# *Preface*

1. The role of multinational enterprises (MNEs) in world trade has continued to increase dramatically since the adoption of these Guidelines in 1995. This in part reflects the increased pace of integration of national economies and technological progress, particularly in the area of communications. The growth of MNEs presents increasingly complex taxation issues for both tax administrations and the MNEs themselves since separate country rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in a broad international context.

2. These issues arise primarily from the practical difficulty, for both MNEs and tax administrations, of determining the income and expenses of a company or a permanent establishment that is part of an MNE group that should be taken into account within a jurisdiction, particularly where the MNE group's operations are highly integrated.

3. In the case of MNEs, the need to comply with laws and administrative requirements that may differ from jurisdiction to jurisdiction creates additional problems. The differing requirements may lead to a greater burden on an MNE, and result in higher costs of compliance, than for a similar enterprise operating solely within a single tax jurisdiction.

4. In the case of tax administrations, specific problems arise at both policy and practical levels. At the policy level, jurisdictions need to reconcile their legitimate right to tax the profits of a taxpayer based upon income and expenses that can reasonably be considered to arise within their territory with the need to avoid the taxation of the same item of income by more than one tax jurisdiction. Such double or multiple taxation can create an impediment to cross-border transactions in goods and services and the movement of capital. At a practical level, a jurisdiction's determination of such income and expense allocation may be impeded by difficulties in obtaining pertinent data located outside its own jurisdiction.

5. At a primary level, the taxing rights that each jurisdiction asserts depend on whether the jurisdiction uses a system of taxation that is residence-based, source-based, or both. In a residence-based tax system, a jurisdiction

will include in its tax base all or part of the income, including income from sources outside that jurisdiction, of any person (including juridical persons such as corporations) who is considered resident in that jurisdiction. In a source-based tax system, a jurisdiction will include in its tax base income arising within its tax jurisdiction, irrespective of the residence of the taxpayer. As applied to MNEs, these two bases, often used in conjunction, generally treat each enterprise within the MNE group as a separate entity. OECD member countries have chosen this separate entity approach as the most reasonable means for achieving equitable results and minimising the risk of unrelieved double taxation. Thus, each individual group member is subject to tax on the income arising to it (on a residence or source basis).

6. In order to apply the separate entity approach to intra-group transactions, individual group members must be taxed on the basis that they act at arm's length in their transactions with each other. However, the relationship among members of an MNE group may permit the group members to establish special conditions in their intra-group relations that differ from those that would have been established had the group members been acting as independent enterprises operating in open markets. To ensure the correct application of the separate entity approach, OECD member countries have adopted the arm's length principle, under which the effect of special conditions on the levels of profits should be eliminated.

7. These international taxation principles have been chosen by OECD member countries as serving the dual objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation, thereby minimising conflict between tax administrations and promoting international trade and investment. In a global economy, co-ordination among jurisdictions is better placed to achieve these goals than tax competition. The OECD, with its mission to contribute to the expansion of world trade on a multilateral, non-discriminatory basis and to achieve the highest sustainable economic growth in member countries, has continuously worked to build a consensus on international taxation principles, thereby avoiding unilateral responses to multilateral problems.

8. The foregoing principles concerning the taxation of MNEs are incorporated in the *OECD Model Tax Convention on Income and on Capital* (OECD Model Tax Convention), which forms the basis of the extensive network of bilateral income tax treaties between OECD member countries and between OECD member and non-member countries. These principles also are incorporated in the Model United Nations Double Taxation Convention between Developed and Developing Nations.

9. The main mechanisms for resolving issues that arise in the application of international tax principles to MNEs are contained in these bilateral treaties. The Articles that chiefly affect the taxation of MNEs are:

Article 4, which defines residence; Articles 5 and 7, which determine the taxation of permanent establishments; Article 9, which relates to the taxation of the profits of associated enterprises and applies the arm's length principle; Articles 10, 11, and 12, which determine the taxation of dividends, interest, and royalties, respectively; and Articles 24, 25, and 26, which contain special provisions relating to non-discrimination, the resolution of disputes, and exchange of information.

10. The Committee on Fiscal Affairs, which is the main tax policy body of the OECD, has issued a number of reports relating to the application of these Articles to MNEs and to others. The Committee has encouraged the acceptance of common interpretations of these Articles, thereby reducing the risk of inappropriate taxation and providing satisfactory means of resolving problems arising from the interaction of the laws and practices of different jurisdictions.

11. In applying the foregoing principles to the taxation of MNEs, one of the most difficult issues that has arisen is the establishment for tax purposes of appropriate transfer prices. Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises. For purposes of these Guidelines, an "associated enterprise" is an enterprise that satisfies the conditions set forth in Article 9, sub-paragraphs 1a) and 1b) of the OECD Model Tax Convention. Under these conditions, two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control, or capital of the other or if "the same persons participate directly or indirectly in the management, control, or capital" of both enterprises (i.e. if both enterprises are under common control). The issues discussed in these Guidelines also arise in the treatment of permanent establishments as discussed in the *Report on the Attribution of Profits to Permanent Establishments* that was adopted by the OECD Council in July 2010, which supersedes the OECD Report *Model Tax Convention: Attribution of Income to Permanent Establishments* (1994). Some relevant discussion may also be found in the OECD Report *International Tax Avoidance and Evasion* (1987).

12. Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions. Transfer pricing issues originally arose in transactions between associated enterprises operating within the same tax jurisdiction. The domestic issues are not considered in these Guidelines, which focus on the international aspects of transfer pricing. These international aspects are more difficult to deal with because they involve more than one tax jurisdiction and therefore any adjustment to the transfer price in one jurisdiction implies that a corresponding change in another jurisdiction is appropriate. However, if the other jurisdiction does not

agree to make a corresponding adjustment the MNE group will be taxed twice on this part of its profits. In order to minimise the risk of such double taxation, an international consensus is required on how to establish for tax purposes transfer prices on cross-border transactions.

13. These Guidelines are intended to be a revision and compilation of previous reports by the OECD Committee on Fiscal Affairs addressing transfer pricing and other related tax issues with respect to multinational enterprises. The principal report is *Transfer Pricing and Multinational Enterprises* (1979) (the "1979 Report") which was repealed by the OECD Council in 1995. Other reports address transfer pricing issues in the context of specific topics. These reports are *Transfer Pricing and Multinational Enterprises – Three Taxation Issues* (1984) (the "1984 Report"), and *Thin Capitalisation* (the "1987 Report"). A list of amendments made to these Guidelines is included in the Foreword.

14. These Guidelines also draw upon the discussion undertaken by the OECD on the proposed transfer pricing regulations in the United States [see the OECD Report *Tax Aspects of Transfer Pricing within Multinational Enterprises: The United States Proposed Regulations* (1993)]. However, the context in which that Report was written was very different from that in which these Guidelines have been undertaken, its scope was far more limited, and it specifically addressed the United States proposed regulations.

15. OECD member countries continue to endorse the arm's length principle as embodied in the OECD Model Tax Convention (and in the bilateral conventions that legally bind treaty partners in this respect) and in the 1979 Report. These Guidelines focus on the application of the arm's length principle to evaluate the transfer pricing of associated enterprises. The Guidelines are intended to help tax administrations (of both OECD member countries and non-member countries) and MNEs by indicating ways to find mutually satisfactory solutions to transfer pricing cases, thereby minimising conflict among tax administrations and between tax administrations and MNEs and avoiding costly litigation. The Guidelines analyse the methods for evaluating whether the conditions of commercial and financial relations within an MNE satisfy the arm's length principle and discuss the practical application of those methods. They also include a discussion of global formulary apportionment.

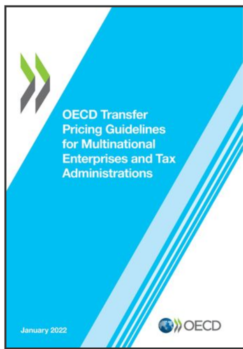
16. OECD member countries are encouraged to follow these Guidelines in their domestic transfer pricing practices, and taxpayers are encouraged to follow these Guidelines in evaluating for tax purposes whether their transfer pricing complies with the arm's length principle. Tax administrations are encouraged to take into account the taxpayer's commercial judgement about the application of the arm's length principle in their examination practices and to undertake their analyses of transfer pricing from that perspective.

17. These Guidelines are also intended primarily to govern the resolution of transfer pricing cases in mutual agreement proceedings between OECD member countries and, where appropriate, arbitration proceedings. They further provide guidance when a corresponding adjustment request has been made. 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 co-operative approach in resolving mutual agreement cases.

18. In seeking to achieve the balance between the interests of taxpayers and tax administrators in a way that is fair to all parties, it is necessary to consider all aspects of the system that are relevant in a transfer pricing case. One such aspect is the allocation of the burden of proof. In most jurisdictions, the tax administration bears the burden of proof, which may require the tax administration to make a *prima facie* showing that the taxpayer's pricing is inconsistent with the arm's length principle. It should be noted, however, that even in such a case a tax administration might still reasonably oblige the taxpayer to produce its records to enable the tax administration to undertake its examination of the controlled transactions. In other jurisdictions the taxpayer may bear the burden of proof in some respects. Some OECD member countries are of the view that Article 9 of the OECD Model Tax Convention establishes burden of proof rules in transfer pricing cases which override any contrary domestic provisions. Other countries, however, consider that Article 9 does not establish burden of proof rules (cf. paragraph 4 of the Commentary on Article 9 of the OECD Model Tax Convention). Regardless of which party bears the burden of proof, an assessment of the fairness of the allocation of the burden of proof would have to be made in view of the other features of the jurisdiction's tax system that have a bearing on the overall administration of transfer pricing rules, including the resolution of disputes. These features include penalties, examination practices, administrative appeals processes, rules regarding payment of interest with respect to tax assessments and refunds, whether proposed tax deficiencies must be paid before protesting an adjustment, the statute of limitations, and the extent to which rules are made known in advance. It would be inappropriate to rely on any of these features, including the burden of proof, to make unfounded assertions about transfer pricing. Some of these issues are discussed further in Chapter IV.

19. These Guidelines focus on the main issues of principle that arise in the transfer pricing area. The Committee on Fiscal Affairs intends to continue its work in this area. A revision of Chapters I-III and a new

Chapter IX were approved in 2010, reflecting work undertaken by the Committee on comparability, on transactional profit methods and on the transfer pricing aspects of business restructurings. In 2013, the guidance on safe harbours was also revised in order to recognise that properly designed safe harbours can help to relieve some compliance burdens and provide taxpayers with greater certainty. In 2016, these Guidelines were substantially revised in order to reflect the clarifications and revisions agreed in the 2015 BEPS Reports on Actions 8-10 *Aligning Transfer pricing Outcomes with Value Creation* and on Action 13 *Transfer Pricing Documentation and Country-by-Country Reporting*. In 2018, a revision of the guidance on the application of the profit split method in Chapter II was approved, as well as the addition of a new annex to Chapter VI which provides guidance for tax administrations on the application of the approach to hard-to-value intangibles. Finally, in 2020 a new Chapter X was added to these Guidelines to incorporate guidance on the transfer pricing aspects of financial transactions. The Committee intends to have regular reviews of the experiences of OECD member and selected non-member countries in applying the arm's length principle in order to identify areas on which further work could be necessary.

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