ Together with new Section D.8 Chapter I TPG.

not, in any legal sense, an asset of this nature; it is an attribute or characteristic of the parent, not something it can “own” in a proprietary sense. Secondly, it seems at least dubious to assert that the attribute is dissipated when a subsidiary enjoys a funding advantage (and thus perhaps a business enhancing opportunity for the MNE group) attributable to its passive association with the parent. One could conduct a separate research project into the effect on parental credit ratings of incremental subsidiary borrowings. But the proponents of this argument in the legal literature do not cite any such evidence. And reference to consolidated ratings is misguided in the transfer pricing context where the touchstone is the separateness of the transaction parties.

4.11 Arguments which amount to policy proposals (including arguments favoured by enthusiasts for abandonment of the arm’s length principle) are mentioned in this chapter because they are often intertwined with more legalistic arguments. Hence for example the proposal that “synergy rents” be taxed in the country from which they “emanate”. But like it or not, that is not what the arm’s length principle prescribes. And a policy proposition which favours aligning the treatment of inter-company transactions with “dealings” between a permanent establishment and its head office is detached from legal and commercial reality.

4.12 The potential “free ride” enjoyed by a subsidiary benefiting from passive association provokes objections from traditionalists. But surely this is precisely what paragraph 7.13 TPG prescribes? If one focuses on the required process in undertaking a comparability analysis, with the central objective of identifying internal or external CUPs in transactions involving independent parties, adjusting for transactional differences, but also having regard to the *circumstances* of the parties, it seems entirely right that a subsidiary’s ability to enjoy benefits from passive association should go into the mix.

4.13 The proposition that implicit support, where present, must be “reversed out” of the comparator transaction to align it with the actual transaction (where, it is said, no implicit support can exist) presents what I term the “lender as guarantor paradox”. This is the apparent conceptual peculiarity in asserting that a parent company which might otherwise generally be expected to support its subsidiary

will do so in relation to a loan made by itself to that subsidiary, such that the interest rate on the intra-group loan should be reduced on account of that support. However, even aside from the case where implicit support might be found within a group but other than between the affiliated parties to a controlled transaction (e.g. potentially the sister-to-sister lending situation with assumed parental support⁷⁶⁶), the “reverse out” principle would surely lead to absurdity when tested against an actual internal comparable: it would be perverse to ratchet up the internal CUP from an essentially identical transaction with an independent party to arrive at the “arm’s length” price of a controlled transaction.

4.14 A final introductory comment is that the literature arguing against the recognition of passive association does not actively engage with some of the most compelling arguments to the contrary. In particular, little attention is paid to the fundamental concept in transfer pricing of *parity* or neutrality between controlled and independent taxpayers, and hence the fundamental objective, pursuant to Article 9(1) OECD MTC and its analogues, of eliminating price *distortions* which are *caused* by the exercise of control.

Literature discussing fundamental elements of the arm’s length principle with relevance to the recognition of passive association

4.15 There is of course a huge volume of material discussing the nature of the arm’s length principle. It would be naïve and misdirected (and impractical) to attempt to summarise it all here. Nonetheless, certain key themes emerge and are worth exploring to the extent relevant to the topic of this study.

4.16 Rollinson and Frisch (1988), writing in the aftermath of the U.S. “White Paper” (paragraph 3.226 above), noted that:

“[a] market based approach is presently adopted by the income tax regulations for the purpose of allocating income under section 482 [citing Regs. §1.482]. The goal of this approach is to attribute income in the same way that the market would distribute the income. That is, related parties are to earn the same return that unrelated parties would

⁷⁶⁶ Paragraph 4.19 below.

earn under similar circumstances. This approach, often referred to as the arm's length standard, is implemented through separate accounting.”⁷⁶⁷

They extol the objective of market neutrality i.e. avoiding tax rules which distort commercial behaviour. “Rules which distort a firm’s activities would not meet the goal of clearly reflecting income and would cause needless economic inefficiencies in the marketplace.”⁷⁶⁸ This is consistent with the proposition that if (say) a subsidiary company can borrow from a third party lender at $x\%$, it should not be compelled or indeed permitted by transfer pricing rules to borrow (or be treated for tax purposes as borrowing) from its parent company at $>x\%$. A critical objective of transfer pricing is to avoid discrimination between controlled and uncontrolled transactions. This is a central tenet of the TPG e.g. through the “parity of treatment” proposition in paragraph 1.8 (paragraph 2.22 above). Thus there should be no discrimination between cases where the subsidiary borrows either from a third party or from its parent. “Use of the arm’s length standard does not distort the decision to use affiliates versus unrelated parties.”⁷⁶⁹ As Rollinson and Frisch put the policy point:

“Recall the fundamental objective of tax policy in the area of transfer pricing. In general, tax rules should distort business decisions as little as possible because rules that minimize such distortions will lead to the greatest possible production efficiency. Transfer pricing rules will allow the most efficient production technology to come to the fore if, holding the cost functions constant, they result in the same tax burdens whether or not the parties are related. ... If this goal can be met, transfer pricing policy will refrain from distorting the optimal mix of unrelated-party versus within-multinational transactions in the market.”⁷⁷⁰

4.17 One might recall here the closely-related policy concern to avoid commerce-inhibiting double taxation. This in turn leads to the need for consistent treatment between states taxing cross-border transactions. If national tax laws are mismatched regarding the recognition of passive association, this will tend to result in double taxation (or non-taxation). Double tax may discourage an MNE

⁷⁶⁷ Page 1.

⁷⁶⁸ *Ibid.*

⁷⁶⁹ *Ibid.*, page 12.

⁷⁷⁰ *Ibid.*, page 5.

group from entering into an intra-group transaction and, in a distortive way, tend to induce recourse to third parties, quite possibly in a way that is economically inefficient for the group.

4.18 Maisto (1992)⁷⁷¹ cites Black’s Law Dictionary as defining an “arm’s length transaction” as a “transaction negotiated by unrelated parties, each acting in his or her own self-interest” or “the basis for a fair market value determination” or “a transaction in good faith in the ordinary course of business by parties with independent interests”. Maisto also lists six basic elements of the concept, derived from the OECD 1979 Report: (i) “transactional” (pricing by reference to a transaction, given “the price” terminology in the TPG); (ii) comparison/similarity, in view of the need for comparability with another actual or hypothetical transaction with similar characteristics; (iii) respect for the legal effects of the transaction; (iv) the open market feature i.e. pricing based on market conditions, reflecting ordinary business practices and by reference to available data; (v) subjective features – taking into account the particular circumstances which characterize the transaction; and (vi) functional analysis. It seems to me that one can take account of all of these factors in a way which respects market forces, and at the same time strives for a rigorous approach to comparability, especially having regard to “subjective” (in essence, personalized) characteristics of the parties, so as to bring into account the effects of passive association.

4.19 Hamaekers (2002) considers that “the essence of the arm’s length principle is not comparability of prices and results, but *dealing* with each other as would independent enterprises”⁷⁷². Thus the emphasis is on particular transactions. Hamaekers is a proponent of what he terms the “negotiated price method” i.e. related parties bargaining with each other as independent parties would do⁷⁷³. This prompts reflection on the case of a sister-to-sister company

⁷⁷¹ Page 28.

⁷⁷² Cited approvingly by Biegalski (2010) page 186. But Vögel (2015) considers that advocacy for this approach “seems to be disappearing” (page 652).

⁷⁷³ Paragraph 1.5 TPG states that “it may occur that the relationship between associated enterprises may influence the outcome of the bargaining. Therefore, evidence of hard bargaining alone is not sufficient to establish that the transactions are at arm’s length.” Note also the need to

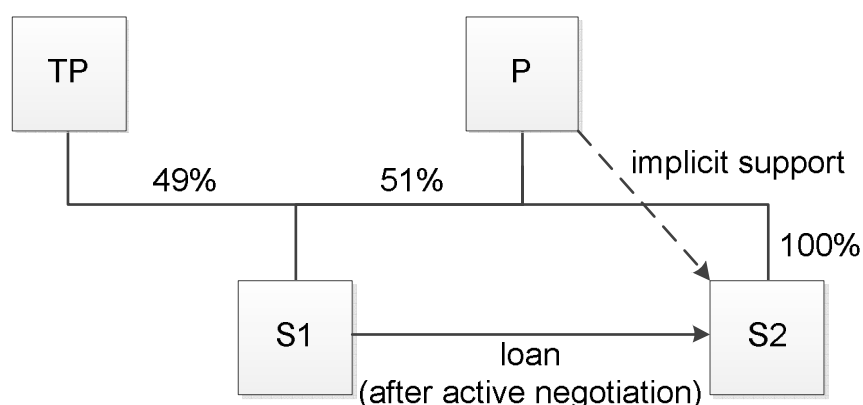
loan, where – let us assume - it is evidenced that the companies’ common parent is likely to support the borrower. To make that likelihood more obvious, consider a case, as in Fig. IX, where the lender company, S1, is a joint venture vehicle 51% owned by the parent company, P, and 49% by a third party, TP, whereas the borrower company, S2, is a wholly-owned strategically important subsidiary of P. The joint venture relationship may itself act as a driver of genuine arm’s length style negotiation. Take for example the observation of the Canadian Federal Court of Appeal in *Petro-Canada v The Queen*, referring to the Supreme Court’s judgment in *Swiss Bank v Minister of National Revenue*:

*“[I]n any normal commercial transaction between the corporation and one of the shareholders, the other shareholder would ensure that the corporation would be able to assert its own interest and would do so. To paraphrase Swiss Bank, there would be some assurance that the terms of any such transaction would reflect ordinary commercial dealing between parties acting in their separate interests”.*⁷⁷⁴

be wary of a “negotiating function clipped by the will of the parent”: *Commissioner v SNF (Australia) Pty Ltd* [2011] FCAFC 74 at paragraph [1]i.

⁷⁷⁴ *Petro-Canada*: [2004] 3 CTC 156 paragraph [59]; *Swiss Bank*: [1974] SCR 1144, 1152. Paragraph 3.26 TPG recognises the potential (though not necessarily determinative) impact of minority shareholders in assessing comparability, and the finding in *R T French v Commissioner* 60 TC 836, 851 supports this theory: “the opportunity may have existed for petitioner’s [parents], which also jointly owned [an indirect 51% holding] of MPP’s stock, to cause petitioner to agree to an arrangement that unfairly favoured MPP, but it seems unlikely that petitioner’s parent companies would have done so, because they would thus have been diverting funds from a corporation (petitioner) in which they were the sole stockholders to another corporation (MPP) in which a stranger (Chivers) owned 49% of the stock. The position of Chivers in the scheme of things in all likelihood assured the arm’s length character of the transaction”. The UN in its *Practical Manual on Transfer Pricing* at 3.3.3 and note 35 observes that “an equal-footing arrangement is generally not understood to pose a high risk of income shifting, although there could still be some room for non-arm’s length pricing.”

Fig. IX



4.20 Although fact-dependent, it does not seem outlandish in such a case to expect that S2’s passive association with P should influence S1’s view of S2’s credit-standing and thus the price of the loan.

4.21 Hamaekers (1992) also identifies in early twentieth century US and UK transfer pricing laws the *neutrality principle*, which he considers to underpin the arm’s length principle. Echoing the policy propounded by Rollinson and Frisch (paragraph 4.16 above), and the “parity” objective, the neutrality principle attempts to avoid influencing taxpayer commercial decisions and aligns the tax treatment of related party transactions with that of transactions between independent persons.

4.22 Transfer pricing rules seek to prevent the manipulation of prices via the exercise of control. Wilkie (2012)⁷⁷⁵ refers to the TPG as “guiding the *elimination of profit distortions* attributable to terms of dealing *imposed through actions made possible by association* – the assertion of organizational power ... The inquiry is about whether the opportunity and power to dictate terms and conditions of dealing, itself, is accountable for profit distortions”. This strongly suggests that in a comparability study, any actual internal comparable, or failing that a conscientious assessment of what *would have* occurred between a controlled

⁷⁷⁵ Pages 144, 146, my emphasis.

company and an independent third party, provides the best benchmark for the actual controlled transaction under scrutiny. Hamaekers further observes⁷⁷⁶ that “an external CUP which is widely known in the relevant economic sector concerned would have a high degree of authority for the parties so it would be difficult to justify any deviation. The bottom line is that a sound business manager⁷⁷⁷ would not buy from a related party at a particular price if the open market price was lower.” Again, this perspective is strongly supportive of the view that (in the *a fortiori* internal CUP case), if a subsidiary could actually borrow from a third party on certain terms at a certain rate (reflecting the lender’s beneficial recognition of the borrower’s passive affiliation with its group), then the arm’s length price for an equivalent related party loan should be equal to that of the comparable external debt.

4.23 Schön (2009-10) quotes paragraph 1.8 TPG’s ambition of putting “associated and independent enterprises on a more equal footing for tax purposes [and thus] avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity”. This is analysed⁷⁷⁸ as “a legal statement, putting fair and equal treatment of foreign and domestic taxpayers into the centre of the argument” and one which –

“has three major economic ramifications: on the one hand, the local market in a country shall not be distorted by the fact that one of several competing economic agents is connected to an outside firm; on the other hand, the decision by a multinational enterprise whether to internalize certain supplies and services within the firm or to hire an independent contractor shall not be distorted by a tax wedge. The classical ‘make or buy’ option for a firm shall be decided on its business merits without having regard to tax considerations. Last but not least, the territorial choice between domestic and foreign production within the firm shall remain as undistorted as possible.”

4.24 Schön also notes that between independent enterprises “transaction prices truly allocate income” and “the full recognition of the contractual

⁷⁷⁶ Page 603.

⁷⁷⁷ See further paragraph 4.284.27.

⁷⁷⁸ Part III, *World Tax Journal*, October 2010, page 232.

obligations, their execution and the arising profit should be maintained”. This prompts the question “[d]oes ‘common control’ change the picture?”

4.25 Several major consequences of the “mere existence” of a controlling shareholding are identified: power to appoint the board of a subsidiary thereby influencing policy; the ability to extract proprietary information; control over profit distributions; the receipt of dividends, this removing normal arm’s length conflicts of interests; the risk of a subsidiary’s business failure. Thus common control phenomena “justify traditional transfer pricing rules, which are meant to prevent *abusive or otherwise misleading contractual terms* between the involved group companies”.⁷⁷⁹

4.26 Pichhadze (2013)⁷⁸⁰ cites paragraph 6 of the preface to the TPG and Bullen (2011) to note that “the effect of special conditions on the levels of profits [of parties to a controlled transaction] should be eliminated” so as to construct “a hypothetical controlled transaction which is imputed with the ‘conditions’ of the controlled transaction, except for those non-arm’s length special conditions”. “Structural conditions” are imputed to the hypothetical transaction e.g. “attributes of the transaction or enterprises”, “the economically relevant characteristics of the situation” and “comparability factors”. Pichhadze does not in terms engage with the treatment of passive association, but the imputation of “structural conditions”, which include the attributes of the parties, to the hypothetical transaction is consistent with the view that passive association should be taken into account.

4.27 Bloom and Vincent (2012), in discussing section 247(2) of the Canadian Income Tax Act (see paragraph 3.10ff) pose the case of a foreign parent (FP) hiring its Canadian subsidiary (Cansub) to perform engineering work. FP agrees in the contract that it will not seek indemnification from Cansub in any circumstances for losses caused by Cansub’s work (presumably as a pretext for reduced remuneration for Cansub). All Cansub’s third party contracts provide for indemnification. It is suggested that the waiver of indemnification should probably be disregarded in pricing the services because it arises solely by reason

⁷⁷⁹ *Ibid.*, pages 236-239, my emphasis.

⁷⁸⁰ Page 147.

of FP’s ability to exercise control over Cansub; or control may serve as a proxy for an indemnity. This is seen as a “minor deviation” from the *ceteris paribus* approach (paragraph 3.14 above) “in order to prevent terms and conditions that spring exclusively from one party’s control over another party (or the control exercised over both parties by another party) from biasing, or – according to the Federal Court of Appeal in *General Electric*⁷⁸¹ – distorting, the price that otherwise would have prevailed if the parties had been dealing at arm’s length with each other”⁷⁸². Thus again the emphasis is on *distortions caused by control*.

4.28 Becker (1987) promotes the theory that the arm’s length price has to be determined taking into account the discretion of the “reasonable businessman”. The concept is traced back to Roman days but is alive and well in a number of common and civil law jurisdictions. With maybe only a bit of a leap, Becker concludes that “[b]ecause the concept of the ‘reasonable businessman’ is an integral part of the legal systems herein considered, it can also be applied in the intercompany pricing area as an international standard of comparison to determine an arm’s length price. Therefore, the ‘reasonable businessman’ is a mandatory and fundamental part of the arm’s length principle.”⁷⁸³ This discussion resonates somewhat with the discussion of the “business judgment” rule in *General Electric* (paragraph 3.23 above) and also with the ATO’s view of the arm’s length principle, at least as it was applied under the old Division 13 Income Tax Assessment Act 1936 (paragraph 3.68 above, and Taxation Rulings TR 94/14 paragraph 166 and TR 97/20 paragraphs 1.1/2.5). If this rather vague concept has anything to say about passive association, I suggest it militates in favour of recognising passive association as part of factual and commercial reality.

4.29 The role of “synergy rents” or “economies of integration” is an important aspect of the critical debate concerning the effectiveness of the arm’s length principle. The TPG get off to an unpromising start on this subject, noting simply that the principle is in some cases “difficult to apply” e.g. to MNE groups

⁷⁸¹ Paragraph 3.16ff above.

⁷⁸² Section 2.b.

⁷⁸³ Page 17.

dealing in the integrated production of highly specialised goods; and there are “no widely accepted objective criteria for allocating economies of scale or benefits of integration between associated enterprises”⁷⁸⁴. But the new material in Chapter I on MNE group synergies takes an important step forward (paragraph 2.80ff above), particularly given the confirmation that (passive) “synergistic benefits of group membership need not be separately compensated or specifically allocated among members of the MNE group”⁷⁸⁵.

4.30 According to Li (2012) –

*“[t]he term ‘synergy rents’ is used to describe the economic value derived by MNEs from the synergy effects that are unique to MNEs. Theories of MNEs emphasise that MNEs arise in part due to organizational and internalization advantages relative to purely domestic firms. Typically, synergy effects can be achieved only by related parties. MNEs make greater profit by directing the allocation of productive resources instead of leaving resource allocation decisions to the market, thereby benefiting from the economy of scale, savings on transaction costs, and exploitation of assets which because of their special characteristics cannot be fully exploited in the market.”*⁷⁸⁶

To twist a cliché, the sum of the parts of an MNE group, applying arm’s length pricing to individual transactions, is less than the whole. Of course, the actual whole (of the group’s profits) is actually earned, and actually divided between the group members; but the location of the incremental share of value can be manipulated. This problem does not however seem to me to be an acute one when it comes to the recognition of passive association, particularly in the financing context. Implicit support for a borrower might be regarded as a species of group “synergy”⁷⁸⁷. However, CUPs are often available for loans, and financing cases are not typically associated with the continuum price problem, which is more a result of failure to recognise the value of intangibles. See further Avi-Yonah (2009), paragraph 4.46 below. Moreover, “[a]t least outside the financial sector,

⁷⁸⁴ TPG paragraphs 1.9–1.10.

⁷⁸⁵ TPG paragraph 1.158.

⁷⁸⁶ Page 82.

⁷⁸⁷ Indeed it appears under the “synergies” heading in the new material in Chapter I TPG: paragraph 2.80 above.

debt finance does not increase in value as it passes through a firm's internal supply chain; it is a cost centre rather than a source of economic rents"⁷⁸⁸.

4.31 Kane (2014) proposes an interpretation of Article 9(1) MTC which does not require the allocation of total profits attributable to group synergies, and therefore rejects the notion of a "synergy intangible". His focus is on remuneration attributable to separately transferable assets and services; the OECD has now (paragraph 4.28 above) confirmed that group synergies should not be regarded for transfer pricing purposes as intangibles. Kane's proposal that synergistic profits cannot be taxed by the application of Article 9(1) and the arm's length principle is offered as a legal argument: "[i]f the suggested interpretation is superior as a legal matter but one dislikes the outcome from a policy standpoint, then one must acknowledge that getting rid of the discretionary aspect [*i.e. the discretion of MNE groups to allocate synergy profits unconstrained by traditional transfer pricing rules*] would seem to implicate a very cumbersome and extensive modification of the existing treaty network"⁷⁸⁹. Kane's view is somewhat vindicated by the BEPS 2015 Final Reports, paragraph 2.80 above.

4.32 Wittendorff (2010a) identifies⁷⁹⁰ several instances of the implied or express recognition of economies of integration in the TPG, namely in relation to cost contribution arrangements (paragraph 8.8), the services rules (paragraphs 7.12-7.13 TPG) and application of the transactional profit split method (now TPG paragraph 2.113). See also Chapter IX on business restructurings driven by economies of scale and other synergies (paragraphs 9.57-58) and the discussion of a central purchasing function (paragraphs 9.154-160), including the specific mention in paragraph 9.158 of savings generated by the "activity" of the central purchasing entity: compare the inert buying vehicle in the Canadian *Indalex* case (note 50 above) and the OECD's reference to "deliberate concerted action" (paragraph 2.81ff above). Yet none of this TPG material demands the remuneration of passive association, the benefit of which rests where it falls.

⁷⁸⁸ Burnett (2014) page 42.

⁷⁸⁹ Section 3.1, page 304.

⁷⁹⁰ Section 9.2.2, page 334.

4.33 In any event, the passive association phenomenon is something rather different from conventional notions of economies of integration. Some MNE economies rely on cutting out the middle-man, or *aggregating* positive attributes (e.g. purchasing power), whereas the paradigm case of passive association involving the provision of finance points to, or hypothesises, a comparable transaction with a third party lender. “Economies of integration” is generally a concept related to group-wide efficiencies or savings vis-à-vis the outside world. It would not generally be thought of as being in play in the case of an intra-group loan⁷⁹¹ or simply because a parent company guarantees a subsidiary’s debt; still less so, then, when support for an external borrowing is implicit.

Argumentation in the literature to recognise passive association in pricing controlled transactions

4.34 Horst (2011) provides a useful summary of credit rating methodology, but mostly concerns himself with an approving review of the *General Electric* case⁷⁹². He uses the concept of an “incremental benefit principle” to describe how the court addressed pricing of the related party guarantee by reference to the incremental benefit enjoyed by the subsidiary (which he predicts “will likely be widely cited in future transfer pricing cases in Canada and other countries”⁷⁹³). He suggests that economic and policy considerations should equalise the creditworthiness treatment for subsidiaries and branches, and also that a credit rating should be viewed as an intangible asset jointly owned by all affiliates in an MNE group not as the property of the parent company. But he acknowledges that these suggestions are policy proposals not reflected in current tax law. Mention is made of a parent’s right to *disclaim* explicit guarantees – “a by-product of its legal ownership and control (direct or indirect) of the stocks of its subsidiary companies” (Horst (2011) page 601). This is a little odd: if “explicit” means contractually binding, it is not obvious how a guarantee can be disclaimed. Anyway, a parent could even more so disclaim implicit support. On the other

⁷⁹¹ Not being a “source of economic rents”; paragraph 4.30 above.

⁷⁹² Paragraph 3.16ff above.

⁷⁹³ Horst (2012) page 161.

hand, refraining from doing so – i.e. just acquiescing to a particular state of affairs - is not a service or other *activity* which demands remuneration⁷⁹⁴. Wittendorff (2010a)⁷⁹⁵ discusses how omissions may fall within the scope of Article 9(1), particularly in the sense of “refraining from acting”. Various examples are given which are concerned with failures to exercise rights e.g. failure to call for repayment of a fixed rate demand loan where interest rates rise: that is regarded as susceptible to adjustment. It seems too much though to say that refraining from disclaiming support for a subsidiary – essentially doing nothing in circumstances where no pre-existing rights are in play - is a condition made or imposed in Article 9(1) terms.

4.35 Tremblay (2011) considers that “the arm’s length test should consider the relative bargaining powers of the parties, economies of integration, synergetic resources, business relationships, and the actual business experience of the parties. This means that there must be a subjective, entity-specific valuation made *ex ante*”⁷⁹⁶. And the “TPG independent enterprise hypothesis ... appears to require that we hypothesize parties with no management, control or capital relationship – but presumably all other characteristics remain”⁷⁹⁷.

4.36 Hollas and Hands (2014)⁷⁹⁸ consider that lenders may have regard to both (i) an expectation of group financial support to a subsidiary in times of financial distress, and (ii) an assumption that a borrower would have access to management depth and operational capabilities of the group as a whole. They rightly identify the distinction between passive association and active promotion, but then focus upon the potential for “active promotion by the treasury or finance function regarding the credit rating of the parent, which then benefits the subsidiary” – not, they say, to be considered a benefit to the subsidiary of passive

⁷⁹⁴ See paragraph 1.7 above.

⁷⁹⁵ Paragraph 3.3.6.3.4.

⁷⁹⁶ “Is FMV really different from ALPrice?” section.

⁷⁹⁷ “The ITA 247/ALP paradigm” section. Perhaps there is a contradiction here if Tremblay advocates disregarding the group *relationships*?

⁷⁹⁸ Attracting some judicial approval in the *Chevron* case at paragraph 606 (paragraph 3.82 above).

association⁷⁹⁹. Surely however the distinction to be drawn is between a (compensable) activity which the parent performs in a way designed to benefit its subsidiary, and a (non-compensable) activity by the parent of self-promotion or an activity undertaken *qua* shareholder.

4.37 Interestingly, Hollas and Hands compare and contrast the separate entity approach promoted by the TPG⁸⁰⁰ with the notion of “stand-alone” creditworthiness. They express the separate entity principle as requiring one to view “the financial transaction as occurring between an entity that is a subsidiary of a hypothetically separate multinational group and an entity that is the parent of a hypothetically separate multinational group. In this view, the implicit parental support is coming from the hypothetically separate parent of the subsidiary, which is, for analysis purposes, different from the actual parent (or related-party lender);” it follows that “the stand-alone concept is not consistent with either the arm’s length principle or the separate entity approach. Therefore, implicit parental support must be considered to be consistent with the separate entity concept and the arm’s length principle.”⁸⁰¹ Thus a fully “stand-alone” approach, i.e. one which deliberately excises the effects of passive association, is at odds with factual reality and thus the relevant economic circumstances of the parties – which the TPG require to be taken into account. In my view Hollas and Hands accurately frame the hypothetical comparator.

4.38 The alleged inability of the arm’s length principle to cope with the economics of the MNE group (see e.g. Schön (2011)) prompts consideration of whether the recognition of passive association is an aspect of that problem. The MNE group economics phenomenon was described vividly by Moses (2001) quoting Irving Plotkin: if two unrelated parties that together manufacture a product merge, “two amazing things happen”: the price of the final product decreases and the profit of both companies increases; and “there is no logical way

⁷⁹⁹ *Connection between passive association and implicit support* section. One can draw an analogy with the incidental benefits Examples (7 and 8) in the draft UN Services chapter; paragraph 2.91 above.

⁸⁰⁰ TPG preface, paragraph 6.

⁸⁰¹ *Stand-alone versus separate entities* section.

to ascribe the increase in profit to A or B. It emanates from the fact that they are now one company”⁸⁰². Sometimes though the difficulty of the problem is, in my view, over-stated, perhaps due to an economics-led tendency to view the MNE firm as a whole as a single unit. When one focuses on the separate legal entities in a MNE group (as tax systems require), and comparability adjustments are brought to bear, many difficulties fall away. For Lebowitz (2000)⁸⁰³, credit risks are described as presenting an illustration of the issue: “[w]here a sale to an unrelated party entails bearing some risk of non-payment by the purchaser or incurring a cost to eliminate that risk, a sale within a single enterprise does not because the buyer and the seller are the same economic entity”. This is by its terms an economic viewpoint. While it is of course true that sometimes MNE groups will not concern themselves with intra-group credit risk, that is simply to rehearse the task that transfer pricing presents i.e. (as Lebowitz himself puts it) “to construct hypothetical unrelated parties that together replicate the economic results of the single enterprise but that nevertheless remain unrelated”. One cannot disregard intra-group credit risk and keep faith with the arm’s length principle.

4.39 Another exposition of the “group dynamics” problem was offered by Franciscucci (2004). His starting point was that the arm’s length principle “is in many cases unable to account for integrated MNEs’ network profit (i.e. the profit attributable to the existence of an MNE) usually represented by the economies of scale and other synergies realized”, known as the “continuum price problem”⁸⁰⁴. His proposal was for “a cascading consideration of group dynamics in the application of the ALP ... i.e. a spectrum of solutions for the conceptual shortcomings of the ALP”, comprising a “group dynamics adjustment so as to consider all economically relevant characteristics of the controlled transaction under review” or, if that is inadequate, the use of a residual profit split method (RPSM), and then a “multilateral RPSM” designed to reflect value contributions

⁸⁰² 9 TMTPR 815.

⁸⁰³ 9 TMTPR 61.

⁸⁰⁴ The concept is attributed to Stanley Langbein, see e.g. the Bloomberg BNA Special Report (2000) and Langbein (1986), see note 8 above.

from core members of the MNE group⁸⁰⁵. Franciscucci described the crucial question as “where [the] additional profit (i.e. the MNE efficiency premium) is taxed” (compare Kane (2014), paragraph 4.31 above). However, the problem is regarded as one which arises typically as a result of the use of “one-sided” transfer pricing methodologies (e.g. the cost plus method and the residual profit method). For such methods, having regard to the choice of tested party, identified as the least complex party to the controlled transaction that does not own valuable or unique intangibles, the result tends to be that the “MNE efficiency premium” is taxed in a jurisdiction other than that of the tested party⁸⁰⁶. That is regarded as an insufficiently precise outcome, and thus two-sided methods (i.e. the CUP and profit split methods) are to be preferred. Franciscucci acknowledges that the CUP method, as a two-sided transfer pricing approach (based on a negotiated bargain between independent parties) that does not require an analysis of the performance of a tested party, should not give rise to the continuum price problem. A profit split approach is proposed for cases where adequate CUPs are not available⁸⁰⁷.

4.40 It is often said that reliable CUPs are not available in analysing related party transactions within highly integrated MNE groups⁸⁰⁸. In lending cases, however, the working assumption is that CUPs are commonly available. According to Avi-Yonah, “[t]he basic problem arises in situations where there are no good comparables. If good comparables exist, the traditional methods (CUP, cost plus and resale price) can be used, and that would end the story.”⁸⁰⁹ Although passive association in some senses resembles the type of “synergy” reflected in the MNE efficiency premium, the benefit of passive association is not in a legal sense derived from an “asset” as such of the parent. Loan cases do not display an

⁸⁰⁵ Franciscucci (2004) pages 55-56.

⁸⁰⁶ *Ibid.*, page 72, citing Moses (2001).

⁸⁰⁷ *Ibid.*, pages 73, 240, citing TPG paragraph 3.47’s endorsement of the profit split method as a means “to achieve a division of the profits from economies of scale or other joint efficiencies that satisfies both the taxpayer and tax administrations”.

⁸⁰⁸ E.g. Avi-Yonah (2009) page 8: “in those markets in which multinational groups operate – that is, in those markets in which transfer pricing issues arise – it is unlikely that reasonably close ‘uncontrolled comparables’ can be found. For example, ... there are no independently owned distributors of mass-market automobiles in the United States; all of the distributors are owned by their manufacturers.”

⁸⁰⁹ Avi-Yonah (2009) page 11.

“economy of integration”: the fact of affiliation does not reduce the costs to the MNE firm as a whole of borrowing externally compared e.g. with the price of a loan to the group entity with the highest credit rating. Consider also the sister-to-sister loan case (paragraph 4.19 above) where implicit support of the parent for the borrower is no part of the transaction as such and so cannot on any basis be rewarded via the transaction price (including via transactional profit splits). Finally, returning to the black-letter established norms represented by the TPG, paragraph 1.10 (see paragraph 2.23 above) observes that there are “no widely accepted objective criteria for allocating” economies of scale or benefits of integration; and under TPG paragraph 7.13, read with the revised Chapter I TPG⁸¹⁰, mere affiliation benefit is not to be rewarded. At the heart of Francescucci’s argument is a policy proposal to attribute remuneration to the “provider” of the economy of integration, rather than its beneficiary. That may be a valid proposal, but it is not where the law currently stands.

4.41 Nielsen and Holmes (2010) propose that “there is a fundamental conflict between the ‘separate entity’ approach and the realities of market pricing” i.e. “maintaining a strict ‘separate entity’ approach does not reflect ‘normal open market terms’ and is therefore in conflict with Article 9” MTC⁸¹¹. They note that it is the “idea that a subsidiary may freely benefit from the group credit rating which is challenging to conceptually reconcile with a strict ‘stand-alone’ approach”⁸¹². They conclude that “if the ‘separate entity’ approach adopted by the OECD Guidelines leads to a strict ‘stand-alone’ credit analysis there is a patent conflict between the market realities advocated by Article 9 and the possible application of the arm’s length principle as set out by the OECD Guidelines”⁸¹³. They appear, therefore, to support the recognition of implicit support (without quite saying that); the “patent conflict” is surely resolved by recognising “market realities” as a component of the “application of the arm’s length principle” i.e. by moving away from a “strict ‘stand-alone’ approach”.

⁸¹⁰ See paragraphs 2.44, 2.80ff above.

⁸¹¹ Introduction.

⁸¹² *Implicit credit support* section.

⁸¹³ Conclusion.

4.42 A summary is presented by Brooks (2013)⁸¹⁴:

“Strident adherents to the vision of the arm’s length principle may view that principle as requiring that adjudicators ignore all aspects of the relationship between the related parties. A review of the OECD materials on the meaning of arm’s length seems to suggest that the arm’s length approach requires the parties to ignore their relationship in setting prices. However, an approach to giving meaning to the arm’s length principle that completely neglects the relationship between the parties seems to stretch reality too far. The parties in this case [General Electric Capital Canada], as in all transfer pricing cases, are related. It seems more honest to delineate the benefits of that relationship and to grapple with them transparently than to force taxpayer and adjudicators to ignore altogether the reality of the facts in front of them.”

Argumentation in the literature to disregard passive association in pricing controlled transactions

4.43 Wittendorff (2011)⁸¹⁵ argues that implicit support should be disregarded in applying the arm’s length principle to price a controlled transaction. He writes on the differences between arm’s length pricing and fair market value. The distinction is said⁸¹⁶ to be between a “subjective” arm’s length price which takes into account the economically relevant aspects and context of the transaction and its parties, and an “objective” market value typically assessed as if between hypothetical knowledgeable and willing market participants, excluding elements of entity-specific value⁸¹⁷.

4.44 Having proposed the arm’s length/market value distinction, Wittendorff considers the approach in various contexts to the effects of implicit support – which he defines as “the fact that the credit rating of a company that is part of a group may be higher than it would if it were a stand-alone company, if a bank or

⁸¹⁴ [2010] BTR 132, 139.

⁸¹⁵ At page 223.

⁸¹⁶ An alternative view is acknowledged, *ibid.*, footnote 36.

⁸¹⁷ In 1963, the Australian Taxation Board of Review thought that “the independent arm’s length test prescribed ... (in the UK tax treaty) ... is not materially different from the fair market value test”: *Case N69* [1962] 13 TBRD (NS) 270; 11 CTBR (NS) 261 *Case 53*, cited in ATO Taxation Ruling TR 94/14 paragraph 165.

rating agency believes that associated enterprises would support the company in a period of financial stress even in the absence of an explicit guarantee”⁸¹⁸. An illustration is provided of interest rates chargeable by (a) Parent to Subsidiary (4%); (b) Bank to Subsidiary (i) with implicit support assumed (3%), or (ii) without (4.5%); and (c) Bank to IndependentCo “with rating characteristics identical to those of the subsidiary” (5%). The 4% Parent-to-Subsidiary loan is said to be an arm’s length rate; but this assumes the answer to the question being debated. Likewise, describing IndependentCo as having characteristics identical to Subsidiary begs the critical question of which characteristics (notably passive association with Parent) must be taken into account; there is no discussion of comparability requiring that IndependentCo is assumed to benefit from a comparable measure of passive association.

4.45 In my view, Wittendorff errs in inferring from economic analysis the nature of the relevant transaction. Thus: “in practice it is often difficult to distinguish between the definition and the pricing of services”⁸¹⁹. I fundamentally disagree. Transfer pricing must always involve two essential stages: (1) identify the nature of the activity (what is “made or imposed”?) (typically a transaction) between the associated enterprises – “delineating” the transaction to use modern TPG terminology⁸²⁰; (2) determine the arm’s length price to be paid for that activity by its beneficiary. It is straightforward to understand that certain manifestations of the “economies of integration” entail intra-group activity which must be priced. Wittendorff gives pooled purchasing power as an example. This often requires organisation and the making or imposition of a particular arrangement (“deliberate concerted action”⁸²¹). However, passive association inherently does not entail any activity.

4.46 Wittendorff’s argument is based upon the proposition that a subsidiary’s “use” of implicit support “may expose a strong parent company to economic

⁸¹⁸ Wittendorff (2011), page 243.

⁸¹⁹ *Ibid.*, page 244.

⁸²⁰ E.g. paragraph 1.33 TPG.

⁸²¹ Paragraph 1.158 TPG.

disadvantages” in three ways⁸²². The first is that “when a parent company enjoys a higher rating than its subsidiaries, a rating consolidation will lead to raising the status of the subsidiaries and downgrading the rating of the parent company”. The precise meaning here of “rating consolidation” is unclear. Generally, credit ratings attach to specific legal entities or particular obligations (e.g. bonds) of specific legal entities. It is true that in assessing an issuer credit rating (“ICR”) a step in the process may involve consideration of a “group credit profile” (“GCP”). However this is not a rating, but rather a component of the ICR of a particular group member⁸²³. Thus for example (unless a particular subsidiary has a potential ICR *higher* than the GCP on the basis of extraordinary government support, or the subsidiary is classified as an “insulated subsidiary” with an ICR above the GCP) the ICR for a “core group entity” equals the GCP, and for a “highly strategic subsidiary is one notch lower than the GCP (unless the stand-alone credit profile – ‘SACP’ – is equal to or higher than the GCP, in which case use the GCP)”⁸²⁴. Secondly, it is said that the raising of additional debt finance may result in a downgrading of the consolidated rating, yet again the focus on a consolidated rating here seems misplaced. Thirdly, Wittendorff says that a “parent company’s high rating may be achieved by reliance on more equity financing, which is generally more expensive than debt financing”. But “more” (equity finance) than what? The passive association proposition being tested does not rely upon the parent raising any finance, or any particular form of finance, or indeed doing anything at all.

4.47 In my view, Wittendorff constructs what is essentially an economics-based argument (including through use of consolidation concepts) for a policy approach which departs from the meaning of Article 9(1) MTC. The parent’s supposed “economic disadvantages” are equated with “income shifting among associated enterprises”. But whatever the economic theory, in the real world, and (in case this is different) certainly through the eyes of a tax lawyer, in the simple case where a subsidiary borrows from an unrelated bank and the bank makes some

⁸²² Wittendorff (2011), page 244.

⁸²³ See e.g. Standard & Poor’s *Group Rating Methodology*, paragraph 33 (2013).

⁸²⁴ *Ibid.*, paragraph 74.

pricing allowance in view of the subsidiary's passive association with its parent, there is no question of income shifting – which reflects the fact that nothing has happened between parent and subsidiary. I agree with Wittendorff that things are different if a comfort letter or similar is issued: as discussed at paragraph 1.16 above, that entails positive action which may well require remuneration.

4.48 Wittendorff asserts that HMRC consider that implicit support is recognized in principle as a compensable transaction⁸²⁵, but this misunderstands HMRC's (less than precise) guidance: paragraph 3.180ff above.

4.49 Wittendorff doubts whether the view that implicit support is relevant for pricing controlled transactions conforms to the arm's length principle of Article 9(1) MTC. Five reasons are given⁸²⁶:

(i) because in general the form of the controlled transaction must be respected⁸²⁷, and because a comparable should be a “perfect mirror image” of the controlled transaction, implicit support should be disregarded – it is said that in the controlled transaction (unlike the uncontrolled transaction), it “is not present”. For example, in a parent-to-subsidary loan it is circular to say that the loan should be priced having regard to the parent's likely support of the subsidiary's obligation to pay the parent. I read this as proposing – to sidestep the “lender as guarantor” paradox - that the effect of implicit support present in a comparable should be “reversed out” of the comparable to align it with the actual transaction. (HMRC voice a version of this argument, albeit on the basis that the parent “cannot guarantee an obligation owed to itself”.⁸²⁸) This almost-Cartesian logic is at first seductive, but on closer scrutiny may be found to lose sight of the basic objective of arriving at a price for the loan comparable to an arm's length price. Say the subsidiary had two loans on identical terms (leaving aside for a moment interest

⁸²⁵ *Ibid.*, page 246, citing INTM 502040.

⁸²⁶ *Ibid.*, page 247.

⁸²⁷ TPG paragraph 1.64.

⁸²⁸ Paragraph 3.188 above.

rate), and in essentially identical circumstances⁸²⁹, respectively from its parent and also from an unrelated bank. It would be peculiar if the robust internal comparable did not provide a compelling indication of the arm's length price, even where the bank has regard to an expectation of parental support. Consider also the sister-to-sister lending case: it is no longer circular to point to implicit *parental* support of the borrower subsidiary. The notion that a “parent may not have the same incentive to support” a subsidiary in such cases is a quantitative proposition; it may be true – to the point of the measure of implicit support being zero in some cases (parent won't favour one subsidiary over the other); but it could be significant in other cases: see e.g. the joint venture scenario at Fig. IX, paragraph 4.19 above;

(ii) although a subsidiary's ability to borrow from an unrelated bank at a certain price might be viewed as a “realistically available option”, this concept is said to be informative regarding the relative bargaining powers of the parties in the context of comparability, but not as a separate means to determine transfer prices⁸³⁰. The citation for the latter proposition however simply expresses a concern that “the examination of alternatives may nevertheless be used to second-guess the appropriateness of bona fide business decisions. The construction of alternative business arrangements would be, at best, an uncertain enterprise and could prove to be arbitrary”; and the OECD recommendation is simply against such second-guessing. This concern should not arise in a case where there is clear evidence (possibly an actual internal comparable) of the alternative available;

(iii) it is said that “when a benefit of a controlled transaction stems from group affiliation, the market price of an uncontrolled transaction is not decisive for the transfer price of the controlled transaction”. (That of course simply states the argument.) The Norwegian *ConocoPhillips* cash pooling case⁸³¹ is given as an example of market interest rates not being decisive for “the allocation of

⁸²⁹ Assume a strong degree of contextual comparability e.g. strong informational symmetry as between parent and bank, and a strong measure of *relevant* control by bank (contractually, via loan covenants), and perhaps even security over subsidiary's assets.

⁸³⁰ Citing paragraphs 3.14-18 of the OECD's *Task Force Report* (1992).

⁸³¹ Utv. 2010 at 199.

economies of integration of the controlled transactions”. But that case concerned the *active* and collaborative participation in the pool by group members such that the effects of economic integration themselves fell to be priced – in that case on the basis of a contribution analysis; a passive association case is quite different;

(iv) a case is proposed where an unrelated party would be prepared to lend at a rate less than the relevant associated enterprise would be *able* to offer; this is posed as a scenario where the seller’s minimum price (that required by the associated enterprise, say, the parent) exceeds the buyer’s maximum price (presumably because the subsidiary has a realistic option to borrow more cheaply from the bank; that economic dynamic would ordinarily prevent the transaction occurring). One could conceive of a case where a hypothetical lender with all the attributes of the actual parent lender would seek a higher return on its investment than the bank in question: the comparability analysis would then require adjustment of the terms of the bank loan to align the comparable with the parties’ actual circumstances. But implicit support may nonetheless remain in play as a relevant borrower attribute. The potential pricing “gap” identified in this scenario does not bear on the relevance of passive association;

(v) finally, the fact that implicit support is non-compensable is said to be a reason to disregard it in pricing controlled transactions; otherwise parent becomes a “two-time loser”, first, for being uncompensated for “use” of the support “at the expense of the parent”, and, second, for being inadequately rewarded for its risk (though surely these are just two ways of expressing the same point). However, the first of these “losses” is itself the established rule in TPG paragraph 7.13 (“use” here being an economic concept, but not a “condition made or imposed” in Article 9(1) MTC terms); and the second (“inadequate reward”) is itself the conclusion sought to be demonstrated. Both flow naturally from the absence of any *activity*. Why should the rate charged by an unrelated bank be regarded as inadequate? It is the ideal benchmark. Evidently the potential “free ride” enjoyed by the subsidiary is considered offensive, but it is both (i) a necessary corollary of paragraph 7.13 TPG, and (ii) a “fact of family life” – in that children (subsidiaries) may often benefit freely in one way or another from their family affiliations (usually their parents).

4.50 Wittendorff's earlier book proposed a nice formulation of comparability: "[a]n ideal reference transaction should therefore be a perfect mirror image of the controlled transaction in relation to all the objective and subjective factors that can influence the price formation."⁸³² The reference here to subjectivity is interesting, and does present a potential challenge to the "perfection" of an uncontrolled lending transaction as a comparator for an intra-group arrangement. If "subjectivity" refers to the state of mind of the parties, and in particular the lender, one might worry that a difference would be present between the mindset of an independent lender prepared to attach some value to the borrower's group affiliations, and that of the borrower's parent, to the extent it turned its mind to the question at all, which might take the position that a pricing discount based on its own willingness to support the subsidiary-borrower would be a business contradiction. This does articulate the particular problem of the loan from the specific entity which is also assumed to be the provider of group support ("lender as guarantor" paradox); the difficulty does not arise in the same way in the sister-to-sister lending case (where the sister-lender might – though always dependent on the precise facts and circumstances – anticipate parental support for the borrower). But the answer appears to lie with the construction of the hypothetical counter-factual in which the lender assumes implicit support not from itself but from the hypothetical borrower's hypothetical parent or other affiliate.

4.51 Kamphuis (2010) proposes that the Court in *General Electric* "wrongly interpreted the arm's length principle by rejecting the reference to comparable transactions between independent parties"⁸³³. But the criticism of the Court is not backed with reasoning other than by pointing to the example of a central procurement company and potential disagreement with Example 19 in the US services regulations (paragraph 3.210(v) above). As I observe at paragraph 1.23, the concentration of buying power within a MNE group, with its attendant efficiencies, usually arises because of the concrete ("deliberate concerted") actions of one or more of the participants, so is not a good illustration of the effects of passive association.

⁸³² Wittendorff (2010a) page 298.

⁸³³ Kamphuis (2010), page 296.

4.52 Blessing (2010) proposes⁸³⁴ that “the compensation-free passive association concept is not appropriately applied mandatorily to intercompany financial guarantees or loans”. Several arguments are proposed:

(i) the recognition of passive association could give rise to a form of economic double taxation. If a company in one country were to be regarded as benefiting from implicit support from a foreign affiliate (thus enjoying reduced costs, and hence increased profits), but the other country could claim that value was crossing the border by way of provision of that support such that a fee should be paid, but no deductible fee is permitted, the MNE group is effectively being taxed twice. The answer to this however is that (consistent with paragraph 7.13 TPG⁸³⁵) no fee is appropriate (from either party’s perspective): the “supporter’s” tax authority should not be imputing a fee. A line has to be drawn somewhere to demarcate transfer pricing borders: that line, in Article 9(1) MTC terms, is articulated via “conditions made or imposed” i.e. some sort of active arrangement⁸³⁶ (see paragraphs 2.44-2.45 above on “activity”), rather than the presence of mere economic phenomena;

(ii) acceptance of the principle that a group’s ability to pool purchasing power and thus achieve volume discounts⁸³⁷ is “antithetical to the application of non-compensable passive association in a financial standing context”. This is said to give rise to a “directional” issue: whereas the greater the usage of volume discount arrangements, the greater the benefit to the group, the greater the usage of implicit support, the greater the detriment to the group’s credit status. Credit-standing is regarded as a “finite asset”. Economists might applaud, and economic thinking could be thus presented with a view to shaping policy, but from a legal

⁸³⁴ Pages 164–168.

⁸³⁵ Blessing argues that “loans are certainly not services and so Para. 7.13 has no direct relevance” (page 164). That might be a legitimate view as a matter of US tax law (though cf. *Container Corp v Commissioner* 14 TC 5 (2010), which Blessing considers wrongly decided), but the view seems unduly dogmatic in the context of the TPG and international tax parlance more generally.

⁸³⁶ Translated, for example, into “transactions” in the US and Canadian transfer pricing rules and “provisions” in the UK code.

⁸³⁷ Compare Example 19 in the US section 482 Services Regulations: paragraph 3.210(v) above.

perspective it seems wrong to regard credit standing as an asset i.e. a form of intangible property: surely it is more in the nature of a characteristic of the legal person that is the company in question. As noted at paragraph 4.46, it seems misplaced, in legal (and indeed transfer pricing) terms, to speak of a “group’s credit status”: the group is just an aggregation of entities, but it is each separate entity that will have its own credit standing. Moreover, it is at least questionable that the credit-standing of (say) a parent company is in some way eroded because a subsidiary “uses” its passive association with the parent to borrow favourably (there is no reason why the consummation by a subsidiary of a transaction favourable to its business must necessarily be regarded as weakening its parent);

(iii) from a US-oriented view of debt/equity instrument classification, it is said that the basic determination must be made on the assumption that the borrower receives no credit support from its parent. Blessing says that recognising passive association in setting an interest rate would create an “apples and oranges” situation – presumably the concern is potential inconsistency between the separate but related issues of instrument classification and pricing? This feels too emphatic. Although the presence of a guarantee may be regarded by some taxing jurisdictions as an incremental symptom of equity, it is at most only one factor to be weighed in the balance: a guaranteed bond is no less a bond. And I see no reason for a conceptual objection to a two-step approach whereby one first characterises an instrument, and then moves on to evaluate its pricing; indeed, this is what is mandated by OECD, see e.g. paragraph 4.45 above;

(iv) case law is said to support a stand-alone approach, though again the viewpoint is through US tax spectacles. *Nestlé Holdings Inc v Commissioner*⁸³⁸ is cited, with the remark that each of the taxpayer, the IRS and the Court accepted that, in addressing the IRS’s argument that the interest rate paid by the US taxpayer to its Swiss affiliate was too low, the determination was to be made on a separate company basis. But although in the debt/equity characterisation context the taxpayer’s ability to raise debt “as a separate entity” was relevant, the case

⁸³⁸ 70 TCM 682 (1995).

does not investigate the meaning of that concept at all, let alone the possible effect of passive association as a characteristic of the separate entity;

(v) like Wittendorff (paragraph 4.49(i) above), Blessing argues that if the putative provider of support is also the creditor, the effect of implicit support is “displaced” because “it would be circular to conclude that the parent company should derive a lower rate on the assumption that it would support the credit of the obligor”⁸³⁹; but the contrary argument is that it is appropriate to assess what would have happened between independent parties with the same characteristics as the actual parties, but not to assume that the independent lender would be the provider of support;

(vi) a case involving a loan to a borrower company from a sister (rather than parent) entity is used to suggest that, if passive association is disregarded, the sister/lender would be receiving excessive interest relative to its risk of loss – and therefore that part of the interest should in fact be paid to the parent company “as a guarantee fee”. But that contradicts the guidance in paragraph 7.13 TPG. A better solution seems to be to reflect the sister/lender’s true risk of loss (as affected by any possibility of parental support). Blessing also suggests that in the sister/lender case, there is a less clear rationale for a parent to step in to support the borrower in preference to allowing the sister to suffer loss: again this seems to place too much emphasis on the attitudes of the actual parties when what is required is a test of the hypothetical behaviour of independent parties. See paragraph 4.19 above and the quantitative aspect mentioned at paragraph 4.49(i);

(vii) Blessing considers that recognition of passive association is “inconsistent with the strict legal rights and relationships”. But the non-compensation of implicit support (paragraph 7.13 TPG) properly reflects the absence of a legal act or event demanding remuneration; the recognition of passive association as an economically relevant circumstance or characteristic of the borrower is a valuation/pricing consideration based upon fact;

⁸³⁹ Blessing (2010), page 166.

(viii) finally, in a discussion of relative bargaining power⁸⁴⁰, Blessing perceives an inconsistency in Justice Hogan’s decision in *General Electric* by taking account of (a) the taxpayer’s vulnerability from market expectation that a parent guarantee would be provided, and at the same time (b) parental implicit support as viewed by those markets: the former is rejected as irrelevant to pricing a guarantee fee “regardless of whether a third party would take it into account” – but this seems a rather extraordinary proposition in the context of determining what would happen between independent parties.

4.53 Soon after the Tax Court’s decision in *General Electric*, Blessing was reported as criticising the recognition of implicit support as creating uncertainty and “inexactitude”. At the same time Muris Dujsic of Deloitte & Touche argued that if implicit support provided a benefit to a subsidiary it should be “considered as a separate transaction” with a separate charge (but this is contrary to paragraph 7.13 TPG). And KPMG Canada highlighted the use by the subsidiary of its parent’s trade name (presumably as an aspect taken into account in measuring implicit support⁸⁴¹) as a relevant “transaction”⁸⁴². But while that could be the case (as where a parent formally or informally licenses a trade name to its subsidiary), and could thus merit compensation, it would not necessarily be so; it might even be the case that the subsidiary was using the name first. The TPG say that “[a]s a general rule, no payment should be recognised for transfer pricing purposes for simple recognition of group membership or the use of the group name merely to reflect the fact of group membership”. On the other hand, the licensing of a trademark or “other intangible for the group name” which provides a financial benefit for the licensee obviously merits remuneration⁸⁴³.

⁸⁴⁰ *Ibid.*, page 173.

⁸⁴¹ E.g. according to Moody’s *Rating Non-Guaranteed Subsidiaries: Credit Considerations in Assigning Subsidiary Ratings in the Absence of Legally Binding Parent Support* (December 2003), page 2.

⁸⁴² All this reportage in Menyasz (2009).

⁸⁴³ Paragraphs 6.81-83 TPG; paragraph 2.80 above.

4.54 Blessing was also reported as opining, at an ABA Tax Section meeting on 7 May 2010⁸⁴⁴, that “passive association in the context of financial transactions is a fallacy ... It makes sense for volume discounts, but rating agencies do not view there as being an indivisible asset that corresponds to some credit rating”. In that context too Blessing promoted the argument that the use of credit “wastes” the credit capability of the supporting entity: the greater the borrowing, “the more the asset is used up”; whereas with volume discounts the effect of use was directionally the opposite. This reiterates the points described at paragraph 4.52(ii) above. As noted, in my view it is mistaken in this context to regard a parent company’s creditworthiness as an asset which is dissipated by sensible business transactions; and the volume discount case usually entails some level of activity, not mere passivity.

4.55 Hoffman, Dupuis and Rockall (2007) consider that the recognition of passive association may amount to a “deemed consolidation”⁸⁴⁵, i.e. something akin to regarding the separate permanent establishments of a company as having the same credit rating of the enterprise as a whole⁸⁴⁶, or the notion of “substantive consolidation” as used by a bankruptcy court. This goes too far in the transfer pricing context. Even the authors acknowledge that “substantial [*sic*] consolidation is considered in the bankruptcy setting to be appropriate only in extraordinary circumstances” e.g. fraud. Although one can see a potential policy rationale for arguing for neutrality as between subsidiary and PE cases, the legal distinction is self-evident: a PE does in fact generally enjoy the same credit standing as the whole enterprise – it simply is part of that enterprise, and the assets of the enterprise are generally available to creditors⁸⁴⁷; this is inherently not the

⁸⁴⁴ Reported by Moses in 19 TMTPR 58. At the same meeting, David Ernick, Treasury Associate International Tax Counsel, said that ignoring the implicit benefit of affiliation would be a misinterpretation of the arm’s length standard because “related parties do not really have to act like unrelated parties to fulfil the arm’s length standard. Rather, they only have to reach the price that unrelated parties would reach”:
http://apps.americanbar.org/dch/thedl.cfm?filename=/TX357000/sitesofinterest_files/2010_May_Session_D.C_Minutes_TP_Session.pdf (accessed 30 December 2015).

⁸⁴⁵ Section headed “Deemed Consolidation” in 16 TMTPR 333.

⁸⁴⁶ See paragraph 2.66 above regarding the OECD PEs Report, and e.g. the UK provision at section 21(2)(a) Corporation Tax Act 2009.

⁸⁴⁷ Compare note 143 above.

case for a separate legal entity. Moreover, the ratings equalisation approach of some rating agencies may bear some broad similarity, in terms of its effect, with a notion of consolidation, but again that is not manifesting a legal state of affairs: it is itself simply the recognition of the very concept of passive association I am analysing. In other words, it is not the case that “potential lenders or creditors should assume deemed consolidation” [of a borrower with its parent]⁸⁴⁸; this is no more than the raters (who, as the authors note, operate in the “real world”) recognising the “economically relevant circumstances” of the borrower as a legal entity.

4.56 Two non-financial transaction examples are given which are said, by logical extension, to illustrate how the recognition of passive association causes incongruous results in transfer pricing terms. First, the case is given of a parent owning valuable technology which is licensed to a subsidiary. Applying “deemed consolidation principles”, it is said that the interrelationship between parent and subsidiary cannot be ignored – and therefore the licence should be royalty-free because, within the MNE group, the technology should be regarded as a “public good”. This conclusion appears to be based on the idea that, within the MNE group, the technology is in fact freely-available, so that the price should be zero. But then all is lost in transfer pricing terms! Secondly, the authors consider a manufacturer parent with a full-risk distributor subsidiary. Because of an assumption that parent would in fact assume the risks of subsidiary (and indeed *vice versa*) it is said that it becomes impossible to apply traditional transfer pricing methodologies. Again, this seems to me not to follow at all. The authors’ view of supposed risk assumption, particularly the subsidiary’s “upstream” assumption of parent’s manufacturing risks, seems to contradict the proposed fact-pattern: if the commercial reality is that parent will always step in to bear distribution risks (e.g. market, inventory or customer credit risks), the pricing of transactions between parent and subsidiary should take that state of affairs into account⁸⁴⁹. In any event, it is not clear why the proposed fact pattern should render it impossible to

⁸⁴⁸ Hoffman *et al* (2007), *ibid*.

⁸⁴⁹ Particularly given the sharper focus nowadays on the conduct of the parties in delineating transactions: see e.g. paragraph 1.46 TPG.

arrive at arm's length prices (typically CUPs) for basic sales of goods transactions between parent and subsidiary.

4.57 Vincent (2010), prior to the decision of the Federal Court of Appeal, criticised the Tax Court's judgment in *General Electric*. He doubted why, in an arm's length setting, the US parent would have felt compelled to bail out the Canadian taxpayer. In the context of subsection 247(2) of the Canadian Income Tax Act, Vincent's approach was to insert the names of the parties into his reading of the legislation, and from there to assert that, dealing at arm's length, the US parent would not have provided support⁸⁵⁰. Yet Vincent did not engage with the argument that the correct counter-factual is one in which a hypothetical borrower (with all the characteristics of the actual borrower) buys a guarantee from a hypothetical third party (with all the characteristics of the actual guarantor). Vincent proposes to "remove all forms and attributes of arrangements that are present by virtue of the fact that the [parties] are not dealing at arm's length (such as implicit support as a result of being part of the non-resident person's multinational group)". But, as the Federal Court of Appeal confirmed⁸⁵¹, implicit support should not be regarded as emanating from the control relationship as such. In my view it is significant that paragraph 247(2)(c), which is the Canadian statutory articulation of the counter-factual, points to the "terms and conditions ... that would have been made between *persons* dealing at arm's length" [my emphasis]. This can sensibly be read as referring to hypothetical persons; the Article 9(1) MTC analogue is "independent enterprises". I disagree therefore with:

- (i) Vincent's proposition that the correct interpretation of the legislation is that the reference to "persons" means the actual transaction participants;
- (ii) his criticism of *General Electric* on the basis that recognising implicit support "turns into the Kafkaesque exercise of trying to evaluate the value of an

⁸⁵⁰ *Legal Framework* section; see also Vincent (2013), pages 213-214.

⁸⁵¹ 2010 FCA 344, paragraphs [53]-[55].

explicit guarantee in light of an implicit support that will never be exercised as a result of the existence of the explicit guarantee”⁸⁵²; and also

(iii) his proposed reconciliation of the rejection of implicit support as a pricing factor with the *GlaxoSmithKline* decision⁸⁵³: “one should include other contractual arrangements that are linked to or have a bearing on the transaction in question, and exclude those features or characteristics of a party or arrangement that do not result from legally binding contractual arrangements, but rather ensue solely from belonging to the multinational group in question”. This formulation fails to take account of the “price distorting” element of the decision in the *General Electric* case⁸⁵⁴.

4.58 Vincent also asserts that an arm’s length guarantor could not rely on implicit support from the Canadian taxpayer’s US parent to mitigate its risk; it would set the price for its guarantee by “excluding any wishful implicit support”. This seems to overlook the principle of subrogation: a guarantor called upon to satisfy a creditor would typically (either contractually or by operation of law) step into the shoes of the creditor and thus acquire a direct claim against the borrower. Might not the US parent, in such circumstances, continue to be motivated, to some extent at least, to bail out its subsidiary e.g. to avoid painful litigation against the group by the guarantor? See further paragraph 4.68 below.

4.59 Schön (January 2011)⁸⁵⁵ develops the discussion around the tension between the arm’s length principle and the fundamentals of the theory of the firm, and in particular the way in which –

“within a firm, business units are meant to cater to other business units ... this is reflected in upfront specific investment, in the creation of proprietary intangibles, in long-term

⁸⁵² Vincent (2013), page 224.

⁸⁵³ Then in the Federal Court of Appeal.

⁸⁵⁴ Paragraph 3.24 above.

⁸⁵⁵ My impression is that Schön is supportive of recognition of passive association as a matter of current law, but is a proponent of change from the policy perspective.

*contracting and so on. This brings about ‘synergies’ which contribute to the overall profit of the firm”*⁸⁵⁶.

A consequence is that it will be -

*“possible for some business units to extract rents from the existence of other business units within the firm ... These rents are due to the fact that the ‘losing’ business unit provides a specific business opportunity to the other divisions of the firm. In other words: the ‘winning’ business unit should be taxed not only in its location country but also in the jurisdiction where the other unit resides.”*⁸⁵⁷

Thus Schön promotes the concept that synergy benefits – i.e. presumably the profit attributable to such benefits - should be taxable in the territory from which such benefits emanate, but upon the entity that is the beneficiary. The policy proposition is that “[i]nternational tax allocation should be built on two elements ... transfer pricing will be the starting point for profit allocation to the involved companies but synergy rents drawn by a group company from dealings with another group company shall be taxed in the ‘source country’ as well”⁸⁵⁸.

4.60 So in *General Electric*, should the Canadian taxpayer’s “winning business” be taxable in the US in respect of the implicit support found to have emanated from its AAA-rated parent? This is a radically different approach from conventional territorial/water’s-edge international tax norms. Perhaps Schön’s broad objective could be achieved after all by disregarding passive association, so that General Electric Capital Canada’s guarantee fee expense would not be suppressed by reference to potential support from its US parent (“an economic factor which is largely connected with the United States”⁸⁵⁹), so that greater income is earned by the parent, thus shifting the synergy rent into the US tax net?

⁸⁵⁶ Page 6.

⁸⁵⁷ *Ibid.*, page 9.

⁸⁵⁸ *Ibid.*, page 14.

⁸⁵⁹ *Ibid.*, page 17.

At any rate, it is apparent that Schön's position is advocacy for a policy change, not for a construction of current law.⁸⁶⁰

4.61 Horst (2012) considers that “allowing a parent corporation to charge a guarantee fee to its subsidiary corporation, but not to its unincorporated branch, is perfectly logical from a legal perspective, but not from a broader tax policy perspective”⁸⁶¹. Noting the rule in the OECD PEs Report that all parts of an enterprise have the same creditworthiness and therefore there is no scope for the rest of an enterprise to guarantee the PE's creditworthiness or *vice versa*,⁸⁶² Horst criticises the resulting distinction (between the treatment of subsidiaries compared with branches) as contrary to the goal of tax neutrality. “But ... treating a subsidiary as if it were a branch would require fundamental changes in countries' tax laws and their bilateral tax treaties and cannot generally be achieved by tax authorities under existing law.”⁸⁶³ He also condones the (economic policy) proposition of treating “the parent company's credit rating as a collective asset that should be available at no charge to the affiliates of a multinational group, rather as intangible property that is owned just by the parent company.”⁸⁶⁴ But this tramples over the separateness of the corporate entities which form a group, that separateness sitting at the core of transfer pricing.

Some examples of the literature define the problem but do not promote an answer

4.62 An excellent non-partisan exposition of the arguments for and against the recognition of passive association in pricing controlled guarantee transactions was presented to the US Treasury by the American Bar Association in 2012. By

⁸⁶⁰ Vroemen (2015) observes that (in a conventional supply chain context) it is common for residual profit to be allocated to a principal/entrepreneur entity – and therefore “it can be argued that the principal is implicitly charging the companies for group synergies” (section C.3). There is a loose parallel here with a case of an intra-group loan priced without regard to the beneficial effects of passive association on the borrower, where the outcome is tantamount to a charge being levied by the parent/lender for the benefit of affiliation (contrary, I suggest, to paragraph 7.13 TPG).

⁸⁶¹ Page 180.

⁸⁶² Paragraph 2.66 above.

⁸⁶³ Horst (2012) page 181.

⁸⁶⁴ Compare paragraph 4.52(ii) above.

analogy, much of the reasoning can equally be applied to related party loan transactions. The effect of passive association is an important potential component in such a pricing exercise. No formal response has yet been issued by the Treasury or IRS.

4.63 This “ABA Guarantees Paper”, which embraces the arm’s length principle (“the independent market price is generally the conceptual North Star”⁸⁶⁵), sets out the pros and cons for what is termed the “no affiliation” model (passive association ignored – as if the borrower had no “upper-tier” affiliations) and the “market/affiliation” model (passive association taken into account in pricing).

4.64 Proponents of the “no affiliation” model assert that the arm’s length principle requires related party relationships to be disregarded; as passive association benefits arise from such relationships, they too must be disregarded. Leaving aside argumentation based upon the specificities of US domestic tax law⁸⁶⁶, the “no affiliation” model is said to be based on the following propositions⁸⁶⁷:

(i) the “separate entity approach” promoted by the TPG⁸⁶⁸ “requires that benefits flowing from affiliation that represent disguised transfers of value be disregarded in an arm’s length analysis”: in my view, this represents an unwarranted extension of the proposition that distorting pricing effects caused by the control relationship should be disregarded; the passive association phenomenon does not necessarily entail any *transfer* of value, let alone a “disguised” transfer (though perhaps there is a nod here to the policy argument for reallocating profits from synergy benefits, see e.g. paragraph 4.59);

⁸⁶⁵ Page 50.

⁸⁶⁶ Including an argument based upon consistency with “the conceptual framework for debt/equity determinations” – which must refer to US tax law (otherwise: whose framework?).

⁸⁶⁷ ABA Guarantees Paper (2012) pages 56-57, and a “rejoinder” to the “market/affiliation” approach at pages 59-60.

⁸⁶⁸ Paragraph 1.6.

(ii) where a parent company guarantor is perceived as the source of implicit support for a subsidiary borrower, it is not comparable to a third party guarantor – it cannot itself hope someone else will step in to support the borrower; ignoring the effect of passive association thus adjusts for this non-comparability. This is the “reverse out implicit support” argument – see e.g. Wittendorff, paragraph 4.49(i) above;

(iii) disregarding the benefit to (typically) a subsidiary borrower of passive association (by refraining from suppressing the price of the parent guarantee) effectively compensates the parent for any economic cost it suffers; but (I respond) this is an economic policy proposition which is at odds with paragraph 7.13 TPG;

(iv) third party guarantees in “real-world markets” are rare, and so do not present realistically available options to a borrower subsidiary (but this seems empirically weak: certainly there are many contexts where third party guarantees – typically given by banks⁸⁶⁹ – can be found, and analogues are available in the monoline and surety bond insurance markets; in any event, in the loan context there are typically plentiful comparables available);

(v) often a parent company will undertake some affirmative act e.g. providing a “comfort letter”, indicating support of a subsidiary; the absence of such action (where only implicit support can be present) is said to be an artificial distinction – but (as I propose at paragraph 1.5 on the meaning of “passive association”, and at paragraph 2.41 as to the scope of “services” for transfer pricing purposes) the presence of parental *activity* (however low-key) is a threshold condition for assessing compensation for the support, so the distinction is fundamental and not at all artificial;

(vi) (related to (iii) above) as an economic matter, disregarding passive association is appropriate because it effectively rewards the parent company (assumed to be the provider of support) for the borrower subsidiary’s “use” of an

⁸⁶⁹ An example is found in *The Queen v Melford Developments Inc* [1982] 2 SCR 504, concerning the deductibility of a 1% p.a. guarantee fee paid by the taxpayer to a German bank for a guarantee of the taxpayer’s borrowing from Bank of Nova Scotia.

asset of parent's, namely its financial standing (compare paragraphs 4.49(v), 4.52(ii) above).

4.65 Those supporting the “market/affiliation” approach are said to argue as follows:

(i) fundamentally, evaluating a loan/guarantee transaction by taking account of all the borrower's attributes (including benefits from passive association) applies the arm's length standard “taking the borrower as it is and marketplace realities as they are”⁸⁷⁰, and taking account of all relevant factors. The “separate entity” approach in TPG paragraph 1.6 does not require that the borrower's affiliations be ignored⁸⁷¹. The subsidiary may still be considered to be affiliated to a comparable (hypothetical) parent, not “treating a child with parents as if she were an orphan ... [but] simply ... as being the ‘child’ of someone else”;

(ii) the approach is consistent with the “options realistically available” principle (paragraph 2.25 above): a controlled subsidiary borrower would never pay more for a guarantee from its parent than one available from an independent third party; equally, I propose, a subsidiary should never pay more for a loan from its parent than it would for an equivalent loan available from an unrelated lender;

(iii) requiring a parental guarantee to be priced on a basis which ignores implicit support effectively remunerates the parent for this attribute (as commended at paragraph 4.64(vi) above); but this offends the rule in TPG paragraph 7.13 that passive association should not give rise to remuneration.

4.66 The ABA Guarantees Paper also discusses “adjustments for supposed benefits to the guarantor”, noting that “some tax authorities have taken the position – rarely seconded by commentators or practitioners – that the transfer pricing analysis of a related party guarantee must involve a two-step process” i.e. first determine the arm's length price of the guarantee and then “adjust” that price to account for “benefits supposedly flowing back to the related party guarantor”.

⁸⁷⁰ Page 57.

⁸⁷¹ Page 59.

Each of the potential benefits is discussed and dismissed, with the concluding – and in the context of this study, telling – rhetorical question: “[i]f the guarantee reflects an arm’s length price, why should it matter to whom it is paid?”⁸⁷²

4.67 Boidman (2011) presents the cases for and against accounting for implicit support, but evidently has some sympathies with the “against” camp – so I have included my reactions to his article here. First, a distorting effect on the arm’s length principle is perceived if implicit support is to be recognised, because “arm’s length profit allocations require that each unit of a multinational enterprise be rewarded commensurate with its contribution”⁸⁷³. A comparative example is given of a parent selling highly branded goods to a subsidiary distributor, and the question is asked (though dismissed out of hand) whether the subsidiary should be able to argue that the transfer price must be reduced because once it owns the goods it should be highly rewarded “as owner” of the goods. Is this different from taking into account passive association? I would say it clearly is very different, not least because of the markedly different contexts, and also because the goods case entails simple and clearly-defined actions by the related parties, not mere passivity.

4.68 An important legal concept which seems not to have attracted attention in the literature is the equitable doctrine of *subrogation* i.e. a guarantor’s right, as a consequence of its payment under a guarantee in respect of a debtor’s defaulted obligation, to step into the shoes of the creditor vis-à-vis the debtor. Boidman challenges whether a third party would typically provide a guarantee at all: “[i]s the acid test whether a third party financial institution lender or guarantor that is not laying off (syndicating out) the credit risk would reduce the financing charges to a borrower by reason of implicit support?”⁸⁷⁴ But third party guarantees do exist in the commercial world, and the doctrine of subrogation contributes to their viability as a financial instrument. Opponents of the recognition of passive support in the guarantee context urge that a third party would not place any (or

⁸⁷² Pages 61-63.

⁸⁷³ *Basic Issues and Factors* section.

⁸⁷⁴ *The FCA Position and a Push-Pull Dynamic* section.

any significant) reliance upon implicit support because the parent company “generally would prefer to have the third party guarantor pay the subsidiary’s creditors”⁸⁷⁵; put another way, an attempt to get a third party guarantor “suggests the parent company is not willing to support the subsidiary”⁸⁷⁶. But this does not follow, at least in a typical common law environment, specifically in view of the guarantor’s right of subrogation. Once the guarantor has paid out, it will enjoy essentially the same rights against the (subsidiary) borrower as had the previous creditor. So (although it is possible that market visibility of the group’s predicament may be lessened) the parent is still faced with the dilemma of whether to support or abandon its subsidiary, and might in appropriate circumstances indeed “come running in to save the hide of the guarantor”⁸⁷⁷. Anyway, the same dynamic is not present in the case of simple loans, where only two parties are present and the comparability exercise is uncluttered by the involvement of a third.

4.69 Boidman criticises the Federal Court of Appeal in *General Electric*⁸⁷⁸ for reasoning from the *GlaxoSmithKline* decision⁸⁷⁹ that, if the intercompany licence from the UK parent in that case was to be taken into account in setting the price payable to the taxpayer’s Swiss affiliate for active pharmaceutical ingredient, then so should implicit parental support in *General Electric*. This is said (correctly in my view) to be a flawed analogy because, whereas in *Glaxo* the taxpayer’s conduct was readily comparable with the behaviour of market participants, implicit support does not arise between unrelated parties. This flawed analogy is said to call into question the Court’s conclusion on implicit support. But while the analogy may be poor, that does not seem to me to undermine the reasoning as a whole of the Court in *General Electric*.

⁸⁷⁵ Blessing (2011), page 160. See also the 30 September 2013 comments of the US National Foreign Trade Council on the OECD’s 2013 discussion draft on Intangibles: “[a] third party guarantor would not take into account the ‘implicit support’ provided by P [parent company in respect of its subsidiary’s debt] because P is unlikely to provide such support once the guarantee is in place”. For public comments website see note 163 above.

⁸⁷⁶ Moses (2010), reporting comments of Jean-Paul van den Berg (referred to in Boidman (2011)).

⁸⁷⁷ Boidman (2011), *Other Background Factors* section.

⁸⁷⁸ 2010 FCA 344, paragraph 3.16ff above.

⁸⁷⁹ In the same Court, 2010 FCA 201, the Supreme Court not then having heard the case.

4.70 Of course, as Boidman observes, it is entirely possible that a third party guarantor, when invited to assume implicit support, would ask for that to be put in writing. As discussed at paragraphs 1.8 and 2.41, however, that would turn the parent’s actions into a potentially compensable activity – thus presenting a straightforward answer to the transfer pricing enquiry.

4.71 Averyanova and Sampat (2015) present a very recent overview of opinion differences concerning the recognition of passive association. They note the divergent views of tax authorities⁸⁸⁰ and practitioners, including those who focus on stand-alone credit analysis, supposedly based on paragraph 1.6 TPG⁸⁸¹. They think that what they call the “function-of-the-group-affiliation” approach remains “questionable” in the light of the TPG, and thus potentially not applicable to the pricing of an explicit guarantee⁸⁸²; thus they plead the “necessity of additional clarifications”⁸⁸³.

Conclusions

4.72 Here are my summary conclusions drawn from the literature described above (putting aside further discussion of economic policy advocacy):

- (i) while passive association does not obviously give rise to “synergy rents” for the benefit of a MNE group, in any event it may be argued that such profits do not fall to be allocated by the arm’s length principle (Kane (2014)) – and MNE group synergies are now firmly recognised by the OECD as a comparability issue in Chapter I TPG;
- (ii) the independent entities hypothesis mandated by Article 9(1) MTC requires one to postulate a hypothetical transaction between hypothetical independent enterprises – but with the same characteristics as the actual parties to the

⁸⁸⁰ “So far, most countries have applied a stand-alone analysis to ascertain the arm’s length interest rate for intra-group debt”: page 368, quoting Burnett (2014) page 47.

⁸⁸¹ Page 363.

⁸⁸² Page 366, presumably analogous to the “market/affiliation” approach, paragraph 4.65 above, contrary to the conclusion in *General Electric*, paragraph 3.16ff above.

⁸⁸³ Page 368.

controlled transaction (Hollas and Hands (2014)); this resolves the “lender as guarantor” paradox (objected to by Blessing (2010) and Wittendorff (2011));

- (iii) while arm’s length and market value prices respectively may not necessarily be identical, it is apparent that the “market” is strongly influential in conditioning the prices that may be expected between the hypothetical independent enterprises (Hamaekers (1997, 2002));
- (iv) the essential tax treaty purpose of achieving *parity* between controlled and uncontrolled taxpayers (Schön 2009-10) as an aspect of the *neutrality* principle (Hamaekers (1992)) informs the process of comparability analysis; thus if, empirically, third parties would accord pricing significance to passive association, controlled transaction pricing should do likewise;
- (v) the independent enterprises hypothesis operates by eliminating pricing distortions caused by or attributable to a control relationship (Rollinson and Frisch (1988); Wilkie (2012)); it is not necessary (and would contravene the requirement to postulate similar circumstances) to eliminate all aspects or consequences of affiliation (Nielsen and Holmes (2010); Brooks (2013); *per contra* Vincent (2010));
- (vi) notions of the “use” by a group member of implicit support eroding an asset of the “provider” or causing a consolidated ratings deterioration or providing a “free ride” (Blessing (2010) and Wittendorff (2011)) are not based on legal or transactional foundations, so should not distract from an empirical factual focus (and, in any event, according to the express direction of Chapter I TPG, should not merit compensation).

5. SUMMARY OF CONCLUSIONS

*“There is a need to find an answer to all transfer pricing problems.”*⁸⁸⁴

5.1 Any differences between national approaches to the recognition of passive association in pricing controlled transactions will tend to result in double taxation, or possibly double non-taxation. Double taxation is axiomatically a bad thing; there is growing acceptance in modern times that double non-taxation is itself a social ill. Ultimately therefore the aim must be to eliminate differences between national treatments so that tax operates symmetrically across borders. With this objective in mind, the foregoing analysis of supranational guidance and selected national legislation, judicial interpretation and tax authority practice represents an attempt to identify some relevant common guiding themes in the application of the internationally accepted and defended arm’s length standard.

5.2 Let me attempt to summarise those key themes, and the momentum which, in my view, they provide in establishing the legal validity of the recognition of passive association in pricing controlled transactions.

5.3 ***Comparability analysis*** is fundamental to arriving at arm’s length pricing. Internal CUPs, where available, will often present the best evidence of the price appropriate to a (truly comparable) controlled transaction. The essence of comparability is the alignment (including by adjustment if required) of both the transaction under review, and the circumstances of the parties, with one or more independent comparables. The emphasis on the *circumstances* of the parties is critical. The starting point must be that it is appropriate to take into account *all* circumstances in order to draw an accurate comparison. The effect of passive association on a party is self-evidently one of the characteristics and thus circumstances of that party.

5.4 Comparability analysis requires the postulation of two hypothetical parties who are independent of one another – at least in control terms – but which

⁸⁸⁴ An existential proposition from ATO Taxation Ruling TR 97/20 Chapter 3, section E.

have the same characteristics and circumstances as the actual parties. Therefore e.g. in a lending context one should have regard to all the characteristics of the borrower (highly relevant to loan pricing), and indeed all the characteristics of the lender (relevant to loan pricing in a relatively limited way⁸⁸⁵). In principle, the independence hypothesis should result in the analysis excluding pricing distortions attributable to the exercise of control which affect the making or imposition of the conditions. But that need not result in group membership attributes being disregarded.

5.5 *Eliminate distortions caused by the control relationship.* A fundamental objective of the arm's length principle is *parity* between controlled taxpayers and independent parties. Within a MNE group a controlling parent company can *impose* non-arm's length behaviour on its subsidiaries, including off-market pricing of transactions. This presents the risk of tax avoidance via the *diversion* of profits (noted in this context by Mitchell B. Carroll even in the 1930s⁸⁸⁶); it is this phenomenon that is to be counteracted by transfer pricing rules. Therefore the task that those rules must perform is the elimination of transactional pricing *distortions* which are *caused by or attributable to* the control relationship. Transfer pricing operates by deeming a controlled transaction to have occurred on arm's length terms. Thus a legal fiction is imposed on the taxpayer. In arriving at the fictional/deemed outcome, and applying a careful purposive approach to tax treaty interpretation, there is no need to extend the legal hypothesis beyond what is demanded by the task of eliminating distortions. From another viewpoint, there is no legal mandate in Article 9(1) OECD MTC and its analogues for eliminating

⁸⁸⁵ A word here about the relevance of the characteristics of lenders in a loan context. Different lenders have different characteristics which may affect pricing at the edges e.g. a bank's cost of capital and market/shareholder requirements for return on equity compared with unregulated lenders e.g. investors in the capital markets, bank depositors or crowd-funders. On the other hand, in straightforward cases of conventional loans in home market currency, the market is highly competitive and transparent, and borrowers may be largely indifferent to lender internal considerations, simply looking for the best deal, assuming that the overall "service" is the same. To that extent lender characteristics are likely to play only a small role, if at all, in the comparability analysis. In the Canadian *McKesson* decision (see paragraph 3.32 above) the judge considered it highly doubtful that an arm's length receivables seller would settle upon a discount rate by reference to the buyer's cost of funds. In the Australian *Chevron* case (paragraph 3.82 above), evidence was presented contending that attributes of lenders are relatively unimportant.

⁸⁸⁶ See Vögel (2015) page 608.

from consideration all characteristics of a party which are in any way attributable to or connected with affiliation. Moreover, “distortion” of pricing necessarily implies active manipulation of the control relationship. This proposition resonates with the OECD’s modern use of the phrase “deliberate concerted actions” in the context of its discussion of MNE group synergies (see paragraph 2.81 above).

5.6 ***Options realistically available.*** Commercial arm’s length behaviour naturally entails looking for the best possible bargain. Thus businesses should consider all the “options realistically available” to them and generally choose the most attractive of those. In circumstances where a taxpayer entity, which is the beneficiary of passive association, could enter into a transaction with an independent third party on certain terms (which take into account that association), it would be perverse to require that the characteristic of the taxpayer attributable to affiliation be disregarded so as to demand a higher controlled transaction price for tax purposes.

5.7 ***Hypothetical parties to the comparator transaction.*** There is remarkably little jurisprudence as to the nature or identity of the “independent” parties to a comparator transaction. What seems convincing, and is at least consistent with the law and practice reviewed in this thesis, is that the parties to the hypothetical transaction posited by Article 9(1) are indeed hypothetical parties. Yet for this to present a workable framework for comparability analysis, those parties must have the *same characteristics* as the parties to the controlled transaction. An important example characteristic is relative bargaining power. But this is just one from an infinite menu of attributes. Where characteristics are relevant to pricing, they should be imputed to the hypothetical parties to the independent transaction with which the controlled transaction is to be compared. The effects of passive association are no less valid a characteristic to be taken into account than any other. When one party to a transaction assumes performance risk (typically contractual) on the other, the attributes of that other party become fundamental to pricing. In the paradigm case of lending, creditworthiness of the borrower is the critical factor. A market assumption or expectation of group support for the borrower, where present, will be an aspect of the creditworthiness analysis.

5.8 *No compensation for the effects of passive association.* This has long been implicit in paragraph 7.13 TPG and has now become an explicit injunction in the update of Chapter I TPG⁸⁸⁷. Logically it should follow that failing to recognise passive association (at least where it would suppress pricing) is tantamount to “charging for it”. See paragraph 2.46 above.

5.9 Thus I arrive at an answer to the question posed at the beginning of this study. At paragraph 1.12 I asked: “In assessing a comparable uncontrolled price (*CUP*), to what extent is the *control* relationship to be disregarded? This is at the centre of the paradox: one must construct an arm’s length comparator, but take into account all economically relevant circumstances, some of which may be consequent upon group affiliations.” The answer, and the resolution of the paradox, is that the control relationship must be disregarded to the extent, but only to the extent, that it has had the effect of distorting the pricing of a controlled transaction.

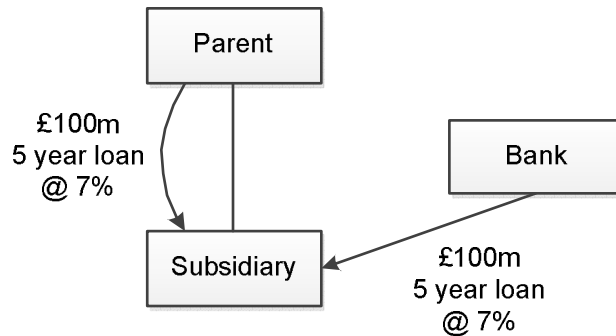
5.10 It should follow from the above that there is no conceptual barrier to recognising passive association in a case where a parent company is both lender to its subsidiary and the presumed source of implicit financial support to that subsidiary (the “lender as guarantor” case). The comparability exercise can readily impute all the characteristics of the respective parties to the hypothetical independent parties (including the borrower’s benefit from implicit support). It need simply eliminate pricing distortions to the conditions of the actual (controlled) loan made or imposed, typically, by a parent upon a subsidiary. For those who object to the apparent “free ride” (upon the parent’s balance sheet) enjoyed by the subsidiary, my response is simply that this is one factor in the overall factual matrix and, in the context of a MNE group, is a “fact of life” – just as a hope or expectation of financial support from a parent may be present in many families.

5.11 A simple example provides a telling insight into the “right” answer. See Fig. X below. This is closely based on (but is a simplification of) Example 1

⁸⁸⁷ New paragraph 1.158.

now included in the “group synergies” section of Chapter I TPG (see paragraph 2.83 above), that new material itself representing a significant step towards clarity on the topic of passive association.

Fig. X



5.12 Subsidiary has just borrowed an unsecured loan of £100m for general corporate purposes from an independent bank lender for 5 years at 7% p.a. on certain conventional commercial terms, including typical negative pledge and financial ratio covenants, events of default and comprehensive information provision obligations. Bank has priced the loan having some regard to Subsidiary’s affiliation with Parent: without that element, Bank would have sought 8%. Subsidiary retains plentiful borrowing capacity. Parent now proposes to lend Subsidiary £100m on exactly identical terms, but conscientiously asks itself whether to charge 7% by reference to the seemingly robust internal comparable, or 8% on the theory that affiliation should be disregarded. (Suppose further, for added spice, that Subsidiary is resident in a high tax territory with an aggressive tax authority, whereas Parent is located in a sandy tax haven.⁸⁸⁸) Having regard to Subsidiary’s realistically available options, and the commercial need for it not to pay more to its affiliate than the price it could find in the marketplace, surely the right rate is 7%?

5.13 I noted at paragraph 1.20 above that there is a thin capitalisation aspect to this study. In other words, just as one may enquire whether passive association

⁸⁸⁸ These are of course intellectually irrelevant considerations.

may influence the pricing of a loan (essentially, its interest rate), it is legitimate to ask whether passive association may affect borrowing capacity – the ability, on an arm’s length basis, to raise a certain quantum of debt⁸⁸⁹. I have noted how the United Kingdom’s HMRC, while beginning to get used to the idea of passive association pricing effects, are resistant to the debt capacity proposition⁸⁹⁰. But it seems to me that, at least where national transfer pricing codes address thin capitalisation by means of application of the arm’s length principle – as does the UK’s – rather than by formulaic ratios or similar, then once the pricing impact of implicit support is accepted, it is logically irresistible that an independent lender, cognisant of implicit parental support for a borrower, could be prepared to lend more than would have been the case absent such support. HMRC has never explained its position satisfactorily: in my view this is because there is no such explanation.

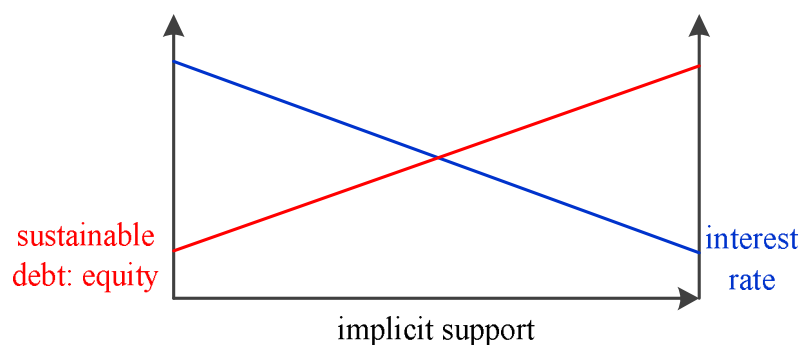
5.14 Convincingly, “increased borrowing capacity” now features expressly in Chapter I TPG as a “group synergy” (see paragraph 2.81 above). Moreover, and although one should be cautious of “banker’s letters” as evidence of what would actually happen at arm’s length, in my own recent (October 2014) professional experience a highly reputable banking institution was prepared to confirm in writing its willingness to lend a certain amount to a relatively weak subsidiary in the light of various objective indicia of group affiliations (e.g. commonality of directors, use of the group name, centrality to the overall group business). By the way, to illustrate the non-partisan nature of this study, the directionally opposite effects of implicit support on sustainable debt quantum and interest rate, respectively, are illustrated in Fig. XI below. But remember that “interest rate is influenced by debt amount and *vice versa*: the two concepts cannot

⁸⁸⁹ In their 30 September 2013 comments on the OECD’s 2013 discussion draft on Intangibles (see note 163 above), the International Alliance for Principled Taxation noted that “if implicit parental support is relevant to the pricing of financial transactions, then it should be taken into account not only in the interest rate but also in the quantum of debt a borrower can support”.

⁸⁹⁰ Paragraph 3.188 above. One must acknowledge however that the particular terms of domestic law may bear upon the recognition of passive association e.g. the UK’s sections 152-154 TIOPA discussed at paragraph 3.158 above; query whether the requirement found there to disregard “guarantees” should give way to a double tax treaty provision based on Article 9(1) MTC: see paragraph 2.7 above.

be separated”⁸⁹¹. Thus for a given rating, say AA, in principle incrementally greater gearing could (up to a point) be supported by an incrementally greater interest rate.

Fig. XI



5.15 In conclusion it can be observed that the recognition of passive association in pricing controlled transactions should be regarded as a correct application of the arm’s length principle as embodied in Article 9(1) OECD MTC. In the financing field, such recognition should extend to the evaluation of debt capacity (quantum) as well as to interest rates and guarantee fees (pricing). A principled judicial recognition of the pricing effect of implicit support is found in the Canadian *General Electric* case, and has emerged in Australian legislation and litigation (*Chevron*); New Zealand can be expected to follow suit. Despite a long-unfulfilled IRS promise of clarification, the section 482 Services Regulations at least provide for comparability adjustments based on group affiliations. It is only a matter of time before taxpayer or Government advances implicit support to further a case in Indian transfer pricing litigation. HMRC have accepted that passive association may influence loan pricing (although they are not yet convinced on quantum). Several other countries around the world are falling into line.

⁸⁹¹ Burnett (2014) page 62.

5.16 With these conclusions in mind, I have offered in the Annex which follows some recommendations for amendments to the OECD TPG.

ANNEX

PRINCIPLES FOR USE BY TAXPAYERS AND TAX ADMINISTRATIONS

The first Annex to the TPG contains Guidelines for Monitoring Procedures on the OECD Transfer Pricing Guidelines and the Involvement of the Business Community. The CFA is instructed to monitor implementation of the TPG, including identifying areas where the TPG may require amendments or additions including “difficult paradigms” and problem areas which present obstacles to an internationally consistent application of the transfer pricing methods set out in the TPG.

Proposals:

Add a paragraph following paragraph 1.113 TPG⁸⁹² as follows:

“1.113A As noted at paragraph 1.36 above, the economic circumstances of the parties are also comparability factors. Attributes or comparability factors that may be important when determining comparability include all the characteristics of the parties (including circumstances attributable to their group affiliations), and the business strategies pursued by the parties. In taking into account group affiliations as characteristics of the parties, relationships within the group may be included in the analysis (though in determining the price that would have been paid between independent enterprises, pricing distortions attributable to such relationships must be eliminated).”

Add to paragraph 1.163 (“Comparability adjustments may be warranted to account for group synergies.”):

“This may be the case where a potentially comparable transaction does not itself take account of relevant group synergies. One purpose of comparability

⁸⁹² As updated in the BEPS 2015 Final Reports.

adjustments is to align the circumstances and characteristics of the parties to the potential comparable transaction with those of the parties to the transaction between the associated enterprises. So if, for example, an external comparable transaction in fact does not reflect any pricing effect attributable to group affiliation, but a party to the controlled transaction would be expected to enjoy a pricing advantage (or suffer a disadvantage) attributable solely to its being part of a larger MNE group (as described in paragraph 7.13), the pricing of the external comparable should be adjusted to align the transaction in this respect with the circumstances and characteristics of the parties to the controlled transaction. On the other hand, if an internal comparable transaction is priced with regard to such group affiliation, that transaction will, in that respect, provide appropriate comparability for the controlled transaction (as in Example 1 below).”

Add a new Example 3 (and renumber the subsequent Examples accordingly):

“The facts relating to S’s credit standing are identical to those in Example 1. On a stand-alone basis, S would only be able to sustain a debt:equity ratio of 3:1. The independent lender, however, is prepared to advance the Euro 50 million despite S’s debt:equity ratio becoming 4:1, on the basis of some degree of expectation (not backed by any guarantee or other assurance) that P would support S if S faced financial difficulties. In other words, S benefits, in the context of an arm’s length transaction, from an increased borrowing capacity solely by virtue of group affiliation. In these circumstances, the loan by T to S should be regarded as a loan to a borrower with an arm’s length quantum of debt; and, as in Example 1, no payment or comparability adjustment is required for the group synergy benefit.”

Amend Chapter III TPG as follows:

Amend paragraph 3.48 by the addition of the underlined wording as follows:

“Examples of comparability adjustments include ... adjustments for differences in capital, functions, assets, risks and the characteristics or circumstances of the parties including characteristics attributable to their group affiliations.”

Amend Chapter IV TPG as follows:

Amend paragraph 4.29 by the addition of the underlined wording as follows:

“The mutual agreement procedure ... described and authorised by Article 25 of the OECD Model Tax Convention, can be used to eliminate double taxation that could arise from a transfer pricing adjustment, including cases where the respective tax administrations might differ in their interpretation of, or of the application of, the arm’s length principle. Agreement between administrations could be specific to a particular taxpayer’s case, or a matter of agreeing an interpretation of the relevant treaty in general (as contemplated by Article 31(3)(a) of the Vienna Convention on the Law of Treaties).”

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