



JÖNKÖPING INTERNATIONAL
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The Revised Chapters I-III of the OECD Transfer Pricing Guidelines

A Comparative Analysis of the Changes and the US Transfer Pricing Regulations

Master Thesis in Tax Law (Transfer Pricing)

Author: Petronella Suhr

Tutors: Giammarco Cottani and Camilla Hallbäck

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| Author: | Petronella Suhr |
| Tutor: | Giammarco Cottani and Camilla Hallbäck |
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Abstract

In 2010 the OECD approved the new Transfer Pricing Guidelines. The transactional profit methods were earlier only recommended as last resort methods, which is changed now. However, the same hierarchy regarding the selection of an appropriate transfer pricing method remains, as the new Guidelines express that the CUP method is the most reliable method followed by the other traditional transaction methods.

The OECD now promotes that the most appropriate method must be chosen after comparing the different methods together with the availability of reasonable and reliably information. This standard has got criticism for being similar to the US best method rule. Both aim to find the most reliable method when determining an arm's length price. The best method rule requires the taxpayer to do an exhaustive analysis of each relevant method. Contrary, the OECD express that it is not necessary to do an in-depth analysis of each method or to prove that a particular method is inappropriate. The most appropriate method rule gives less administrative burden on the taxpayer than the best method rule.

A tricky issue is the valuation of intangibles and to foresee the future profits, due to the lack of comparables and proper valuation methods. The OECD and the US tackle this problem differently. The US has a rule that the transfers of intangibles has to be commensurate with income, allowing the IRS to make periodical adjustments if the actual profits differ from the projections. The OECD approaches hindsight on intangibles in accordance with the arm's length principle, since they only allow retroactive adjustments if independent

enterprises would do that under similar circumstances, and stress the importance of avoiding hindsight.

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Abbreviation List

| | |
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| CPM | Comparable Profits Method |
| CUP | Comparable Uncontrolled Price |
| CUT | Comparable Uncontrolled Transaction |
| e.g. | <i>exempli gratia</i> |
| etc. | <i>et cetera</i> |
| Id. | Identical |
| i.e. | <i>id est</i> |
| IRS | Internal Revenue Service |
| OECD | Organization for Economic Cooperation and Development |
| p. | page |
| para | paragraph |
| US | United States of America |

I Introduction

I.1 Background

With the increased globalization, companies have grown internationally and cross-border intra-group transactions take place with increasing frequency. Approximately 70 % of all the cross-border trade in the world take place between related enterprises.¹ Multinational group companies that transfer goods or services within the group may, for tax purposes, set prices that differ from what they would set to similar uncontrolled transactions. The tax authorities want to ensure that the profits from the multinational enterprises are not shifted out from their jurisdiction, which would result in losses of important tax revenues. This issue has resulted in countries enacting transfer pricing legislation with the attempt to render the usage of tax avoidance activities more difficult.² The purpose of the transfer pricing legislation is to guarantee the proper apportionment of taxable income among the countries involved in the transaction and to avoid double taxation.³ The leading actors in transfer pricing regulation in the world are the United States of America (US) and the Organization for Economic Cooperation and Development (OECD).

The standard to assess transfer prices, the arm's length principle, was introduced already in the 1930s in the US.⁴ They feared that tax profits belonging to their jurisdiction would be moved out to lower taxed jurisdictions. If the transfer price would not match the arm's length principle the US tax administration would adjust it.⁵ The arm's length principle is the international standard that the OECD member countries have agreed to be used for determining transfer prices for tax purposes.⁶ The wide acceptance of this method in most

¹ Hubert Hamaekers, *Arm's Length – how long?*, International Transfer Pricing Journal, 2001, No. 2, p. 30.

² Monica Boos, *International Transfer Pricing – The Valuation of Intangible Assets*, Kluwer Law International, The Hague, 2003, p. 2.

³ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995, Preface, para 7.

⁴ 1935 Treasury Regulations, Section 45-1(b).

⁵ Hubert Hamaekers, *Arm's Length – how long?*, International Transfer Pricing Journal, 2001, No. 2, p. 30.

⁶ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, Glossary, 'Arm's length principle'.

countries in the world has, however, significant disagreements over the way the arm's length method should be applied in practice.⁷

The OECD started to include the arm's length principle in the Model Convention for the avoidance of double taxation in the 1963 version. To ensure that the tax base of multinational enterprises are allocated fairly and to avoid double taxation, the OECD has made Guidelines on how to set transfer prices at an arm's length. The first guidance was issued 1979 by the Committee on Fiscal Affairs and the Council of Ministers of the OECD as a report.⁸ This report contained three different transfer pricing methods: the comparable uncontrolled price method (CUP), the cost-plus method and the resale price method (also referred to as the traditional transaction methods).

The OECD Transfer Pricing Guidelines were significantly revised and updated in 1995, and presented five different transfer pricing methods to determine an arm's length price. This change was also followed because of the development in the US transfer pricing regulations. These five methods contained the traditional transaction methods as in the report from 1979 and two new ones, the profit split method and the transactional net margin method (also referred to as the transactional profit methods).⁹ The traditional transaction methods were preferred to be used as transfer pricing methods and the transactional profit methods were only to be used as last resort methods in exceptional cases.¹⁰ However, in many cases the traditional transaction methods were difficult to apply due to the uniqueness of the goods or services and, more in particular, because of the lack of reliable comparable third party data information.

The US is also a member of the OECD. However, some of the transfer pricing rules that they apply are inconsistent with the OECD Transfer Pricing Guidelines.¹¹ The US also recommend the traditional transaction methods to determine the arm's length price, but the CUP method is referred as the comparable uncontrolled transaction method (CUT) in the

⁷ Brian J. Arnold and Michael J McIntyre, *International Tax Primer*, 2nd Edition, Kluwer Law International, The Hague, 2002, p. 57.

⁸ OECD Report, *Transfer Pricing and Multinational Enterprises*, 1979.

⁹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995, Chapter III.

¹⁰ These five methods are further explained in chapter 2 of this master thesis.

¹¹ For example the commensurate with income standard that is described in chapter 5.4 in this master thesis.

US. Furthermore they recommend the comparable profits method (CPM), the profit split method and unspecified methods.¹² There is no internal hierarchy between these methods, instead the most reliable one has to be chosen, which is called the best method rule. The best method rule in the US implies that when available data enables that two or more methods can be applied on a comparable uncontrolled transaction, the method that gives the most reliable result should be used.¹³ In order to determine that, an in depth analysis of these methods has to be made.

The 22nd of July 2010 the OECD approved a new revised version of its Transfer Pricing Guidelines. The focus for the revision was the comparability analysis and the transactional profit methods.¹⁴ In particular, the purpose of the revision was to change the hierarchy of the transfer pricing methods and instead granting equal weight to the different methods.¹⁵ The most appropriate method must be chosen after comparing the different methods together with the availability of reasonable and reliably information. The 2010 version of the OECD Transfer Pricing Guidelines provides a more detailed guidance on assessing comparability, and has removed the status of *'last resort'* to the transactional profit methods that existed in the 1995 version.

Intangibles are often very unique in their features, which creates problems finding comparable transactions due to the lack of reliable third party data for these type of transactions. The risk of double taxation increases for this type of transfers, since it is harder for the taxpayer to prove that the transfer price is at arm's length. In the 1980s the US introduced a new rule to the US Internal Revenue Code, §482, that the arm's length consideration for transfers of intangibles has to be commensurate with income.¹⁶ This rule allows the Internal Revenue Service (IRS) to make periodical adjustments during a five-years period after the transfer if the actual profits differ from the profit projections.¹⁷ The commensurate

¹² Treasury Regulation §1.482-3(a)(1-6).

¹³ Jan Källqvist and Anders Köhlmark, *Internationella skattehandboken*, 6th Edition, Norstedts Juridik, Stockholm, 2007, p. 270.

¹⁴ Danny Oosterhoff, *Proposed Revision of OECD Transfer Pricing Guidelines: The Importance of Facts and Circumstances*, International Transfer Pricing Journal, 2010, No 1, p. 3.

¹⁵ Mayra O. Lucas Mas and Giammarco Cottani, *OECD Proposed Revision of Chapters I-III of the OECD Transfer Pricing Guidelines: Business Comments on Selected Issues*, International Transfer Pricing Journal, 2010, No 4, p. 239.

¹⁶ Treasury Regulation §1.482-4(f)(2)(i), this standard is further described in chapter 5.4 in this master thesis.

¹⁷ Treasury Regulation §1.482-4(f)(2)(ii)(E).

with income standard in the US implies that the actual amount of income that results from the use of the intangible over the long run should be the primary factor determining the royalty payments.¹⁸ These retroactive adjustments are a use of hindsight that the OECD wish to avoid and has a different viewpoint from the US regulations.¹⁹ The OECD approach regarding the use of hindsight in transactions involving intangibles may be found in chapter III and VI of the new Guidelines. This is a complex issue since regards both has to be taken from the perspective of the tax administrations to protect their tax revenues, as well as from the perspective of the taxpayer that needs certainty for the avoidance of future tax adjustments.

I.2 Purpose and Approach

The purpose of this master thesis is to analyse the differences in the light of the updated chapters I-III of the OECD Transfer Pricing Guidelines. This master thesis will focus on the following three matters:

- Is the hierarchy between the OECD recommended transfer pricing methods completely removed in the 2010 version of the Guidelines?
- How does the OECD's most appropriate method rule differ from the US's best method rule?
- Is the hindsight properly addressed in chapter III in the new Guidelines regarding intangible properties, and how does it differ from the commensurate with income standard in the US? Does it have a valid response or should it be addressed differently?

I.3 Method

The main method applied in this master thesis is the comparative method. It is comparative in the sense that the 2010 version of the OECD Transfer Pricing Guidelines is compared with the 1995 version, as well as with the US regulations regarding transfer pricing. The choice to compare the OECD Transfer Pricing Guidelines with the US regulation is because the US is a leading actor on the field of transfer pricing. Further, a descriptive method is also required to use in order to describe the legal systems, which then are analysed and compared.

¹⁸ Monica Boos, *International Transfer Pricing – The Valuation of Intangible Assets*, Kluwer Law International, The Hague, 2003, p. 103.

¹⁹ See more about this in chapter 5 of this master thesis.

The comparative method aims to compare different legal systems with the purpose of discovering their similarities or differences.²⁰ Even though the OECD Transfer Pricing Guidelines are not legally binding, the method could be used since the Guidelines are international soft law obligations that are used by most countries in the world as a guidance for their transfer pricing practices.²¹ It is the comparison that is the most important element of the comparative work.²² By using the comparative method the author strives to understand and analyse the similarities and differences between the 2010 version and the 1995 version of the Transfer Pricing Guidelines, as well as comparing parts of the new Guidelines with the US regulations on those transfer pricing matters.

When doing a comparative study, one must keep in mind that there are difficulties with the acquisition of knowledge of foreign law.²³ As parts of US transfer pricing regulations are compared and analysed in this master thesis, the reader should keep in mind that the author is not educated in American law. This is an obstacle that many comparative studies has. To make a comparative study credible the author must make every effort to learn and remember as much as possible about the foreign civilization and legal framework in order to best understand the law.²⁴ The author strives to do this in order to best overcome this obstacle.

The member countries of the OECD are encouraged to follow the Transfer Pricing Guidelines in their domestic transfer pricing practices,²⁵ hence they are not legally binding. Neither is the OECD model convention.²⁶ Nevertheless, due to their strong influence on the transfer pricing arena and that many member countries follows these Guidelines and the model convention, they have a high value as a legal source when writing a master thesis from an international perspective.

²⁰ Michael Bogdan, *Comparative Law*, Kluwer Law and Taxation Publishers, 1994, p. 18.

²¹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, Preface, para 16.

²² Michael Bogdan, *Comparative Law*, Kluwer Law and Taxation Publishers, 1994, p. 20.

²³ Michael Bogdan, *Comparative Law*, Kluwer Law and Taxation Publishers, 1994, p. 20.

²⁴ Konrad Zweigert and Hein Kötz, *An Introduction to Comparative Law*, Third Edition, Oxford University Press, p. 36.

²⁵ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, Preface, para 16.

²⁶ OECD Recommendation (1997), Recommendation of the OECD Council Concerning the Model Tax Convention on Income and Capital.

An international approach is held through this entire master thesis. Hence, no national law is analysed other than selected US regulations that are compared to the OECD materials. Due to the international approach to the transfer pricing rules, international sources are mainly used. The OECD materials, such as the Transfer Pricing Guidelines, have been collected from the OECD iLibrary.²⁷ The US regulations, such as the US Treasury Regulation, have been collected from the IRS webpage, which is the official government webpage of the US tax administration.²⁸ The credibility of these sources are therefore high. These are the main sources applied.

The OECD published a proposal of the revision in 2009, which is almost the same as the approved version. This proposal was open for comments during 2010. These comments and articles about the proposal are also analysed and used to find answers to the questions addressed in this master thesis. For the descriptive part of this master thesis, legal doctrine on the area of transfer pricing is also used, for the purpose of further understanding of the OECD Transfer Pricing Guidelines and the US regulations.

I.4 Delimitation

This master thesis focuses mainly on chapter I-III and parts of chapter VI of the OECD Transfer Pricing Guidelines, hence changes in the other chapters will be omitted. This master thesis is written towards those with some background knowledge within the area of transfer pricing, thus the concept of transfer pricing is only explained briefly in the background. Due to the international approach of this master thesis, national law, except from the US regulation, that differ from the OECD's recommendations will not be taken into consideration. The OECD Transfer Pricing Guidelines value as a source of law can be questioned as mentioned in the method, however, it will not be further discussed in this master thesis. Furthermore, the thesis is written from a legal perspective and will avoid economical analysis.

I.5 Outline

Chapter 1 The first chapter gives a background to the transfer pricing subject and establishes the purpose and the approach of this master thesis. It also de-

²⁷ www.oecd-ilibrary.org (2010-09-03).

²⁸ www.irs.gov (2010-09-30).

scribes the methodology used as well as delimitations. It ends with the outline of the master thesis.

- Chapter 2* The second chapter describes the arm's length principle and the OECD recognized methods to determine the arm's length prices. This chapter provides the reader with the basic information regarding the OECD's recommendations for the transfer pricing area in order to better understand the next chapter.
- Chapter 3* The third chapter illustrates the hierarchy of the different OECD recognized methods that existed in the 1995 version of the OECD Transfer Pricing Guidelines. Further on, this chapter explains the new standard of the most appropriate method rule, but also looks into whether the hierarchy still exist in the new version of the OECD Transfer Pricing Guidelines.
- Chapter 4* The fourth chapter compares the most appropriate method rule with the US standard of the best method rule. This chapter aims at finding the differences and similarities of these two standards.
- Chapter 5* The fifth chapter provides the reader with information regarding the problems of establishing the value pertaining to intangible property. This chapter compares the OECD's approach to the use of hindsight with the US standard of the commensurate with income.
- Chapter 6* Chapter six consists of a comparative analysis where the questions approached in this master thesis are analyzed further. This chapter aims to compare and contrast these questions together with the information given in the earlier chapters.
- Chapter 7* The last chapter gives the concrete conclusion to the questions addressed in this master thesis.

2 The Arm's Length Principle and the Transfer Pricing Methods

2.1 Introduction

This chapter will introduce the reader to the international transfer pricing standard, namely the arm's length principle. Both the 1995 and the 2010 versions of the OECD Transfer Pricing Guidelines use the arm's length principle as a guidance to determine the transfer prices. It is therefore important to go through this standard before comparing the two versions of the Guidelines.

In the new revised Guidelines all the transfer pricing methods are described in chapter II. In the 1995 version they were divided into two chapters, as the traditional transaction methods were described in chapter II and the transactional profit methods were described in chapter III. The change of placing them all in the same chapter is part of the removal of the hierarchy.²⁹

2.2 The Arm's Length Principle

The arm's length principle was first founded in the US, where it is referred to as the arm's length standard. However, the arm's length standard and the arm's length principle have the same meaning, i.e. that transfers between associated enterprises should have the same conditions as if they would be transferred between non-related enterprises under similar circumstances.³⁰

National rules regarding transfer pricing might differ from country to country. Because of these differences economic double taxation might arise. The purpose of article 9 in the OECD model Convention on Income and Capital³¹ is to eradicate such double taxation.³² Article 9 of the OECD Model Convention establishes the foundation of the comparability analysis, since it introduce a need for comparisons between conditions made within a group, and those that would be done in an uncontrolled transaction:

²⁹ Mayra O. Lucas Mas and Giammarco Cottani, *OECD Proposed Revision of Chapters I-III of the OECD Transfer Pricing Guidelines: Business Comments on Selected Issues*, International Transfer Pricing Journal, 2010, No 4, p. 240.

³⁰ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para. 1.6.

³¹ OECD (2010), *Model Tax Convention on Income and on Capital: Condensed Version 2010*, OECD Publishing.

³² Dahlberg, M., *Internationell beskattning*, 2nd edition, Studentlitteratur, Lund, 2007, p. 176.

[Where] ‘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 not so accrued, may be included in the profits of that enterprise and taxed accordingly’.³³

By applying the arm’s length principle to transfer prices, the profits are allocated as if the transaction would be made between independent enterprises under similar circumstances.³⁴ The purpose of the arm’s length principle is for that reason to achieve a fair share of multinational groups’ tax bases for all the tax jurisdictions where they operate by preventing manipulation of profits earned.³⁵ The arm’s length principle focuses on the nature of the transaction, and if the conditions differ from what would be set with an independent enterprise.³⁶ There are five different methods that the OECD recommends when determining the arm’s length principle, namely: the CUP method; the resale price method; the cost plus method; the transactional net margin method; and the transactional profit split method.³⁷ The arm’s length principle is advocated as the most appropriate way to determine the market value of a transaction.

One drawback with the arm’s length principle is that it may be difficult to apply on certain transactions that independent enterprises normally would not undertake.³⁸ Another disadvantage is that it may result in an administrative burden for both the taxpayer and the tax administration to collect all data about comparable transactions.³⁹ Opponents of the arm’s length principle argues that it does not reflect the economic reality of integrated multinational enterprises.⁴⁰

³³ OECD (2010), *Model Tax Convention on Income and on Capital: Condensed Version 2010*, OECD Publishing, Article 9, para 1.

³⁴ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para. 1.6.

³⁵ Angharad Miller and Lynne Oats, *Principles of International Taxation*, 2nd Edition, Tottel Publishing, West Sussex, 2009, p. 306.

³⁶ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para. 1.6.

³⁷ See more detailed information about these methods under chapter 2.3 and 2.4.

³⁸ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para. 1.11.

³⁹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para. 1.12-13.

⁴⁰ Monica Boos, *International Transfer Pricing – The Valuation of Intangible Assets*, Kluwer Law International, The Hague, 2003, p. 12.

2.3 The Traditional Transaction Methods

2.3.1 Comparable Uncontrolled Price Method

The CUP method compares the controlled transaction within the group with uncontrolled transactions between independent enterprises.⁴¹ There are two types of the CUP method, e.i. internal CUP and external CUP. The internal CUP compares the price charged in the controlled transaction with transactions between one of the parties and an uncontrolled transaction made with an independent enterprise.⁴² The external CUP compares transactions between two third parties, which neither of whom is a party to the controlled transaction.⁴³ As the internal CUP compares transactions that are more equal to the controlled transaction and there is no need to perform an external database search, it gives a more fair result, and is therefore preferred.⁴⁴

However, in order for this method to give a fair result there cannot be any differences between the compared transactions that would affect the price. If there are some minor differences the price could be reasonably adjusted to eliminate the material effects on the price of such differences.⁴⁵ OECD states in the Guidelines that this is the most direct and reliable method to apply when determining the arms length price.⁴⁶ There has not been any change in the description of the CUP method from the 1995 version to the 2010 version.⁴⁷

2.3.2 Resale Price Method

The resale price method focuses on the gross margin, i.e. the resale price margin. This is determined by looking at the price at which a product that has been purchased from an associated enterprise is sold to an independent enterprise. This price is then reduced by the gross margin, which should cover the selling and other operating expenses and, make an appropriate profit. The profit will depend on the assets used and the risk assumed. This

⁴¹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para. 2.13.

⁴² Adams, C. and Coombes, R., *Global Transfer Pricing: Principles and Practice*, LexisNexis, London, 2003, p. 16.

⁴³ Adams, C. and Coombes, R., *Global Transfer Pricing: Principles and Practice*, LexisNexis, London, 2003, p. 16.

⁴⁴ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 3.27.

⁴⁵ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.14.

⁴⁶ Id.

⁴⁷ See chapter II paras 2.6-2.13 of the 1995 version and chapter II paras 2.13-2.20 of the 2010 version of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

method is most useful in marketing and simple distribution operations.⁴⁸ Due to the character of gross compensation, differences in the product become less important and fewer adjustments will be required than with the CUP method.⁴⁹ The reliability of the resale price method might be affected when there are material differences in the ways associated enterprises and independent enterprises carry out their businesses.⁵⁰ The arm's length resale margin is easiest to determine where the reseller does not add substantially to the value of the product that is transferred.⁵¹ Therefore the resale price method is difficult to apply in situations where the goods are further processed or incorporated into another product before the resale.⁵²

2.3.3 Cost Plus Method

The cost plus method focuses on the costs that arise to the supplier of the property or service in a controlled transaction. Added to the costs is also a cost plus mark up, which should correspond to an appropriate profit in the light of the functions performed and the market conditions.⁵³ This method is most useful and reliable for transfers between associated enterprises of semi finished goods, provisions of services, or where the associated parties have concluded joint facility agreements or long term buy-and-supply arrangements.⁵⁴

This method requires a comparison of the mark up. The cost plus method uses mark up after direct and indirect costs of production. This means that the different accounting standards and the different cost definitions in the world, might create difficulties when determining the arm's length price with this method.⁵⁵

⁴⁸ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.21.

⁴⁹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.23.

⁵⁰ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.27.

⁵¹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.29.

⁵² Id.

⁵³ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.39.

⁵⁴ Id.

⁵⁵ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.48- 2.49.

2.4 The Transactional Profit Methods

2.4.1 Transactional Net Margin Method

The transactional net margin method examines the net profit in relation to an appropriate base, such as costs, sales, and assets, in the controlled transaction. The net profit should appropriately be determined by comparing the net profit in similar uncontrolled transactions.⁵⁶ This method is less affected by transactional differences than the CUP method and is more tolerant to some functional differences, since it is based on net profit indicators.⁵⁷ The transactional net margin method should not be used in transactions where there are differences in the characteristics of the enterprise being compared, which have a material effect on the net profit indicators, unless an adjustment in the price for those differences can be made.⁵⁸

The OECD has made several changes to the description about this method in the new Transfer Pricing Guidelines, especially on how to apply this method in an appropriate way. One change is that this method is now described before the transactional profit split method, which in the 1995 version had the opposite placement. Further on, three additional paragraphs have been included in the general information about this method, where it is said that the transactional net margin method is unlikely to be reliable if each party makes valuable, unique contributions.⁵⁹ In this case the transactional profit split method is recommended to be used. Also, they clear out that in transactions with non-unique intangibles the traditional transaction methods would be more appropriate to use.⁶⁰ The OECD has developed detailed guidance in the new Transfer Pricing Guidelines on how to determine the net profit with this method.

⁵⁶ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.58.

⁵⁷ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.62.

⁵⁸ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.74.

⁵⁹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.59.

⁶⁰ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.60.

2.4.2 Transactional Profit Split Method

The transactional profit split method also focuses on the profits, but is determined by allocating the profits between the associated enterprises based on a division of the functions that independent enterprises would have expected by engaging in the transaction.⁶¹ This method is therefore suitable for transactions where all parties make valuable and unique contributions to the transaction, such as in the case with some unique intangibles.⁶² In those type of co-operations independent parties would most likely wish to share the profits of the transaction in relation to their contribution. The biggest weakness of this method is that it can be difficult to apply in the sense that it may be hard to measure combined revenue and costs for all the associated enterprises participating in the controlled transaction, which would necessitate stating books and records on a common basis and making adjustments in accounting practices and currencies.⁶³

The main purpose of this method is to approximate as closely as possible the split of profits between the associated enterprises that would have been expected between enterprises at arm's length.⁶⁴ The Guidelines points out that when tax administrations examines how reliable the approximations of the method is, it is of importance that the tax administration acknowledges that the taxpayer could not have known the actual profits at the time that the conditions of the controlled transaction were established.⁶⁵ This would be contrary to the arm's length principle and a use of hindsight since unrelated parties in a similar transaction would only rely upon the projections and could not have known the actual profits.⁶⁶

The OECD has also developed more detailed guidance on how to apply this method in a reliable manner in the new Transfer Pricing Guidelines. The new Guidelines contains more detailed information of when the transactional profit split method is likely to be the most

⁶¹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.108.

⁶² OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.109.

⁶³ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.114.

⁶⁴ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.116.

⁶⁵ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.128.

⁶⁶ This matter is further discussed under chapter 5.

appropriate method and how it should be applied.⁶⁷ Since the transactional profit methods are no more seen as last resort methods, it was necessary to develop a better guidance on how to apply them, both for taxpayers and tax administrations.

⁶⁷ Isabel Verlinden, Ian Dykes, Andrew Casley, Garry Stone, Adam Katz, Elisabeth Finch, Ryann Thomas, Nick Houseman, Alan Ross, Loek de Preter, Rahul Mitra, Marc Diepstraten, Yoku Mondelaers, *OECD Publishes Revised Guidelines on Transfer Pricing, Accommodating 15 Years of Juggling the Arm's Length Principle in a Globalizing Business World*, *International Transfer Pricing Journal*, 2010, No 5, p. 337.

3 The Hierarchy of the Arm's Length Methods

3.1 Introduction

This chapter describes the hierarchy that existed in the 1995 version of the OECD Transfer Pricing Guidelines, and compares it with the new standard of the most appropriate method and if it still exist any hierarchy between the methods in the new version of the Guidelines.

3.2 The Hierarchy in the 1995 Version of the Guidelines

The 1995 version of the OECD Transfer Pricing Guidelines showed a clear hierarchy between the two categories of transfer pricing methods: the traditional transaction methods and the transactional profit methods. It emphasized that the traditional transaction methods were the most direct way to find out whether the conditions made between enterprises were at arm's length, and that these methods were preferable to other methods.⁶⁸ It also existed a hierarchy between the traditional transaction methods, where the CUP method was pointed out to be the most direct way to establish an arm's length transfer price.⁶⁹ The CUP method should be used if it was possible, and where minor differences between the compared transactions existed adjustments to the price should be done. The Guidelines expressed that *'every effort should be made to adjust the data so that it may be used appropriately in a CUP method'*.⁷⁰

If it was not possible to use the CUP method; the resale price method or the cost plus method should be examined in order to see if they generated a more reliable measure of arm's length conditions where the gross margin was compared instead. Further, the OECD argued in the 1995 version of the Guidelines that only in exceptional situations where the traditional transaction methods could not be used, it may became needed to use the transactional profit methods as a last resort.⁷¹ The transactional methods should only be used when the traditional transaction methods could not be used.⁷² Moreover, it was stated that

⁶⁸ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995, para 2.49.

⁶⁹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995, para 2.5.

⁷⁰ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995, para 2.9.

⁷¹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995, para 2.49.

⁷² OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995, para 3.1 & 3.49.

it is unusual to find enterprises that enters into transactions in which profit is a condition in the transaction, and thus only find in exceptional cases.⁷³

It was expressed that it could only be accepted to apply transactional profit methods in exceptional circumstances, i.e. as a last resort, as long as they were compatible with the arm's length principle. When evaluating the reliability of a transactional profit method the same factors had to be evaluated that led to the conclusion that none of the traditional transaction methods were reliable.⁷⁴ Thus, before using a transactional profit method the traditional transaction methods had to be analysed and eventually rejected, as they had a higher degree of comparability and a more direct and close relationship to the transaction.⁷⁵

3.3 The Most Appropriate Method Standard

One of the main purposes with the 2010 version of the OECD Transfer Pricing Guidelines was to change the hierarchy of the transfer pricing methods that existed in the 1995 version and instead granting equal weight to the different methods. In the 2010 version of the Guidelines the selection of transfer pricing method should aim at finding the most appropriate method for a particular case.⁷⁶ The reason why the OECD removed the status of the transactional profit methods as last resort methods was that the OECD member countries and other countries have been using these methods in practice to a high extent the past 15 years.⁷⁷ Research have shown that the transactional net margin method have been commonly applied in practice the past decades, despite the hierarchy that existed between the transfer pricing methods in the 1995 version of the OECD Transfer Pricing Guidelines.⁷⁸

According to the new Guidelines there are four main aspects that should be considered while selecting the most appropriate method for a particular case and are aimed to guide the taxpayer during the selection process. These four criteria are:

⁷³ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995, para 3.2.

⁷⁴ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995, para 3.2.

⁷⁵ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995, para 1.70.

⁷⁶ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.2.

⁷⁷ Isabel Verlinden, Ian Dykes, Andrew Casley, Garry Stone, Adam Katz, Elisabeth Finch, Ryann Thomas, Nick Houseman, Alan Ross, Loek de Preter, Rahul Mitra, Marc Diepstraten, Yoku Mondelaers, *OECD Publishes Revised Guidelines on Transfer Pricing, Accommodating 15 Years of Juggling the Arm's Length Principle in a Globalizing Business World*, International Transfer Pricing Journal, 2010, No 5, p. 337.

⁷⁸ Joel Cooper and Rachit Agarwal, *The Transactional Profit Methods in Practice: A Survey of APA Reports*, International Transfer Pricing Journal, 2011, No 1.

- *the respective strengths and weaknesses of the OECD recognised methods;*
- *the appropriateness of the method considered in the view of the nature of the controlled transaction, determined in particular through a functional analysis;*
- *the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods;*
- *and the degree of comparability adjustments that may be needed to eliminate material differences between them*.⁷⁹

The most significant change is that the transactional profit methods are no longer a last resort choice of method, as it was expressed in the 1995 version of the Transfer Pricing Guidelines. The OECD has now acknowledged that the transactional profit methods are not only found in exceptional and rare cases. Instead the traditional transaction methods and the transactional profit methods are both as reliable ways of determining an arm's length transfer price.⁸⁰ Coopman and Agarwal argues that this reflects a greater acceptance of the transactional profit methods in the revised OECD Transfer Pricing Guidelines.⁸¹

3.4 Current Hierarchy in the Guidelines

Although the OECD stresses that the most appropriate method should be used, the traditional transaction methods are still preferred as the Guidelines still remain to point out in several places that the traditional transaction methods are the most direct means of establishing whether conditions are at arm's length.⁸² When selecting a transfer pricing method the OECD expresses that when the CUP method and any other method can be applied in equally reliable manners, the CUP method is the most preferable.⁸³ Hence, in a transfer pricing situation where the CUP method and another method are equally reliable, the CUP method should be used. Consequently, the taxpayer does not have a free choice of which method to use in those situations. Therefore, if it is possible for a multinational enterprise

⁷⁹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.2.

⁸⁰ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.3.

⁸¹ Joel Cooper and Rachit Agarwal, *The Transactional Profit Methods in Practice: A Survey of APA Reports*, International Transfer Pricing Journal, 2011, No 1.

⁸² OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.3.

⁸³ Id.

to find comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle and thus preferable over all other methods.⁸⁴

The OECD also states in the new Guidelines that the traditional transaction methods are regarded as the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are at arm's length.⁸⁵ In a transaction where a traditional transaction method and a transactional profit method can be applied with equally reliable manner, the traditional transaction method is preferred.

In order to reliably apply a transactional profit method the OECD argues that the taxpayer must first conclude that none of the traditional transaction methods could be reliably applied under the circumstances of the case.⁸⁶ This statement clearly demonstrate that in order to reliably apply a transactional profit method, the traditional transaction methods must first be analysed and rejected. Thus, a hierarchy still exist between the two categories of methods. Furthermore, the OECD states that it is not appropriate to use a transactional profit method merely because data about uncontrolled transactions are difficult to find or incomplete in one or more aspects.⁸⁷ The taxpayer should therefore always strive to find a comparable transaction under the CUP method.

By keeping a hierarchy among the transfer pricing methods the OECD believes that it will bring certainty and guidance for the taxpayer together with the four criteria that should be considered in the selection process of the most appropriate method.⁸⁸ By keeping some sort of hierarchy it gives guidance to both the taxpayers and the tax administrations in situations where two methods are equally reliable.⁸⁹

⁸⁴ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.14.

⁸⁵ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.3.

⁸⁶ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.5.

⁸⁷ Id.

⁸⁸ Mayra O. Lucas Mas and Giammarco Cottani, *OECD Proposed Revision of Chapters I-III of the OECD Transfer Pricing Guidelines: Business Comments on Selected Issues*, International Transfer Pricing Journal, 2010, No 4, p. 247.

⁸⁹ Id.

4 The Most Appropriate Method rule and the Best Method Rule

4.1 Introduction

The change regarding the hierarchy between the traditional transaction methods and the transaction profit methods in the new OECD Transfer Pricing Guidelines, and the new standard of choosing the most appropriate method makes it more close to the US regulation and the best method rule. This chapter explains the best method rule in the US and compares it with the most appropriate method rule applied by the OECD.

4.2 Best Method Rule

Currently the US also promotes the use of the arm's length principle. In the US the different arm's length methods have no internal hierarchy, hence no method have priority over the other like it has in the OECD Guidelines. Instead they must be determined under the method that is the most reliable under the facts and circumstances of the specific case.⁹⁰ Accordingly, more than one method may give an appropriate result. The method that is shown to produce the most reliable arm's length result must be used. Since there is not a strict hierarchy between the transfer pricing methods in the US, no one method will be considered more reliable than any of the others.⁹¹ When the taxpayer selects a method, there are two main factors to be considered, i.e. the comparability with the free-market situation and the quality of the data and assumptions.⁹²

The most objective way of determining which method to use is by doing a comparability analysis. As a part of the comparability analysis the taxpayer should also analyse the comparability result with the result of other methods.⁹³ In practise, when a multinational enterprise apply the best method rule and select a method it is necessary to take into account the business and economic circumstances of the controlled transaction, the availability and quality of potential comparables under all the different methods that may be applied to the transaction in question. Consequently, the best method rule leads to a heavy administrative

⁹⁰ The US Treasury Regulation §1.482-1(c).

⁹¹ Monica Boos, *International Transfer Pricing – The Valuation of Intangible Assets*, Kluwer Law International, The Hague, 2003, p. 102.

⁹² The US Treasury Regulation §1.482-1(c)(2).

⁹³ The US Treasury Regulation §1.482-1(c).

burden on the taxpayer that has to investigate, compare and analyse each method to ensure that no other method is more reliable than the others.

4.3 The Most Appropriate Method in Relation to the Best Method Rule

The OECD points out in the Guidelines that the selection of the most appropriate method and, more importantly, the search of reliable comparables should not be too burdensome for the taxpayer. In other words, it is not compulsory to do an exhaustive search of all the possible sources of comparables, due to limitations of available information.⁹⁴ The arm's length principle does not oblige the application of more than one method for a given transaction, since such approach would create a significant burden for taxpayers.⁹⁵ Consequently, neither the taxpayer nor the tax examiner are required to perform analysis on more than one method. Instead the method that is estimated to provide the best arm's length price should be analysed.⁹⁶

Also expressed in the OECD Transfer Pricing Guidelines, in order to find the most appropriate method the taxpayer has to perform a comparability analysis. The OECD Transfer Pricing Guidelines gives a nine step process on how to find the most appropriate method. The section in the Guidelines about the comparability analysis recommends the taxpayer to do the search for information on external comparables and the selection of appropriate method process repeatedly until a satisfactory conclusion is reached.⁹⁷ In very complex transactions this might therefore become a heavy workload.

The selection process of finding the most appropriate method for a particular case should take into account the respective strengths and weaknesses of the different methods recommended by the OECD; the appropriateness of the method considered in the analysis of the controlled transaction; the availability of reliable information; and the degree of comparability between the controlled and uncontrolled transactions, including the reliability of comparability adjustments that might be needed in order to eliminate material differences

⁹⁴ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 3.2.

⁹⁵ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.11.

⁹⁶ Id.

⁹⁷ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, paras 3.4-3.5.

between them.⁹⁸ These criteria, as mentioned above in chapter 3.3, aim to guide the tax payer to select the most appropriate method for a particular case.

Business representatives have commented that the most appropriate method rule reminds of the best method rule, whereby they believe that all methods should be tested and justify their rejection in order to avoid adjustments from tax administrations.⁹⁹ Further, they have also pointed out that the word ‘*most*’ creates doubts in the meaning of the selection process, as they compare it with the word ‘*best*’ in the best method rule.¹⁰⁰ KPMG expressed in their open comments to the proposed revision of the Guidelines that the term ‘most appropriate method’ should be replaced with only ‘appropriate method’, and with the qualification that no other method is superior to the method used.¹⁰¹

The new standard of finding the most appropriate method comes close to the US standard of the best method rule, in the sense that both aim to find the most reliable method to the case. The revised Guidelines have also included a definition of the tested party, which comes close to the one in the US regulations.¹⁰² The OECD defines the tested party as: ‘*As a general rule, the tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found, i.e. it will most often be the one that has the less complex functional analysis.*’¹⁰³ The US defines the tested party as: ‘*the tested party will be the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located. Consequently, in most cases the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.*’¹⁰⁴

⁹⁸ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.2.

⁹⁹ Mayra O. Lucas Mas and Giammarco Cottani, *OECD Proposed Revision of Chapters I-III of the OECD Transfer Pricing Guidelines: Business Comments on Selected Issues*, International Transfer Pricing Journal, 2010, No 4, p. 247.

¹⁰⁰ Id.

¹⁰¹ KPMG’s Global Transfer Pricing Services, *Comments on the OECD’s Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines*, p. 2.

¹⁰² OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 3.18 compared with The US Treasury Regulation §1.482-5(2).

¹⁰³ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 3.18.

¹⁰⁴ The US Treasury Regulation §1.482-5(2).

The main difference between the best method rule and the most appropriate rule is that the taxpayer has to examine each method under the best method rule, while using the most appropriate method rule the taxpayer only need to repeat the comparability of methods until finding a satisfactory one. Another important difference between these two standards are that when selecting the transfer pricing method the best method rule stress the importance of the comparability with the free-market situation while the most appropriate method rule stress the importance of the functionality analysis.¹⁰⁵ Consequently, it is not necessary to examine each of the methods and justify their rejection under the most appropriate method rule.

It is pointed out in the Guidelines that the aim to find the most appropriate method for each particular case does not mean that the taxpayer should analyse each of the transfer pricing methods in depth.¹⁰⁶ Furthermore, paragraph 2.2. in the new Guidelines states that *'No one method is suitable in every possible situation, nor is it necessary to prove that a particular method is not suitable under the circumstances'*.¹⁰⁷ In this sense the most appropriate method differ remarkably from the best method rule, by minimizing the administrative burden on the taxpayer. Although the OECD states that it should not be necessary to perform an in-depth analysis of each method to find the most appropriate, they do stress that while evaluating the reliability of a transactional profit method, the taxpayer should reach the conclusion that none of the traditional transaction method could be reliably applied.¹⁰⁸

As shown in chapter three the hierarchy is not completely removed in the new Guidelines. The OECD still promotes the CUP method as the best method, and if the taxpayer wishes to use the transactional profit methods when selecting a transfer pricing method, the taxpayer has to analyse and evaluate why the reliability of the those methods are better than the traditional transaction methods. This implies that the taxpayer should evaluate the reliability of at least two methods, as long as the chosen method is not the CUP method.

¹⁰⁵ See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.2 and The US Treasury Regulation §1.482-1(c).

¹⁰⁶ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.8.

¹⁰⁷ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.2.

¹⁰⁸ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.5.

5 The Use of Hindsight on Intangible Properties

5.1 Introduction

One of the most difficult issues within transfer pricing is how to properly address the valuation of intangible property and foresee the potential future profits arising from their exploitation, due to the lack of comparables as well as lack of a proper valuation method. Only after a few years it may be possible to know if the performed valuation turned out to be correct. The OECD and the US have different point of views on how to solve this valuation problem from the tax perspective, as the US have been one of the most aggressive actors. This chapter will go through a brief introduction to the problem with the valuation of intangible properties, the OECD's approach to the use of hindsight in the revised Guidelines and the commensurate with income standard in the US. The chapter ends with a comparison between the different approaches taken by OECD and the US on this matter.

5.2 The Valuation of Intangible Properties

The OECD has included a section in their Transfer Pricing Guidelines for special considerations regarding intangible property, which aims to give extra guidance on how to apply the arm's length principle involving these transfers. Intangible properties should in general not be treated different from other types of transactions when it comes to the comparability and the application of the arm's length principle.¹⁰⁹

There are different definitions of what an intangible is. Markham defines it as '*a nonphysical claim of future profits or rents*'.¹¹⁰ Market values of modern corporations are strongly related to its intangible assets. For some intangibles it is very hard to find organised and competitive markets, and hence it will be hard to find similar comparable transactions.¹¹¹

There are different types of intangible properties, which requires different considerations. The intangibles talked about in chapter VI in the OECD Transfer Pricing Guidelines are: rights to use industrial assets, literary and artistic property rights, and intellectual property.

¹⁰⁹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 6.13.

¹¹⁰ Monica Boos, *International Transfer Pricing – The Valuation of Intangible Assets*, Kluwer Law International, The Hague, 2003, p. 23-24.

¹¹¹ Monica Boos, *International Transfer Pricing – The Valuation of Intangible Assets*, Kluwer Law International, The Hague, 2003, p. 24.

The focus lies on business rights, i.e. intangible properties associated with commercial activities.¹¹²

When it comes to the valuation of intangibles for determining the arm's length price, one must consider, for purposes of the comparability, both the perspectives of the transferor and the transferee.¹¹³ While the transferor might be willing to transfer the intangible for a certain price in the open market, the transferee might not be willing to pay such price. When determining the comparability the usefulness of the property and all other facts and circumstances should be taken into account.¹¹⁴ Furthermore, special considerations regarding the comparability should also be done to the expected benefits of the intangible property, for example by using the net present value calculation.¹¹⁵

The value of marketing intangibles, such as trademarks and trade names, depend upon many factors. For instance, the reputation and credibility of the trade name or the trademark brought up by the quality of goods and services under the name or the mark in the past can influence the value remarkably.¹¹⁶ However, a high perception on these values can also be destroyed and decreased fast if the company that holds the trade name goes through a crisis, and contrary a low value might increase unexpectedly because of events that were unforeseeable. Other factors that influence the value on the intangible property would be the degree of quality control and ongoing research and development, distribution and availability of the goods or services being marketed, the extent and success of the promotional expenditures earned in order to familiarise potential customers with the goods or services, the value of the market where the intangible properties will present in, and the nature of any right created in the intangible under the law.¹¹⁷

Most research and developments, and marketing expenditures are highly costly, but might not always succeed with bringing the return of investment. The companies transferring in-

¹¹² OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 6.2.

¹¹³ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 6.14.

¹¹⁴ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 6.15.

¹¹⁵ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 6.20.

¹¹⁶ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 6.4.

¹¹⁷ Id.

tangible properties are facing possibilities of sudden devaluation as the innovative competition is getting more increased in the world today. This makes the estimations of the future profits and the valuation very difficult, if not close to impossible.¹¹⁸ The OECD acknowledges that in the Guidelines, as they point out that it can be difficult to evaluate the degree to which any particular expenditure has successfully resulted in a business asset, since it may both have a short-term and a long-term effect.¹¹⁹ In these difficult valuation situations where the future profit is highly uncertain, independent enterprises might adopt short-term licence agreements or include price adjustment clauses, in order to protect against subsequent developments that might not be foreseeable.¹²⁰

5.3 The OECD's Approach to the Use of Hindsight in the Transfer Pricing Guidelines

When it comes to some intangible properties the outcome is very uncertain to foresee in the beginning of the process, such as with the development of new patents, and marketing activities etc. At the time of the valuation of the cross-border transaction, the future profits can vary a lot from the predictions, depending on unpredictable events, the financial market and so on. In these situations the OECD wants to ensure that the tax authorities avoid the use of hindsight and making retroactive adjustments.

The OECD acknowledges the difficulties with applying the arm's length principle to controlled transactions involving intangible properties as they may have a special character complicating the search for comparables and in some cases making it hard to determine the value at the time of the transfer.¹²¹ One way of determining the arm's length price for the transaction of the intangible property when the valuation is highly uncertain at the time of the transaction is to use expected benefits as a means for establishing the pricing at the out-

¹¹⁸ Michelle Markham, *The Transfer Pricing of Intangibles*, Kluwer Law International, The Hague, 2005, p. 81.

¹¹⁹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 6.6 and 6.7.

¹²⁰ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 6.30.

¹²¹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 6.13.

set of the transaction, and of course also taking all relevant economic factors into account.¹²²

When tax administrations evaluate the pricing in a controlled transaction, the OECD express the view that the tax administration should investigate whether the associated enterprises made adequate projections, while also considering all the developments that were reasonably predictable, without using hindsight.¹²³ In this aspect it is questionable how far the tax administrations can go when determining if a highly uncertain valuation was at arm's length when they already have the answers in their hands.

The approach of the OECD is that when dealing with the problems of the transfer pricing analysis in such difficult valuations, the issue should be solved by comparing the circumstances of the case to how independent entities would have dealt with it under similar circumstances.¹²⁴ If the transaction would require a price adjustment mechanism or a renegotiation between enterprises at arm's length, it should also have that in the transaction between the associated enterprises.¹²⁵ Consequently, the OECD justifies tax administrations to make retroactive adjustments to the arm's length price in situations where adjustment clauses or renegotiations would be applied in comparable uncontrolled transactions.¹²⁶ In this case the OECD favours hindsight to be used at arm's length. However, the tax administrations should not make any price adjustments in situations where there was no reason to believe that the valuation was sufficiently uncertain, as that would represent a use of the hindsight.¹²⁷ The OECD stresses that the mere existence of uncertainty should not justify the tax administrations to adjust the price, if independent enterprises would have made adjustments to the price.¹²⁸

¹²² OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 6.29.

¹²³ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 6.32.

¹²⁴ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 3.72.

¹²⁵ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 3.73.

¹²⁶ Id.

¹²⁷ Id.

¹²⁸ Id.

The most important is to compare what independent enterprises would do in similar transactions. However, transactions with intangible properties are often extremely unique and it is therefore difficult to find comparables at all. Enterprises that deal with intangible properties faces the problem where they are difficult to valuate and to foresee the future profits. This is a problem that both independent and associated enterprises faces.

5.4 Commensurate With Income in the US

The US has a rule for intangible property, which allows the IRS to adjust the price charged for an intangible property based on the actual outcome of that transfer. This standard is called the commensurate with income.¹²⁹ The purpose of this standard is to come across the intangibles that have high future profit potential, but no comparable transactions at the time of transfer. This standard came into force in 1986 after a congressional finding that taxpayers often transferred intangibles to related enterprises in low taxed countries.¹³⁰ It was especially triggered after the Eli Lilly case¹³¹ where a US based parent company transferred intangibles to their Puerto Rican subsidiary in exchange for stocks, which resulted in big tax revenue losses for the US tax administration. The US Department of Treasury and the IRS conducted the so-called White Paper, which addressed the appropriate application of the commensurate with income standard.

The US Treasury Regulation states that: *If an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible.*¹³² The IRS must consider all the relevant facts and circumstances before doing any periodic adjustments. Furthermore, the regulation also states that any periodic adjustment made has to be consistent with the arm's length standard.¹³³ However, the IRS cannot do any periodic adjustments if it concerns an intangible that has also been transferred to an independent enterprise under similar circumstances.¹³⁴ The periodic adjustments may be done for a five-years period after the transfer

¹²⁹ The US Treasury Regulation §1.482-4 (f)(2)(i).

¹³⁰ Marc M. Levey, C. Wrappe Steven, Chung Kerwin, *Transfer Pricing Rules and Compliance Handbook*, CCH, 2006, p.44.

¹³¹ *Eli Lilly & Co v Commissioner*, 84 T.C. 996, 1985.

¹³² The US Treasury Regulation §1.482-4 (f)(2)(i).

¹³³ *Id.*

¹³⁴ The US Treasury Regulation §1.482-4 (f)(2)(ii)(A).

was done.¹³⁵ Although the transfer price is considered to be at arm's length one year does not mean that adjustments cannot be done for another year during the five years period.

The taxpayer must, in accordance with the best method rule, show that the method chosen is at arm's length and that no other method is more reliable. This is a considerably heavy burden of proof for the taxpayer in order to avoid adjustments. Since the tax administration has the actual profit results at hand while doing the adjustments, it is hard for the taxpayer to argue that the valuation at the time of transfer was projected at arm's length. It is beyond reasonable to demand the taxpayer to know the actual future profit at the time of the initial valuation of the transfer.

In practice, the commensurate with income standard may require the related parties to make periodic adjustments in the royalty charged for the use of the intangible property to reflect the level of profits earned from the manufactures and sales.¹³⁶ In other words, the actual profit is compared with the projected profit, and adjusted thereafter. The adjustment may not get a corresponding adjustment in the jurisdiction where the controlled transaction is transferred, which may result in double taxation. The commensurate with income standard is certainly a use of hindsight that is only benefitting the tax administration and puts a heavy burden on behalf of the taxpayer. It can also be questioned whether independent parties would adjust a licence agreement in years subsequent to the year of contract.¹³⁷

5.5 Comparison between the OECD and the US

As transfer pricing is not an exact science it can arise many opinions whether the transfer price is at a correct arm's length. The use of hindsight and commensurate with income automatically puts the taxpayer into a vulnerable position and creates much uncertainties.

The OECD desires to avoid the use of hindsight, and the negative effect that might have for the taxpayer. The US, on the other hand, has their primer goal to tax the intangibles according to their actual profits, independently whether that gives an extra burden to the taxpayer. The OECD only allows the tax administrations to use the hindsight and adjust the transfer price if unrelated parties would have adjusted their prices. However, it is most

¹³⁵ The US Treasury Regulation §1.482-4 (f)(2)(ii)(E).

¹³⁶ Brian J. Arnold, Michael J. McIntyre, *International tax primer*, 2nd edition, Kluwer Law International 2002, p. 70.

¹³⁷ Monica Boos, *International Transfer Pricing – The Valuation of Intangible Assets*, Kluwer Law International, The Hague, 2003, p. 105.

probably uncertain to know at the time of the transfer if the intangible will need some adjustments in the future. In this sense, the OECD Transfer Pricing Guidelines also provide an undeniable amount of uncertainty for the taxpayer to foresee the future possible adjustments.

The OECD responded to the commensurate with income standard by including a few paragraphs in the Guidelines when the valuation is highly uncertain at the outset and the situation of unpredictable events. The organization points out clearly that it is important to avoid the use of hindsight and that retroactive adjustments should only be allowed where non-related parties would have included an adjustment-clause. The commensurate with income is obviously a use of hindsight and therefore contrary with the arm's length principle, since the information available during the adjustment was not available for the taxpayer at the time of the transfer. Further, independent enterprises in a similar transaction would neither have known the actual profit experience, and could also only have relied their valuation upon projections.¹³⁸

¹³⁸ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010, para 2.128.

6 Comparative Analysis

6.1 Introduction

In this chapter the questions addressed in this master thesis are further compared and analysed. It starts off with an analysis of the first question regarding the hierarchy of the OECD's recommended transfer pricing methods. The analysis then continues to compare the most appropriate method rule with the best method rule. Finally the use of hindsight regarding intangibles in the OECD Transfer Pricing Guidelines is analysed and compared with the US standard of commensurate with income.

6.2 Comparison of the Past and Current Hierarchy of the OECD's Recommended Arm's Length Methods

The application of the transactional profit methods have been used to a large extent since the 1995 version of the OECD Transfer Pricing Guidelines came out. The OECD have acknowledged this, and attempted to change the hierarchy that existed between the methods when the 2010 version of the Guidelines was designed. However, as pointed out above in chapter 3 of this thesis, questions can be raised whether this hierarchy still exist or is removed.

In the 1995 version of the OECD Transfer Pricing Guidelines it was stated that the transactional profit methods should only be used in exceptional cases, and were only to be used as last resort methods. Instead they promoted the CUP method followed by the cost plus method and the resale price method to be applied. However, due to the uniqueness of many transactions, taxpayers ended up using one of the transactional profit methods.

The main differences between the two versions are that the OECD Transfer Pricing Guidelines now acknowledge that the transactional profit methods should not only be applied in exceptional cases and it is no longer expressed that these methods are to be used only as a last resort. This is the most important difference, i.e. the acceptance of using transactional profit methods. This is well appreciated from the practitioners since they have been using these methods to a large extent since the 1995 Guidelines came out. Another change that has been done in order to remove the hierarchy was that all the five transfer pricing methods were put in the same chapter instead of two different ones. However, when it comes to selecting and applying the arm's length methods the same hierarchy still exist in the new Guidelines.

When comparing the two versions of the OECD Transfer Pricing Guidelines, it is quite clear that there is still a hierarchy existing between the CUP method, the other two traditional transaction methods, and the transactional profit methods. The CUP method is still expressed as the most reliable method, followed by the other traditional transaction methods.

It seems contradictory and slightly confusing when the OECD expresses in the new Transfer Pricing Guidelines that all the methods are equally reliable and also stating that the CUP method and the other traditional transactional methods are preferred before the transactional profit methods. It indicates that in order to apply the transactional profit methods, all the traditional transaction methods have to be explained why they are rejected before. Although, in situations where the taxpayer is choosing between two equally reliable methods a hierarchy between the methods gives a good guidance.

In order to avoid troubles with the tax administrations, the taxpayer will therefore most probably explain in their documentation why they reject the traditional transaction methods as part of their justification of why they choose one of the transactional profit methods. In practice, not much have therefore change from the 1995 version of the OECD Transfer Pricing Guidelines when it comes to the hierarchy of the different methods.

As a result, this indicates that the OECD still promotes a similar hierarchy between the transfer pricing methods as they did in the 1995 version of the Transfer Pricing Guidelines. Consequently, the new standard of the most appropriate method should not make any difference when it comes to selecting an appropriate method. The main difference is that both the traditional transaction methods and the transactional profit methods are expressed as equally appropriate. The OECD is slowly going in a direction where the transactional profit methods are becoming more accepted, although not fully as accepted as the traditional transaction methods. Thus, the hierarchy of the different methods is now removed when it comes to being equally appropriate, but in practice the taxpayer should still try to find a traditional transaction method first as they are expressed as a more direct and reliable way of finding an arm's length price. It should be more accepted to apply the transactional profit methods now since the new Guidelines shows more acceptance towards the use of these methods. The hierarchy is therefore partly removed, but not completely.

6.3 Comparison of the OECD's Most Appropriate Method Rule and the US' Best Method Rule

The best method rule in the US imposes a considerable workload and burden of proof on the taxpayer as all the relevant methods have to be tested and evaluated in order to find the best one. Contrary, the OECD expresses that in order to find the most appropriate method the taxpayer is not obliged to test and evaluate each of the methods in the Guidelines. While the US strives to counteract tax evasion, the OECD strives to counteract economic double taxation. This reflects the differences in the workload and administrative burden that is imposed on the taxpayer while selecting a reliable method.

The US is quite straight forward with the approach on how to find the best method. The OECD, on the other hand, emphasizes that it is not required to analyse more than one method. However, in order to minimize the risk of tax adjustments, the taxpayer should justify the application of another method than the CUP method in the documentation, and why that method is more appropriate. Due to the still existing hierarchy in the OECD Transfer Pricing Guidelines, the rejection of a traditional transaction method should be well-argued, if it is not obvious that a transactional profit method should be applied as in the case of certain unique intra-group cross-border transactions.

Due to the deep analysis that has to be made of all the different methods when using the best method rule, a more reliable result should be the outcome, than with the most appropriate method rule. However, this must be weighted to the administrative burden that is put both on the taxpayer and the tax administration with the best method rule. The OECD clearly states that it is not mandatory to do a deep analysis of each method nor that it is necessary to prove that a particular method is not appropriate under the circumstances of the case. If the taxpayer knows from the beginning that the profit split method will be the most appropriate method, due to both parties valuable and unique contributions to the transaction, then it should not be necessary to do an extensive explanation why all the other methods are not chosen. Although, most taxpayers will probably explain why they reject the other methods in their documentation in order to stay out of disputes with the tax administrations.

The OECD states in the Guidelines that neither the tax administration nor the taxpayer have to perform an analysis on more than one method. This has a good cause since it shows a distinction from the best method rule. Although, it can be questioned whether it

will be that simple in the reality. It is good that they point out that for transactions that are simple and can be priced easily with e.g. an internal CUP. However, in many of the intra-group cross-border transactions there are difficulties finding any comparable transactions at all. In these situations the taxpayer will probably evaluate more than one method in their documentation just to be on the safe side with the tax administrations.

As described in chapter 4.3, many business representatives commented that the most appropriate method rule reminds of the best method rule. The word '*most*' creates doubts whether all the methods should be evaluated before concluding which one is the '*most*' appropriate one. This together with the still existing hierarchy among the arm's length methods in the OECD Transfer Pricing Guidelines, is another reason why the taxpayer will evaluate as many methods as possible to be safe against possible tax adjustments.

Generally the most appropriate method standard allows the taxpayer to select a method that provides reliably the best estimation. Hence it does not require the taxpayer to analyse all the methods in the sense as the best method rule requires. When legislating transfer pricing rules it is very important to consider the administrative burden imposed on the taxpayer in order to follow these rules. The OECD has a more generous approach than the US when it comes to the administrative burden of selecting the method to determine the transfer price. The most appropriate method rule and the best method rule both aim to find the most reliable method for determining an arm's length transfer price. The most appropriate method rule differ from the best method rule in the sense that the taxpayer does not have to do an in-depth analysis of each method nor that it is necessary to prove that a particular method is not appropriate under the circumstances of the case. Instead the taxpayer has to argue why a certain method is the most appropriate one rather than why the other methods are not appropriate. Furthermore, these two standards differ in the sense that the best method rule stress the importance of the comparability with the free-market situation while the most appropriate method rule stress the importance of the functionality analysis when selecting a transfer pricing method.

6.4 The Use of Hindsight on Intangible Property

6.4.1 Is the Hindsight Properly Addressed in Chapter III in the New Guidelines Regarding Intangible Property?

Intangibles are very important for multinational groups. As many intangibles have a high value, the tax administrations are protective not to lose any of their tax revenues to low tax jurisdictions when intra-group cross-border transactions take place. There are many ways to challenge this problem, and some countries have taken more aggressive actions in order to protect their taxable basis.

The valuation of intangibles where the future profits are highly uncertain is a big problem when it comes to the allocation of the tax base for cross-border intra-group transactions. The OECD approaches the problem by referring to what independent enterprises would have done in an uncontrolled transaction under similar circumstances should be the reference to whether retroactive adjustments in the price are appropriate or not. The OECD has a clear opinion in chapter III of the Guidelines that the use of hindsight should be avoided.

The OECD opens a door for retroactive adjustments in their Guidelines. However, the organisation expresses clearly that while doing adjustments, it is important to not use hindsight. The adjustments are only allowed in situations where independent enterprises in similar situations would do such adjustments. The OECD Transfer Pricing Guidelines approach this matter in a way that is consistent with the arm's length principle, since the Guidelines express that adjustments should only be done if it would be done in an uncontrolled transaction. Therefore they have addressed the problem properly.

6.4.2 How is OECD's Approach Different from the Commensurate With Income Standard in the US?

The commensurate with income standard and the periodic adjustments belongs to one of the most contentious issues between the US and the OECD. The OECD's approach to highly uncertain valuations of intangibles can be interpreted as a form of the commensurate with income standard. However, the OECD strives to avoid the use of hindsight and the negative effect it can cause the taxpayer.

A consequence of the commensurate with income standard used in the US is that the predictability decreases for the taxpayer. When the taxpayer has done all the efforts that it possibly can at the time of the transfer and, based on these efforts, set a reliable transfer price,

the taxpayer can still suffer from a retroactive adjustment of the price and thus a tax adjustment. It can clearly be questioned whether the commensurate with income standard is consistent with the arm's length principle or if it has gone from a market valuation to a income valuation. As a result of the commensurate with income standard the taxpayer is left with uncertainty for future adjustments and perhaps even double taxation.

The US regulation on cross-border intra-group transactions with intangibles are stricter and therefore better than the OECD when it comes to avoiding tax evasion, although the commensurate with income standard is somehow contradictory with the arm's length principle. It is also important to take into account the heavy burden the commensurate with income standard puts on the taxpayer. The commensurate with income standard in the US is a way to increase the tax revenue that causes a heavy burden and uncertainty on the taxpayer.

The use of hindsight and retroactive adjustments have been approached differently by the OECD and the US. The OECD have clearly expressed in the Guidelines the importance of avoiding the use of hindsight and that retroactive adjustments should only be allowed in situations where non-related parties would have included an adjustment clause. The primer goal of the US standard of commensurate with income is to tax the intangibles according to their actual profits, independently if that gives uncertainty or an extra burden to the taxpayer. The OECD has a better approach to the use of hindsight than the US when it comes to the arm's length principle, as independent enterprises would not have the actual outcome at hand at the outset of the transfer.

6.4.3 Does it Have a Valid Response or Should it be Addressed Differently?

The approach to retroactive adjustments for transfers of intangible properties and royalties with uncertain valuations between associated enterprises should correspond to how independent enterprises would act under similar circumstances, as promoted by the OECD. If independent enterprises would be aware of the uncertainties regarding the valuation of the intangible properties at the time of the transfer, retroactive adjustments should be allowed on the basis on how independent enterprises would renegotiate the price/adjustments. The actual income should not be the only factor for the determination of the retroactive adjustment, as in the US, since that would be a use of hindsight. This would be more close to the real market. Taxpayers need to have certainty and predictability as well as tax administrations need to protect their tax base. If the tax administrations can do retroactive adjust-

ments to the transfer price on the basis of the actual income, all the certainty for the taxpayer is removed. That is not how it would be in the real market between independent enterprises. One party would not be able to come five years after the transaction and say that they would want more money because the other party made more profits than what they expected at the time of the transfer. Renegotiations of an agreement and the conditions is only likely to happen if both parties would agree on that.

The OECD has a good approach to the use of hindsight in its Guidelines, since they express that no adjustments should be done unless it would be done between independent enterprises. This could be more developed though. For instance, the OECD does not clarify how the adjustments or the renegotiation should be done more than specifying that they should follow what independent enterprises would do under similar circumstances. This opens up for national interpretation on the area of retroactive adjustments by the tax administrations. For example, if a tax administration finds it clear that independent enterprises would have made an adjustment-clause in the agreement, how would they retroactively adjust the price? They might use the actual income over the years as a source for the adjustment, or they might use an arm's length range over what they believe would have been negotiated between the independent enterprises. The purpose of the OECD Transfer Pricing Guidelines is to harmonise the regulation and facilitate for international trade. However, when they open up for national interpretation the recommendations are too vague and should be covered, to decrease the differences between the national regulations.

One of the main objectives of the OECD is to eradicate the economical double taxation that can arise with intra-group cross-border transactions. If one jurisdiction finds it appropriate to do an adjustment years after the cross-border transaction occurred, the other jurisdiction might not agree to do a corresponding adjustment, due to differences in their national legislation or that they just do not agree on the adjustment. Then economic double taxation would be the result.

The OECD has a more valid approach than the US since it only recommend the retroactive adjustments if independent enterprises under similar circumstances would allow it. However, it may be a difficult task to find similar transactions/adjustments when the intangible property is unique. As transfer pricing is not an exact science, it can be hard to prove that the transfer price is consistent with the arm's length principle for the taxpayer in

case of a dispute with the tax administration. On the other hand, it may also be hard for the tax administrations to prove that the transfer price is not at arm's length.

The OECD's approach towards the use of hindsight has a valid response and should not be addressed differently. However, the OECD can specify more clearly how the tax administrations should do the retroactive adjustments without the use of hindsight. As they open up the door for retroactive adjustments they need to specify or give better guidance on how to do that in accordance with how independent enterprises would have renegotiated the price.

7 Conclusions

7.1 Introduction

This chapter gives the answer to the three questions addressed in this master thesis. It starts of with the first question regarding the hierarchy between the transfer pricing methods in the OECD Transfer Pricing Guidelines. Thereafter the second question is answered concerning the differences between the most appropriate method rule and the best method rule. Lastly, answers are given to the questions regarding the use of hindsight on intangible property.

7.2 The Hierarchy of the OECD's Arm's Length Methods

The OECD is going in a direction where it becomes easier and more accepted to use the transactional profit methods in the 2010 version of the Transfer Pricing Guidelines. All the methods are put in chapter II of the Guidelines, and the transactional profit methods are no longer expressed as last resort methods. This should make it easier to apply these methods in practice. However, the OECD still keep the same hierarchy as in the previous Guidelines when it comes to selecting an appropriate transfer pricing method, as the new Guidelines still express that the CUP method is the most reliable method followed by the other two traditional transaction methods. The answer to the question, i.e. whether the hierarchy is completely removed between the transfer pricing methods in the new Guidelines, is that it is partly removed, but not completely.

7.3 The Differences and Similarities between the Most Appropriate Method Rule and the Best Method Rule

The revised OECD Transfer Pricing Guidelines recommends its member countries to follow the most appropriate method rule when selecting a reliable arm's length method. This new standard have got criticism for being to similar to the US standard of the best method rule. Both the best method rule and the most appropriate method rule aims to find the most reliable method when determining an arm's length price for an intra-group transaction. With the best method rule the taxpayer must do an exhaustive analysis and evaluation of each of the relevant methods for the specific case. This result in a heavy administrative burden on the taxpayer. Contrary, the OECD express clearly in the new Guidelines that it is not necessary to do an in-depth analysis of each method nor that it is necessary to prove that a particular method is not appropriate under the circumstances of the case. In this sense the most appropriate method rule gives less administrative burden on the taxpayer

than the best method rule does. When selecting the transfer pricing method the two standards differ in the way that the best method rule stress the importance of the comparability with the free-market situation while the most appropriate method rule stress the importance of the functionality analysis.

7.4 The Use of Hindsight on Intangible property

7.4.1 Is the Hindsight Properly Addressed in Chapter III in the New Guidelines Regarding Intangible Property?

The OECD allows retroactive adjustments in situations where independent enterprises would have such agreements. The OECD approaches the use of hindsight on intangibles in accordance with the arm's length principle, since it is expressed that retroactive price adjustments are only allowed if independent enterprises would have done the adjustments under similar circumstances. Therefore they have addressed the use of hindsight properly in chapter III of the OECD Transfer Pricing Guidelines.

7.4.2 How is OECD's Approach Different from the Commensurate With Income Standard in the US?

The US can retroactively adjust the price of an intangible in accordance with the actual income up to five years of the transfer. The OECD, on the other hand, only allows retroactive adjustments if independent enterprises would have included such an agreement. Furthermore, the OECD stress that it is important that the tax administrations avoid the use of hindsight when doing such adjustments. That is a significant difference between the approaches, since the US do the retroactive adjustments with the actual income of the intangible and consequently uses the hindsight.

7.4.3 Does it Have a Valid Response or Should it be Addressed Differently?

The approach to the use of hindsight on intangibles by the OECD has a valid response since it only allows it in situations where independent enterprises would do such a retroactive price adjustment. It is important that the transfer pricing of the intangible property when the valuation is highly uncertain at the time of the transaction is consistent with the arm's length principle. The OECD's approach is more consistent with the arm's length principle than the commensurate with income standard. However, the OECD can give more guidance on how the tax administrations should do the retroactive adjustments without the use of hindsight.

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