

Chapter IV

Administrative approaches to avoiding and resolving transfer pricing disputes

A. Introduction

4.1. This chapter examines various administrative procedures that could be applied to minimise transfer pricing disputes and to help resolve them when they do arise between taxpayers and their tax administrations, and between different tax administrations. Such disputes may arise even though the guidance in these Guidelines is followed in a conscientious effort to apply the arm's length principle. It is possible that taxpayers and tax administrations may reach differing determinations of the arm's length conditions for the controlled transactions under examination given the complexity of some transfer pricing issues and the difficulties in interpreting and evaluating the circumstances of individual cases.

4.2. Where two or more tax administrations take different positions in determining arm's length conditions, double taxation may occur. Double taxation means the inclusion of the same income in the tax base by more than one tax administration, when either the income is in the hands of different taxpayers (economic double taxation, for associated enterprises) or the income is in the hands of the same juridical entity (juridical double taxation, for permanent establishments). Double taxation is undesirable and should be eliminated whenever possible, because it constitutes a potential barrier to the development of international trade and investment flows. The double inclusion of income in the tax base of more than one jurisdiction does not always mean that the income will actually be taxed twice.

4.3. This chapter discusses several administrative approaches to resolving disputes caused by transfer pricing adjustments and for avoiding double taxation. Section B discusses transfer pricing compliance practices by tax administrations, in particular examination practices, the burden of proof, and penalties. Section C discusses corresponding adjustments (Paragraph 2 of Article 9 of the OECD Model Tax Convention) and the mutual agreement

procedure (Article 25). Section D describes the use of simultaneous tax examinations by two (or more) tax administrations to expedite the identification, processing, and resolution of transfer pricing issues (and other international tax issues). Sections E and F describe some possibilities for minimising transfer pricing disputes between taxpayers and their tax administrations. Section E addresses the possibility of developing safe harbours for certain taxpayers, and Section F deals with advance pricing arrangements, which address the possibility of determining in advance a transfer pricing methodology or conditions for the taxpayer to apply to specified controlled transactions. Section G considers briefly the use of arbitration procedures to resolve transfer pricing disputes between jurisdictions.

B. Transfer pricing compliance practices

4.4. Tax compliance practices are developed and implemented in each jurisdiction according to its own domestic legislation and administrative procedures. Many domestic tax compliance practices have three main elements: a) to reduce opportunities for non-compliance (e.g. through withholding taxes and information reporting); b) to provide positive assistance for compliance (e.g. through education and published guidance); and, c) to provide disincentives for non-compliance. As a matter of domestic sovereignty and to accommodate the particularities of widely varying tax systems, tax compliance practices remain within the province of each jurisdiction. Nevertheless a fair application of the arm's length principle requires clear procedural rules to ensure adequate protection of the taxpayer and to make sure that tax revenue is not shifted to jurisdictions with overly harsh procedural rules. However, when a taxpayer under examination in one jurisdiction is a member of an MNE group, it is possible that the domestic tax compliance practices in a jurisdiction examining a taxpayer will have consequences in other tax jurisdictions. This may be particularly the case when cross-border transfer pricing issues are involved, because the transfer pricing has implications for the tax collected in the tax jurisdictions of the associated enterprises involved in the controlled transaction. If the same transfer pricing is not accepted in the other tax jurisdictions, the MNE group may be subject to double taxation as explained in paragraph 4.2. Thus, tax administrations should be conscious of the arm's length principle when applying their domestic compliance practices and the potential implications of their transfer pricing compliance rules for other tax jurisdictions, and seek to facilitate both the equitable allocation of taxes between jurisdictions and the prevention of double taxation for taxpayers.

4.5. This section describes three aspects of transfer pricing compliance that should receive special consideration to help tax jurisdictions administer their transfer pricing rules in a manner that is fair to taxpayers and other jurisdictions. While other tax law compliance practices are in common use in

OECD member countries – for example, the use of litigation and evidentiary sanctions where information may be sought by a tax administration but is not provided – these three aspects will often impact on how tax administrations in other jurisdictions approach the mutual agreement procedure process and determine their administrative response to ensuring compliance with their own transfer pricing rules. The three aspects are: examination practices, the burden of proof, and penalty systems. The evaluation of these three aspects will necessarily differ depending on the characteristics of the tax system involved, and so it is not possible to describe a uniform set of principles or issues that will be relevant in all cases. Instead, this section seeks to provide general guidance on the types of problems that may arise and reasonable approaches for achieving a balance of the interests of the taxpayers and tax administrations involved in a transfer pricing inquiry.

B.1. Examination practices

4.6. Examination practices vary widely among OECD member countries. Differences in procedures may be prompted by such factors as the system and the structure of the tax administration, the geographic size and population of the jurisdiction, the level of domestic and international trade, and cultural and historical influences.

4.7. Transfer pricing cases can present special challenges to the normal audit or examination practices, both for the tax administration and for the taxpayer. Transfer pricing cases are fact-intensive and may involve difficult evaluations of comparability, markets, and financial or other industry information. Consequently, a number of tax administrations have examiners who specialise in transfer pricing, and transfer pricing examinations themselves may take longer than other examinations and follow separate procedures.

4.8. Because transfer pricing is not an exact science, it will not always be possible to determine the single correct arm's length price; rather, as Chapter III recognises, the correct price may have to be estimated within a range of acceptable figures. Also, the choice of methodology for establishing arm's length transfer pricing will not often be unambiguously clear. Taxpayers may experience particular difficulties when the tax administration proposes to use a methodology, for example a transactional profit method, that is not the same as that used by the taxpayer.

4.9. In a difficult transfer pricing case, because of the complexity of the facts to be evaluated, even the best-intentioned taxpayer can make an honest mistake. Moreover, even the best-intentioned tax examiner may draw the wrong conclusion from the facts. Tax administrations are encouraged to take this observation into account in conducting their transfer pricing examinations. This involves two implications. First, tax examiners are encouraged to be flexible in their approach and not demand from taxpayers in their transfer

pricing a precision that is unrealistic under all the facts and circumstances. Second, tax examiners are encouraged to take into account the taxpayer's commercial judgment about the application of the arm's length principle, so that the transfer pricing analysis is tied to business realities. Therefore, tax examiners should undertake to begin their analyses of transfer pricing from the perspective of the method that the taxpayer has chosen in setting its prices. The guidance provided in Chapter II, Part I dealing with the selection of the most appropriate transfer pricing method also may assist in this regard.

4.10. A tax administration should keep in mind in allocating its audit resources the taxpayer's process of setting prices, for example whether the MNE group operates on a profit centre basis. See paragraph 1.5.

B.2. Burden of proof

4.11. Like examination practices, the burden of proof rules for tax cases also differ among OECD member countries. In most jurisdictions, the tax administration bears the burden of proof both in its own internal dealings with the taxpayer (e.g. assessment and appeals) and in litigation. In some of these jurisdictions, the burden of proof can be reversed, allowing the tax administration to estimate taxable income, if the taxpayer is found not to have acted in good faith, for example, by not co-operating or complying with reasonable documentation requests or by filing false or misleading returns. In other jurisdictions, the burden of proof is on the taxpayer. In this respect, however, the conclusions of paragraphs 4.16 and 4.17 should be noted.

4.12. The implication for the behaviour of the tax administration and the taxpayer of the rules governing burden of proof should be taken into account. For example, where as a matter of domestic law the burden of proof is on the tax administration, the taxpayer may not have any legal obligation to prove the correctness of its transfer pricing unless the tax administration makes a *prima facie* showing that the pricing is inconsistent with the arm's length principle. Even in such a case, of course, the tax administration might still reasonably oblige the taxpayer to produce its records that would enable the tax administration to undertake its examination. In some jurisdictions, taxpayers have a duty to co-operate with the tax administration imposed on them by law. In the event that a taxpayer fails to co-operate, the tax administration may be given the authority to estimate the taxpayer's income and to assume relevant facts based on experience. In these cases, tax administrations should not seek to impose such a high level of co-operation that would make it too difficult for reasonable taxpayers to comply.

4.13. In jurisdictions where the burden of proof is on the taxpayer, tax administrations are generally not at liberty to raise assessments against taxpayers which are not soundly based in law. A tax administration in a jurisdiction that applies the arm's length principle, for example, could

not raise an assessment based on a taxable income calculated as a fixed percentage of turnover and simply ignore the arm's length principle. In the context of litigation in jurisdictions where the burden of proof is on the taxpayer, the burden of proof is often seen as a shifting burden. Where the taxpayer presents to a court a reasonable argument and evidence to suggest that its transfer pricing was arm's length, the burden of proof may legally or *de facto* shift to the tax administration to counter the taxpayer's position and to present argument and evidence as to why the taxpayer's transfer pricing was not arm's length and why the assessment is correct. On the other hand, where a taxpayer makes little effort to show that its transfer pricing was arm's length, the burden imposed on the taxpayer would not be satisfied where a tax administration raised an assessment which was soundly based in law.

4.14. When transfer pricing issues are present, the divergent rules on burden of proof among OECD member countries will present serious problems if the strict legal rights implied by those rules are used as a guide for appropriate behaviour. For example, consider the case where the controlled transaction under examination involves one jurisdiction in which the burden of proof is on the taxpayer and a second jurisdiction in which the burden of proof is on the tax administration. If the burden of proof is guiding behaviour, the tax administration in the first jurisdiction might make an unsubstantiated assertion about the transfer pricing, which the taxpayer might accept, and the tax administration in the second jurisdiction would have the burden of disproving the pricing. It could be that neither the taxpayer in the second jurisdiction nor the tax administration in the first jurisdiction would be making efforts to establish an acceptable arm's length price. This type of behaviour would set the stage for significant conflict as well as double taxation.

4.15. Consider the same facts as in the example in the preceding paragraph. If the burden of proof is again guiding behaviour, a taxpayer in the first jurisdiction being a subsidiary of a taxpayer in the second jurisdiction (notwithstanding the burden of proof and these Guidelines), may be unable or unwilling to show that its transfer prices are arm's length. The tax administration in the first jurisdiction after examination makes an adjustment in good faith based on the information available to it. The parent company in the second jurisdiction is not obliged to provide to its tax administration any information to show that the transfer pricing was arm's length as the burden of proof rests with the tax administration. This will make it difficult for the two tax administrations to reach agreement in competent authority proceedings.

4.16. In practice, neither jurisdictions nor taxpayers should misuse the burden of proof in the manner described above. Because of the difficulties with transfer pricing analyses, it would be appropriate for both taxpayers and tax administrations to take special care and to use restraint in relying on the burden of proof in the course of the examination of a transfer pricing

case. More particularly, as a matter of good practice, the burden of proof should not be misused by tax administrations or taxpayers as a justification for making groundless or unverifiable assertions about transfer pricing. A tax administration should be prepared to make a good faith showing that its determination of transfer pricing is consistent with the arm's length principle even where the burden of proof is on the taxpayer, and taxpayers similarly should be prepared to make a good faith showing that their transfer pricing is consistent with the arm's length principle regardless of where the burden of proof lies.

4.17. The Commentary on paragraph 2 of Article 9 of the OECD Model Tax Convention makes clear that the State from which a corresponding adjustment is requested should comply with the request only if that State “considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length”. This means that in competent authority proceedings the State that has proposed the primary adjustment bears the burden of demonstrating to the other State that the adjustment “is justified both in principle and as regards the amount.” Both competent authorities are expected to take a cooperative approach in resolving mutual agreement cases.

B.3. Penalties

4.18. Penalties are most often directed toward providing disincentives for non-compliance, where the compliance at issue may relate to procedural requirements such as providing necessary information or filing returns, or to the substantive determination of tax liability. Penalties are generally designed to make tax underpayments and other types of non-compliance more costly than compliance. The Committee on Fiscal Affairs has recognised that promoting compliance should be the primary objective of civil tax penalties. OECD Report *Taxpayers' Rights and Obligations* (1990). If a mutual agreement results in a withdrawal or reduction of an adjustment, it is important that there exist possibilities to cancel or mitigate a penalty imposed by the tax administrations.

4.19. Care should be taken in comparing different national penalty practices and policies with one another. First, any comparison needs to take into account that there may be different names used in the various jurisdictions for penalties that accomplish the same purposes. Second, the overall compliance measures of a jurisdiction should be taken into account. National tax compliance practices depend, as indicated above, on the overall tax system in the jurisdiction, and they are designed on the basis of domestic need and balance, such as the choice between the use of taxation measures that remove or limit opportunities for noncompliance (e.g. imposing a duty on taxpayers to cooperate with the tax administration or reversing the burden of proof in

situations where a taxpayer is found not to have acted in good faith) and the use of monetary deterrents (e.g. additional tax imposed as a consequence of underpayments of tax in addition to the amount of the underpayment). The nature of tax penalties may also be affected by the judicial system of a jurisdiction. Most jurisdictions do not apply no-fault penalties; in some jurisdictions, for example, the imposition of a no-fault penalty would be against the underlying principles of their legal system.

4.20. There are a number of different types of penalties that tax jurisdictions have adopted. Penalties can involve either civil or criminal sanctions – criminal penalties are virtually always reserved for cases of very significant fraud, and they usually carry a very high burden of proof for the party asserting the penalty (i.e. the tax administration). Criminal penalties are not the principal means to promote compliance in any of the OECD member countries. Civil (or administrative) penalties are more common, and they typically involve a monetary sanction (although as discussed above there may be a non-monetary sanction such as a shifting of the burden of proof when, e.g. procedural requirements are not met or the taxpayer is uncooperative and an effective penalty results from a discretionary adjustment).

4.21. Some civil penalties are directed towards procedural compliance, such as timely filing of returns and information reporting. The amount of such penalties is often small and based on a fixed amount that may be assessed for each day in which, e.g. the failure to file continues. The more significant civil penalties are those directed at the understatement of tax liability.

4.22. Although some jurisdictions may refer to a “penalty”, the same or similar imposition by another jurisdiction may be classified as “interest”. Penalty regimes in some jurisdictions may therefore include an “additional tax”, or “interest”, for understatements which result in late payments of tax beyond the due date. This is often designed to ensure the revenue recovers at least the real time value of money (taxes) lost.

4.23. Civil monetary penalties for tax understatement are frequently triggered by one or more of the following: an understatement of tax liability exceeding a threshold amount, negligence of the taxpayer, or wilful intent to evade tax (and also fraud, although fraud can trigger much more serious criminal penalties). Many OECD member countries impose civil monetary penalties for negligence or wilful intent, while only a few countries penalise “no-fault” understatements of tax liability.

4.24. It is difficult to evaluate in the abstract whether the amount of a civil monetary penalty is excessive. Among OECD member countries, civil monetary penalties for tax understatement are frequently calculated as a percentage of the tax understatement, where the percentage most often ranges from 10% to 200%. In most OECD member countries, the rate of the penalty increases as the conditions for imposing the penalty increase. For instance, the higher rate penalties

often can be imposed only by showing a high degree of taxpayer culpability, such as a wilful intent to evade. “No-fault” penalties, where used, tend to be at lower rates than those triggered by taxpayer culpability (see paragraph 4.28).

4.25. Improved compliance in the transfer pricing area is of some concern to OECD member countries and the appropriate use of penalties may play a role in addressing this concern. However, owing to the nature of transfer pricing problems, care should be taken to ensure that the administration of a penalty system as applied in such cases is fair and not unduly onerous for taxpayers.

4.26. Because cross-border transfer pricing issues implicate the tax base of two jurisdictions, an overly harsh penalty system in one jurisdiction may give taxpayers an incentive to overstate taxable income in that jurisdiction contrary to Article 9. If this happens, the penalty system fails in its primary objective to promote compliance and instead leads to non-compliance of a different sort – non-compliance with the arm’s length principle and under-reporting in the other jurisdiction. Each OECD member country should ensure that its transfer pricing compliance practices are not enforced in a manner inconsistent with the objectives of the OECD Model Tax Convention, avoiding the distortions noted above.

4.27. It is generally regarded by OECD member countries that the fairness of the penalty system should be considered by reference to whether the penalties are proportionate to the offence. This would mean, for example, that the severity of a penalty would be balanced against the conditions under which it would be imposed, and that the harsher the penalty the more limited the conditions in which it would apply.

4.28. Since penalties are only one of many administrative and procedural aspects of a tax system, it is difficult to conclude whether a particular penalty is fair or not without considering the other aspects of the tax system. Nonetheless, OECD member countries agree that the following conclusions can be drawn regardless of the other aspects of the tax system in place in a particular jurisdiction. First, imposition of a sizable “no-fault” penalty based on the mere existence of an understatement of a certain amount would be unduly harsh when it is attributable to good faith error rather than negligence or an actual intent to avoid tax. Second, it would be unfair to impose sizable penalties on taxpayers that made a reasonable effort in good faith to set the terms of their transactions with associated enterprises in a manner consistent with the arm’s length principle. In particular, it would be inappropriate to impose a transfer pricing penalty on a taxpayer for failing to consider data to which it did not have access, or for failure to apply a transfer pricing method that would have required data that was not available to the taxpayer. Tax administrations are encouraged to take these observations into account in the implementation of their penalty provisions.

C. Corresponding adjustments and the mutual agreement procedure: Articles 9 and 25 of the OECD Model Tax Convention¹

C.1. The mutual agreement procedure

4.29. The mutual agreement procedure is a well-established means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. This procedure, described and authorised by Article 25 of the OECD Model Tax Convention, can be used to eliminate double taxation that could arise from a transfer pricing adjustment.

4.30. Article 25 sets out three different areas where mutual agreement procedures are generally used. The first area includes instances of “taxation not in accordance with the provisions of the Convention” and is covered in paragraphs 1 and 2 of the Article. Procedures in this area are typically initiated by the taxpayer. The other two areas, which do not necessarily involve the taxpayer, are dealt with in paragraph 3 and involve questions of “interpretation or application of the Convention” and the elimination of double taxation in cases not otherwise provided for in the Convention. Paragraph 10 of the Commentary on Article 25 makes clear that Article 25 is intended to be used by competent authorities in resolving not only problems

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1. Members of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS) have agreed to a minimum standard with respect to the resolution of treaty-related disputes. This Section C of Chapter IV is not intended to be an explanation of the minimum standard, and thus there is no implication that all members of the Inclusive Framework are in agreement with the guidance contained in this section, except where a particular statement is explicitly identified as an element of the minimum standard. The minimum standard has three general objectives: (1) jurisdictions should ensure that treaty obligations related to the mutual agreement procedure are fully implemented in good faith and that MAP cases are resolved in a timely manner; (2) jurisdictions should ensure that administrative processes promote the prevention and timely resolution of treaty-related disputes; and (3) jurisdictions should ensure that taxpayers that meet the requirements of paragraph 1 of Article 25 can access the mutual agreement procedure. The detailed elements of the minimum standard are set out in OECD (2015), *Making Dispute Resolution Mechanisms More Effective, Action 14 – 2015 Report*, OECD/G20 BEPS Project, OECD Publishing, Paris. The minimum standard is complemented by a set of best practices (to which not all members of the Inclusive Framework have committed) that respond to the obstacles that prevent the resolution of treaty-related disputes through the mutual agreement procedure. In addition, although there is currently no consensus among all members of the Inclusive Framework on the adoption of mandatory binding arbitration as a mechanism to ensure the timely resolution of MAP cases, a significant group of countries has committed to adopt and implement mandatory binding arbitration.

of juridical double taxation but also those of economic double taxation arising from transfer pricing adjustments made pursuant to paragraph 1 of Article 9.

4.31. Paragraph 5 of Article 25, which was incorporated in the OECD Model Tax Convention in 2008, provides that, in mutual agreement procedure cases in which the competent authorities are unable to reach an agreement within two years of the initiation of the case under paragraph 1 of Article 25, the unresolved issues will, at the request of the person who presented the case, be resolved through an arbitration process. This extension of the mutual agreement procedure ensures that where the competent authorities cannot reach an agreement on one or more issues that prevent the resolution of a case, a resolution of the case will still be possible by submitting those issues to arbitration. Where one or more issues have been submitted to arbitration in accordance with such a provision, and unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both States, the taxation of any person directly affected by the case will have to conform with the decision reached on the issues submitted to arbitration and the decisions reached in the arbitral process will be reflected in the mutual agreement that will be presented to these persons. Where a particular bilateral treaty does not contain an arbitration provision similar to paragraph 5 of Article 25, the competent authorities are not obliged to reach an agreement to resolve their dispute; paragraph 2 of Article 25 requires only that the competent authorities “endeavour ... to resolve the case by mutual agreement”. The competent authorities may be unable to come to an agreement because of conflicting domestic laws or restrictions imposed by domestic law on the tax administration’s power of compromise. Even in the absence of a mandatory binding arbitration provision similar to paragraph 5 of Article 25 in a particular bilateral treaty, however, the competent authorities of the Contracting States may by mutual agreement establish a binding arbitration procedure for general application or to deal with a specific case (see paragraph 69 of the Commentary on Article 25 of the OECD Model Tax Convention). It should also be noted that a multilateral Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises² (the Arbitration Convention) was signed by the Member States of the European Communities on 23 July 1990; the Arbitration Convention, which entered into force on 1 January 1995, provides for an arbitration mechanism to resolve transfer pricing disputes between European Union Member States.

C.2. Corresponding adjustments: Paragraph 2 of Article 9

4.32. To eliminate double taxation in transfer pricing cases, tax administrations may consider requests for corresponding adjustments as described in

2. Convention 90/436/EEC.

paragraph 2 of Article 9. A corresponding adjustment, which in practice may be undertaken as part of the mutual agreement procedure, can mitigate or eliminate double taxation in cases where one tax administration increases a company's taxable profits (i.e. makes a primary adjustment) as a result of applying the arm's length principle to transactions involving an associated enterprise in a second tax jurisdiction. The corresponding adjustment in such a case is a downward adjustment to the tax liability of that associated enterprise, made by the tax administration of the second jurisdiction, so that the allocation of profits between the two jurisdictions is consistent with the primary adjustment and no double taxation occurs. It is also possible that the first tax administration will agree to decrease (or eliminate) the primary adjustment as part of the consultative process with the second tax administration, in which case the corresponding adjustment would be smaller (or perhaps unnecessary). It should be noted that a corresponding adjustment is not intended to provide a benefit to the MNE group greater than would have been the case if the controlled transactions had been undertaken at arm's length conditions in the first instance.

4.33. Paragraph 2 of Article 9 specifically provides that the competent authorities shall consult each other if necessary to determine appropriate corresponding adjustments. This confirms that the mutual agreement procedure of Article 25 may be used to consider corresponding adjustment requests. See also paragraph 10 of the Commentary on Article 25 of the OECD Model Tax Convention (“... the corresponding adjustments to be made in pursuance of paragraph 2 of [Article 9] ... fall within the scope of mutual agreement procedure, both as concerns assessing whether they are well-founded and for determining their amount.”) However, the overlap between the two Articles has caused OECD member countries to consider whether the mutual agreement procedure can be used to achieve corresponding adjustments where the bilateral income tax convention between two Contracting States does not include a provision comparable to paragraph 2 of Article 9. Paragraphs 11 and 12 of the Commentary on Article 25 of the OECD Model Tax Convention expressly state the view of most OECD member countries that the mutual agreement procedure is considered to apply to transfer pricing adjustment cases, including issues of whether a corresponding adjustment should be provided, even in the absence of a provision comparable to paragraph 2 of Article 9. Paragraph 12 notes that those States that do not agree with this view in practice find means of remedying economic double taxation in most cases involving *bona fide* companies by making use of provisions in their domestic laws.

4.34. Under paragraph 2 of Article 9, a corresponding adjustment may be made by a Contracting State either by recalculating the profits subject to tax for the associated enterprise in that jurisdiction using the relevant revised price or by letting the calculation stand and giving the associated enterprise

relief against its own tax paid in that State for the additional tax charged to the associated enterprise by the adjusting State as a consequence of the revised transfer price. The former method is by far the more common among OECD member countries.

4.35. In the absence of an arbitration decision arrived at pursuant to an arbitration procedure comparable to that provided for under paragraph 5 of Article 25 which provides for a corresponding adjustment, corresponding adjustments are not mandatory, mirroring the rule that tax administrations are not obliged to reach agreement under the mutual agreement procedure. Under paragraph 2 of Article 9, a tax administration should make a corresponding adjustment only insofar as it considers the primary adjustment to be justified both in principle and in amount. The non-mandatory nature of corresponding adjustments is necessary so that one tax administration is not forced to accept the consequences of an arbitrary or capricious adjustment by another State. It also is important to maintaining the fiscal sovereignty of each OECD member country.

4.36. Once a tax administration has agreed to make a corresponding adjustment it is necessary to establish whether the adjustment is to be attributed to the year in which the controlled transactions giving rise to the adjustment took place or to an alternative year, such as the year in which the primary adjustment is determined. This issue also often raises the question of a taxpayer's entitlement to interest on the overpayment of tax in the jurisdiction which has agreed to make the corresponding adjustment (discussed in paragraphs 4.65-4.67). The first approach is more appropriate because it achieves a matching of income and expenses and better reflects the economic situation as it would have been if the controlled transactions had been at arm's length. However, in cases involving lengthy delays between the year covered by the adjustment and the year of its acceptance by the taxpayer or a final court decision, the tax administration should have the flexibility to agree to make corresponding adjustments for the year of acceptance of or decision on the primary adjustment. This approach would need to rely on domestic law for implementation. While not ordinarily preferred, it could be appropriate as an equitable measure in exceptional cases to facilitate implementation and to avoid time limit barriers.

4.37. Corresponding adjustments can be a very effective means of obtaining relief from double taxation resulting from transfer pricing adjustments. OECD member countries generally strive in good faith to reach agreement whenever the mutual agreement procedure is invoked. Through the mutual agreement procedure, tax administrations can address issues in a non-adversarial proceeding, often achieving a negotiated settlement in the interests of all parties. It also allows tax administrations to take into account other taxing rights issues, such as withholding taxes.

4.38. At least one OECD member country has a procedure that may reduce the need for primary adjustments by allowing the taxpayer to report a transfer price for tax purposes that is, in the taxpayer's opinion, an arm's length price for a controlled transaction, even though this price differs from the amount actually charged between the associated enterprises. This adjustment, sometimes known as a "compensating adjustment", would be made before the tax return is filed. Compensating adjustments may facilitate the reporting of taxable income by taxpayers in accordance with the arm's length principle, recognising that information about comparable uncontrolled transactions may not be available at the time associated enterprises establish the prices for their controlled transactions. Thus, for the purpose of lodging a correct tax return, a taxpayer would be permitted to make a compensating adjustment that would record the difference between the arm's length price and the actual price recorded in its books and records.

4.39. However, compensating adjustments are not recognised by most OECD member countries, on the grounds that the tax return should reflect the actual transactions. If compensating adjustments are permitted (or required) in the jurisdiction of one associated enterprise but not permitted in the jurisdiction of the other associated enterprise, double taxation may result because corresponding adjustment relief may not be available if no primary adjustment is made. The mutual agreement procedure is available to resolve difficulties presented by compensating adjustments, and competent authorities are encouraged to use their best efforts to resolve any double taxation which may arise from different jurisdictional approaches to such year-end adjustments.

C.3. Concerns with the procedures

4.40. While corresponding adjustment and mutual agreement procedures have proved to be able to resolve most transfer pricing conflicts, serious concerns have been expressed by taxpayers. For example, because transfer pricing issues are so complex, taxpayers have expressed concerns that there may not be sufficient safeguards in the procedures against double taxation. These concerns are mainly addressed with the introduction in the 2008 update of the OECD Model Tax Convention of a new paragraph 5 to Article 25 which introduces a mechanism that allows taxpayers to request arbitration of unresolved issues that have prevented competent authorities from reaching a mutual agreement within two years. There is also in the Commentary on Article 25 a favourable discussion of the use of supplementary dispute resolution mechanisms in addition to arbitration, including mediation and the referral of factual disputes to third party experts.

4.41. Taxpayers have also expressed fears that their cases may be settled not on their individual merits but by reference to a balance of the results in other cases. An established good practice is that, in the resolution of mutual

agreement cases, a competent authority should engage in discussions with other competent authorities in a principled, fair, and objective manner, with each case being decided on its own merits and not by reference to any balance of results in other cases. To the extent applicable, these Guidelines and proposals detailed in the Report on BEPS Action 14 (bearing in mind the difference between the minimum standard and best practices) are an appropriate basis for the development of a principled approach. Similarly, there may be a fear of retaliation or offsetting adjustments by the jurisdiction from which the corresponding adjustment has been requested. It is not the intention of tax administrations to take retaliatory action; the fears of taxpayers may be a result of inadequate communication of this fact. Tax administrations should take steps to assure taxpayers that they need not fear retaliatory action and that, consistent with the arm's length principle, each case is resolved on its own merits. Taxpayers should not be deterred from initiating mutual agreement procedures where Article 25 is applicable.

4.42. Concerns that have been expressed regarding the mutual agreement procedure, as it affects corresponding adjustments, include the following, which are discussed separately in the sections below:

1. Taxpayers may be denied access to the mutual agreement procedure in transfer pricing cases;
2. Time limits under domestic law for the amendments of tax assessments may make corresponding adjustments unavailable if the relevant tax treaty does not override those limits;
3. Mutual agreement procedure cases may take a long time;
4. Taxpayer participation may be limited;
5. Published guidance may not be readily available to instruct taxpayers on how the mutual agreement procedure may be used; and
6. There may be no procedures to suspend the collection of tax deficiencies or the accrual of interest pending resolution of the mutual agreement procedure case.

C.4. Guidance, approaches and actions taken to address concerns with the mutual agreement procedure

C.4.1. Denial of access to the mutual agreement procedure in transfer pricing cases

4.43. A fundamental concern with respect to the mutual agreement procedure as it relates to corresponding adjustments is the failure to grant access to the mutual agreement procedure for transfer pricing cases. The undertaking to resolve by mutual agreement cases of taxation not in accordance with the

Convention is an integral part of the obligations assumed by a Contracting State in entering into a tax treaty and must be performed in good faith. The failure to grant mutual agreement procedure access with respect to a treaty partner's transfer pricing adjustments, may frustrate a primary objective of tax treaties. The work on Action 14 of the BEPS Action Plan directly addressed concerns related to the denial of access to the mutual agreement procedure with respect to a treaty partner's transfer pricing adjustments by including, as element 1.1 of the Action 14 minimum standard, a commitment to provide access to the mutual agreement procedure in transfer pricing cases.

4.44. The Action 14 minimum standard also comprises a number of other elements intended to address more generally concerns related to the denial of access to the mutual agreement procedure. These include: a commitment to provide access to the mutual agreement procedure in cases in which there is a disagreement between the taxpayer and the tax authorities making an adjustment as to whether the conditions for the application of a treaty anti-abuse provision have been met or as to whether the application of a domestic law anti-abuse provision is in conflict with the provisions of a treaty (element 1.2); a commitment to publish rules, guidelines and procedures regarding the mutual agreement procedure (element 2.1) and to identify in that guidance the specific information and documentation that a taxpayer is required to submit with a request for mutual agreement procedure assistance (element 3.2); a commitment to clarify that audit settlements between tax authorities and taxpayers do not preclude access to the mutual agreement procedure (element 2.6); and a commitment to ensure that both competent authorities are made aware of requests for mutual agreement procedure assistance by either (i) amending Article 25(1) to permit requests to be made to the competent authority of either Contracting State or (ii) implementing a bilateral notification or consultation process for cases in which the competent authority to whom the case is presented does not consider the taxpayer's objection to be justified (element 3.1).

C.4.2. Time limits

4.45. Relief under paragraph 2 of Article 9 may be unavailable if the time limit provided by treaty or domestic law for making corresponding adjustments has expired. Paragraph 2 of Article 9 does not specify whether there should be a time limit after which corresponding adjustments should not be made. Some jurisdictions prefer an open-ended approach so that double taxation may be mitigated. Other jurisdictions consider the open-ended approach to be unreasonable for administrative purposes. Thus, relief may depend on whether the applicable treaty overrides domestic time limitations, establishes other time limits, or links the implementation of relief to the time limits prescribed by domestic law.

4.46. Time limits for finalising a taxpayer's tax liability are necessary to provide certainty for taxpayers and tax administrations. In a transfer pricing case a jurisdiction may under its domestic law be legally unable to make a corresponding adjustment if the time has expired for finalising the tax liability of the relevant associated enterprise. Thus, the existence of such time limits and the fact that they vary from jurisdiction to jurisdiction should be considered in order to minimise double taxation.

4.47. Paragraph 2 of Article 25 of the OECD Model Tax Convention addresses the time limit issue by requiring that any agreement reached by the competent authorities pursuant to the mutual agreement procedure shall be implemented notwithstanding the time limits in the domestic law of the Contracting States. Paragraph 29 of the Commentary on Article 25 recognises that the last sentence of Article 25(2) unequivocally states the obligation to implement such agreements (and notes that impediments to implementation that exist at the time a tax treaty is entered into should generally be built into the terms of the agreement itself). Time limits therefore do not impede the making of corresponding adjustments where a bilateral treaty includes this provision. Some jurisdictions, however, may be unwilling or unable to override their domestic time limits in this way and have entered explicit reservations on this point. OECD member countries therefore are encouraged as far as possible to extend domestic time limits for purposes of making corresponding adjustments when mutual agreement procedures have been invoked.

4.48. Where a bilateral treaty does not override domestic time limits for the purposes of the mutual agreement procedure, tax administrations should be ready to initiate discussions quickly upon the taxpayer's request, well before the expiration of any time limits that would preclude the making of an adjustment. Furthermore, OECD member countries are encouraged to adopt domestic law that would allow the suspension of time limits on determining tax liability until the discussions have been concluded.

4.49. The work on Action 14 of the BEPS Action Plan directly addresses the obstacle that domestic law time limits may present to effective mutual agreement procedures. Element 3.3 of the Action 14 minimum standard includes a recommendation that jurisdictions should include the second sentence of paragraph 2 of Article 25 in their tax treaties to ensure that domestic law time limits (1) do not prevent the implementation of competent authority mutual agreements and (2) do not thereby frustrate the objective of resolving cases of taxation not in accordance with the Convention.

4.50. Where a jurisdiction cannot include the second sentence of paragraph 2 of Article 25 in its tax treaties, element 3.3 of the Action 14 minimum standard states that it should be willing to accept an alternative treaty provision that limits the time during which a Contracting State may make an adjustment pursuant to Article 9(1), in order to avoid late adjustments with respect to which

mutual agreement procedure relief will not be available. Such a jurisdiction would satisfy this element of the minimum standard where the alternative treaty provision was drafted to reflect the time limits for adjustments provided for in that country’s domestic law. That alternative provision, as presented in the Report on BEPS Action 14, reads as follows:

[*In Article 9*]:

3. A Contracting State shall not include in the profits of an enterprise, and tax accordingly, profits that would have accrued to the enterprise but by reason of the conditions referred to in paragraph 1 have not so accrued, after [*bilaterally agreed period*] from the end of the taxable year in which the profits would have accrued to the enterprise. The provisions of this paragraph shall not apply in the case of fraud, gross negligence or wilful default.

Element 3.3 of the Action 14 minimum standard also states that such a jurisdiction accept a similar alternative provision in Article 7 with respect to adjustments to the profits that are attributable to a permanent establishment.

4.51. While it is not possible to recommend generally a time limit on initial assessments, tax administrations are encouraged to make these assessments within their own domestic time limits without extension. If the complexity of the case or lack of cooperation from the taxpayer necessitates an extension, the extension should be made for a minimum and specified time period. Further, where domestic time limits can be extended with the agreement of the taxpayer, such an extension should be made only when the taxpayer’s consent is truly voluntary. Tax examiners are encouraged to indicate to taxpayers at an early stage their intent to make an assessment based on cross-border transfer pricing, so that the taxpayer can, if it so chooses, inform the tax administration in the other interested State, which could accordingly begin to consider the relevant issues with a view to a possible mutual agreement procedure.

4.52. Another time limit that must be considered is the three-year time limit within which a taxpayer must invoke the mutual agreement procedure under Article 25 of the OECD Model Tax Convention. The three-year period begins to run from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention, which can be the time when the tax administration first notifies the taxpayer of the proposed adjustment, described as the “adjustment action” or “act of taxation”, or an earlier date as discussed in paragraphs 21-24 of the Commentary on Article 25. Although some jurisdictions consider three years too short a period for invoking the procedure, other countries consider it too long and have entered reservations on this point. The Commentary on Article 25 indicates that the time limit “must be regarded as a minimum so that Contracting States are left free to agree in their

bilateral conventions upon a longer period in the interests of taxpayers”. In this regard, it should be noted that element 1.1 of the Action 14 minimum standard includes a recommendation that jurisdictions include in their tax treaties paragraphs 1 through 3 of Article 25, as interpreted in the Commentary.

4.53. The three-year time limit raises the issue of determining its starting date, which is addressed in paragraphs 21-24 of the Commentary on Article 25. In particular, paragraph 21 states that the three-year time period “should be interpreted in the way most favourable to the taxpayer”. Paragraph 22 contains guidance on the determination of the date of the act of taxation. Paragraph 23 discusses self-assessment cases. Paragraph 24 clarifies that “where it is the combination of decisions or actions taken in both Contracting States resulting in taxation not in accordance with the Convention, the time limit begins to run only from the first notification of the most recent decision or action.”

4.54. In order to minimise the possibility that time limits may prevent the mutual agreement procedure from effectively ensuring relief from or avoidance of double taxation, taxpayers should be permitted to avail themselves of the procedure at the earliest possible stage, which is as soon as an adjustment appears likely. Early competent authority consultation, before any irrevocable steps are taken by either tax administration, may ensure that there are as few procedural obstacles as possible in the way of achieving a mutually acceptable conclusion to the discussions. Some competent authorities, however, may not like to be involved at such an early stage because a proposed adjustment may not result in final action or may not trigger a claim for a corresponding adjustment. Consequently, too early an invocation of the mutual agreement process may create unnecessary work.

C.4.3. Duration of mutual agreement proceedings

4.55. Once discussions under the mutual agreement procedure have commenced, the proceedings may turn out to be lengthy. The complexity of transfer pricing cases may make it difficult for the competent authorities to reach a swift resolution. Distance may make it difficult for the competent authorities to meet frequently, and correspondence is often an unsatisfactory substitute for face-to-face discussions. Difficulties also arise from differences in language, procedures, and legal and accounting systems, and these may lengthen the duration of the process. The process also may be prolonged if the taxpayer delays providing all of the information the competent authorities require for a full understanding of the transfer pricing issue or issues.

4.56. Whilst the time taken to resolve a mutual agreement procedure case may vary according to its complexity, most competent authorities endeavour to reach bilateral agreement for the resolution of a mutual agreement procedure

case within 24 months. Accordingly, in order to ensure the timely, effective and efficient resolution of treaty-related disputes, the minimum standard that was adopted in the context of the work on Action 14 of the BEPS Action Plan includes a commitment to seek to resolve mutual agreement procedure cases within an average timeframe of 24 months (element 1.3). Jurisdictions' progress toward meeting that target will be periodically reviewed on the basis of the agreed reporting framework for mutual agreement procedure statistics³ that was developed to provide a tangible measure to evaluate the effects of the implementation of the Action 14 minimum standard (see elements 1.5 and 1.6). Moreover, other elements of the Action 14 minimum standard related to the authority of staff in charge of mutual agreement processes (element 2.3), performance indicators for competent authority functions (element 2.4) and adequate competent authority resources (element 2.5) are expected to contribute to the timely resolution of mutual agreement procedure cases.

4.57. More fundamentally, the adoption in tax treaties of a mandatory binding arbitration provision similar to paragraph 5 of Article 25 to resolve issues that the competent authorities have been unable to resolve within the two year period referred to in that provision should considerably reduce the risk of lengthy mutual agreement procedures. See paragraphs 4.177-4.179.

C.4.4. Taxpayer participation

4.58. Paragraph 1 of Article 25 of the OECD Model Tax Convention gives taxpayers the right to submit a request to initiate a mutual agreement procedure. Although the taxpayer has the right to initiate the procedure, the taxpayer has no specific right to participate in the process. It has been argued that the taxpayer also should have a right to take part in the mutual agreement procedure, including the right at least to present its case to both competent authorities, and to be informed of the progress of the discussions. It should be noted in this respect that implementation of a mutual agreement in practice is subject to the taxpayer's acceptance. Some taxpayer representatives have suggested that the taxpayer also should have a right to be present at face-to-face discussions between the competent authorities. The purpose would be to ensure that there is no misunderstanding by the competent authorities of the facts and arguments that are relevant to the taxpayer's case.

4.59. The mutual agreement procedure envisaged in Article 25 of the OECD Model Tax Convention and adopted in many bilateral agreements is not a process of litigation. While input from the taxpayer in some cases can be helpful to the procedure, it must be recalled that the mutual agreement

3. See OECD (2016), *BEPS Action 14 on More Effective Dispute Resolution Mechanisms – Peer Review Documents*, OECD/G20 Base Erosion and Profit Shifting Project, OECD, Paris.

procedure is a government-to-government process and that any taxpayer participation in that process should be subject to the discretion and mutual agreement of the competent authorities.

4.60. Outside the context of the actual discussions between the competent authorities, it is essential for the taxpayer to give the competent authorities all the information that is relevant to the issue in a timely manner. Competent authorities have limited resources and taxpayers should make every effort to facilitate the process, particularly in complex, fact-intensive transfer pricing cases in which it may be challenging for the competent authorities to develop a complete and accurate understanding of the associated enterprises' activities. Further, because the mutual agreement procedure is fundamentally designed as a means of providing assistance to a taxpayer, competent authorities should allow taxpayers every reasonable opportunity to present the relevant facts and arguments to them to ensure as far as possible that the matter is not subject to misunderstanding.

4.61. In practice, the competent authorities of many OECD member countries routinely give taxpayers such opportunities, keep them informed of the progress of the discussions, and often ask them during the course of the discussions whether they can accept the settlements contemplated by the competent authorities. These practices, already standard procedure in most jurisdictions, should be adopted as widely as possible. They are reflected in the OECD's Manual for Effective Mutual Agreement Procedures.

C.4.5. Publication of mutual agreement procedure programme guidance

4.62. Taxpayers' contributions to the mutual agreement procedure process are of course facilitated where public guidance on applicable procedures is readily accessible. The work on Action 14 of the BEPS Action Plan directly recognised the importance of providing such guidance. Element 2.1 of the Action 14 minimum standard states that jurisdictions should develop and publish rules, guidelines and procedures regarding the mutual agreement procedure and take appropriate measures to make such information available to taxpayers. Such guidance should include information on how taxpayers may make requests for competent authority assistance. It should be drafted in clear and plain language and should be readily available to the public. The Report on BEPS Action 14 also notes that such information may be of particular relevance where an adjustment may potentially involve issues within the scope of a tax treaty, such as where a transfer pricing adjustment is made with respect to a controlled transaction with an associated enterprise in a treaty partner jurisdiction, and that jurisdictions should appropriately seek to ensure that mutual agreement procedure programme guidance is available to taxpayers in such cases. To promote the transparency and dissemination of such published guidance, element 2.2 of the Action 14 minimum standard

includes the publication of country mutual agreement procedure profiles on a shared public platform, in order to make broadly available competent authority contact details, links to relevant domestic guidance and other useful country-specific information. These country profiles, prepared by the members of the Inclusive Framework on BEPS⁴ pursuant to an agreed reporting template developed for that purpose, are published on the OECD website.⁵

4.63. The work on Action 14 also addresses a number of other aspects related to the content of mutual agreement procedure programme guidance:

- Element 3.2 of the Action 14 minimum standard states that jurisdictions should identify in their mutual agreement procedure programme guidance the specific information and documentation that a taxpayer is required to submit with a request for competent authority assistance. Pursuant to element 3.2, jurisdictions should not deny access to the mutual agreement procedure based on the argument that a taxpayer has provided insufficient information where the taxpayer has provided the required information and documentation consistent with such guidance.
- Element 2.6 of the Action 14 minimum standard states that jurisdictions should clarify in their mutual agreement procedure programme guidance that audit settlements between tax authorities and taxpayers do not preclude access to the mutual agreement procedure.
- Certain of the non-binding Action 14 best practices additionally recommend that jurisdictions' mutual agreement procedure programme guidance should include: an explanation of the relationship between the mutual agreement procedure and domestic law administrative and judicial remedies (best practice 8); guidance on the consideration of interest and penalties in the mutual agreement procedure (best practice 10); and guidance on multilateral mutual agreement procedures and advance pricing arrangements (best practice 11). Best practice 9 recommends that this guidance provide that taxpayers will be allowed access to the mutual agreement procedure so that the competent authorities can resolve through consultation the double taxation that can arise in the case of *bona fide* taxpayer initiated foreign adjustments.

4.64. There is no need for the competent authorities to agree to rules or guidelines governing the procedure, since the rules or guidelines would be limited in effect to the competent authority's relationship with taxpayers seeking its assistance. However, competent authorities should routinely communicate such unilateral rules or guidelines to the competent authorities of their treaty partners and ensure that their country mutual agreement procedure profiles (see paragraph 4.62 above) are kept up-to-date.

4. See www.oecd.org/tax/beps/beps-about.htm#membership.

5. See www.oecd.org/tax/beps/country-map-profiles.htm.

C.4.6. Problems concerning collection of tax deficiencies and accrual of interest

4.65. The process of obtaining relief from double taxation through a corresponding adjustment can be complicated by issues relating to the collection of tax deficiencies and the assessment of interest on those deficiencies or overpayment. A first problem is that the assessed deficiency may be collected before the corresponding adjustment proceeding is completed, because of a lack of domestic procedures allowing the collection to be suspended. This may cause the MNE group to pay the same tax twice until the issues can be resolved. This problem arises not only in the context of the mutual agreement procedure but also for internal appeals. The work on Action 14 of the BEPS Action Plan recognised that the collection of tax by both Contracting States pending the resolution of a case through the mutual agreement procedure may have a significant impact on a taxpayer's business (for example, as a result of cash flow problems). Such collection of tax may also make it more difficult for a competent authority to engage in good faith mutual agreement procedure discussions when it considers that it may likely have to refund taxes already collected. The Report on BEPS Action 14 accordingly includes as best practice 6 a recommendation that jurisdictions should take appropriate measures to provide for a suspension of collection procedures during the period in which a mutual agreement procedure case is pending; such a suspension of collections should be available, at a minimum, under the same conditions as apply to a person pursuing a domestic administrative or judicial remedy. In this regard, it should be noted that the country mutual agreement procedure profiles prepared pursuant to element 2.2 of the Action 14 minimum standard (see paragraph 4.62) include information on the availability of procedures for the suspension of collections in specific jurisdictions.

4.66. Whether or not collection of the deficiency is suspended or partially suspended, other complications may arise. Because of the lengthy time period for processing many transfer pricing cases, the interest due on a deficiency or, if a corresponding adjustment is allowed, on the overpayment of tax in the other jurisdiction can equal or exceed the amount of the tax itself. Jurisdictions should take into account in their mutual agreement procedures that inconsistent interest rules across the two jurisdictions may result in additional cost for the MNE group, or in other cases provide a benefit to the MNE group (e.g. where the interest paid in the jurisdiction making the corresponding adjustment exceeds the interest imposed in the jurisdictions making the primary adjustment) that would not have been available if the controlled transactions had been undertaken on an arm's length basis originally. As noted above, the Report on BEPS Action 14 includes as best practice 10 a recommendation that jurisdictions' published mutual agreement procedure guidance should provide guidance on the consideration of interest in the mutual agreement procedure. In addition, the country mutual agreement procedure profiles prepared pursuant to element 2.2 of the Action 14 minimum standard

include information on how interest and penalties are dealt with by specific jurisdictions in the context of the mutual agreement procedure.

4.67. The amount of interest (as distinct from the rate at which it is applied) may also have more to do with the year to which the jurisdiction making the corresponding adjustment attributes the corresponding adjustment. The jurisdiction making the corresponding adjustment may decide to make the adjustment for the year in which the primary adjustment is determined, in which case relatively little interest is likely to be payable (regardless of the rate of interest), whereas the jurisdiction making the primary adjustment may seek to impose interest on the understated and uncollected tax liability from the year in which the controlled transactions took place (notwithstanding that a relatively low rate of interest may be imposed). The issue of the year to which a corresponding adjustment is attributed is raised in paragraph 4.36. It may be appropriate in certain cases for both competent authorities to agree not to assess or pay interest in connection with the adjustment at issue, but this may not be possible in the absence of a specific provision addressing this issue in the relevant bilateral treaty. This approach would also reduce administrative complexities. However, as the interest on the deficiency and the interest on the overpayment are attributable to different taxpayers in different jurisdictions, there would be no assurance under such an approach that a proper economic result would be achieved.

C.5. Secondary adjustments

4.68. Corresponding adjustments are not the only adjustments that may be triggered by a primary transfer pricing adjustment. Primary transfer pricing adjustments and their corresponding adjustments change the allocation of taxable profits of an MNE group for tax purposes but they do not alter the fact that the excess profits represented by the adjustment are not consistent with the result that would have arisen if the controlled transactions had been undertaken on an arm's length basis. To make the actual allocation of profits consistent with the primary transfer pricing adjustment, some jurisdictions having proposed a transfer pricing adjustment will assert under their domestic legislation a constructive transaction (a secondary transaction), whereby the excess profits resulting from a primary adjustment are treated as having been transferred in some other form and taxed accordingly. Ordinarily, the secondary transactions will take the form of constructive dividends, constructive equity contributions, or constructive loans. For example, a jurisdiction making a primary adjustment to the income of a subsidiary of a foreign parent may treat the excess profits in the hands of the foreign parent as having been transferred as a dividend, in which case withholding tax may apply. It may be that the subsidiary paid an excessive transfer price to the foreign parent as a means of avoiding that withholding tax. Thus, secondary adjustments attempt to account for the difference between the re-determined taxable profits and the originally booked profits. The subjecting to tax of a

secondary transaction gives rise to a secondary transfer pricing adjustment (a secondary adjustment). Thus, secondary adjustments may serve to prevent tax avoidance. The exact form that a secondary transaction takes and of the consequent secondary adjustment will depend on the facts of the case and on the tax laws of the jurisdiction that asserts the secondary adjustment.

4.69. Another example of a tax administration seeking to assert a secondary transaction may be where the tax administration making a primary adjustment treats the excess profits as being a constructive loan from one associated enterprise to the other associated enterprise. In this case, an obligation to repay the loan would be deemed to arise. The tax administration making the primary adjustment may then seek to apply the arm's length principle to this secondary transaction to impute an arm's length rate of interest. The interest rate to be applied, the timing to be attached to the making of interest payments, if any, and whether interest is to be capitalised would generally need to be addressed. The constructive loan approach may have an effect not only for the year to which a primary adjustment relates but to subsequent years until such time as the constructive loan is considered by the tax administration asserting the secondary adjustment to have been repaid.

4.70. A secondary adjustment may result in double taxation unless a corresponding credit or some other form of relief is provided by the other country for the additional tax liability that may result from a secondary adjustment. Where a secondary adjustment takes the form of a constructive dividend any withholding tax which is then imposed may not be relievable because there may not be a deemed receipt under the domestic legislation of the other jurisdiction.

4.71. The Commentary on paragraph 2 of Article 9 of the OECD Model Tax Convention notes that the Article does not deal with secondary adjustments, and thus it neither forbids nor requires tax administrations to make secondary adjustments. In a broad sense, the purpose of double tax agreements can be stated as being for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital. Many jurisdictions do not make secondary adjustments either as a matter of practice or because their respective domestic provisions do not permit them to do so. Some jurisdictions might refuse to grant relief in respect of other jurisdictions' secondary adjustments and indeed they are not required to do so under Article 9.

4.72. Secondary adjustments are rejected by some jurisdictions because of the practical difficulties they present. For example, if a primary adjustment is made between brother-sister companies, the secondary adjustment may involve a hypothetical dividend from one of those companies up a chain to a common parent, followed by constructive equity contributions down another chain of ownership to reach the other company involved in the transaction. Many hypothetical transactions might be created, raising questions whether tax consequences should be triggered in other jurisdictions besides those involved

in the transaction for which the primary adjustment was made. This might be avoided if the secondary transaction were a loan, but constructive loans are not used by most jurisdictions for this purpose and they carry their own complications because of issues relating to imputed interest. It would be inappropriate for minority shareholders that are not parties to the controlled transactions and that have accordingly not received excess cash to be considered recipients of a constructive dividend, even though a non-pro-rata dividend might be considered inconsistent with the requirements of applicable corporate law. In addition, as a result of the interaction with the foreign tax credit system, a secondary adjustment may excessively reduce the overall tax burden of the MNE group.

4.73. In light of the foregoing difficulties, tax administrations, when secondary adjustments are considered necessary, are encouraged to structure such adjustments in a way that the possibility of double taxation as a consequence thereof would be minimised, except where the taxpayer's behaviour suggests an intent to disguise a dividend for purposes of avoiding withholding tax. In addition, jurisdictions in the process of formulating or reviewing policy on this matter are recommended to take into consideration the above-mentioned difficulties.

4.74. Some jurisdictions that have adopted secondary adjustments also give the taxpayer receiving the primary adjustment another option that allows the taxpayer to avoid the secondary adjustment by having the taxpayer arrange for the MNE group of which it is a member to repatriate the excess profits to enable the taxpayer to conform its accounts to the primary adjustment. The repatriation could be effected either by setting up an account receivable or by reclassifying other transfers, such as dividend payments where the adjustment is between parent and subsidiary, as a payment of additional transfer price (where the original price was too low) or as a refund of transfer price (where the original price was too high).

4.75. Where a repatriation involves reclassifying a dividend payment, the amount of the dividend (up to the amount of the primary adjustment) would be excluded from the recipient's gross income (because it would already have been accounted for through the primary adjustment). The consequences would be that the recipient would lose any indirect tax credit (or benefit of a dividend exemption in an exemption system) and a credit for withholding tax that had been allowed on the dividend.

4.76. When the repatriation involves establishing an account receivable, the adjustments to actual cash flow will be made over time, although domestic law may limit the time within which the account can be satisfied. This approach is identical to using a constructive loan as a secondary transaction to account for excess profits in the hands of one of the parties to the controlled transaction. The accrual of interest on the account could have its own tax consequences, however, and this may complicate the process,

depending upon when interest begins to accrue under domestic law (as discussed in paragraph 4.69). Some jurisdictions may be willing to waive the interest charge on these accounts as part of a competent authority agreement.

4.77. Where a repatriation is sought, a question arises about how such payments or arrangements should be recorded in the accounts of the taxpayer repatriating the payment to its associated enterprise so that both it and the tax administration of that jurisdiction are aware that a repatriation has occurred or has been set up. The actual recording of the repatriation in the accounts of the enterprise from whom the repatriation is sought will ultimately depend on the form the repatriation takes. For example, where a dividend receipt is to be regarded by the tax administration making the primary adjustment and the taxpayer receiving the dividend as the repatriation, then this type of arrangement may not need to be specially recorded in the accounts of the associated enterprise paying the dividend, as such an arrangement may not affect the amount or characterisation of the dividend in its hands. On the other hand, where an account payable is set up, both the taxpayer recording the account payable and the tax administration of that jurisdiction will need to be aware that the account payable relates to a repatriation so that any repayments from the account or of interest on the outstanding balance in the account are clearly able to be identified and treated according to the domestic laws of that jurisdiction. In addition, issues may be presented in relation to currency exchange gains and losses.

4.78. As most OECD member countries at this time have not had much experience with the use of repatriation, it is recommended that agreements between taxpayers and tax administrations for a repatriation to take place be discussed in the mutual agreement proceeding where it has been initiated for the related primary adjustment.

D. Simultaneous tax examinations

D.1. Definition and background

4.79. A simultaneous tax examination is a form of mutual assistance, used in a wide range of international issues, that allows two or more jurisdictions to co-operate in tax investigations. Simultaneous tax examinations can be particularly useful where information based in a third jurisdiction is a key to a tax investigation, since they generally lead to more timely and more effective exchanges of information. Historically, simultaneous tax examinations of transfer pricing issues have focused on cases where the true nature of transactions was obscured by the interposition of tax havens. However, in complex transfer pricing cases, it is suggested that simultaneous examinations could serve a broader role since they may improve the adequacy of data available to the participating tax administrations for transfer pricing analyses. It has also been suggested that simultaneous examinations could help reduce the possibilities for economic double taxation, reduce the compliance

cost to taxpayers, and speed up the resolution of issues. In a simultaneous examination, if a reassessment is made, both jurisdictions involved should endeavour to reach a result that avoids double taxation for the MNE group.

4.80. Simultaneous tax examinations are defined in Part A of the *OECD Model Agreement for the Undertaking of Simultaneous Tax Examinations* (OECD Model Agreement). According to this agreement, a simultaneous tax examination means an “arrangement between two or more parties to examine simultaneously and independently, each on its own territory, the tax affairs of (a) taxpayer(s) in which they have a common or related interest with a view to exchanging any relevant information which they so obtain”. This form of mutual assistance is not meant to be a substitute for the mutual agreement procedure. Any exchange of information as a result of the simultaneous tax examination continues to be exchanged via the competent authorities, with all the safeguards that are built into such exchanges. Practical information on simultaneous examinations can be found in the relevant module of the Manual on Information Exchange that was adopted by the Committee on Fiscal Affairs on 23 January 2006 (see www.oecd.org/ctp/eoi/manual).

4.81. While provisions that follow Article 26 of the OECD Model Tax Convention may provide the legal basis for conducting simultaneous examinations, competent authorities frequently conclude working arrangements that lay down the objectives of their simultaneous tax examination programmes and practical procedures connected with the simultaneous tax examination and exchange of information. Once such an agreement has been reached on the general lines to be followed and specific cases have been selected, tax examiners and inspectors of each state will separately carry out their examination within their own jurisdiction and pursuant to their domestic law and administrative practice.

D.2. Legal basis for simultaneous tax examinations

4.82. Simultaneous tax examinations are within the scope of the exchange of information provision based on Article 26 of the OECD Model Tax Convention. Article 26 provides for co-operation between the competent authorities of the Contracting States in the form of exchanges of information necessary for carrying out the provisions of the Convention or of their domestic laws concerning taxes covered by the Convention. Article 26 and the Commentary do not restrict the possibilities of assistance to the three methods of exchanging information mentioned in the Commentary (exchange on request, spontaneous exchanges, and automatic exchanges).

4.83. Simultaneous tax examinations may be authorised outside the context of double tax treaties. For example, Article 12 of the Nordic Convention on Mutual Assistance in Tax Matters governs exchange of information and

assistance in tax collection between the Nordic countries and provides for the possibility of simultaneous tax examinations. This convention gives common guidelines for the selection of cases and for carrying out such examinations. Article 8 of the joint Council of Europe and OECD Convention on Mutual Administrative Assistance in Tax Matters also provides expressly for the possibility of simultaneous tax examinations.

4.84. In all cases the information obtained by the tax administration of a state has to be treated as confidential under its domestic legislation and may be used only for certain tax purposes and disclosed only to certain persons and authorities involved in specifically defined tax matters covered by the tax treaty or mutual assistance agreement. The taxpayers affected are normally notified of the fact that they have been selected for a simultaneous examination and in some jurisdictions they may have the right to be informed when the tax administrations are considering a simultaneous tax examination or when information will be transmitted in conformity with Article 26. In such cases, the competent authority should inform its counterpart in the foreign state that such disclosure will occur.

D.3. Simultaneous tax examinations and transfer pricing

4.85. In selecting transfer pricing cases for simultaneous examinations, there may be major obstacles caused by the differences in time limits for conducting examinations or making assessments in different jurisdictions and the different tax periods open for examination. However, these problems may be mitigated by an early exchange of examination schedules between the relevant competent authorities to find out in which cases the tax examination periods coincide and to synchronise future examination periods. While at first glance an early exchange of examination schedules would seem beneficial, some jurisdictions have found that the chances of a treaty partner accepting a proposal are considerably better when one is able to present issues more comprehensively to justify a simultaneous examination.

4.86. Once a case is selected for a simultaneous examination it is customary for tax inspectors or examiners to meet, to plan, to co-ordinate and to follow closely the progress of the simultaneous tax examination. Especially in complex cases, meetings of the tax inspectors or examiners concerned may also be held with taxpayer participation to clarify factual issues. In those jurisdictions where the taxpayer has the right to be consulted before information is transferred to another tax administration, this procedure should also be followed in the context of a simultaneous examination. In this situation, that tax administration should inform in advance its treaty partners that it is subject to this requirement before the simultaneous examination is begun.

4.87. Simultaneous tax examinations may be a useful instrument to determine the correct tax liability of associated enterprises in cases where, for example, costs are shared or charged and profits are allocated between taxpayers in different taxing jurisdictions or more generally where transfer pricing issues are involved. Simultaneous tax examinations may facilitate an exchange of information on multinational business practices, complex transactions, cost contribution arrangements, and profit allocation methods in special fields such as global trading and innovative financial transactions. As a result, tax administrations may acquire a better understanding of and insight into the overall activities of an MNE and obtain extended possibilities of comparison and checking international transactions. Simultaneous tax examinations may also support the industry-wide exchange of information, which is aimed at developing knowledge of taxpayer behaviour, practices and trends within an industry, and other information that might be suitable beyond the specific cases examined.

4.88. One objective of simultaneous tax examinations is to promote compliance with transfer pricing regulations. Obtaining the necessary information and determining the facts and circumstances about such matters as the transfer pricing conditions of controlled transactions between associated enterprises in two or more tax jurisdictions may be difficult for a tax administration, especially in cases where the taxpayer in its jurisdiction does not co-operate or fails to provide the necessary information in due time. The simultaneous tax examination process can help tax administrations to establish these facts faster and more effectively and economically.

4.89. The process also might allow for the identification of potential transfer pricing disputes at an early stage, thereby minimising litigation with taxpayers. This could happen when, based upon the information obtained in the course of a simultaneous tax examination, the participating tax examiners or inspectors have the opportunity to discuss any differences in opinion with regard to the transfer pricing conditions which exist between the associated enterprises and are able to reconcile these contentions. When such a process is undertaken, the tax examiners or inspectors concerned should, as far as possible, arrive at concurring statements as to the determination and evaluation of the facts and circumstances of the controlled transactions between the associated enterprises, stating any disagreements about the evaluation of facts, and any differences with respect to the legal treatment of the transfer pricing conditions which exist between the associated enterprises. Such statements could then serve as a basis for subsequent mutual agreement procedures and perhaps obviate the problems caused by one jurisdiction examining the affairs of a taxpayer long after the treaty partner country has finally settled the tax liability of the relevant associated enterprise. For example, such an approach could minimise mutual agreement procedure difficulties due to the lack of relevant information.

4.90. In some cases the simultaneous tax examination procedure may allow the participating tax administrations to reach an agreement on the transfer pricing conditions of a controlled transaction between the associated enterprises. Where an agreement is reached, corresponding adjustments may be made at an early stage, thus avoiding time-limit impediments and economic double taxation to the extent possible. In addition, if the agreement about the associated enterprises' transfer pricing is reached with the taxpayers' consent, time-consuming and expensive litigation may be avoided.

4.91. Even if no agreement between the tax administrations can be reached in the course of a simultaneous tax examination with respect to the associated enterprises' transfer pricing, the OECD Model Agreement envisions that either associated enterprise may be able to present a request for the opening of a mutual agreement procedure to avoid economic double taxation at an earlier stage than it would have if there were no simultaneous tax examination. If this is the case, then simultaneous tax examinations may significantly reduce the time span between a tax administration's adjustments made to a taxpayer's tax liability and the implementation of a mutual agreement procedure. Moreover, the OECD Model Agreement envisions that simultaneous tax examinations may facilitate mutual agreement procedures, because tax administrations will be able to build up more complete factual evidence for those tax adjustments for which a mutual agreement procedure may be requested by a taxpayer. Based upon the determination and evaluation of facts and the proposed tax treatment of the transfer pricing issues concerned as set forth in the tax administrations' statements described above, the practical operation of the mutual agreement procedure may be improved significantly, allowing the competent authorities to reach an agreement more easily.

4.92. The associated enterprises may also benefit from simultaneous tax examinations from the savings of time and resources due to the co-ordination of inquiries from the tax administrations involved and the avoidance of duplication. In addition, the simultaneous involvement of two or more tax administrations in the examination of transfer pricing between associated enterprises may provide the opportunity for an MNE to take a more active role in resolving its transfer pricing issues. By presenting the relevant facts and arguments to each of the participating tax administrations during the simultaneous tax examination the associated enterprises may help avoid misunderstandings and facilitate the tax administrations' concurring determination and evaluation of their transfer pricing conditions. Thus, the associated enterprises may obtain certainty with regard to their transfer pricing at an early stage. See paragraph 4.79.

D.4. Recommendation on the use of simultaneous tax examinations

4.93. As a result of the increased use of simultaneous tax examinations among OECD member countries, the Committee on Fiscal Affairs decided it

would be useful to draft the OECD Model Agreement for those countries that are able and wish to engage in this type of co-operation. On 23 July 1992, the Council of the OECD made a recommendation to member countries to use this Model Agreement, which provides guidelines on the legal and practical aspects of this form of co-operation.

4.94. With the increasing internationalisation of trade and business and the complexity of transactions of MNEs, transfer pricing issues have become more and more important. Simultaneous tax examinations can alleviate the difficulties experienced by both taxpayers and tax administrations connected with the transfer pricing of MNEs. A greater use of simultaneous tax examinations is therefore recommended in the examination of transfer pricing cases and to facilitate exchange of information and the operation of mutual agreement procedures. In a simultaneous examination, if a reassessment is made, both jurisdictions involved should endeavour to reach a result that avoids double taxation for the MNE group.

E. Safe harbours

E.1. Introduction

4.95. Applying the arm's length principle can be a resource-intensive process. It may impose a heavy administrative burden on taxpayers and tax administrations that can be exacerbated by both complex rules and resulting compliance demands. These facts have led OECD member countries to consider whether and when safe harbour rules would be appropriate in the transfer pricing area.

4.96. When these Guidelines were adopted in 1995, the view expressed regarding safe harbour rules was generally negative. It was suggested that while safe harbours could simplify transfer pricing compliance and administration, safe harbour rules may raise fundamental problems that could potentially have perverse effects on the pricing decisions of enterprises engaged in controlled transactions. It was suggested that unilateral safe harbours may have a negative impact on the tax revenues of the jurisdiction implementing the safe harbour, as well as on the tax revenues of jurisdictions whose associated enterprises engage in controlled transactions with taxpayers electing a safe harbour. It was further suggested that safe harbours may not be compatible with the arm's length principle. Therefore, it was concluded that transfer pricing safe harbours are not generally advisable, and consequently the use of safe harbours was not recommended.

4.97. Despite these generally negative conclusions, a number of jurisdictions have adopted safe harbour rules. Those rules have generally been applied to smaller taxpayers and/or less complex transactions. They are generally evaluated favourably by both tax administrations and taxpayers, who indicate

that the benefits of safe harbours outweigh the related concerns when such rules are carefully targeted and prescribed and when efforts are made to avoid the problems that could arise from poorly considered safe harbour regimes.

4.98. The appropriateness of safe harbours can be expected to be most apparent when they are directed at taxpayers and/or transactions which involve low transfer pricing risks and when they are adopted on a bilateral or multilateral basis. It should be recognised that a safe harbour provision does not bind or limit in any way any tax administration other than the tax administration that has expressly adopted the safe harbour.

4.99. Although safe harbours primarily benefit taxpayers, by providing for a more optimal use of resources, they can benefit tax administrations as well. Tax administrations can shift audit and examination resources from smaller taxpayers and less complex transactions (which may typically be resolved in practice on a consistent basis as to both transfer pricing methodology and actual results) to more complex, higher-risk cases. At the same time, taxpayers can price eligible transactions and file their tax returns with more certainty and with lower compliance burdens. However, the design of safe harbours requires careful attention to concerns about the degree of approximation to arm's length prices that would be permitted in determining transfer prices under safe harbour rules for eligible taxpayers, the potential for creating inappropriate tax planning opportunities including double non-taxation of income, equitable treatment of similarly situated taxpayers, and the potential for double taxation resulting from the possible incompatibility of the safe harbours with the arm's length principle or with the practices of other jurisdictions.

4.100. The following discussion considers the benefits of, and concerns regarding, safe harbour provisions and provides guidance regarding the circumstances in which safe harbours may be applied in a transfer pricing system based on the arm's length principle.

E.2. Definition and concept of safe harbours

4.101. Some of the difficulties that arise in applying the arm's length principle may be avoided by providing circumstances in which eligible taxpayers may elect to follow a simple set of prescribed transfer pricing rules in connection with clearly and carefully defined transactions, or may be exempted from the application of the general transfer pricing rules. In the former case, prices established under such rules would be automatically accepted by the tax administrations that have expressly adopted such rules. These elective provisions are often referred to as "safe harbours".

4.102. A safe harbour in a transfer pricing regime is a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a jurisdiction's

general transfer pricing rules. A safe harbour substitutes simpler obligations for those under the general transfer pricing regime. Such a provision could, for example, allow taxpayers to establish transfer prices in a specific way, e.g. by applying a simplified transfer pricing approach provided by the tax administration. Alternatively, a safe harbour could exempt a defined category of taxpayers or transactions from the application of all or part of the general transfer pricing rules. Often, eligible taxpayers complying with the safe harbour provision will be relieved from burdensome compliance obligations, including some or all associated transfer pricing documentation requirements.

4.103. For purposes of the discussion in this Section, safe harbours do not include administrative simplification measures which do not directly involve determination of arm's length prices, e.g. simplified, or exemption from, documentation requirements (in the absence of a pricing determination), and procedures whereby a tax administration and a taxpayer agree on transfer pricing in advance of the controlled transactions (advance pricing arrangements), which are discussed in Section F of this chapter. The discussion in this section also does not extend to tax provisions designed to prevent “excessive” debt in a foreign subsidiary (“thin capitalisation” rules).

4.104. Although they would not fully meet the foregoing description of a safe harbour, it may be the case that some jurisdictions adopt other administrative simplification measures that use presumptions to realise some of the benefits discussed in this Section. For example, a rebuttable presumption might be established under which a mandatory pricing target would be established by a tax authority, subject to a taxpayer's right to demonstrate that its transfer price is consistent with the arm's length principle. Under such a system, it would be essential that the taxpayer does not bear a higher burden to demonstrate its price is consistent with the arm's length principle than it would if no such system were in place. In any such system, it would be essential to permit resolution of cases of double taxation arising from application of the mandatory presumption through the mutual agreement process.

E.3. Benefits of safe harbours

4.105. The basic benefits of safe harbours are as follows:

1. Simplifying compliance and reducing compliance costs for eligible taxpayers in determining and documenting appropriate conditions for qualifying controlled transactions;
2. Providing certainty to eligible taxpayers that the price charged or paid on qualifying controlled transactions will be accepted by the tax administrations that have adopted the safe harbour with a limited audit or without an audit beyond ensuring the taxpayer has met the eligibility conditions of, and complied with, the safe harbour provisions;

3. Permitting tax administrations to redirect their administrative resources from the examination of lower risk transactions to examinations of more complex or higher risk transactions and taxpayers.

E.3.1. Compliance relief

4.106. Application of the arm's length principle may require collection and analysis of data that may be difficult or costly to obtain and/or evaluate. In certain cases, such compliance burdens may be disproportionate to the size of the taxpayer, its functions performed, and the transfer pricing risks inherent in its controlled transactions.

4.107. Properly designed safe harbours may significantly ease compliance burdens by eliminating data collection and associated documentation requirements in exchange for the taxpayer pricing qualifying transactions within the parameters set by the safe harbour. Especially in areas where transfer pricing risks are small, and the burden of compliance and documentation is disproportionate to the transfer pricing exposure, such a trade-off may be mutually advantageous to taxpayers and tax administrations. Under a safe harbour, taxpayers would be able to establish transfer prices which will not be challenged by tax administrations providing the safe harbour without being obligated to search for comparable transactions or expend resources to demonstrate transfer pricing compliance to such tax administrations.

E.3.2. Certainty

4.108. Another advantage provided by a safe harbour is the certainty that the taxpayer's transfer prices will be accepted by the tax administration providing the safe harbour, provided they have met the eligibility conditions of, and complied with, the safe harbour provisions. The tax administration would accept, with limited or no scrutiny, transfer prices within the safe harbour parameters. Taxpayers could be provided with relevant parameters which would provide a transfer price deemed appropriate by the tax administration for the qualifying transaction.

E.3.3. Administrative simplicity

4.109. A safe harbour would result in a degree of administrative simplicity for the tax administration. Although the eligibility of particular taxpayers or transactions for the safe harbour would need to be carefully evaluated, depending on the specific safe harbour provision, such evaluations would not necessarily have to be performed by auditors with transfer pricing expertise. Once eligibility for the safe harbour has been established, qualifying taxpayers would require minimal examination with respect to the transfer prices of controlled transactions qualifying for the safe harbour. This would enable tax

administrations to secure tax revenues in low risk situations with a limited commitment of administrative resources and to concentrate their efforts on the examination of more complex or higher risk transactions and taxpayers. A safe harbour may also increase the level of compliance among small taxpayers that may otherwise believe their transfer pricing practices will escape scrutiny.

E.4. Concerns over safe harbours

4.110. The availability of safe harbours for a given category of taxpayers or transactions may have adverse consequences. These concerns stem from the fact that:

1. The implementation of a safe harbour in a given jurisdiction may lead to taxable income being reported that is not in accordance with the arm's length principle;
2. Safe harbours may increase the risk of double taxation or double non-taxation when adopted unilaterally;
3. Safe harbours potentially open avenues for inappropriate tax planning, and
4. Safe harbours may raise issues of equity and uniformity.

E.4.1. Divergence from the arm's length principle

4.111. Where a safe harbour provides a simplified transfer pricing approach, it may not correspond in all cases to the most appropriate method applicable to the facts and circumstances of the taxpayer under the general transfer pricing provisions. For example, a safe harbour might require the use of a particular method when the taxpayer could otherwise have determined that another method was the most appropriate method under the facts and circumstances. Such an occurrence could be considered as inconsistent with the arm's length principle, which requires the use of the most appropriate method.

4.112. Safe harbours involve a trade-off between strict compliance with the arm's length principle and administrability. They are not tailored to fit exactly the varying facts and circumstances of individual taxpayers and transactions. The degree of approximation of prices determined under the safe harbour with prices determined in accordance with the arm's length principle could be improved by collecting, collating, and frequently updating a pool of information regarding prices and pricing developments in respect of the relevant types of transactions between uncontrolled parties of the relevant nature. However, such efforts to set safe harbour parameters accurately enough to satisfy the arm's length principle could erode the administrative simplicity of the safe harbour.

4.113. Any potential disadvantages to taxpayers from safe harbours diverging from arm's length pricing are avoided when taxpayers have the option to either elect the safe harbour or price transactions in accordance with the arm's length principle. With such an approach, taxpayers that believe the safe harbour would require them to report an amount of income exceeding the arm's length amount could apply the general transfer pricing rules. While such an approach can limit the divergence from arm's length pricing under a safe harbour regime, it would also limit the administrative benefits of the safe harbour to the tax administration. Moreover, tax administrations would need to consider the potential loss of tax revenue from such an approach where taxpayers will pay tax only on the lesser of the safe harbour amount or the arm's length amount. Jurisdictions may also be concerned over the ability of taxpayers to opt in and out of a safe harbour, depending on whether the use of the safe harbour is favourable to the taxpayer in a particular year. Jurisdictions may be able to gain greater comfort regarding this risk by controlling the conditions under which a taxpayer can be eligible for the safe harbour, for example by requiring taxpayers to notify the tax authority in advance of using the safe harbour or to commit to its use for a certain number of years.

E.4.2. Risk of double taxation, double non-taxation, and mutual agreement concerns

4.114. One major concern raised by a safe harbour is that it may increase the risk of double taxation. If a tax administration sets safe harbour parameters at levels either above or below arm's length prices in order to increase reported profits in its jurisdiction, it may induce taxpayers to modify the prices that they would otherwise have charged or paid to controlled parties, in order to avoid transfer pricing scrutiny in the safe harbour jurisdiction. The concern of possible overstatement of taxable income in the jurisdiction providing the safe harbour is greater where that jurisdiction imposes significant penalties for understatement of tax or failure to meet documentation requirements, with the result that there may be added incentives to ensure that the transfer pricing is accepted in that jurisdiction without further review.

4.115. If the safe harbour causes taxpayers to report income above arm's length levels, it would work to the benefit of the tax administration providing the safe harbour, as more taxable income would be reported by such domestic taxpayers. On the other hand, the safe harbour may lead to less taxable income being reported in the tax jurisdiction of the foreign associated enterprise that is the other party to the transaction. The other tax administrations may then challenge prices derived from the application of a safe harbour, with the result that the taxpayer would face the prospect of double taxation. Accordingly, any administrative benefits gained by the tax administration of the safe harbour jurisdiction would potentially be obtained at the expense of other jurisdictions

which, in order to protect their own tax base, would have to determine systematically whether the prices or results permitted under the safe harbour are consistent with what would be obtained by the application of their own transfer pricing rules. The administrative burden saved by the jurisdiction offering the safe harbour would therefore be shifted to the foreign jurisdictions.

4.116. In cases involving smaller taxpayers or less complex transactions, the benefits of safe harbours may outweigh the problems raised by such provisions. Provided the safe harbour is elective, taxpayers may consider that a moderate level of double taxation, if any arises because of the safe harbour, is an acceptable price to be paid in order to obtain relief from the necessity of complying with complex transfer pricing rules. One may argue that the taxpayer is capable of making its own decision in electing the safe harbour as to whether the possibility of double taxation is acceptable or not.

4.117. Where safe harbours are adopted unilaterally, care should be taken in setting safe harbour parameters to avoid double taxation, and the jurisdiction adopting the safe harbour should generally be prepared to consider modification of the safe-harbour outcome in individual cases under mutual agreement procedures to mitigate the risk of double taxation. At a minimum, in order to ensure that taxpayers make decisions on a fully informed basis, the jurisdiction offering the safe harbour would need to make it explicit in advance whether or not it would attempt to alleviate any eventual double taxation resulting from the use of the safe harbour. Obviously, if a safe harbour is not elective and if the jurisdiction in question refuses to consider double tax relief, the risk of double taxation arising from the safe harbour would be unacceptably high and inconsistent with double tax relief provisions of treaties.

4.118. On the other hand, if a unilateral safe harbour permits taxpayers to report income below arm's length levels in the jurisdiction providing the safe harbour, taxpayers would have an incentive to elect application of the safe harbour. In such a case, there would be no assurance that the taxpayer would report income in other jurisdictions on a consistent basis or at levels above arm's length levels based on the safe harbour. Moreover it is unlikely that other tax administrations would have the authority to require that income be reported above arm's length levels. While the burden of under-taxation in such situations would fall exclusively upon the jurisdiction adopting the safe harbour provision, and should not adversely affect the ability of other jurisdictions to tax arm's length amounts of income, double non-taxation would be unavoidable and could result in distortions of investment and trade.

4.119. It is important to observe that the problems of non-arm's length results and potential double taxation and double non-taxation arising under safe harbours could be largely eliminated if safe harbours were adopted on a bilateral or multilateral basis by means of competent authority agreements between jurisdictions. Under such a procedure, two or more jurisdictions

could, by agreement, define a category of taxpayers and/or transactions to which a safe harbour provision would apply and by agreement establish pricing parameters that would be accepted by each of the contracting jurisdictions if consistently applied in each of the jurisdictions. Such agreements could be published in advance and taxpayers could consistently report results in each of the affected jurisdictions in accordance with the agreement.

4.120. The rigor of having two or more jurisdictions with potentially divergent interests agree to such a safe harbour should serve to limit some of the arbitrariness that otherwise might characterise a unilateral safe harbour and would largely eliminate safe harbour-created double taxation and double non-taxation concerns. Particularly for some smaller taxpayers and/or less complex transactions, creation of bilateral or multilateral safe harbours by competent authority agreement may provide a worthwhile approach to transfer pricing simplification that would avoid some of the potential pitfalls of unilateral safe harbour regimes.

4.121. The Annex I to Chapter IV of these Guidelines contains sample memoranda of understanding that competent authorities might use to establish bilateral or multilateral safe harbours in appropriate situations for common classes of transfer pricing cases. The use of these sample memoranda of understanding should not be considered as either mandatory or prescriptive in establishing bilateral or multilateral safe harbours. Rather, they are intended to provide a possible framework for adaptation to the particular needs of the tax authorities of the jurisdictions concerned.

E.4.3. Possibility of opening avenues for tax planning

4.122. Safe harbours may also provide taxpayers with tax planning opportunities. Enterprises may have an incentive to modify their transfer prices in order to shift taxable income to other jurisdictions. This may also possibly induce tax avoidance, to the extent that artificial arrangements are entered into for the purpose of exploiting the safe harbour provisions. For instance, if safe harbours apply to “simple” or “small” transactions, taxpayers may be tempted to break transactions up into parts to make them seem simple or small.

4.123. If a safe harbour were based on an industry average, tax planning opportunities might exist for taxpayers with better than average profitability. For example, a cost-efficient company selling at the arm’s length price may be earning a mark-up of 15% on controlled sales. If a jurisdiction adopts a safe harbour requiring a 10% mark-up, the company might have an incentive to comply with the safe harbour and shift the remaining 5% to a lower tax jurisdiction. Consequently, taxable income would be shifted out of the jurisdiction. When applied on a large scale, this could mean significant revenue loss for the jurisdiction offering the safe harbour.

4.124. This concern may largely be avoided by the solution noted in paragraph 4.119 of adopting safe harbours on a bilateral or multilateral basis, thus limiting application of safe harbours to transactions involving jurisdictions with similar transfer pricing concerns. In adopting bilateral and multilateral safe harbours, tax administrations would need to be aware that the establishment of an extensive network of such arrangements could potentially encourage “safe harbour shopping” via the routing of transactions through territories with more favourable safe harbours and take appropriate steps to avoid that possibility. Similarly, jurisdictions adopting bilateral safe harbours would be well advised to target fairly narrow ranges of acceptable results and to require consistent reporting of income in each jurisdiction that is a party to the safe harbour arrangement. Treaty exchange of information provisions could be used by jurisdictions where necessary to confirm the use of consistent reporting under such a bilateral safe harbour.

4.125. Whether a jurisdiction is prepared to possibly suffer some erosion of its own tax base in implementing a safe harbour is for that jurisdiction to decide. The basic trade-off in making such a policy decision is between the certainty and administrative simplicity of the safe harbour for taxpayers and tax administrations on the one hand, and the possibility of tax revenue erosion on the other.

E.4.4. Equity and uniformity issues

4.126. Safe harbours may raise equity and uniformity issues. By implementing a safe harbour, one would create two distinct sets of rules in the transfer pricing area. Clearly and carefully designed criteria are required to differentiate those taxpayers or transactions eligible for the safe harbour to minimise the possibility of similar and possibly competing taxpayers finding themselves on opposite sides of the safe harbour threshold or, conversely, of allowing application of the safe harbour to unintended taxpayers or transactions. Insufficiently precise criteria could result in similar taxpayers receiving different tax treatment: one being permitted to meet the safe harbour rules and thus to be relieved from general transfer pricing compliance provisions, and the other being obliged to price its transactions in conformity with the general transfer pricing compliance provisions. Preferential tax treatment under safe harbour regimes for a specific category of taxpayers could potentially entail discrimination and competitive distortions. The adoption of bilateral or multilateral safe harbours could, in some circumstances, increase the potential of a divergence in tax treatment, not merely between different but similar taxpayers but also between similar transactions carried out by the same taxpayer with associated enterprises in different jurisdictions.

E.5. Recommendations on use of safe harbours

4.127. Transfer pricing compliance and administration is often complex, time consuming and costly. Properly designed safe harbour provisions, applied in appropriate circumstances, can help to relieve some of these burdens and provide taxpayers with greater certainty.

4.128. Safe harbour provisions may raise issues such as potentially having perverse effects on the pricing decisions of enterprises engaged in controlled transactions and a negative impact on the tax revenues of the jurisdiction implementing the safe harbour as well as on the jurisdictions whose associated enterprises engage in controlled transactions with taxpayers electing a safe harbour. Further, unilateral safe harbours may lead to the potential for double taxation or double non-taxation.

4.129. However, in cases involving smaller taxpayers or less complex transactions, the benefits of safe harbours may outweigh the problems raised by such provisions. Making such safe harbours elective to taxpayers can further limit the divergence from arm's length pricing. Where jurisdictions adopt safe harbours, willingness to modify safe-harbour outcomes in mutual agreement proceedings to limit the potential risk of double taxation is advisable.

4.130. Where safe harbours can be negotiated on a bilateral or multilateral basis, they may provide significant relief from compliance burdens and administrative complexity without creating problems of double taxation or double non-taxation. Therefore, the use of bilateral or multilateral safe harbours under the right circumstances should be encouraged.

4.131. It should be clearly recognised that a safe harbour, whether adopted on a unilateral or bilateral basis, is in no way binding on or precedential for jurisdictions which have not themselves adopted the safe harbour.

4.132. For more complex and higher risk transfer pricing matters, it is unlikely that safe harbours will provide a workable alternative to a rigorous, case by case application of the arm's length principle under the provisions of these Guidelines.

4.133. Tax administrations in each jurisdiction should carefully weigh the benefits of and concerns regarding safe harbours, making use of such provisions where they deem it appropriate.

F. Advance pricing arrangements⁶

F.1. Definition and concept of advance pricing arrangements

4.134. An advance pricing arrangement (APA) is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax administrations. APAs are intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues. They may be most useful when traditional mechanisms fail or are difficult to apply. Detailed guidelines for conducting advance pricing arrangements under the mutual agreement procedure (MAP APAs) were adopted in October 1999 and are found as an Annex to this chapter. The work pursuant to Action 14 of the BEPS Action Plan to ensure the timely, effective and efficient resolution of treaty-related disputes recommended, as non-binding best practice 4, that jurisdictions should implement bilateral APA programmes as soon as they have the capacity to do so, recognising that APAs provide a greater level of certainty in both treaty partner jurisdictions, lessen the likelihood of double taxation and may proactively prevent transfer pricing disputes. In this regard, it should be noted that the country mutual agreement procedure profiles prepared pursuant to element 2.2 of the Action 14 minimum standard include information on the bilateral APA programmes.

4.135. One key issue in the concept of APAs is how specific they can be in prescribing a taxpayer's transfer pricing over a period of years, for example whether only the transfer pricing methodology or more particular results can be fixed in a particular case. In general, great care must be taken if the APA goes beyond the methodology, the way it will be applied, and the critical assumptions, because more specific conclusions rely on predictions about future events.

4.136. The reliability of any prediction used in an APA depends both on the nature of the prediction and the critical assumptions on which the prediction is based. For example, it would not be reasonable to assert that the arm's length short-term borrowing rate for a certain corporation on intra-group borrowings will remain at 6% during the entire coming three years. It would be more plausible to predict that the rate will be LIBOR plus a fixed percentage. The prediction would become even more reliable if an

6. Additional guidance for conducting Advance Pricing Arrangements under the Mutual Agreement Procedure is found in Annex II to Chapter IV.

appropriate critical assumption were added regarding the company's credit rating (e.g. the addition to LIBOR will change if the credit rating changes).

4.137. As another example, it would not be appropriate to specify a profit split formula between associated enterprises if it is expected that the allocation of functions between the enterprises will be unstable. It would, however, be possible to prescribe a profit split formula if the role of each enterprise were articulated in critical assumptions. In certain cases, it might even be possible to make a reasonable prediction on the appropriateness of an actual profit split ratio if enough assumptions were provided.

4.138. In deciding how specific an APA can be in a particular case, tax administrations should recognise that predictions of absolute future profit experience seems least plausible. It may be possible to use profit ratios of independent enterprises as comparables, but these also are often volatile and hard to predict. Use of appropriate critical assumptions and use of ranges may enhance the reliability of predictions. Historical data in the industry in question can also be a guide.

4.139. In sum, the reliability of a prediction depends on the facts and circumstances of each actual case. Taxpayers and tax administrations need to pay close attention to the reliability of a prediction when considering the scope of an APA. Unreliable predictions should not be included in APAs. The appropriateness of a method and its application can usually be predicted, and the relevant critical assumptions made, with more reliability than future results (price or profit level).

4.140. Some jurisdictions allow for unilateral arrangements where the tax administration and the taxpayer in its jurisdiction establish an arrangement without the involvement of other interested tax administrations. However, a unilateral APA may affect the tax liability of associated enterprises in other tax jurisdictions. Where unilateral APAs are permitted, the competent authorities of other interested jurisdictions should be informed about the procedure as early as possible to determine whether they are willing and able to consider a bilateral arrangement under the mutual agreement procedure. In any event, jurisdictions should not include in any unilateral APA they may conclude with a taxpayer a requirement that the taxpayer waive access to the mutual agreement procedure if a transfer pricing dispute arises, and if another jurisdiction raises a transfer pricing adjustment with respect to a transaction or issue covered by the unilateral APA, the first jurisdiction is encouraged to consider the appropriateness of a corresponding adjustment and not to view the unilateral APA as an irreversible settlement.

4.141. Because of concerns over double taxation, most jurisdictions prefer bilateral or multilateral APAs (i.e. an arrangement in which two or more jurisdictions concur), and indeed some jurisdictions will not grant a unilateral

APA (i.e. an arrangement between the taxpayer and one tax administration) to taxpayers in their jurisdiction. The bilateral (or multilateral) approach is far more likely to ensure that the arrangements will reduce the risk of double taxation, will be equitable to all tax administrations and taxpayers involved, and will provide greater certainty to the taxpayers concerned. It is also the case in some jurisdictions that domestic provisions do not permit the tax administrations to enter into binding agreements directly with the taxpayers, so that APAs can be concluded with the competent authority of a treaty partner only under the mutual agreement procedure. For purposes of the discussion in this section, an APA is not intended to include a unilateral arrangement except where specific reference to a unilateral APA is made.

4.142. Tax administrations may find APAs particularly useful in profit allocation or income attribution issues arising in the context of global securities and commodity trading operations, and also in handling multilateral cost contribution arrangements. The concept of APAs also may be useful in resolving issues raised under Article 7 of the OECD Model Tax Convention relating to allocation problems, permanent establishments, and branch operations.

4.143. APAs, including unilateral ones, differ in some ways from more traditional private rulings that some tax administrations issue to taxpayers. An APA generally deals with factual issues, whereas more traditional private rulings tend to be limited to addressing questions of a legal nature based on facts presented by a taxpayer. The facts underlying a private ruling request may not be questioned by the tax administration, whereas in an APA the facts are likely to be thoroughly analysed and investigated. In addition, an APA usually covers several transactions, several types of transactions on a continuing basis, or all of a taxpayer's international transactions for a given period of time. In contrast, a private ruling request usually is binding only for a particular transaction.

4.144. The co-operation of the associated enterprises is vital to a successful APA negotiation. For example, the associated enterprises ordinarily would be expected to provide the tax administrations with the methodology that they consider most reasonable under the particular facts and circumstances. The associated enterprises also should submit documentation supporting the reasonableness of their proposal, which would include, for example, data relating to the industry, markets, and jurisdictions to be covered by the agreement. In addition, the associated enterprises may identify uncontrolled businesses that are comparable or similar to the associated enterprises' businesses in terms of the economic activities performed and the transfer pricing conditions, e.g. economic costs and risks incurred, and perform a functional analysis as described in Chapter I of these Guidelines.

4.145. Typically, associated enterprises are allowed to participate in the process of obtaining an APA, by presenting the case to and negotiating

with the tax administrations concerned, providing necessary information, and reaching agreement on the transfer pricing issues. From the associated enterprises' perspective, this ability to participate may be seen as an advantage over the conventional mutual agreement procedure.

4.146. At the conclusion of an APA process, the tax administrations should provide confirmation to the associated enterprises in their jurisdiction that no transfer pricing adjustment will be made as long as the taxpayer follows the terms of the arrangements. There should also be a provision in an APA (perhaps by reference to a range) that provides for possible revision or cancellation of the arrangement for future years when business operations change significantly, or when uncontrolled economic circumstances (e.g. significant changes in currency exchange rates) critically affect the reliability of the methodology in a manner that independent enterprises would consider significant for purposes of their transfer pricing.

4.147. An APA may cover all of the transfer pricing issues of a taxpayer (as is preferred by some jurisdictions) or may provide a flexibility to the taxpayer to limit the APA request to specified affiliates and intercompany transactions. An APA would apply to prospective years and transactions and the actual term would depend on the industry, products or transactions involved. The associated enterprises may limit their request to specified prospective tax years. An APA can provide an opportunity to apply the agreed transfer pricing methodology to resolve similar transfer pricing issues in open prior years. However, this application would require the agreement of the tax administration, the taxpayer, and, where appropriate, the treaty partner. Element 2.7 of the Action 14 minimum standard states that jurisdictions with bilateral APA programmes should provide for the roll-back of APAs (to previous filed tax years not included within the original scope of the APA) in appropriate cases, subject to the applicable time limits (such as domestic law statutes of limitation for assessments) where the relevant facts and circumstances in the earlier tax years are the same and subject to the verification of these facts and circumstances on audit.

4.148. Each tax administration involved in the APA will naturally wish to monitor compliance with the APA by the taxpayers in its jurisdiction, and this is generally done in two ways. First, it may require a taxpayer that has entered into an APA to file annual reports demonstrating the extent of its compliance with the terms and conditions of the APA and that critical assumptions remain relevant. Second, the tax administration may continue to examine the taxpayer as part of the regular audit cycle but without re-evaluating the methodology. Instead, the tax administration may limit the examination of the transfer pricing to verifying the initial data relevant to the APA proposal and determining whether or not the taxpayer has complied with the terms and conditions of the APA. With regard to transfer pricing, a tax administration may also examine the reliability and accuracy of the representations in

the APA and annual reports and the accuracy and consistency of how the particular methodology has been applied. All other issues not associated with the APA fall under regular audit jurisdiction.

4.149. An APA should be subject to cancellation, even retroactively, in the case of fraud or misrepresentation of information during an APA negotiation, or when a taxpayer fails to comply with the terms and conditions of an APA. Where an APA is proposed to be cancelled or revoked, the tax administration proposing the action should notify the other tax administrations of its intention and of the reasons for such action.

F.2. Possible approaches for legal and administrative rules governing advance pricing arrangements

4.150. APAs involving the competent authority of a treaty partner should be considered within the scope of the mutual agreement procedure under Article 25 of the OECD Model Tax Convention, even though such arrangements are not expressly mentioned there. Paragraph 3 of that Article provides that the competent authorities shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. Although paragraph 50 of the Commentary indicates that the matters covered by this paragraph are difficulties of a general nature concerning a category of taxpayers, it specifically acknowledges that the issues may arise in connection with an individual case. In a number of cases, APAs arise from cases where the application of transfer pricing to a particular category of taxpayer gives rise to doubts and difficulties. Paragraph 3 of Article 25 also indicates that the competent authorities may consult together for the elimination of double taxation in cases not provided for in the Convention. Bilateral APAs should fall within this provision because they have as one of their objectives the avoidance of double taxation. Even though the Convention provides for transfer pricing adjustments, it specifies no particular methodologies or procedures other than the arm's length principle as set out in Article 9. Thus, it could be considered that APAs are authorised by paragraph 3 of Article 25 because the specific transfer pricing cases subject to an APA are not otherwise provided for in the Convention. The exchange of information provision in Article 26 also could facilitate APAs, as it provides for co-operation between competent authorities in the form of exchanges of information.

4.151. Tax administrations might additionally rely on general domestic authority to administer taxes as the authority for entering into APAs. In some jurisdictions tax administrations may be able to issue specific administrative or procedural guidelines to taxpayers describing the appropriate tax treatment of transactions and the appropriate pricing methodology. As mentioned above, the tax codes of some OECD member countries include provisions

that allow taxpayers to obtain specific rulings for different purposes. Even though these rulings were not designed specifically to cover APAs, they may be broad enough to be used to include APAs.

4.152. Some jurisdictions lack the basis in their domestic law to enter into APAs. However, when a tax convention contains a clause regarding the mutual agreement procedure similar to Article 25 of the OECD Model Tax Convention, the competent authorities generally should be allowed to conclude an APA, if transfer pricing issues were otherwise likely to result in double taxation, or would raise difficulties or doubts as to the interpretation or application of the Convention. Such an arrangement would be legally binding for both States and would create rights for the taxpayers involved. Inasmuch as double tax treaties take precedence over domestic law, the lack of a basis in domestic law to enter into APAs would not prevent application of APAs on the basis of a mutual agreement procedure.

F.3. Advantages of advance pricing arrangements

4.153. An APA programme can assist taxpayers by eliminating uncertainty through enhancing the predictability of tax treatment in international transactions. Provided the critical assumptions are met, an APA can provide the taxpayers involved with certainty in the tax treatment of the transfer pricing issues covered by the APA for a specified period of time. In some cases, an APA may also provide an option to extend the period of time to which it applies. When the term of an APA expires, the opportunity may also exist for the relevant tax administrations and taxpayers to renegotiate the APA. Because of the certainty provided by an APA, a taxpayer may be in a better position to predict its tax liabilities, thereby providing a tax environment that is favourable for investment.

4.154. APAs can provide an opportunity for both tax administrations and taxpayers to consult and co-operate in a non-adversarial spirit and environment. The opportunity to discuss complex tax issues in a less confrontational atmosphere than in a transfer pricing examination can stimulate a free flow of information among all parties involved for the purpose of coming to a legally correct and practicably workable result. The non-adversarial environment may also result in a more objective review of the submitted data and information than may occur in a more adversarial context (e.g. litigation). The close consultation and co-operation required between the tax administrations in an APA programme also leads to closer relations with treaty partners on transfer pricing issues.

4.155. An APA may prevent costly and time-consuming examinations and litigation of major transfer pricing issues for taxpayers and tax administrations. Once an APA has been agreed, less resources may be needed

for subsequent examination of the taxpayer's return, because more information is known about the taxpayer. It may still be difficult, however, to monitor the application of the arrangement. The APA process itself may also present time savings for both taxpayers and tax administrations over the time that would be spent in a conventional examination, although in the aggregate there may be no net time savings, for example, in jurisdictions that do not have an audit procedure and where the existence of an APA may not directly affect the amount of resources devoted to compliance.

4.156. Bilateral and multilateral APAs substantially reduce or eliminate the possibility of juridical or economic double or non taxation since all the relevant jurisdictions participate. By contrast, unilateral APAs do not provide certainty in the reduction of double taxation because tax administrations affected by the transactions covered by the APA may consider that the methodology adopted does not give a result consistent with the arm's length principle. In addition, bilateral and multilateral APAs can enhance the mutual agreement procedure by significantly reducing the time needed to reach an agreement since competent authorities are dealing with current data as opposed to prior year data that may be difficult and time-consuming to produce.

4.157. The disclosure and information aspects of an APA programme as well as the co-operative attitude under which an APA can be negotiated may assist tax administrations in gaining insight into complex international transactions undertaken by MNEs. An APA programme can improve knowledge and understanding of highly technical and factual circumstances in areas such as global trading and the tax issues involved. The development of specialist skills that focus on particular industries or specific types of transactions will enable tax administrations to give better service to other taxpayers in similar circumstances. Through an APA programme tax administrations have access to useful industry data and analysis of pricing methodologies in a co-operative environment.

F.4. Disadvantages relating to advance pricing arrangements

4.158. Unilateral APAs may present significant problems for tax administrations and taxpayers alike. From the point of view of other tax administrations, problems arise because they may disagree with the APA's conclusions. From the point of view of the associated enterprises involved, one problem is the possible effect on the behaviour of the associated enterprises. Unlike bilateral or multilateral APAs, the use of unilateral APAs may not lead to an increased level of certainty for the taxpayer involved and a reduction in economic or juridical double taxation for the MNE group. If the taxpayer accepts an arrangement that over-allocates income to the jurisdiction making the APA in order to avoid lengthy and expensive transfer pricing enquiries or excessive penalties, the administrative burden shifts from the jurisdiction providing the

APA to other tax jurisdictions. Taxpayers should not feel compelled to enter into APAs for these reasons.

4.159. Another problem with a unilateral APA is the issue of corresponding adjustments. The flexibility of an APA may lead the taxpayer and the associated party to accommodate their pricing to the range of permissible pricing in the APA. In a unilateral APA, it is critical that this flexibility preserve the arm's length principle since a foreign competent authority is not likely to allow a corresponding adjustment arising out of an APA that is inconsistent, in its view, with the arm's length principle.

4.160. Another possible disadvantage would arise if an APA involved an unreliable prediction on changing market conditions without adequate critical assumptions, as discussed above. To avoid the risk of double taxation, it is necessary for an APA programme to remain flexible, because a static APA may not satisfactorily reflect arm's length conditions.

4.161. An APA programme may initially place a strain on transfer pricing audit resources, as tax administrations will generally have to divert resources earmarked for other purposes (e.g. examination, advising, litigation, etc.) to the APA programme. Demands may be made on the resources of a tax administration by taxpayers seeking the earliest possible conclusion to an APA request, keeping in mind their business objectives and time scales, and the APA programme as a whole will tend to be led by the demands of the business community. These demands may not coincide with the resource planning of the tax administrations, thereby making it difficult to process efficiently both the APAs and other equally important work. Renewing an APA, however, is likely to be less time-consuming than the process of initiating an APA. The renewal process may focus on updating and adjusting facts, business and economic criteria, and computations. In the case of bilateral arrangements, the agreement of the competent authorities of both Contracting States is to be obtained on the renewal of an APA to avoid double taxation (or non-taxation).

4.162. Another potential disadvantage could occur where one tax administration has undertaken a number of bilateral APAs which involve only certain of the associated enterprises within an MNE group. A tendency may exist to harmonise the basis for concluding later APAs in a way similar to those previously concluded without sufficient regard being had to the conditions operating in other markets. Care should therefore be taken with interpreting the results of previously concluded APAs as being representative across all markets.

4.163. Concerns have also been expressed that, because of the nature of the APA procedure, it will interest taxpayers with a good voluntary compliance history. Experience in some jurisdictions has shown that, most often, taxpayers

which would be interested in APAs are very large corporations which would be audited on a regular basis, with their pricing methodology then being examined in any event. The difference in the examination conducted of their transfer pricing would be one of timing rather than extent. As well, it has not been demonstrated that APAs will be of interest solely or principally to such taxpayers. Indeed, there are some early indications that taxpayers, having experienced difficulty with tax administrations on transfer pricing issues and not wishing these difficulties to continue, are often interested in applying for an APA. There is then a serious danger of audit resources and expertise being diverted to these taxpayers and away from the investigation of less compliant taxpayers, where these resources could be better deployed in reducing the risk of losing tax revenue. The balance of compliance resources may be particularly difficult to achieve since an APA programme tends to require highly experienced and often specialised staff. Requests for APAs may be concentrated in particular areas or sectors, e.g. global trading, and this can overstretch the specialist resources already allocated to those areas by the authorities. Tax administrations require time to train experts in specialist fields in order to meet unforeseeable demands from taxpayers for APAs in those areas.

4.164. In addition to the foregoing concerns, there are a number of possible pitfalls as described below that could arise if an APA programme were improperly administered, and tax administrations who use APAs should make strong efforts to eliminate the occurrence of these problems as APA practice evolves.

4.165. For example, an APA might seek more detailed industry and taxpayer specific information than would be requested in a transfer pricing examination. In principle, this should not be the case and the documentation required for an APA should not be more onerous than for an examination, except for the fact that in an APA the tax administration will need to have details of predictions and the basis for those predictions, which may not be central issues in a transfer pricing examination that focuses on completed transactions. In fact, an APA should seek to limit the documentation, as discussed above, and focus the documentation more closely on the issues in light of the taxpayer's business practices. Tax administrations need to recognise that:

- a) Publicly available information on competitors and comparables is limited;
- b) Not all taxpayers have the capacity to undertake in-depth market analyses; and,
- c) Only parent companies may be knowledgeable about group pricing policies.

4.166. Another possible concern is that an APA may allow the tax administration to make a closer study of the transactions at issue than would occur in

the context of a transfer pricing examination, depending on the facts and circumstances. The taxpayer must provide detailed information relating to its transfer pricing and satisfy any other requirements imposed for the verification of compliance with the terms and conditions of the APA. At the same time, the taxpayer is not sheltered from normal and routine examinations by the tax administration on other issues. An APA also does not shelter a taxpayer from examination of its transfer pricing activities. The taxpayer may still have to establish that it has complied in good faith with the terms and conditions of the APA, that the material representations in the APA remain valid, that the supporting data used in applying the methodology were correct, that the critical assumptions underlying the APA are still valid and are applied consistently, and that the methodology is applied consistently. Tax administrations should, therefore, seek to ensure that APA procedures are not unnecessarily cumbersome and that they do not make more demand of taxpayers than are strictly required by the scope of the APA application.

4.167. Problems could also develop if tax administrations misuse information obtained in an APA in their examination practices. If the taxpayer withdraws from its APA request or if the taxpayer's application is rejected after consideration of all of the facts, any nonfactual information provided by the taxpayer in connection with the APA request, such as settlement offers, reasoning, opinions, and judgments, cannot be treated as relevant in any respect to the examination. In addition, the fact that a taxpayer has applied unsuccessfully for an APA should not be taken into account by the tax administration in determining whether to commence an examination of that taxpayer.

4.168. Tax administrations also should ensure the confidentiality of trade secrets and other sensitive information and documentation submitted to them in the course of an APA proceeding. Therefore, domestic rules against disclosure should be applied. In a bilateral APA the confidentiality requirements on treaty partners would apply, thereby preventing public disclosure of confidential data.

4.169. An APA programme cannot be used by all taxpayers because the procedure can be expensive and time-consuming and small taxpayers generally may not be able to afford it. This is especially true if independent experts are involved. APAs may therefore only assist in resolving mainly large transfer pricing cases. In addition, the resource implications of an APA programme may limit the number of requests a tax administration can entertain. In evaluating APAs, tax administrations can alleviate these potential problems by ensuring that the level of inquiry is adjusted to the size of the international transactions involved.

F.5. Recommendations

F.5.1. In general

4.170. Since the Guidelines were published in their original version in 1995, a significant number of OECD member countries have acquired experience with APAs. Those jurisdictions which do have some experience seem to be satisfied so far, so that it can be expected that under the appropriate circumstances the experience with APAs will continue to expand. The success of APA programmes will depend on the care taken in determining the proper degree of specificity for the arrangement based on critical assumptions, the proper administration of the programme, and the presence of adequate safeguards to avoid the pitfalls described above, in addition to the flexibility and openness with which all parties approach the process.

4.171. There are some continuing issues regarding the form and scope of APAs that require greater experience for full resolution and agreement among member countries, such as the question of unilateral APAs. The Committee on Fiscal Affairs intends to monitor carefully any expanded use of APAs and to promote greater consistency in practice among those countries that choose to use them.

F.5.2. Coverage of an arrangement

4.172. When considering the scope of an APA, taxpayers and tax administrations need to pay close attention to the reliability of any predictions so as to exclude unreliable predictions. In general, great care must be taken if the APA goes beyond the methodology, its application, and critical assumptions. See paragraphs 4.134-4.139.

F.5.3. Unilateral versus bilateral (multilateral) arrangements

4.173. Wherever possible, an APA should be concluded on a bilateral or multilateral basis between competent authorities through the mutual agreement procedure of the relevant treaty. A bilateral APA carries less risk of taxpayers feeling compelled to enter into an APA or to accept a non-arm's-length agreement in order to avoid expensive and prolonged enquiries and possible penalties. A bilateral APA also significantly reduces the chance of any profits either escaping tax altogether or being doubly taxed. Moreover, concluding an APA through the mutual agreement procedure may be the only form that can be adopted by a tax administration which lacks domestic legislation to conclude binding agreements directly with the taxpayer.

F.5.4. Equitable access to APAs for all taxpayers

4.174. As discussed above, the nature of APA proceedings may *de facto* limit their accessibility to large taxpayers. The restriction of APAs to large taxpayers may raise questions of equality and uniformity, since taxpayers in identical situations should not be treated differently. A flexible allocation of examination resources may alleviate these concerns. Tax administrations also may need to consider the possibility of adopting a streamlined access for small taxpayers. Tax administrations should take care to adapt their levels of inquiry, in evaluating APAs, to the size of the international transactions involved.

F.5.5. Developing working agreements between competent authorities and improved procedures

4.175. Between those jurisdictions that use APAs, greater uniformity in APA practices could be beneficial to both tax administrations and taxpayers. Accordingly, the tax administrations of such jurisdictions may wish to consider working agreements with the competent authorities for the undertaking of APAs. These agreements may set forth general guidelines and understandings for the reaching of mutual agreement in cases where a taxpayer has requested an APA involving transfer pricing issues.

4.176. In addition, bilateral APAs with treaty partners should conform to certain requirements. For example, the same necessary and pertinent information should be made available to each tax administration at the same time, and the agreed upon methodology should be in accordance with the arm's length principle.

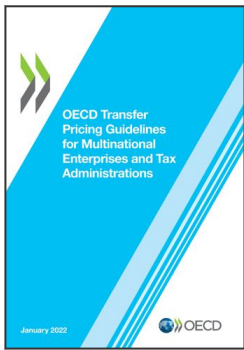
G. Arbitration

4.177. As trade and investment have taken on an increasingly international character, the tax disputes that, on occasion, arise from such activities have likewise become increasingly international. And more particularly, the disputes no longer involve simply controversy between a taxpayer and its tax administration but also concern disagreements between tax administrations themselves. In many of these situations, the MNE group is primarily a stakeholder and the real parties in interest are the governments involved. Although traditionally problems of double taxation have been resolved through the mutual agreement procedure, relief is not guaranteed if the tax administrations, after consultation, cannot reach an agreement on their own and if there is no mechanism, such as an arbitration clause similar to the one of paragraph 5 of Article 25, to provide the possibility of a resolution. However, where a particular tax treaty contains an arbitration clause similar to the one of paragraph 5 of Article 25, this extension of the mutual agreement procedure

makes a resolution of the case still possible by submitting one or more issues on which the competent authorities cannot reach an agreement to arbitration.

4.178. In the 2008 update to the OECD Model Tax Convention, Article 25 was supplemented with a new paragraph 5 which provides that, in the cases where the competent authorities are unable to reach an agreement within two years, the unresolved issues will, at the request of the person who presented the case, be solved through an arbitration process. This extension of the mutual agreement procedure ensures that where the competent authorities cannot reach an agreement on one or more issues that prevent the resolution of a case, a resolution of the case will still be possible by submitting those issues to arbitration. Arbitration under paragraph 5 of Article 25 is an integral part of the mutual agreement procedure and does not constitute an alternative route to solving tax treaty disputes between States. Paragraphs 63-85 of the Commentary on Article 25 provide guidance on the arbitration phase of the mutual agreement procedure.

4.179. The existence of an arbitration clause similar to paragraph 5 of Article 25 in a particular bilateral treaty should make the mutual agreement procedure itself more effective even in cases where resort to arbitration is not necessary. The very existence of this possibility should encourage greater use of the mutual agreement procedure since both governments and taxpayers will know at the outset that the time and effort put into the mutual agreement procedure will be likely to produce a satisfactory result. Further, governments will have an incentive to ensure that the mutual agreement procedure is conducted efficiently in order to avoid the necessity of subsequent supplemental procedures.



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