

**DURAN TIMMS**

**THE HARMONISATION OF TRANSFER PRICING: THE  
OBSTACLES, THE ARM'S LENGTH PRINCIPLE AND THE  
OECD GUIDELINES**

**LLM RESEARCH PAPER  
LAWS 516: TAXATION**



**2013**

## ***Abstract***

*This essay argues that the complete harmonisation of transfer pricing rules with the arm's length principle is unattainable for three reasons. First, states are not under a legal obligation to apply the principle outside of treaty or domestic law. Second, the theoretical shortcomings of the principle are creating a divergence from the OECD guidelines on how the principle should be applied. Third, the perception held by states that multinational enterprises are not paying a fair share of tax is also creating a divergence from the OECD guidelines on the principle. The resultant divergence is a significant obstacle to transfer pricing harmonisation.*

## ***Word length***

*The text of this paper (excluding abstract, table of contents, footnotes and bibliography) comprises approximately 14,870 words.*

## ***Subjects and Topics***

*Transfer pricing*

*Arm's length principle*

*OECD*

*Harmonisation*

*Profit-shifting*

## *Contents*

<b>I</b>	<b>Transfer Pricing and Multinational Enterprises .....</b>	<b>1</b>
A	Introduction .....	1
B	Global Context and Transfer Pricing Manipulation .....	3
<b>II</b>	<b>The OECD Response: the Arm's Length Principle and the OECD Guidelines ....</b>	<b>4</b>
A	The OECD Transfer Pricing Policy Framework.....	4
B	Priority of Methods in the OECD Guidelines .....	7
C	Harmonisation, the Arm's Length Principle and the OECD Guidelines.....	9
<b>III</b>	<b>Divergence .....</b>	<b>11</b>
A	Competing Treaty and Domestic Law Rules: Australia .....	12
B	Divergent Domestic Law Provisions: the United States.....	20
C	Understanding the Divergence .....	25
<b>IV</b>	<b>Obstacles to Harmonisation.....</b>	<b>28</b>
A	Legal Status of the Guidelines and the Arm's Length Principle Outside Domestic Law and Treaty Law .....	29
B	Theoretical Shortcomings of the Arm's Length Principle .....	36
C	A Fair Share of Tax .....	43
D	A Cause for Concern?.....	46
<b>V</b>	<b>Conclusion .....</b>	<b>47</b>
<b>VI</b>	<b>Bibliography .....</b>	<b>50</b>

# **I      Transfer Pricing and Multinational Enterprises**

## **A      Introduction**

Transfer pricing is an international tax issue that has grown in importance with the rise of global trading by multinational enterprises.<sup>1</sup> Transfer pricing refers to the price at which goods, services and intellectual property are charged between related parties in cross-border arrangements.<sup>2</sup> For example, suppose that the parent company of a multinational pharmaceutical group is incorporated in the United Kingdom. In order to manufacture a drug for distribution in the United Kingdom, the parent company wishes to acquire a generic drug from a subsidiary of the group incorporated in Canada. The transfer price is the amount that the United Kingdom parent company pays to acquire the drug from the Canadian subsidiary.

The structure of multinationals and the accompanying risks of transfer pricing manipulation present particular difficulties for tax authorities. The main difficulty is in determining how to allocate the income and expenses of a company in one jurisdiction that is part of a multinational group operating across several jurisdictions. A second and related difficulty is how to balance the right to tax the profits of a company arising from within an authority's jurisdiction, with the need to avoid the same profits being taxed again by another tax authority in a different jurisdiction. In order to address these difficulties, tax authorities around the world apply the separate entity approach to the taxation of multinational enterprises. Despite the high level of integration within a multinational, each constituent part of a multinational group is treated as a separate entity by the relevant tax authority and taxed according to source or residence rules. In broad terms, the approach ensures that the profits generated by a multinational subsidiary within a particular jurisdiction are taxable by that jurisdiction's authorities. In the absence of such an approach, multinationals could simply avoid a state's tax jurisdiction by shifting their taxable profits offshore.

---

<sup>1</sup> Jamie Elliot and Clive Emmanuel "International Transfer Pricing" in Andrew Lymer and John Hasseldine (eds) *The International Taxation System* (Kluwer Academic Publishers, Dordrecht, 2002) 157 at 158.

<sup>2</sup> Elliot and Emmanuel, above n 1, at 157.

Since the 1970s, the Organisation for Economic Co-operation and Development (OECD) has publicly promulgated the arm's length principle as a means of applying the separate entity approach to multinational enterprises. The arm's length principle eliminates the special conditions that exist between groups within a multinational structure. The principle requires that the prices or profits from a controlled transaction between the related parts of a multinational group be similar to the prices or profits from an uncontrolled transaction between independent parties in comparable circumstances. Independent parties are subject to ordinary market forces. Transactions between independent parties therefore provide a benchmark to assess whether transactions between related parties were carried out at arm's length.

The thesis of this essay is that the complete harmonisation of transfer pricing rules with the arm's length principle is unattainable.

The essay explores the hypothesis in three ways. First, Part II shows that the harmonisation of transfer pricing rules depends on the application of both the arm's length principle and the OECD guidelines on the interpretation of the principle. Second, Part III explores how transfer pricing rules are diverging from the arm's length principle in the OECD framework. The part shows that OECD member countries are free to develop domestic transfer pricing laws that are at odds with OECD policy. The part uses the transfer pricing laws in Australia and the United States to demonstrate the divergence. Third, Part IV analyses why prominent OECD member states are diverging from OECD transfer pricing policy.

Part IV uncovers three reasons behind the divergence. First, the principle and the guidelines do not have any legal effect until they have been incorporated into domestic law or treaty law. The lack of any binding legal effect outside of domestic or treaty law is a significant obstacle to transfer pricing harmonisation. Second, the arm's length principle has theoretical shortcomings. The shortcomings are being overcome by the use of arm's length methods in ways that diverge from OECD policy. Third, there exists a perception among governments that multinational enterprises are not paying an appropriate amount of tax. Governments are diverging from OECD policy in order to exact what they believe to be a fairer tax revenue return from multinational activities. Each of the three reasons for

divergence is a significant obstacle to the harmonisation of transfer pricing rules. Part V concludes that the complete harmonisation of transfer pricing rules with the arm's length principle is unattainable.

## B Global Context and Transfer Pricing Manipulation

5           The transfer pricing problem accompanied the rise of  
multinational trading in the aftermath of World War II.<sup>3</sup> The  
expansion of multinational trading has not slowed since. According to  
the OECD around 60 per cent of world trade takes place within  
multinational enterprises.<sup>4</sup> Multinationals operate in a marketplace  
10 where jurisdictional boundaries are no obstacle to trade. Typically,  
multinationals conduct their business by establishing a variety of legal  
structures in the countries from which they operate. These structures  
can take the form of subsidiaries, branches, joint ventures or  
partnerships; but the group is usually controlled by a parent company  
15 or partner in a single country.<sup>5</sup> Transactions that occur between  
separate or related parts of a multinational are not necessarily subject  
to the same economic or market forces that shape the dealings  
between independent parties in a similar transaction. The different  
parts of a multinational do not transact with each other on an  
20 uncontrolled open market. Rather, they transact within a controlled  
multinational structure.<sup>6</sup>

          Multinationals can use their structure to manipulate transfer  
prices, exploit avoidance opportunities and shift profits to countries  
where the corporate tax rate is lower.<sup>7</sup> Essentially, multinationals may  
25 manage their transfer pricing in order to arbitrage differences between  
national tax rates.<sup>8</sup> The arbitrage can be done in two ways. First, a  
multinational subsidiary may charge an artificially low price when  
selling a good or service to a related subsidiary in a low tax  
jurisdiction. The seller earns lower profits, and therefore pays less tax.  
30 Second, a multinational subsidiary may charge an artificially high  
price when selling a good or service to a related subsidiary in a high

---

<sup>3</sup> Stanley Langbein "The Unitary Method and the Myth of Arm's Length" (1986) 30 Tax Notes 625 at 642.

<sup>4</sup> OECD *OECD Insights Debate the Issues: Price fixing* (March 2012) <[www.oecdinsights.org](http://www.oecdinsights.org)>.

<sup>5</sup> Terry Thompson "Canada's Transfer Pricing Laws" (1998) 11 Transnat'l Law 311 at 315.

<sup>6</sup> Thompson, above n 5, at 316.

<sup>7</sup> Elliot and Emmanuel, above n 1, at 159.

<sup>8</sup> Elliot and Emmanuel, above n 1, at 159.

tax jurisdiction. The buyer earns lower profits, and therefore pays less tax. Although profits are lower in each case for one of the subsidiaries, the overall after-tax profits of the whole multinational group increase. The multinational, when viewed as a single economic entity, is better off. The transfer price shifts a multinational's profits from a subsidiary in a high tax jurisdiction to a subsidiary in a low one.

## **II The OECD Response: the Arm's Length Principle and the OECD Guidelines**

Part II analyses the policy framework that the OECD promulgates in order to tax multinational enterprises, reduce the risks of double taxation, and combat transfer pricing manipulation. The part assesses the extent to which the arm's length principle and other OECD transfer pricing policies have affected domestic legislation in different states.

### **A The OECD Transfer Pricing Policy Framework**

The arm's length principle is promulgated by the OECD through a combination of bilateral agreements and other OECD documents. Together the agreements and documents form a policy framework to address transfer pricing. At the centre of the framework is the OECD Model Tax Convention on Income and on Capital.<sup>9</sup> The model convention provides a uniform solution to the problem of international double taxation among OECD members. It is accompanied by a commentary that informs the interpretation of the model provisions. Since the first OECD draft model convention in 1963, an increasing number of member states have concluded bilateral tax treaties that follow the model provisions. The Council of the OECD specifically urges this course of action on members in order to achieve the harmonisation of principles, rules and interpretation in matters of double taxation.<sup>10</sup>

---

<sup>9</sup> OECD *Model Tax Convention on Income and in Capital* (OECD, Paris, 2010).

<sup>10</sup> OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (July 2010) at 20.

Article 9(1) of the model convention is the authoritative statement of the arm's length principle in cross-border transactions<sup>11</sup> and provides that:<sup>12</sup>

Where

- 5                   a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a
- 10                   Contracting State and an enterprise of the other Contracting State,

                     and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent

15                   enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

                     Neither art 9(1) nor any other provision in the model

20                   convention provides a way of determining whether a transfer price is consistent with the arm's length principle. Therefore, in addition to commentaries, the OECD publishes comprehensive guidelines on the application and interpretation of art 9(1). The guidelines are intended to harmonise the application of the arm's length principle by member

25                   states.<sup>13</sup> The OECD recommends that member states' domestic transfer pricing rules should align with the OECD transfer pricing guidelines. The OECD regularly publishes updated versions of the guidelines in order to reflect the changing consensus from member states as to how the arm's length principle should be applied. This essay focuses on the

30                   2010 version of the guidelines.<sup>14</sup> The 2010 version provides five methods that tax authorities should use in order to show that transfer prices accord with the arm's length principle.<sup>15</sup> In general terms the methods require that the "price or profits arising from a related party

---

<sup>11</sup> *Model Tax Convention on Income and on Capital*, above n 9, at C(9)-1.

<sup>12</sup> *Model Tax Convention on Income and on Capital*, above n 9, at art 9(1).

<sup>13</sup> Jose Calderon "The OECD Transfer Pricing Guidelines as a Source of Tax Law: Is Globalisation reaching the Tax Law?" (2007) 35 IT Rev 4 at 9.

<sup>14</sup> *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (July 2010).

<sup>15</sup> See *OECD Transfer Pricing Guidelines*, above n 10, at 59–103.



arrangement (a controlled transaction) be compared to the price or profits arising in an arrangement between unrelated parties (an uncontrolled transaction).”<sup>16</sup> Three of the methods, the traditional transaction methods, are regarded as the most direct means of establishing an arm’s length price as they compare a controlled transaction to the price that would have been paid in a comparable uncontrolled transaction between independent parties. The traditional transactional methods are the comparable uncontrolled price method, the resale price method, and the cost plus method.

#### 10     1       *Traditional transactional methods*

          The comparable uncontrolled price method is the preferred method if it is possible to locate data from comparable uncontrolled transactions.<sup>17</sup> The price in a comparable uncontrolled transaction is substituted into the price used by the parties in their controlled transaction in order to create arm’s length conditions.

          The resale price method is slightly different. The method starts with the price at which a product has been purchased from an associated enterprise in a controlled transaction, and then compares that purchase price to the price at which that product is resold to an independent enterprise.<sup>18</sup> In order to arrive at an arm’s length price the resale method reduces the resale price by a margin that reflects the amount of profit that the reseller could appropriately expect based on its costs, assets and risks.<sup>19</sup> The price remaining after the margin has been subtracted is the arm’s length price for the original transfer between the associated enterprises.<sup>20</sup>

          The last of the traditional transactional methods is the cost plus method. The cost plus method takes the costs incurred by the supplier in a controlled transaction and adds a mark-up to reflect the appropriate amount of profit that the supplier should earn on the basis of the functions of the supplier and the market conditions in which it operates.<sup>21</sup> The arm’s length price of the original transaction is arrived

---

<sup>16</sup> Julie Harrison and Mark Keating “New Zealand’s General Anti-Avoidance Provisions: A Domestic Transfer Pricing Regime by Proxy?” (2011) 17 NZ J Tax & Policy 419 at 422.

<sup>17</sup> *OECD Transfer Pricing Guidelines*, above n 10, at 63.

<sup>18</sup> At 65.

<sup>19</sup> At 65.

<sup>20</sup> At 65.

<sup>21</sup> At 71.

at by adding the mark up to the supplier's costs.<sup>22</sup> The cost plus method is most useful where semi-finished goods are sold in an uncontrolled transaction, or where the controlled transaction involves the provision of services.<sup>23</sup>

## 5     2     *Transactional profit methods*

The remaining two methods are known as the transactional profit methods and calculate an arm's length price by reference to the split profit margin that accrues to the relevant parties in a transaction. Profits arising from a controlled transaction may indicate whether the parties were transacting at arm's length.<sup>24</sup>

The first transactional profit method provided in the OECD guidelines is the transactional net margin method. Rather than calculating an arm's length price, the net margin method calculates an arm's length amount of profits. The guidelines require the arm's length amount of profits to be calculated using a range of financial ratios, such as return on assets, operating income to sales revenue and other net profit measures.<sup>25</sup> Ideally, the net profit that a taxpayer realises from a controlled transaction should be compared to the net profit that an identical taxpayer would earn in an uncontrolled transaction in order to ensure that arm's length net profit of the taxpayer in the controlled transaction has been reliably calculated.<sup>26</sup>

The remaining profit method is the transactional profit split method. The profit split method arrives at an arm's length amount of profits by taking the combined profits of a multinational group and splitting that amount between each of the associated enterprises within that multinational group.<sup>27</sup> Each enterprise within the multinational group is attributed an arm's length share of profit that reflects the enterprise's economic contribution to the combined group.<sup>28</sup>

## B     Priority of Methods in the OECD Guidelines

Each of the transfer pricing methods in the OECD guidelines is suited to particular situations. There is no single method that will yield

---

<sup>22</sup> At 71.

<sup>23</sup> At 71.

<sup>24</sup> *OECD Transfer Pricing Guidelines*, above n 10, at 77.

<sup>25</sup> At 78.

<sup>26</sup> At 77–78.

<sup>27</sup> At 93.

<sup>28</sup> At 93.

a reliable arm's length result in every case. The guidelines prioritise the methods by setting out when one method should be selected and applied over another.<sup>29</sup> The traditional transactional methods are regarded as the most reliable way to show whether dealings between associated enterprises are arm's length. The rationale is that any difference between the price of a controlled transaction and the price in an uncontrolled transaction can usually be traced directly back to the dealings and relations between the enterprises. The price differential is then easily overcome by substituting the price from the uncontrolled transaction into that between the parties in the controlled transaction.<sup>30</sup> Even if data concerning comparable uncontrolled transactions are difficult to obtain or are incomplete, the guidelines still urge tax authorities to use the traditional transactional methods and avoid deferring to the transactional profit methods.<sup>31</sup>

The OECD acknowledges that in some situations the transactional profit methods may be more appropriate than traditional transaction methods. For example, the parties in a transaction may be so highly integrated that no comparable uncontrolled transaction data exist, making profit methods more suitable than traditional transaction ones. However, the guidelines point out weaknesses in the transactional profit methods that tell against their application. The main weakness is that profit-based methods are vulnerable to factors that show losses for reasons completely unconnected with price. Where an enterprise experiences a loss, it is difficult to determine whether that loss is attributable to a deficit in operating income from external factors (such as low sales demand), or whether that loss is attributable to internal factors such as transfer pricing practices. For example, the transactional net margin relies on the use of net profit indicators that can introduce greater volatility into transfer prices. The net profit indicator for a taxpayer may be influenced by factors that do not directly affect the gross margins and prices between independent entities, such as differences in operating expenses across enterprises. The volatility of net profit indicators makes it difficult to reliably compare a controlled entity to an uncontrolled entity.

Not only do the guidelines point out the weaknesses in the profit methods, but the guidelines also highlight particular situations

---

<sup>29</sup> At 59.

<sup>30</sup> *OECD Transfer Pricing Guidelines*, above n 10, at 60.

<sup>31</sup> At 60.

where profit methods should never be used. The guidelines warn tax authorities against using profit methods to attack an enterprise that appears to be more successful or less successful than the enterprise's average performance suggests.<sup>32</sup>

5           In no case should transactional profit methods be used so as to  
result in over-taxing enterprises mainly because they make profits  
lower than the average, or in under-taxing enterprises that make  
higher than average profits. There is no justification under the  
arm's length principle for imposing additional tax on enterprises  
10       that are less successful than average or, conversely, for under-  
taxing enterprises that are more successful than average, when the  
reason for their success or lack thereof is attributable to  
commercial factors.

15           The OECD guidelines show a strong overall preference for the  
application of traditional transactional methods over transactional  
profit methods. The guidelines do allow for the application of  
transactional profit methods, but they warn that such methods should  
be approached with caution and applied only as measures of last  
resort.<sup>33</sup>

20       C       Harmonisation, the Arm's Length Principle and the OECD  
Guidelines

          The widespread acceptance by states of the arm's length  
principle has created a common international approach to transfer  
pricing. The principle has proliferated in bilateral tax conventions  
25       since first appearing in art 4 of the Convention Concerning Double  
Taxation between the United States and France.<sup>34</sup> The United States  
Treasury Department notes that not only is the standard included in all  
United States double tax treaties, but it is also included in most double  
tax treaties to which the United States is not a party.<sup>35</sup> Furthermore,  
30       virtually every major industrial nation uses the arm's length principle  
when addressing transfer pricing issues.<sup>36</sup> Developing countries such

---

<sup>32</sup> At 61.

<sup>33</sup> *OECD Transfer Pricing Guidelines*, above n 10, at 105.

<sup>34</sup> Brian D Lepard "Is the United States Obligated to Drive on the Right? A Multidisciplinary Inquiry into the Normative Authority of Contemporary International Law Using the Arm's Length Standard as a Case Study" (1999) 10 *Duke J Comp & Intl L* 43 at 69; Convention Concerning double Taxation, United States–France (signed April 27 1932), art 4.

<sup>35</sup> Lepard, above n 34, at 57.

<sup>36</sup> Lepard, above n 34, at 57.

as Chile, Argentina, Peru and Venezuela also apply the principle in their transfer pricing rules and even non-member countries such as Colombia apply the principle in their domestic legislation.<sup>37</sup> The prominence of the arm's length principle in transfer pricing rules shows that the rules are already converging to a uniform standard.

In addition to the wide-spread acceptance of the arm's length principle in domestic legislation, harmonisation of transfer prices also requires wide-spread acceptance of the OECD guidelines. Conformity with the guidelines ensures that the arm's length principle is applied consistently by tax authorities. According to a global transfer pricing survey carried out in 2013, all of the 58 countries surveyed apply the methods in the OECD guidelines to calculate an arm's length result.<sup>38</sup> For example, the OECD guidelines are directly incorporated into legislation in the United Kingdom. Paragraph 1(2) of sch 16 to the Finance Act 1998 contains the basic rule on transfer pricing. The rule requires the profits or losses of a potentially advantaged person to be computed as if arm's length provision had been imposed instead of the actual provision.<sup>39</sup> Paragraphs 2(1)–(3) in sch 16 require the schedule to be construed in such manner as best secures consistency between the OECD guidelines, OECD model tax convention and other OECD documents that comprise transfer pricing guidelines.

The development of transfer pricing legislation in Australia also shows how the OECD guidelines can shape and inform a country's transfer pricing rules. The Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013 introduced new rules into the Income Tax Assessment Act 1997.<sup>40</sup> Subdivision 815-B in the amendment Act requires certain amounts (taxable income, particular losses, tax offsets and withholding tax payable) to be worked out by applying arm's length principle set out in the OECD model tax convention.<sup>41</sup> The amendment Act was passed as a direct response to the OECD's own report looking into ways to improve

---

<sup>37</sup> Calderon, above n 13, at 5.

<sup>38</sup> Deloitte "2013 Global Transfer Pricing Country Guide" (2013) <[www.deloitte.com](http://www.deloitte.com)>. The countries that apply the OECD arm's length methods do not necessarily apply them according to the priority of that the OECD guidelines set out.

<sup>39</sup> Finance Act 1998 (UK), sch 16.

<sup>40</sup> Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013 (Cth), sch 2.

<sup>41</sup> Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2012 (No 1) (explanatory memorandum) at 2.18.

transfer pricing.<sup>42</sup> The report is called Addressing Base Erosion and Profit Shifting. The report notes the growing concerns by governments that multinational enterprises are exploiting existing OECD transfer pricing rules in order to engage in profit shifting.<sup>43</sup> Statements by the  
5 then Australian Assistant Treasurer, the Hon Bill Shorten MP, show the connection between Australia’s amended transfer pricing rules and the OECD’s own updates:<sup>44</sup>

10 [Australia’s] Modernised transfer pricing rules will reinforce the integrity of the corporate tax base and align our rules more closely to international standards. Last year, for example, the OECD substantially updated its Transfer Pricing Guidelines, which are used by governments and businesses alike.

The basis for the harmonisation of transfer pricing lies in states accepting both the arm’s length principle and the OECD  
15 guidelines. Once the arm’s length principle is incorporated into domestic legislation or a double tax treaty, the OECD guidelines guide the way that tax authorities apply the principle in order to arrive at an arm’s length result. The ability of the arm’s length principle to induce the harmonisation of transfer pricing is therefore dependent on two  
20 factors: the principle’s inclusion into domestic law or treaty law, and the application of the OECD guidelines to the principle.

### III Divergence

The arm’s length principle has been widely accepted and integrated into both domestic law and treaty law provisions of OECD  
25 member and non-member states. The integration indicates that there is already a high level of convergence in the way that states address cross-border transfer pricing issues. The existence of an international transfer pricing regime has resulted in a gradual creeping whereby domestic tax rules have been increasingly moulded by OECD transfer  
30 pricing policies and principles. The process is all the more remarkable because it has occurred without any binding multilateral agreements

---

<sup>42</sup> Kevin A Bell “Australia Welcomes OECD BEPS Report, Introduces Transfer Pricing Legislation” (2013) 21 Tax Management International Pricing Report 1035 at 1035.

<sup>43</sup> OECD *Addressing Base Erosion and Profit Shifting* (2013) at 13.

<sup>44</sup> Bill Shorten “Robust Transfer Pricing Rules for Multinationals” (press release, 1 November 2011).

backed by an international body, and indeed without any binding written agreement of any sort at all.

5 The fundamental weakness in the harmonisation of transfer pricing policies is that integration into domestic law allows for divergence from the international transfer pricing framework. A state's obligation to apply the principle or the guidelines only arises if the obligation is integrated the domestic law of the state. There are two main ways for the integration to occur. First, domestic transfer pricing provisions may be drafted on the basis of the transfer pricing regime, taking into account the OECD guidelines, the OECD model convention and the accompanying commentary.<sup>45</sup> Second, integration may occur through the conclusion of tax treaties that incorporate the wording of art 9 of the OECD model convention into its provisions.<sup>46</sup> The treaties are then given effect to in domestic law by further state action.<sup>47</sup>

20 There are several examples of where the integration of OECD rules into domestic law has allowed for a divergence from the arm's length principle. The examples fall into two distinct categories: those where there is both a domestic law provision and a treaty law provision that incorporate the arm's length principle, but differ in wording and effect; and those where the domestic law provisions are of themselves inconsistent with the arm's length principle.

#### A Competing Treaty and Domestic Law Rules: Australia

25 The evolution of transfer pricing rules in Australia is a clear example of a divergence from the arm's length principle. Australia's transfer pricing rules are found in both domestic legislation and in the provisions of Australia's double tax treaties. The interaction between treaty rules and domestic rules was considered in *SNF (Australia) Pty*

---

<sup>45</sup> Calderon, above n 13, at 16.

<sup>46</sup> Calderon, above n 13, at 16.

<sup>47</sup> If integration occurs through the conclusion of a double tax treaty, that treaty requires further state action to have the force of law. Such action may occur through a direct adoption method (where a treaty ratified by the executive is automatically incorporated into domestic law); or through an indirect adoption method (where a ratified treaty only has legislative force after it has been legislated into domestic law by parliament). See Nabil Orow "Comparative Approaches to the Interpretation of Double Tax Conventions" (2005) 26 *Adel L Rev* 73 at 78.

*Ltd. v Federal Commissioner of Taxation*.<sup>48</sup> The decision held that differences between Australian domestic law and treaty law preclude the tax authority from reconstructing a transfer price based solely on treaty provisions.<sup>49</sup> Subsequent amendments to Australia's transfer pricing rules overturned the effect of the *SNF* decision.<sup>50</sup> The position of Australian law prior to the transfer pricing amendments was consistent with the arm's length principle. The subsequent amendments to Australia's transfer pricing rules have created a divergence from the principle.

# 10     1       *Interaction between Australian domestic law and treaty law pre-amendments*

Australian treaty law is incorporated into domestic law through an indirect adoption method. A ratified treaty only has legal force after it has been legislated into domestic law by an Act of parliament.<sup>51</sup> A double tax treaty, for example, obtains the force of law by being added as a schedule to the International Tax Agreements Act 1953.<sup>52</sup> Section 4(1) of the International Tax Agreements Act then incorporates the provisions of the Income Tax Assessment Act 1936 into the International Agreements Act so that the two Acts are read together.<sup>53</sup> The Income Tax Assessment Act, which computes the tax base and imposes tax,<sup>54</sup> is duplicated in the treaty law and applies to residents from states that have signed a double tax treaty with Australia.<sup>55</sup> Section 4(2) of the International Tax Agreements Act clarifies any inconsistencies between the scheduled treaty provisions and the incorporated Income Tax Assessment Act provisions. It provides that the provisions of the International Tax Agreements Act (including the scheduled treaty law) apply in the event of any

<sup>48</sup> *SNF (Australia) Pty Ltd. v Federal Commissioner of Taxation* [2010] FCA 635, (2010) 79 ATR 193; aff'd *Federal Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74, [2011] 193 FCR 149.

<sup>49</sup> See *Federal Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74, [2011] 193 FCR 149.

<sup>50</sup> See Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013 (Cth).

<sup>51</sup> Robert L Deutsch (ed) *Australia's Double Taxation Agreements* (Legal Books, Sydney, 2000) at 5.

<sup>52</sup> Robert L Deutsch, above n 51, at 5.

<sup>53</sup> International Tax Agreements Act 1953 (Cth), s 4(1).

<sup>54</sup> See Income Tax Act 1986 (Cth), ss 4 and 5(1).

<sup>55</sup> Richard Krever and Jiaying Zhang "Australia: Resolving the Application of Competing Treaty and Domestic Law Transfer Pricing Rules" in M Lang and others *Tax Treaty Case Law Around the Globe* (Linde, Vienna, 2011) 199 at 202.



inconsistencies with the incorporated Income Tax Assessment Act.<sup>56</sup> An incorporated tax treaty in Australia therefore carries the force of law and features both the existing Australian taxing laws plus the legally binding provisions of the treaty itself.

5           Krever and Zhang point out that in general the interaction  
between provisions in treaty and domestic law is relatively  
straightforward.<sup>57</sup> Usually domestic law will create a right to tax and  
treaty law will act as a restriction on that right. The authors use a  
simple withholding tax example to illustrate the point. Under domestic  
10 law non-residents must pay a 30 per cent withholding tax on royalties  
sourced in Australia.<sup>58</sup> The domestic rule is restricted by Australia's  
double tax treaties that cap the withholding tax payable on the basis of  
art 12 of the OECD model convention.<sup>59</sup> However, because of  
differences in construction, the interaction between domestic law and  
15 treaty law on transfer pricing is less straightforward.

The Australian statutory rules on transfer pricing were  
formerly found in Division 13 of the Income Tax Assessment Act.<sup>60</sup>  
Section 136AD of Division 13 applied to the supply or acquisition of  
property under an international agreement between an Australian  
20 taxpayer and a foreign party who did not deal with each other at arm's  
length in relation to the amount of consideration.<sup>61</sup> Where s 136AD  
applied, the Commissioner was required to substitute an arm's length  
consideration in respect of the supply or acquisition.<sup>62</sup> The amount of  
consideration was treated as income for the purpose of determining  
25 source under s 136AE.<sup>63</sup> Taxable income<sup>64</sup> under Australian law is in  
turn calculated by measuring gross income,<sup>65</sup> and deductions from  
gross income allowed.<sup>66</sup> The calculation differs from other  
jurisdictions, such as the United Kingdom, that treat income as profit

---

<sup>56</sup> International Tax Agreements Act 1953 (Cth), s 4(2).

<sup>57</sup> Krever and Zhang, above n 55, at 203.

<sup>58</sup> Income Tax Assessment Act 1936 (Cth), ss 128B(2B) and 128B(5A); and Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974 (Cth), s 7(c).

<sup>59</sup> *Model Tax Convention on Income and on Capital*, above n 9, art 12.

<sup>60</sup> Repealed by Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013 (Cth), sch 2. The version of the Income Tax Assessment Act 1936 (Cth) prior to repeal is available at <[www.comlaw.gov.au/Details/C2013C00395/Html/Volume\\_1](http://www.comlaw.gov.au/Details/C2013C00395/Html/Volume_1)>.

<sup>61</sup> Income Tax Assessment Act 1936 (Cth), s 136AD (repealed).

<sup>62</sup> Sections 136AD(1)-(3).

<sup>63</sup> Section 136AE.

<sup>64</sup> Section 4-15.

<sup>65</sup> Section 6-5.

<sup>66</sup> Section 4-15.

for the purpose of corporate taxation.<sup>67</sup> Division 13 in Australian law did not provide for the taxation of profits per se. Where a cross-border transaction was not arm's length, the Commissioner of Taxation in Australia could not modify a company's profits when reassessing the taxpayer's taxable income. The Commissioner was only empowered to do recalculate either the consideration paid or received in the impugned transaction.

Australia has entered into over 35 full double tax treaties with a combination OECD member and non-member states.<sup>68</sup> All of the treaties by and large follow the format of the OECD model convention promulgated at the time the treaties were being negotiated and concluded. Cross-border transactions between associated enterprises in the current OECD model are addressed in art 9(1).<sup>69</sup> That article, when incorporated into domestic law as a schedule to the International Agreements Act 1953, obtains the force of law and provides the Commissioner with the power to recalculate the profits of an enterprise, not just gross income or allowed deductions. The distinction between the treaty law that includes art 9(1) and the provisions of Division 13 is that the former provided a wider taxing power than the latter. The treaty law provided a taxing right on profits through the recalculation of income that was not available under the provisions of Division 13. As Krever and Zhang remark, the wider power was previously "unknown in Australian law".<sup>70</sup>

Prior to Australia's transfer pricing amendments, the inconsistency between Division 13 and treaty law was subject to much debate.<sup>71</sup> The Australian Tax Office in its advice on the issue determined that the Commissioner may apply the provisions of either Division 13 or the treaty provisions.<sup>72</sup> Thus the Commissioner has

---

<sup>67</sup> Sections 6(1) and 6(4).

<sup>68</sup> Robert L Deutsch, above n 51, at 5.

<sup>69</sup> *Model Tax Convention on Income and on Capital*, above n 9, art 9(1).

<sup>70</sup> Krever and Zhang, above n 55, at 207.

<sup>71</sup> Dixon Hearder "New Transfer Pricing Legislation – Phase Two" (2013) 19 Asia-Pacific Tax Bulletin 136 at 141.

<sup>72</sup> Australian Tax Office *Income tax: application of the Division 13 transfer pricing provisions to loan arrangements and credit balances* (Taxation Ruling TR 92/11, October 1992) at 62(a). However, where the application of Division 13 would produce a result that is inconsistent with the treaty provisions, the latter will prevail; Australian Tax Office *Income tax: arm's length transfer pricing methodologies for international dealings* (Taxation Ruling TR 97/20, November 1997) at 1.7–1.8; and Australian Tax Office *Income tax: application of Division 13 of Part III (international profit shifting)* -

held to the view that where the treaty provisions yield a higher tax liability than domestic provisions, an assessment can be based on the higher amount under the treaty. The particular situation arose in *SNF (Australia) Pty Ltd. v Federal Commissioner of Taxation*.<sup>73</sup> The  
5 Federal Court ruled that, contrary to the Commissioner's view, alternate taxing powers sourced in treaty law were not available under Australian law.<sup>74</sup>

## 2        *The decision in SNF*

The first instance decision in *SNF* considered the application of  
10 s 136AD in Division 13 to purchases by a multinational subsidiary.<sup>75</sup> The multinational group was a French-based industrial chemicals manufacturer called SNF. The SNF subsidiary in Australia was the taxpayer. It purchased industrial cleaning products from SNF subsidiaries located in the United States, France and China. Australia  
15 has concluded bilateral tax treaties with each of the three countries and each treaty contains an article identical to the terms in art 9 of the OECD model convention. Despite evidence of good sales performance during the period from 1998 to 2004, SNF Australia incurred substantial trading losses.<sup>76</sup> The Commissioner reassessed the  
20 taxpayer's income over the sales period under the treaty provisions in order to produce a higher tax liability on the basis that the taxpayer's trading losses were purely the result of artificially high transfer pricing practices.<sup>77</sup>

On the facts of the case an assessment under Division 13  
25 would have yielded an entirely different result from an assessment under the bilateral tax treaty. Section 136AD of Division 13 permitted the Commissioner to make transfer pricing adjustments to an arrangement after assessing whether the price paid reflects arm's length consideration.<sup>78</sup> Division 13 did not prescribe any particular

---

*some basic concepts underlying the operation of Division 13 and some circumstances in which section 136AD will be applied* (Taxation Ruling TR 94/14, December 2011) at 154–158.

<sup>73</sup> See above n 48.

<sup>74</sup> *Federal Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74, [2011] 193 FCR 149.

<sup>75</sup> *SNF (Australia) Pty Ltd. v Federal Commissioner of Taxation* [2010] FCA 635, (2010) 79 ATR 193.

<sup>76</sup> *SNF (Australia) Pty Ltd. v Federal Commissioner of Taxation*, above n 75, at [12].

<sup>77</sup> At [13] and [164].

<sup>78</sup> Income Tax Assessment Act 1936 (Cth), s 136AD (repealed).

method for the purpose of ascertaining an arm's length amount.<sup>79</sup> However, the court considered that the then 1979 and 1995 OECD guidelines played a role in choosing the appropriate method and set out a priority of methods, beginning with the traditional transactional methods described in Part I.

The court elected to apply the comparable uncontrolled price method in order to find arm's length consideration through comparable transactions.<sup>80</sup> According to the court the comparable uncontrolled price method best accorded with the requirements of Division 13.<sup>81</sup> Section 136AD of the division gave particular focus to the *price* paid between non-arm's length parties in an impugned acquisition. The section required an analysis of the consideration that might reasonably be expected to have passed between independent parties dealing at arm's length with each other *in relation to the acquisition of the property under the transaction*.<sup>82</sup> An analysis of truly comparable transactions involving the acquisition of similar property in similar products, such as in a comparable uncontrolled price method, would best accord with Division 13. The court then accepted the taxpayer's comparable uncontrolled price calculations. The calculations showed that despite continual operating losses, the price it paid for the acquisition was comparable to the arm's length price paid by independent entities in similar transactions.<sup>83</sup> The Commissioner's reassessment therefore failed.

The Commissioner accepted that Division 13 was engaged in the case but nevertheless argued that its interpretation must be construed in the context of Australia's bilateral tax treaties. The treaties would yield a different result from that reached by the first instance court. The essence of the Commissioner's argument was that a reassessment of income on the basis of profit under the wider art 9(1) inquiry in Australia's treaties allowed transactional profit methods to be used as a proxy for price in order to indicate whether the consideration was arm's length under the narrower s 136AD. Applying a profit-based method, the taxpayer's poor profitability relative to other independent entities with similar risk profiles showed that more than arm's length consideration was paid by the taxpayer.

---

<sup>79</sup> At [56].

<sup>80</sup> At [62].

<sup>81</sup> At [129].

<sup>82</sup> At [42].

<sup>83</sup> At [164]–[171].

Reassessment under ss 136AD(1)–(3) was required.<sup>84</sup> The court rejected the argument as Division 13 did not allow a reassessment on the basis of profitability when data showing comparable prices could be adduced.<sup>85</sup>

5           The Commissioner made a similar submission on appeal before the full Federal Court, arguing that the OECD guidelines could be used to assist in the interpretation of Division 13 as those sections ought to be illuminated by the meaning of the treaties.<sup>86</sup> The Federal Court agreed with the reasoning of the trial judge on this point and  
10       dismissed the Commissioner’s appeal.

          The decision in *SNF* clarified the interaction between Australia’s transfer pricing rules found in treaty law and domestic law: the application of Division 13 required as a matter of law the use of methods that use truly comparable transactions if they are available on  
15       the facts. The result is consistent with the arm’s length principle promulgated by the OECD:<sup>87</sup>

          ... where ... a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional  
20       profit method.

          Subsequent amendments to income tax legislation in response to the *SNF* decisions have moved Australia’s transfer price regime away from the OECD guidelines on the arm’s length principle. The next section discusses these amendments in order to show how  
25       Australian law has subsequently diverged from the arm’s length principle and the OECD guidelines.

### 3       *Interaction between Australian domestic law and treaty law post-amendments*

          The Tax Laws Amendment (Countering Tax Avoidance and  
30       Multinational Profit Shifting) Act 2013 overturns the effect of the *SNF* decisions and confirms the availability of a broader, profit-based approach under Australian law. The Act purports to bring Australia’s

---

<sup>84</sup> *Federal Commissioner of Taxation v SNF (Australia) Pty Ltd*, above n 74, at [9].

<sup>85</sup> *SNF (Australia) Pty Ltd. v Federal Commissioner of Taxation*, above n 75, 193 at [129].

<sup>86</sup> *Federal Commissioner of Taxation v SNF (Australia) Pty Ltd*, above n 74, at [118].

<sup>87</sup> *OECD Transfer Pricing Guidelines*, above n 10, at 60.

transfer pricing rules into line with the OECD position.<sup>88</sup> The Act repealed the transfer pricing rules in Division 13 of the Income Tax Assessment Act 1936 and inserted subdivisions 815-B, 815-C and 815-D into the Income Tax Assessment Act 1997.<sup>89</sup> Subdivision 815-B applies to separate legal entities and provides for a closer alignment between Australia's bilateral tax treaties and its domestic laws.<sup>90</sup> The new subdivision continues to apply the arm's length principle. Where an entity receives a transfer pricing benefit from its financial or commercial relations with another entity, arm's length conditions are substituted in place of those that gave rise to the benefit.<sup>91</sup> Subdivision 815-B creates a scheme whereby a taxpayer is deemed to have operated at non-arm's length if a hypothetical taxpayer in similar circumstances would have provided different consideration. In making such an assessment the amendments prescribe a wide range of conditions that must be taken into account.<sup>92</sup> The conditions signal a clear departure from the narrow focus on price that was called for under Division 13. For example, in addition to prices, arm's length conditions include gross margins, net profits, the division of profit between the entities,<sup>93</sup> and any other surrounding circumstances that may be relevant.<sup>94</sup> The Federal Court in *SNF* expressly rejected the type of inquiry that the amendments now permit:<sup>95</sup>

I do not accept the Commissioner's submission that the test is to determine what consideration an arm's length party in the position of the taxpayer *would have given* for the products. The essential task is to determine the arm's length consideration in respect of the acquisition. One way to do this is to find truly comparable transactions ... (emphasis added).

The broader arm's length conditions set out in the amendment Act feed in to the choice of arm's length method. The Commissioner

<sup>88</sup> Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 (explanatory memorandum) at 2.1

<sup>89</sup> Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013 (Cth), sch 2.

<sup>90</sup> Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 (explanatory memorandum) at 2.2.

<sup>91</sup> Income Tax Assessment Act 1997(Cth), s 815-115.

<sup>92</sup> Income Tax Assessment Act 1997(Cth), s 815-125.

<sup>93</sup> Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013 (Cth), note 1 to s 815-115.

<sup>94</sup> Note 1 to s 815-115 is not exhaustive and accommodates other conditions that may be operating between entities where one of them receives a transfer pricing benefit.

<sup>95</sup> *Federal Commissioner of Taxation v SNF (Australia) Pty Ltd*, above n 74, at [93].

no longer faces the restriction that was apparent in *SNF*. The Commissioner, as a matter of law, does not have to rely on the use of pricing data in comparable transactions. Rather, the amendment Act's broader focus permits the Commissioner to prefer transactional profit methods over traditional transactional methods in situations where the latter do not show evidence of a non-arm's length result. The outcome in *SNF* would likely be different if the case were decided under the amended Income Tax Assessment Act 1997. Using a profit method based on a wider range of arm's length conditions under s 815-115 of the Act, the Commissioner would have been able to show that the taxpayer's lack of profitability demonstrated non-arm's length dealings. It would not matter that the taxpayer could already prove that its dealings were arm's length under a transactional method where independent parties in comparable transactions had paid similar prices for similar products. The amendments to Australia's transfer pricing rules permit profitability, not just price, to establish whether a transaction was carried out at arm's length.

#### 4 *Inconsistency with arm's length principle*

The amendments create a divergence from the OECD guidelines. While the OECD guidelines do not prohibit a broader profit-based focus to establish arm's length conditions, they do not endorse it where there is sufficient data to apply a traditional transactional analysis.<sup>96</sup> Australia's amendments are intended to accord with the OECD position on transfer pricing.<sup>97</sup> However, by granting the Commissioner the power to apply profit methods even where traditional transactional ones can be reliably used,<sup>98</sup> the provisions of the amendment Act diverge from the OECD guidelines on the arm's length principle.

#### B Divergent Domestic Law Provisions: the United States

The transfer pricing rules in the United States provide another example of where domestic provisions diverge from the arm's length principle promulgated by the OECD. The United States Tax Court decision in *National Semiconductor Corporation and Consolidated*

---

<sup>96</sup> *OECD Transfer Pricing Guidelines*, above n 10, at 60.

<sup>97</sup> Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 (explanatory memorandum) at 2.1

<sup>98</sup> The question whether traditional transactional methods are as reliable as the OECD guidelines suggest is considered in Part IV.

*Subsidiaries v Commissioner of Internal Revenue* illustrates how the application of United States rules to transfer pricing disputes is inconsistent with the OECD guidelines.<sup>99</sup>

*1 Transfer pricing rules and regulations*

5 Unlike the extensive provisions in subdivision 815B of the Australian transfer pricing rules, the United States Internal Revenue Code only has one provision that addresses transfer pricing. Section 482 provides:<sup>100</sup>

10 In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or  
15 businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

On the face of it § 482 is broad in scope and gives the Internal  
20 Revenue Service a wide adjustment power in order to clearly reflect taxable income. The section has no prescribed conditions that the Service must have regard to in determining an appropriate level of income, nor is there any reference to the arm's length principle to guide any adjustment. Kotraba points out that "[i]n general, § 482  
25 gives the Service carte blanche to adjust the taxable income of a multinational as it deems appropriate."<sup>101</sup> The detail underlying § 482 is left to regulations developed by the United States Department of the Treasury. The regulations are contained in the United States Code of Federal Regulations and set up the general principles and guidelines to  
30 be followed under § 482.<sup>102</sup> According to the regulations, the overarching purpose of § 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the

---

<sup>99</sup> *National Semiconductor Corporation and Consolidated Subsidiaries v Commissioner of Internal Revenue* 67 TC 2849 (1994). Although decided in 1994, the case has received no subsequent negative judicial treatment in the United States.

<sup>100</sup> Internal Revenue Code 26USC, § 482.

<sup>101</sup> Christopher Kotraba "Better than the 'Best': Transfer Pricing Methodology in the Wake of *Roche*" (2009) 48 Colum J Transnat'l L 140 at 146.

<sup>102</sup> Code of Federal Regulations Title 26, reg 1.482-1(a)(1).



avoidance of taxes with respect to such transactions.<sup>103</sup> The purpose is achieved by treating related parties as if they were dealing at arm's length with one another in a similar transaction and under similar circumstances (the arm's length principle).<sup>104</sup>

5           The regulations provide for a range of arm's length methods that may be used to evaluate whether related parties are operating at arm's length from each other. These methods are listed in regs 1.482-3(a)(1)–(6) in respect of tangible property and regs 1.482-4(a)(1)–(4) in respect of intangible property. The methods align with those set out  
10       in the OECD guidelines and consist of the traditional transactional methods and the transactional profit based methods. Crucially, however, the selection of the most appropriate method is not influenced by a priority of methods. Instead, the United States implements a best method rule where the method used to determine an  
15       arm's length standard must be the one that “under the facts and circumstances, provides the most reliable measure of an arm's length result.”<sup>105</sup> The rule represents a significant divergence from the arm's length principle promulgated by the OECD.

## 2       *Inconsistency with arm's length principle*

20           Under the best method rule, reliability is determined by two factors: the degree of comparability between a controlled and uncontrolled transaction; and the quality of the data and assumptions used in the analysis.<sup>106</sup> The degree of comparability and the quality of data are assessed on the basis of a range of conditions, including a  
25       comparison of the functions performed and associated resources employed by the taxpayers in each transaction; the contractual terms in each transaction being compared; and the risks and economic conditions faced by the entities in each transaction.<sup>107</sup>

30           The best method rule is inconsistent with the OECD guidelines. The best method rule allows the use of profit based methods in circumstances where the OECD guidelines recommend traditional transactional based ones. The nature of the divergence is similar to the effect of the Australian transfer pricing amendments described above. For example, suppose that Fictitious Corporation is incorporated in the

---

<sup>103</sup> Regulation 1.482-1(a)(1).

<sup>104</sup> Regulation 1.482-1(a)(1) and 1.482-1(a)(3)(b).

<sup>105</sup> Regulation 1.482-1(c)(1).

<sup>106</sup> Regulation 1.482-1(c)(2)(i).

<sup>107</sup> Regulation 1.482-1(d)(1) and 1.482-1(d)(3)(i)–(v).

United States and is preparing its income tax return for a given year.<sup>108</sup> The best method rule allows Fictitious Corp to choose from five equally appropriate methods so long as it is the most reliable under reg 1.482-1(a)(1). If each of the methods is equally reliable, but  
5 yield a different taxable income, Fictitious Corp will choose the method that yields the lowest taxable amount. The method resulting in the lowest taxable income could be a traditional transactional method (as was the case in *SNF*). The Internal Revenue Service may nevertheless challenge Fictitious Corp's chosen method and elect to  
10 apply another one that yields a higher taxable amount of income; for example, a profit-based method. Regulation 1.482-1(c) allows the selection of another method when it states that "[a]n arm's length result may be determined by any method without establishing the inapplicability of another method".<sup>109</sup> Therefore, the Revenue does  
15 not have to establish the inapplicability of Fictitious Corp's traditional transactional method before choosing to apply its own higher-yielding profit-based method.

These hypothetical facts materialised in *National Semiconductor Corporation and Consolidated Subsidiaries v Commissioner of Internal Revenue*.<sup>110</sup> The decision in *National Semiconductor* considered the application of § 482 of the Internal Revenue Code to purchases by a multinational subsidiary. The multinational group was a United States-based semiconductor manufacturer called National Semiconductor Corporation. The  
25 National Semiconductor subsidiary in the United States was the tax payer. It purchased packaged semiconductor devices from National Semiconductor subsidiaries located in Southeast Asia. The United States operations incurred substantial operating losses from the payments, while the Southeast Asian affiliates reported net profits in  
30 every year in issue.<sup>111</sup>

The taxpayer relied on the comparable uncontrolled price method in order to show that its transfer prices were charged at arm's

---

<sup>108</sup> The following is a hypothetical example adapted from Michael Aoramovich "Intercompany Transfer Pricing Regulations Under Internal Revenue Code Section 482: The Noose Tightens On Multinational Corporations" (1995) 28 J Marshall L Rev 915 at 915–916.

<sup>109</sup> Regulation 1.482-1(c).

<sup>110</sup> *National Semiconductor Corporation and Consolidated Subsidiaries v Commissioner of Internal Revenue*, above n 99.

<sup>111</sup> At 30.

length under § 482; whereas the Revenue presented two analyses under the profit-split and transactional net margin methods. Both parties presented a number of experts to support their positions. The Revenue sought a reallocation of USD 83.1 million to the taxpayer's income on the basis of higher-yielding profit-split and transactional net margin methods.<sup>112</sup> The taxpayer's methods showed that, if anything, the Southeast Asian subsidiaries were undercharging the taxpayer by USD 15.3 million compared to comparable uncontrolled prices.<sup>113</sup> There was no evidence, so the taxpayer argued, that the taxpayer was overcharging for the acquisition of the components in order to shift profits out of the United States.

The Tax Court rejected the Revenue's calculations as being unreasonable on the basis that the data included standard start-up costs for one of the Southeast Asian subsidiaries that did not reflect the true costs involved.<sup>114</sup> However, the court also rejected the taxpayer's calculations for failing to provide satisfactory price comparators under the comparable uncontrolled price method. The court was nevertheless swayed by the economic theory behind the Revenue's case and carried out its own modified assessment based on the Revenue's findings.<sup>115</sup> The Revenue's profit-based analyses compared the profits earned by each entity within the National Semiconductor group to the proportion of total assets held in each location.<sup>116</sup> The comparison showed that the United States entity was earning less profit than it should have been when compared to the proportion of operating assets that the entity held within the group.<sup>117</sup>

The court's attraction to the economic theory behind the Revenue's profit-based method shows that the court was interested in finding the true economic substance of profit from the United States entity. The court did not wish to engage in a narrow analysis of comparable pricing data under a traditional transactional method. Interestingly, the court relied on the Revenue's findings on the basis that out of all the evidence presented, the Revenue's was the least unacceptable.<sup>118</sup> The Revenue's evidence best reflected the economic effect of the taxpayer's transfer pricing practices. Although the

---

<sup>112</sup> At 32.

<sup>113</sup> At 65.

<sup>114</sup> At 93.

<sup>115</sup> At 98.

<sup>116</sup> At 85.

<sup>117</sup> At 86.

<sup>118</sup> At 98.

taxpayer was able to find what it saw as comparable pricing data, in the court's view those data did not adequately explain why the taxpayer was making a loss. The court determined that the United States operations should not have sustained losses while the Asian subsidiaries maintained high profits.<sup>119</sup> An income adjustment was therefore necessary.

The case shows how abandoning a priority of methods gives a tax authority a wide discretion to cut across the taxpayer's own traditional transactional calculations. The Australian discussion detailed how a movement away from a priority of methods is inconsistent with the OECD guidelines. The same observations are equally applicable in respect of the United States transfer pricing rules. The guidelines prefer arm's length prices to be first calculated according to traditional transactional methods. The current best method rule in United States transfer pricing regulations is inconsistent with the OECD preference. The rule allows profit-based methods to trump traditional transactional ones in cases where the latter may already show arm's length's dealings.

## C Understanding the Divergence

The Australia and United States rules on transfer pricing show a divergence from the arm's length principle promulgated by the OECD. It should be stressed that this divergence is not wholesale. This essay does not suggest that countries are completely abandoning the arm's length principle in favour of other approaches to taxing multinationals. The transfer pricing rules in Australia and the United States do show, however, that some OECD member countries are adopting differing views as to what sorts of results the arm's length principle should produce when arm's length conditions are being calculated. When asked the question "how long is arm's length?" the answer by some states is different from the answer by the OECD. The OECD guidelines are a crucial component of the international transfer pricing regime and it is in this document that the OECD expresses its view on how long an arm's length is according to its preferred order of methods. In spite of the OECD's clear direction, states still feel free to develop rules that allow their tax authorities to diverge from the OECD guidelines.

---

<sup>119</sup> At 98.

The divergence is leading to a rise in the use of profit-based allocation methods. For example, in the United States in 2000, 67.2 per cent of all transfer price methods that were agreed on in advance with the Revenue Service were profit-based.<sup>120</sup> The proportion rose to 75.6 per cent in 2008. The Australian Tax Office has also commented that profit methods such as the transactional net margin method have evolved as the transfer pricing method of choice over the years.<sup>121</sup> The problem with profit-based methods is that their application often devolves into an analysis that more closely resembles a formulary division of income between the related parties in a multinational enterprise.<sup>122</sup> Formulary apportionment is a method of income allocation that splits the profits of a multinational group amongst all the subsidiaries in the various countries in which the multinational operates.<sup>123</sup> The method applies a predetermined formula to each of the related parties in different countries and is usually based on factors such as sales, payroll, costs and assets.<sup>124</sup> The relevant tax authority then taxes the relevant related party in its jurisdiction based on the amount of profit that the apportionment formula yields.<sup>125</sup>

Formulary apportionment is considered the antithesis of the arm's length principle because it treats a multinational as a single entity with related parts.<sup>126</sup> By contrast, the arm's length principle treats related parties within a multinational group as separate entities.<sup>127</sup> The similarities between the application of profit-based methods in the OECD guidelines and the application of formulary apportionment are seen in *National Semiconductor Corporation*.<sup>128</sup> In that case the court applied a profit-based method and calculated the taxable income of the United States subsidiary on the basis of the

---

<sup>120</sup> Kotarba, above n 101, at 168.

<sup>121</sup> Pricewaterhouse Coopers "Roche Products Pty Limited v The Commissioner of Taxation: a bitter pill to swallow, but for whom?" (May 2008) TaxTalk Electronic Bulletin of Australian Tax Developments <www.pwc.com.au> at 4.

<sup>122</sup> Richard Schmalbeck "Opinio Juris in International Tax" (paper presented to The Role of *Opinio Juris* in Customary International Law, Duke-Geneva Institute in Transnational Law conference, Geneva, July 2013) at 7.

<sup>123</sup> John Neighbour and Jeffrey Owens "Transfer Pricing in the New Millennium: Will the Arm's Length Principle Survive?" (2002) 10 Geo Mason L Rev 951 at 955.

<sup>124</sup> *OECD Transfer Pricing Guidelines*, above n 10, at 37.

<sup>125</sup> At 37.

<sup>126</sup> Schmalbeck, above n 122, at 7.

<sup>127</sup> See the discussion above at Part II.

<sup>128</sup> *National Semiconductor Corporation*, above n 99.

gross profit margin that could be expected to accrue to the subsidiary relative to the proportion of overall assets that the subsidiary held.<sup>129</sup> In substance there is little difference between the profit-based method that the court settled on and the way that formulary apportionment methods apply. The former is calculated by applying a formula to the profits of each subsidiary within the multinational group.<sup>130</sup> The relevant formula to apply is determined on a *case-by-case* basis for each related party within the group.<sup>131</sup> The latter formulary apportionment allocation is calculated by applying a *predetermined* formula to each subsidiary within a multinational group.

Ideally, the level of taxable profit arrived at under an arm's length profit-method should be compared with the level of profit that an independent enterprise in comparable circumstances would be expected to achieve.<sup>132</sup> The comparability requirement is a distinguishing feature of profit-based methods from formulary apportionment.<sup>133</sup> However, there is often a lack of comparable data that show the level of profit an independent enterprise would have achieved.<sup>134</sup> The court's profit-method in *National Semiconductor* did not utilise a profit comparison for that very reason.<sup>135</sup> The court was not presented with any way to determine whether the taxpayer's prices were comparable to third party prices.<sup>136</sup> As a result, profit-based methods are often applied in a similar fashion to formulary apportionment – that is, without using comparable data. The similarity between these approaches is such that the OECD guidelines even warn tax authorities against confusing profit methods with formulary apportionment.<sup>137</sup>

The liberal use of profit-based methods in ways that resemble formulary apportionment diverges not just from the OECD guidelines, but also from the arm's length principle itself. Some commentators suggest that the rise in the use of profit methods is most likely due to the ease with which they can be applied.<sup>138</sup> Data on comparable prices necessary to apply traditional transactional methods are more difficult

---

<sup>129</sup> At 86.

<sup>130</sup> See the discussion above at Part II.

<sup>131</sup> *OECD Transfer Pricing Guidelines*, above n 10, at 37.

<sup>132</sup> At 37.

<sup>133</sup> At 37.

<sup>134</sup> Neighbour and Owens, above 123, at 954.

<sup>135</sup> *National Semiconductor Corporation*, above n 99, at 97.

<sup>136</sup> At 97.

<sup>137</sup> *OECD Transfer Pricing Guidelines*, above n 10, at 37.

<sup>138</sup> Kotarba, above n 120, at 168.

to obtain than information on operating margins that is used in profit methods.<sup>139</sup> The primary advantage of profit methods therefore appears to be their simplicity. However, given the clear emphasis in the guidelines on traditional transactional methods, simplicity cannot  
5 be the only reason behind why states diverge from OECD policy. There must be other, more fundamental reasons driving the divergence from the arm's length principle. Part IV goes on to explore what these reasons may be and assesses their implications for transfer pricing harmonisation.

## 10 **IV Obstacles to Harmonisation**

Some of the OECD's prominent members are diverging from the guidelines. The insistence of the OECD that the arm's length principle be applied in accordance with the guidelines therefore begs the question. Are there compelling reasons for OECD members to  
15 diverge from the guidelines? The United States has historically been a world leader in international transfer pricing policy. It was one of the first countries to include an arm's length provision in a bilateral tax treaty<sup>140</sup> and in its domestic law.<sup>141</sup> The United States' transfer pricing efforts combined with the League of Nation's own work in the  
20 transfer pricing area prompted other countries to include arm's length provisions in their bilateral treaties.<sup>142</sup> By 1961 the United States had joined the OECD and began actively promoting the arm's length principle as an international norm.<sup>143</sup> The United States federal government campaigned strongly within the OECD on the principle as  
25 it perceived itself to be the nation most seriously affected by a lack of internationally accepted income allocation rules.<sup>144</sup>

The fact that the United States rules on transfer pricing now diverge from the OECD regime that it helped champion suggests that there must be compelling reasons for not adhering to the OECD  
30 guidelines. Part IV assesses the reasons behind why divergence is

---

<sup>139</sup> Kotarba, above n 120, at 168.

<sup>140</sup> Lepard, above n 34, at 69.

<sup>141</sup> Reuven S Avi-Yonah "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation" (1995) 15 Va Tax Rev 89 at 95.

<sup>142</sup> Langbein, above n 3, at 632.

<sup>143</sup> Langbein, above n 3, at 642–643.

<sup>144</sup> Langbein, above n 3, at 642.

occurring and identifies three significant obstacles to transfer pricing harmonisation.

A Legal Status of the Guidelines and the Arm's Length Principle Outside Domestic Law and Treaty Law

5 Some commentators argue that the arm's length principle should be applied as an international rule of law.<sup>145</sup> The argument, if correct, has important implications for the possibility of transfer pricing harmonisation. The stronger the obligation to apply the arm's length principle consistently with the OECD guidelines, the more that  
10 transfer pricing rules in different states should converge. The section concludes that neither the principle nor the OECD guidelines are legally binding of themselves. As a result, the harmonisation of transfer pricing rules will be difficult to achieve, particularly if, as has been seen, states permit themselves to diverge from the transfer pricing  
15 regime that the OECD promulgates.

*1 Legal status of the arm's length principle*

Many legal scholars have debated whether the arm's length principle ought to be applied as a matter of customary international law, irrespective of the principle's inclusion into domestic law or  
20 treaty law.<sup>146</sup> The traditional theory of the requirements for existing customary international law is summarised by Anthony A D'Amato.<sup>147</sup> Existing customary international law has both quantitative and qualitative aspects. The quantitative aspect requires a norm to be uniformly and consistently applied by a large number of  
25 states.<sup>148</sup> There is no bright-line test as to when a practice is sufficiently widespread to satisfy the quantitative requirement of an international law custom. The test is one of general recognition by states and is necessarily a vague one.<sup>149</sup> But it is not necessary to show

---

<sup>145</sup> See Chantal Thomas "Customary International Law and State Taxation of Corporate Income: The Case for the Separate Accounting Method" (1996) 14 Berkeley J Int'l L 99; and Reuven S Avi-Yonah "International Tax as International Law" (2003) 57 Tax L Rev 483 at 498; and Reuven S Avi-Yonah *International Tax as International Law* (Cambridge University Press, New York, 2007).

<sup>146</sup> Lepard, above n 34, at 155; and Thomas, above n 145, at 114.

<sup>147</sup> See Anthony A D'Amato *The Concept of Custom in International Law* (Cornell University Press, London, 1971) at 47–72.

<sup>148</sup> D'Amato, above n 147, at 60–66.

<sup>149</sup> Andrew Clapham *Brierly's Law of Nations* (Oxford University Press, Oxford, 2012) at 59.



that every state has recognised a certain practice.<sup>150</sup> The qualitative aspect requires that states adhere to a norm out of a sense of legal obligation to do so, rather than out of social, moral or political habit (this requirement is referred to as *opinio juris sive necessitas*).<sup>151</sup>

5 Many scholars agree that the arm's length principle satisfies the quantitative requirement of a customary international law rule.<sup>152</sup> The arm's length principle meets the test of consistent and uniform practice by states.<sup>153</sup> It is applied in thousands of bilateral tax treaties; it is expressed in a uniform fashion by prominent multilateral  
10 organisations such as the OECD and the United Nations;<sup>154</sup> nations themselves attest to the widespread practice of the method<sup>155</sup> and commentators frequently observe that the arm's length method prevails in the international arena.<sup>156</sup> As one commentator observes, the arm's length principle is "a strong contender for the status of  
15 customary international law."<sup>157</sup>

The more contentious point is whether states apply the arm's length principle out of a sense of legal obligation (the qualitative aspect). One legal scholar, Lepard, questions whether states regard the principle as universally binding in the absence of a treaty imposing an  
20 obligation to use it.<sup>158</sup> According to Lepard, states' continued resistance against the adoption of a multilateral agreement that includes the arm's length principle constitutes compelling evidence that states do not wish to owe obligations to other states with whom no bilateral tax treaty has been concluded.<sup>159</sup> The reason that the arm's  
25 length principle exists in a network of bilateral tax treaties is because very few states showed any willingness to be bound to a multilateral framework when the League of Nations first considered the problem

---

<sup>150</sup> Clapham, above n 149, at 59.

<sup>151</sup> D'Amato, above n 147, at 66–72.

<sup>152</sup> Lepard, above n 34, at 168; and Thomas, above n 145, at 114. See also Reuven S Avi-Yonah *International Tax as International Law: An Analysis of the International Tax Regime* (Cambridge University Press, New York, 2007) at 5; and Charles McLure "State Taxation of Foreign-Source Dividends: Starting from First Principles" (1986) 30 Tax Notes 475.

<sup>153</sup> Lepard, above n 34, at 168.

<sup>154</sup> Thomas, above n 145, at 123.

<sup>155</sup> Thomas, above n 145, at 130.

<sup>156</sup> Thomas, above n 145, at 130.

<sup>157</sup> Lepard, above n 34, at 168.

<sup>158</sup> Lepard, above n 34, at 169.

<sup>159</sup> Lepard, above n 34, at 172.

of transfer pricing in the 1930s.<sup>160</sup> The OECD attempted to revive the idea of a multilateral agreement some 30 years later and encountered a similar attitude from member states. States' reluctance to be bound by a general obligation to use the arm's length principle made a

5 multilateral agreement impracticable.<sup>161</sup> Member states preferred to apply the arm's length principle in a bilateral tax treaty only after a process of voluntary negotiation with another state.<sup>162</sup> The United Nations Group of Experts carried out its own report into the possibility of a multilateral tax agreement in 1977. The group reported

10 that the development of a bilateral tax treaty network was an important step to the eventual conclusion of a multilateral tax agreement, but that a multilateral agreement was not yet feasible because there lacked a consensus on what standardised terms should be included in such an agreement.<sup>163</sup> The United Nations Ad Hoc

15 Group of Experts on International Cooperation in Tax Matters also looked into the establishment of binding transfer pricing rules through a multilateral agreement. The group rejected a proposal to enshrine a common set of transfer pricing principles because doing so could be perceived as a derogation from national sovereignty.<sup>164</sup> In Lepard's

20 view, the reluctance of states to be bound by a multilateral agreement suggests that states wish to be free to choose their own allocation systems unless a bilateral treaty requires otherwise.<sup>165</sup> States do not consider themselves under an obligation to apply the arm's length principle in the absence of a bilateral treaty.

25 Thomas is among one of a few scholars who claim that the arm's length principle has reached the status of customary international law.<sup>166</sup> Thomas argues that:<sup>167</sup>

30 [The] vast network of bilateral treaties [that include the arm's length principle] militates strongly in favor of a conclusion that separate accounting is a general rule of international law. Thus, there would appear to be a very persuasive general acknowledgement of a binding obligation to practice the separate accounting method.

---

<sup>160</sup> Lepard, above n 34, at 169.

<sup>161</sup> Lepard, above n 34, at 171.

<sup>162</sup> Lepard, above n 34, at 171.

<sup>163</sup> *Work of the Group of Experts on Tax Treaties Between Developed and Developing Countries* ESC Res 1765 (LIV) E/1978/36 (1978) at 4.

<sup>164</sup> Lepard, above n 34, at 172.

<sup>165</sup> Lepard, above n 34, at 172.

<sup>166</sup> See Thomas, above n 145; and Reuven S Avi-Yonah "International Tax as International Law" (2003) 57 Tax L Rev 483 at 498.

<sup>167</sup> Thomas, above n 145, at 131.

Reuven makes a similar argument. Bilateral tax treaties, domestic tax laws and OECD documents form an international tax regime that is part of customary international law.<sup>168</sup> The regime requires that states, as a matter of obligation, implicitly accept and  
5 adhere to the regime's rules and principles. Under this view, which is not without controversy,<sup>169</sup> parts of international tax policy such as transfer pricing rules are binding as customary international law even in the absence of treaties.<sup>170</sup>

The difficulty with the views put forward by Lepard and  
10 Thomas is that each author perceives a state's entry into bilateral tax agreements as evidence of something different. On the one hand Lepard argues that a state's entry into a bilateral tax treaty shows that the state wishes to limit the application of the arm's length principle in transfer pricing to only those states with whom a treaty has been  
15 negotiated. If states wish to control when the principle is applied, then they do not consider themselves bound to apply it out of a sense of general obligation and will resist entering into multilateral agreements that impose such a general obligation. On the other hand, Thomas views a state's entry into a bilateral tax treaty as direct evidence that  
20 the state feels itself bound to apply the principle. A state's obligation to apply the arm's length principle manifests itself through the conclusion of a bilateral treaty containing the principle. A bilateral treaty, rather than a multilateral one, is simply a state's preferred means of giving effect to an obligation that it considers it is already  
25 under. Thus, Lepard's argument that states' resistance to a multilateral agreement proves that states do not view the application of the principle as a matter of obligation is not necessarily decisive. There may be other reasons unconnected with a state's sense of obligation to apply the principle that leads states to refute a multilateral approach.  
30 For example, it could be that states wish to retain control over other aspects of bilateral treaties while at the same time being content to accept the transfer pricing aspects of such a treaty.

Thomas' argument is not decisive either. The problem with  
Thomas' argument is that it fails to identify why states feel obligated  
35 to enter into bilateral treaties containing the arm's length principle in

---

<sup>168</sup> Avi-Yonah, above n 152, at 2.

<sup>169</sup> Avi-Yonah, above n 152, at 1. See also Kerrie Sadiq "The Inherent International Tax Regime and its Constraints on Australia's Sovereignty" (2012) 31 UQLJ 131.

<sup>170</sup> Avi-Yonah, above n 152, at 2.

the first place. Thomas assumes that a state's entry into a bilateral treaty containing the principle necessarily shows that the state considers itself under an obligation to adhere to the principle. But there are many other reasons that explain a state's acceptance of the principle in bilateral tax treaties. For example, states have an economic interest in adhering to a uniform principle in an extensive bilateral treaty network. The use of a uniform standard enhances mutual cooperation between states and optimises the individual pay-offs for each state in the form of reduced administrative burdens on tax authorities and greater certainty for taxpayers. Thomas' argument does not adequately discount the other reasons that explain why states apply the arm's length principle.<sup>171</sup>

The weakness in Thomas' argument may owe more to the weaknesses in the traditional definitions of customary international law. Such definitions are commonly criticised for their circularity. D'Amato opines that "if custom *creates* law, how can a component of custom require that the creative acts be in accordance with some prior right or obligation in international law?".<sup>172</sup> Thomas argues that a high probability of punitive action by other states towards errant states should accompany the existing qualitative requirements of binding custom to overcome the circularity of existing definitions.<sup>173</sup> A state's sense of obligation in adhering to a norm can be shown by that state's desire to avoid sanction.<sup>174</sup> However, even if such a criterion is included in the definition of customary international law, Thomas concedes that it cannot be shown that there is high probability of a negative response by other nations to a nation that refuses to apply the arm's length principle.<sup>175</sup>

Despite the widespread acceptance of the arm's length principle, it is not possible to conclude that the principle is legally binding as a customary international law norm outside of domestic law and treaty law. Whether the principle is being adhered to and included in bilateral treaties out of sense of legal obligation or for some other reason is still unclear. The finding does not mean that the

---

<sup>171</sup> Thomas, above n 145, at 132.

<sup>172</sup> D'Amato, above n 147, at 53.

<sup>173</sup> The perception of states that departure from a particular usage will result in some form of sanction on the transgressor is also considered by Brierly to be evidence of *opinio juris sive necessitas*. See J L Brierly *The Law of Nations* (Clarendon Press, Oxford, 1963) at 59.

<sup>174</sup> Brierly, above n 173, at 59.

<sup>175</sup> Thomas, above n 145, at 132.

principle has no force at all. The high level of convergence in the way that states approach transfer pricing suggests that states do feel compelled to apply the principle. One explanation is that short of the principle having binding legal force, it is nevertheless a persuasive standard to which states ought to give great (but not decisive) weight in deciding how to allocate income. Accordingly, when states are considering the policy reasons for and against adherence to the principle, states ought to significantly discount the policy reasons against applying the principle and give more weight to those policy reasons that favour applying the principle.

## 2 *Legal status of the OECD guidelines*

The question whether the OECD guidelines constitute rules of customary international law is more straightforward. It again depends on the extent to which states consistently and uniformly make use of the OECD guidelines, and the extent to which states apply the guidelines out of a sense of general legal obligation. Only 20 of the 34 OECD member states apply the arm's length principle consistently with the guidelines.<sup>176</sup> The remaining 14 member states' transfer pricing rules diverge from several aspects of the guidelines. For example, despite the priority of methods that the OECD guidelines set out, the Belgian tax authorities commonly accept profit-based methods when calculating arm's length conditions.<sup>177</sup> The Czech Republic does not require its tax authorities or taxpayers to refer to the OECD guidelines at all when calculating an arm's length result. Instead, Czech tax authorities and taxpayers may select the most appropriate transfer pricing method on the basis of what the most reasonable method is, taking into account the specific circumstances of a transaction.<sup>178</sup> The practice of applying the guidelines by states seems insufficiently widespread and insufficiently uniform to amount to a consistent and general practice in international custom.

Even if the guidelines are already sufficiently practised by a large number of countries, they lack the general legal obligation that is required of customary international law. The status and usage of the

---

<sup>176</sup> Deloitte, above n 38, at 4–179. The 20 OECD member states that apply the arm's length principle consistently with the guidelines are Austria, Canada, Chile, Denmark, Estonia, Finland, France, Ireland, Israel, Italy, Mexico, New Zealand, Norway, Poland, Portugal, Slovakia, Sweden, Switzerland and the United Kingdom.

<sup>177</sup> Deloitte, above n 38, at 15.

<sup>178</sup> Deloitte, above n 38, at 34.

OECD guidelines was briefly considered by the Federal Court of Australia in *Federal Commissioner of Taxation v SNF (Australia) Pty Ltd.*<sup>179</sup> In that case the Commissioner of Australia argued that the guidelines could be used as a legitimate aid to the construction of Australia's double tax treaties.<sup>180</sup>

The court was of the opinion that the guidelines were just that – guidelines – and could be applied as a matter of law only if the requirements of art 31(3) of the Vienna Convention on the Law of Treaties were met.<sup>181</sup> Article 31(3) allows subsequent practice between treaty partners to be taken into account when interpreting a treaty in context and in the light of its object and purpose.<sup>182</sup> The court's insistence that the Commissioner could only rely on the guidelines if he could bring them within the rule in art 31(3) shows that the court did not feel a sense of general legal obligation to apply them.

The fact that the guidelines are incorporated into transfer pricing legislation in the United Kingdom also shows that the OECD's guidance is not customary law. If the guidelines did amount to customary law, then states would not be expected to incorporate them into domestic legislation because the guidelines would already apply as binding norms. Statements by the Supreme Court of Canada in *GlaxoSmithKline Inc v R* also deny the guidelines any legally binding character.<sup>183</sup> The Supreme Court stated that the guidelines were not controlling as if they were a Canadian statute.<sup>184</sup> While the guidelines are useful as a tool in interpreting Canadian transfer pricing provisions,<sup>185</sup> they should not be read as if they are legally binding.<sup>186</sup>

The OECD guidelines do not constitute legally binding rules on either member or non-member states. The guidelines are merely recommendations that the OECD Council urges its members to

---

<sup>179</sup> *Federal Commissioner of Taxation v SNF (Australia) Pty Ltd*, above n 74.

<sup>180</sup> At [118].

<sup>181</sup> At [116].

<sup>182</sup> Vienna Convention on the Law of Treaties 1155 UNTS 331 (opened for signature 23 May 1969, entered into force 27 January 1980), art 31(3).

<sup>183</sup> *GlaxoSmithKline Inc v R* 2012 SCR 3 at [20].

<sup>184</sup> At [20].

<sup>185</sup> At [21].

<sup>186</sup> Francois Vincent "Glaxo at the Supreme Court: Not the Final Word, But Some Fine Words for Transfer Pricing in Canada" (2012) 21 Tax Management Transfer Pricing Report 835 at 836.

apply.<sup>187</sup> Despite the absence of binding legal effect as a customary norm, commentators argue that the guidelines “do not lack legal value” and have still been instrumental in bringing about a significant degree of transfer pricing harmonisation.<sup>188</sup> For example, Calderon suggests that although the guidelines are not legally binding, they still form an international touchstone for tax authorities to draw on when solving the problems associated with taxing the activities of multinational enterprises. The use of the guidelines as a touchstone by developed countries within the OECD may also create an expectation that other nations ought to do the same.<sup>189</sup> The comments show that the guidelines have some way to go before achieving the status of custom, but that they are still important in shaping the development of future tax norms.

This essay suggested that the arm’s length principle and the OECD guidelines are the two key elements required to bring about the harmonisation of transfer pricing rules. The essay then suggested that the extent of transfer pricing harmonisation would depend on the strength of the obligation to apply principle and the guidelines. This part has shown that neither the principle nor the guidelines are legally binding outside domestic or treaty law, but that each still exerts some persuasive force on states. Persuasive force is not enough to induce transfer pricing harmonisation. The existence of persuasive force leaves room for states to interpret the arm’s length principle as they see fit. In particular, states have the freedom and the flexibility to disregard the OECD interpretation of the arm’s length principle contained in its guidelines. The lack of legally binding effect of both the principle and the guidelines is a significant obstacle to transfer pricing harmonisation.

## B Theoretical Shortcomings of the Arm’s Length Principle

Another obstacle to harmonisation is the theoretical flaw in the arm’s length principle. The principle is criticised for not taking

---

<sup>187</sup> TW Vogelaar “The OECD Guidelines: their philosophy, history, negotiation, form, legal nature and follow up procedures and review” in Norbert Horn (ed) *Legal Problems of Codes of Conduct for Multinational Enterprises* (Springer, Frankfurt, 1980) at 129–131.

<sup>188</sup> Calderon, above n 13, at 9; Allison Christians “Hard Law, Soft Law, and International Taxation” (2007) 25 *Wis Int’l LJ* 325 at 330.

<sup>189</sup> Allison Christians “Hard Law, Soft Law, and International Taxation” (2007) 25 *Wis Int’l LJ* 325 at 332.

account of the economic interdependence between related entities.<sup>190</sup> By treating the related parts of a multinational enterprise as separate entities, the principle fails to reflect the economies of scale and other benefits of integration that integrated businesses enjoy.<sup>191</sup> It fails to reflect the economic reality in which multinationals operate. The criticism is most apparent in cases where the comparable uncontrolled price method is applied to certain circumstances. The facts of *GlaxoSmithKline Inc v The Queen* in the Tax Court of Canada illustrate the point.<sup>192</sup>

10           The first instance decision in *GlaxoSmithKline Inc* considered the application of Canada's transfer pricing rules to purchases by a multinational subsidiary. The parent in the multinational group was a United Kingdom resident corporation called Glaxo Group Ltd. The Glaxo group provides healthcare and pharmaceutical products around  
15 the world.<sup>193</sup> The Glaxo subsidiary in Canada was the taxpayer. It purchased an active pharmaceutical ingredient called ranitidine from a Glaxo subsidiary in Switzerland called Adecha. Ranitidine is used by the taxpayer an anti-ulcer drug, marketed under the brand name Zantac.<sup>194</sup> The Zantac trademark and the patent for the active  
20 ingredient ranitidine were owned by the parent company in the United Kingdom.<sup>195</sup> In order for the taxpayer to manufacture and market Zantac, it entered into two separate contracts. The first contract was a licence agreement under which the taxpayer paid a six per cent royalty to the parent company on the net sales of Zantac.<sup>196</sup> In return, the  
25 United Kingdom parent company granted the taxpayer the right to

---

<sup>190</sup> See Charles E McLure "Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment" [2002] BFIT 586 at 586; Michael Graetz "Taxing International Income – Inadequate Principle, Outdated Concepts, and Unsatisfactory Policy" (2001) 26 Brook J Int'l L 1417 at 1419; "Multinational Corporation and Income Allocation under Section 482 of the Internal Revenue Code" (1976) 89 Harv L Rev 1202 at 1215; David Rosenbloom "From the Bottom up: Taxing the Income of Foreign Controlled Corporations" (2001) 26 Brook J Int'l L 1525 at 1535; Robert Green "The Future of Source-Based Taxation of the Income of Multinational Enterprises" (1993) 79 Cornell L Rev 18 at 37; Reuven S Avi-Yonah "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation" (1995) 15 Va Tax Rev 89 at 114.

<sup>191</sup> D Hay, F Homer and J Owens "Past and Present Work in the OECD on Transfer Pricing and Selected Issues" (1994) 9 Tax Notes Int'l 249 at 254.

<sup>192</sup> *GlaxoSmithKline Inc v R* 2008 TCC 324.

<sup>193</sup> At [3].

<sup>194</sup> At [3].

<sup>195</sup> At [14].

<sup>196</sup> At [14].



manufacture and sell products, the right to use the trademarks owned by the Glaxo group, including Zantac, and other rights therein.<sup>197</sup> The second contract was a supply agreement under which Adecha granted the taxpayer the right to purchase ranitidine and set the purchase price for the ranitidine.<sup>198</sup>

From 1990 to 1993, the taxpayer paid between CAD 1,512 and CAD 1,651 per kilogram for the purchase of ranitidine from Adescha SA.<sup>199</sup> During the same period, two Canadian pharmaceutical companies that manufactured generic anti-ulcer drugs only paid between CAD 194 and CAD 304 per kilogram for the same active ingredient. The Minister of National Revenue reassessed the taxpayer for the relevant taxation years, increasing its taxable income by nearly CAD 51 million on the basis that it had paid Adescha more than a reasonable amount under the former arm's length provision in the then s 69(2) of the Income Tax Act 1995.<sup>200</sup> To support this position the Minister applied the comparable uncontrolled price method (described in Part II above), and used the prices paid for ranitidine by the two manufacturers of the generic anti-ulcer drugs as the relevant price comparators.<sup>201</sup> The taxpayer argued that the amounts paid for ranitidine by the two manufacturers did not constitute valid comparators.<sup>202</sup> The existence of the licence agreement and supply agreement meant that the taxpayer purchased ranitidine under wholly different business circumstances to the two generic-drug manufacturers.<sup>203</sup> The taxpayer also used the comparable uncontrolled price method, but relied on a different set of price comparators in order to show that the prices it charged to Asecha were arm's length. The Glaxo group corporations often promoted and distributed Zantac through independent third party distributors in addition to its own subsidiaries. Under third party agreements, Glaxo group transfer prices were set so that the independent distributors retained a 60 per cent gross margin from the sale of ranitidine-based products.<sup>204</sup> If, for example, a ranitidine product was sold by an independent distributor in Italy for CAD 10, then the price charged by the Glaxo supplier

---

<sup>197</sup> See at [14].

<sup>198</sup> At [15].

<sup>199</sup> At [5].

<sup>200</sup> At [66]. See also Income Tax Act RSC 1985, s 69 (repealed).

<sup>201</sup> At [67].

<sup>202</sup> At [68].

<sup>203</sup> At [68].

<sup>204</sup> At [47].

would be CAD 4. The taxpayer relied on the prices in these agreements as more appropriate comparators in a comparable uncontrolled method because the prices better reflected the business circumstances faced by the taxpayer.<sup>205</sup>

5           The main difference between the parties' approaches was whether an arm's length transfer price should reflect the total cost of the ranitidine, including the 6 per cent royalty paid to the parent company under the licence agreement, or just the cost of acquiring the ranitidine from Adechsa.<sup>206</sup> The Tax Court rejected the relevance of  
10   the licence agreement, holding that a strict transaction-by-transaction approach was required under a comparable uncontrolled price method.<sup>207</sup> The supply agreement with Adescha and the licence agreement with the parent company covered separate matters and should be considered separately.<sup>208</sup> The taxpayer's comparators that  
15   included similar licence agreements with independent distributors were therefore invalid.

          The Tax Court's exclusion of the licence agreement between the parent company and the taxpayer was overturned on appeal to the Federal Court of Appeal,<sup>209</sup> and the Minister's subsequent appeal to  
20   the Supreme Court was dismissed.<sup>210</sup> The Supreme Court considered that an inquiry into an arm's length price necessarily involved consideration of all the circumstances of the taxpayer that were relevant to the price paid to the supplier.<sup>211</sup> Such circumstances included agreements that conferred rights and benefits in addition to  
25   the purchase of property where those agreements were linked to the purchasing agreement.<sup>212</sup> The Supreme Court remitted the case back to the Tax Court and made the point that "[t]he objective is to determine what an arm's length purchaser would pay for the property and the rights and benefits together where the rights and benefits are  
30   linked to the price paid for the property."<sup>213</sup>

          The Supreme Court's comment that the property, rights and benefits should be considered together exposes the fundamental

---

<sup>205</sup> At [69].

<sup>206</sup> At [72].

<sup>207</sup> At [78].

<sup>208</sup> At [78].

<sup>209</sup> *GlaxoSmithKline Inc v R* 2010 FCA 201.

<sup>210</sup> *GlaxoSmithKline Inc v R* 2012 SCR 3.

<sup>211</sup> *GlaxoSmithKline Inc v R*, above n 210, at [44].

<sup>212</sup> At [44].

<sup>213</sup> At [44].

problem of applying the comparable uncontrolled price method to imperfectly competitive corporations.<sup>214</sup> Such corporations are able to use an imperfectly competitive structure to generate economic profits.<sup>215</sup> Economic profit is the residual of revenue less opportunity costs, where opportunity costs consist of the value of the returns from the next best alternatives foregone.<sup>216</sup> In the case of a distribution chain like that used by the Glaxo group, the economic profit is realised when the last link in the chain sells a product to an arm's length purchaser. Market imperfections that generate economic profits can arise in several ways.<sup>217</sup> The size of a multinational enterprise like the Glaxo group may induce economies of scale that produce cost savings through the production chain as output increases and average costs of production fall.<sup>218</sup> Large firms with global networks may also have information advantages over other market participants allowing them to better manufacture and distribute products. An imperfectly competitive firm may also be able to control prices in a market, forcing other market participants to exit or preventing others from entering. The parent company's licence agreement with the taxpayer is a specific example of a market imperfection in the form of an intangible asset that generates an economic profit. The licence agreement confers on the taxpayer the right to distribute a valuable branded product, Zantac. Assuming for the sake of simplicity that the taxpayer has the exclusive right in the anti-ulcer treatment market to distribute Zantac and that Zantac is a superior product, the demand for the taxpayer's Zantac products will increase.<sup>219</sup> The demand for

---

<sup>214</sup> For a discussion on the definition of an imperfectly competitive firm, see n 215 below.

<sup>215</sup> See Robert H Frank and Ben Bernanke *Principles of Economics* (4<sup>th</sup> ed, McGraw Hill, New York, 2009) at 236–249. An imperfectly competitive market is one that does not exhibit all the features of a perfectly competitive market. A perfectly competitive market is characterised by a large number of small firms operating under perfect information, selling identical goods or services with no influence over the price and where the price received by firms is equal to the marginal cost of production for each firm. Imperfect competition is therefore typically characterised by a market with a small number of suppliers where one or more supplier has sufficient market power to influence prices, create barriers and imperfect information, and where one or more supplier influences the entry and exit decisions of other firms. Typical examples of imperfectly competitive markets include monopoly, duopoly and oligopoly market structures.

<sup>216</sup> Frank and Bernanke, above n 215, at 204.

<sup>217</sup> Frank and Bernanke, above n 215, at 236–249, 270–289.

<sup>218</sup> Nicholas Kaldor “The Equilibrium of the Firm” (1934) 173 *The Economic Journal* 60 at 65.

<sup>219</sup> See Frank and Bernanke, above n 215, at 237–238.

generic substitutes will not. The Glaxo group's global sales revenues increase and so too do its economic (and accounting) profits.

5 The Supreme Court's decision allows the economic profit arising from the licence agreement to be included in the taxable income of the taxpayer. On one hand the court's decision is to be welcomed. The economic profit is capable of being included in the taxable income of the taxpayer whether the Glaxo group chooses to repatriate the economic profit in the form of a royalty to Glaxo Group or a higher transfer price paid to Adecha. The problem, though, is that  
10 it is difficult to determine whether the economic profit in the form of either the royalty or higher transfer price is attributable solely to the licence agreement or to other market imperfections. As was explained above, economic profits can be generated in a number of ways. If the economic profit is generated exclusively from the licence agreement  
15 then the taxpayer's reliance on comparators that feature similar licence agreements seems valid. But if the economic profit is generated from a range of different market imperfections that are unconnected with the licence agreement, then the reliance on similar licence agreements as comparators is questionable.

20 The Glaxo series of decisions show the difficulties in trying to include the economic profit in the taxable income of the firm where those profits are generated from a range of different market imperfections. The economic profit that the taxpayer sought to find comparable arm's length data for could have been attributable to the  
25 licence agreement. But equally, it could also have been attributable to the economies of scale of the Glaxo group, its market power, or its competitive information advantages in drug manufacturing and distributing. More generally, in many cases under the comparable uncontrolled price method, there will be no comparable transactions  
30 between unrelated parties that reflect the precise economic profits made by the imperfectly competitive firm in question.<sup>220</sup> Multinational enterprises by their very nature generate synergies and economic

---

<sup>220</sup> Kerrie Sadiq "The Traditional Rationale of the Arm's Length Approach to Transfer Pricing – Should the Separate Accounting Model be Maintained for Modern International Entities?" (2004) 7 J Aust Tax 196 at 223.

profits that entities trading at arm's length do not.<sup>221</sup> Comparable arm's length profits may simply not exist.

5 The range of arm's length methods in the OECD guidelines is in effect a concession from the OECD that multinational enterprises operate in unique circumstances to which there may be few comparable transactions.<sup>222</sup> It is therefore unsurprising that some states' transfer pricing rules permit tax authorities to prefer profit-based methods over traditional transactional ones. Rather than being restricted to calculating an arm's length price on the basis of  
10 comparable transactions, profit-methods allow tax authorities to calculate arm's length profits on the basis of financial ratios. The use of profit methods like in *National Semiconductor* overcomes, to some extent, the difficulties in identifying reliable comparable pricing data under traditional transactional methods.

15 The theoretical shortcomings of the arm's length principle, particularly in relation to the comparable price method, provide a sound explanation for the divergence that has occurred from the OECD transfer pricing regime. Even countries whose transfer pricing rules show a high degree of convergence with OECD policy have expressed  
20 concerns about the current international framework. The United Kingdom Select Committee on Economic Affairs notes that:<sup>223</sup>

25 We agree that fundamental reform of the international tax framework should be pursued in the OECD. As things stand, there are too many opportunities for multinational companies to manipulate their affairs to reduce their global tax payments. Corporate manipulation of the system so as to avoid taxation reduces governments' revenues, undermines public trust in the tax system. We recommend that the Government should continue to play its full part in encouraging the OECD's reform agenda to an  
30 early successful conclusion. At the same time the Government—and the Treasury review we propose—should explore the scope for more radical alternative approaches to corporate tax.

The OECD has itself acknowledged as much. In 2013 the OECD released its findings on the extent of tax revenue losses from tax

---

<sup>221</sup> "Multinational Corporation and Income Allocation under Section 482 of the Internal Revenue Code" (1976) 89 Harv L Rev 1202 at 1215.

<sup>222</sup> Sadiq, above n 220, at 223.

<sup>223</sup> Select Committee on Economic Affairs (United Kingdom) *Tackling corporate tax avoidance in a global economy: is a new approach needed?* (31 July 2013) at [93].

planning behaviour by multinational enterprises.<sup>224</sup> The OECD report noted that “the international common principles drawn from national experiences to share tax jurisdiction may not have kept pace with the changing business environment,”<sup>225</sup> and that “it is also important to revisit some of the fundamentals of the existing standards.”<sup>226</sup> The report found a “perception among governments that ... the domestic and international [OECD] rules on the taxation of cross-border profits are now broken and that taxes are only paid by the naïve.”<sup>227</sup> According to the report, civil society, news media outlets and non-governmental organisations have been pointing to transfer pricing rules as the cause of corporate profit shifting and tax avoidance.<sup>228</sup> The OECD has not shied from these criticisms. It accepts that the transfer pricing guidelines may be putting too much emphasis on legal structures rather than on the underlying reality of the economically integrated group, and that such an emphasis may be contributing to cross-border profit shifting.<sup>229</sup> The OECD already has proposals underway to simplify and update its transfer pricing guidelines.<sup>230</sup>

## C A Fair Share of Tax

A final obstacle to harmonisation and another reason for the divergence in transfer pricing rules is the desire by governments to combat tax base erosion from profit shifting. The desire stems from the perception that multinational enterprises are not paying a fair share of tax.<sup>231</sup> This essay does not attempt to conclude whether the perception that multinationals are not paying a fair share of tax is correct, nor does it attempt to point out what a fair share constitutes. It is enough to point out that such a perception exists, and that it

---

<sup>224</sup> OECD *Addressing Base Erosion and Profit Shifting* (2013).

<sup>225</sup> OECD, above n 224, at 5.

<sup>226</sup> OECD, above n 224, at 8.

<sup>227</sup> OECD, above n 224, at 13.

<sup>228</sup> OECD, above n 224, at 13.

<sup>229</sup> OECD, above n 224, at 43.

<sup>230</sup> OECD, above n 224, at 49.

<sup>231</sup> See Peter Dunne “Multinational investors – paying fair share of tax” (16 May 2013) The official website of the New Zealand Government <[www.beehive.govt.nz](http://www.beehive.govt.nz)>; “Treasury should undertake review to ensure multinationals pay their fair share” (31 July 2013) <[www.parliament.uk](http://www.parliament.uk)>. This essay does not attempt to conclude whether the perception that multinationals are not paying a fair share of tax is correct, nor does it attempt to point out what a fair share constitutes. It is enough to point out that such a perception exists that, as will be shown, influences the extent to which governments adhere to the OECD transfer pricing framework.

influences the extent to which governments adhere to the OECD transfer pricing framework.

It is often the case that the interests of multinationals conflict with the interests of governments.<sup>232</sup> In microeconomic theory it is assumed that an integrated multinational enterprise acts in order to maximise global profits net of tariffs and taxes.<sup>233</sup> Businesses have an interest in the efficient management of operations in order to maximise profits. Governments have a political responsibility to administer the affairs of the state. Governments introduce taxes in order to fund the provision of state services. Multinationals operate within a business environment that is regulated to varying degrees by the state, and multinationals pursue their goals of profit maximisation within these constraints.<sup>234</sup> Transfer price manipulation is a method of evading the state-imposed constraints on business activity. Rugman and Eden suggest that whether multinationals are economically successful in maximising profit through transfer pricing is an unresolved question.<sup>235</sup> In any case, it is the perception that multinationals have the power to shift profits that matters.<sup>236</sup> Governments view transfer pricing with suspicion and attempt to prevent price manipulation that leads to profit shifting.<sup>237</sup>

Cross-border profit shifting, or at least the suspicion of it, is giving governments a good reason to use arm's length methods that yield higher tax results, even if it means diverging from the priority of methods in the OECD guidelines. Some commentators suggest that the OECD transfer pricing rules constrain the ability of governments to tax multinational enterprises effectively.<sup>238</sup> If the principle had remained as a general one:<sup>239</sup>

... it could have been interpreted flexibly through case-law, and could have evolved into appropriate profit apportionment

---

<sup>232</sup> Alan M Rugman and Lorraine Eden (eds) *Multinational and Transfer Pricing* (Croom Helm, London, 1985) at 1.

<sup>233</sup> Lorraine Eden "The Microeconomics of Transfer Pricing" in Alan M Rugman and Lorraine Eden (eds) *Multinational and Transfer Pricing* (Croom Helm, London, 1985) 13 at 13.

<sup>234</sup> Rugman and Eden, above n 232, at 2.

<sup>235</sup> Rugman and Eden, above n 232, at 2.

<sup>236</sup> Rugman and Eden, above n 232, at 2.

<sup>237</sup> Rugman and Eden, above n 232, at 2.

<sup>238</sup> Select Committee on Economic Affairs (United Kingdom), above n 223, at [32].

<sup>239</sup> Select Committee on Economic Affairs (United Kingdom), above n 223, at [32].

methodologies. Regrettably, the OECD officials have been allowed to go their own way, free from any parliamentary scrutiny, and develop the increasingly complex and inappropriate Guidelines.

Part III showed that jurisdictions such as Australia and the United States have preferred to adopt a more flexible approach to the arm's length principle in order to obviate the constraints of the OECD guidelines. The end goal has been to secure more appropriate returns from multinational activities in their respective jurisdictions.<sup>240</sup> There is some evidence that multinational enterprises are benefiting from profit shifting at the expense of national tax revenue. Between 2005 and 2007 Australia has lost €1.1 billion in tax revenue to the European Union.<sup>241</sup> Over the same period the United States has lost USD 1.5 billion in tax revenue to other jurisdictions.<sup>242</sup> Whether this is the result of transfer price manipulation or other forms of tax planning is difficult to prove. The OECD tentatively suggests that data on foreign direct investments may indicate the existence of profit shifting from high tax jurisdictions to low ones. For example, in 2010 Barbados, Bermuda and the British Virgin Islands combined received more foreign direct investment as a percentage of GDP (5.11 per cent) than Germany or Japan. In the same year these three jurisdictions invested more into the world (4.54 per cent) than Germany.<sup>243</sup> That evidence does not necessarily imply the existence of transfer pricing manipulation.

Whatever the policy reasons for doing so, and whatever the evidential basis for it, multinational enterprises are the subject of increasing scrutiny by tax authorities. Concepts of fairness may be the underlying rationale for closer scrutiny. But, as a former director of tax policy at the OECD warns, fairness is not the only criterion by which to judge multinational enterprises.<sup>244</sup> If governments are dissatisfied with the outcomes under existing OECD transfer pricing rules, then they must go about changing them.<sup>245</sup> In the meantime governments will continue to apply the OECD transfer pricing guidelines in a flexible fashion to achieve a fair return from

---

<sup>240</sup> Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2012 (No. 1) (explanatory memorandum) at 2.10.

<sup>241</sup> Tax Justice Network Australia "Tax Dodging within Multinational Companies" <[www.taxjustice.org](http://www.taxjustice.org)>.

<sup>242</sup> Tax Justice Network Australia, above n 241.

<sup>243</sup> OECD, above n 224, at 18.

<sup>244</sup> Jeffrey Owens "The Taxation of Multinational Enterprises: An Elusive Balance" (2013) 67(8) BFIT at 3.

<sup>245</sup> Owens, above n 244, at 3.



multinational enterprises. Given that fairness is an inherently subjective notion, it can be expected that arm's length results will continue to be arrived at using methods in ways that diverge from the OECD guidelines. As such, the harmonisation of transfer pricing rules will be difficult to achieve.

#### D A Cause for Concern?

The divergence in transfer pricing rules from OECD policy need not necessarily be a cause for concern. The OECD's recommendation that member countries follow the transfer pricing guidelines is largely premised on the principle of certainty. It is axiomatic that certainty is a foundational principle in legal systems and an important element of the rule of law.<sup>246</sup> Certainty of tax rules is desirable from a taxpayer's perspective so that taxpayers can plan their transactions with foreknowledge of the possible consequences.<sup>247</sup> The guidelines point out that certainty of arm's length methods is desirable so that an arm's length result is arrived at on the basis of the highest degree of comparable data available.<sup>248</sup> The guidelines also point out that certainty of arm's lengths methods promotes harmonisation and reduces the risks of double taxation.<sup>249</sup> In the language of the OECD, a major reason that the principle should be adopted is that it "provides a broad parity of tax treatment for members of [multinational enterprise] groups and independent enterprises."<sup>250</sup>

A notable exception to the principle of certainty in the law is the use of general anti-avoidance rules to combat tax avoidance activity.<sup>251</sup> Added to that exception should be the choice of arm's length methods in ways that diverge from the OECD guidelines. States may choose between applying the principle in a certain fashion according to the priority of methods, and applying the principle in a way that most appropriately taxes the true economic substance of

---

<sup>246</sup> See for example Lon Fuller *The Morality of Law* (2<sup>nd</sup> ed, Yale University Press, New Haven, 1969) at ch 2.

<sup>247</sup> Robert A Green "The Future of Source-Based Taxation of the Income of Multinational Enterprises" (1993) 79 Cornell L Rev 18 at 21.

<sup>248</sup> *OECD Transfer Pricing Guidelines*, above n 10, at 61.

<sup>249</sup> At 34.

<sup>250</sup> At 34.

<sup>251</sup> See for example Rebecca Prebble and John Prebble "Does the Use of General Anti-Avoidance Rules to Combat Tax Avoidance Breach Principles of the Rule of Law?" (2010) 55 SLU Law Journal 21 at 28.

profit even if it means that the choice of methodology will be uncertain. States are adopting the latter choice.

General anti-avoidance rules depend on vagueness for their effectiveness, and so certainty may be an inappropriate value for such rules to strive for.<sup>252</sup> Is certainty an inappropriate value for the arm's length principle to strive for? The obstacles to transfer pricing harmonisation suggest that certainty in the choice of arm's length method may not be appropriate. The uncertainty in the selection of transfer pricing methodology is justifiable on the basis that neither the principle nor the guidelines are legally binding on member states outside of domestic or treaty law. The principle may therefore be legitimately subject to permutation when incorporated into domestic legislation.

The uncertainty is also justifiable on the basis that the principle does not reflect the economic reality that multinationals operate in. Comparable data on multinationals and independent parties in similar circumstances are difficult to find. In the absence of comparable data, tax authorities have little choice but to apply profit-based arm's length methods in ways that resemble formulary apportionment. If a rigid principle and strict priority of methods did not provide any flexibility to overcome the problems in finding comparable data, then tax authorities would face considerable difficulty in taxing the activities of multinationals. The shortcomings of the arm's length principle and the OECD guidelines make a departure from certainty a necessary remedy.

## V Conclusion

The thesis of this essay is that the complete harmonisation of transfer pricing rules with the arm's length principle is unattainable. Harmonisation is unattainable for three main reasons. First, the arm's length principle relies on incorporation into either domestic law or treaty law for binding legal effect. Even after being transformed from a non-binding principle to a legal rule, the interpretation of the principle in a consistent fashion is dependent on tax authorities adhering to the OECD guidelines. The OECD guidelines are themselves seldom given the force of law in domestic legislation. Tax authorities

---

<sup>252</sup> Prebble and Prebble, above n 251, at 41.

and courts are therefore free to interpret domestic arm's length provisions in ways that may diverge from the arm's length results contemplated in the OECD guidelines. Transfer pricing legislation in the United States and in Australia is illustrative of the point. In those  
5 jurisdictions, tax authorities may use profit-based methods to calculate arm's length results in situations where the OECD guidelines require the application of traditional transactional methods.

Second, states are compelled to prefer profit-based methods over traditional transactional ones due to theoretical shortcomings in  
10 the separate entity approach. Multinationals generate economic profits from the existence of market imperfections and their unique integrated structure. There is often very little comparable data available that show how independent parties would have transacted in similar circumstances to related parties. The difficulties from a lack of  
15 information are exacerbated when the transactions in question concern payments for intangibles. It is difficult to identify the market imperfections that are generating a multinational's economic profit. The market imperfections may arise from a multinational's use of intangible assets, like a licence agreement. But they might also arise  
20 from other aspects of a multinational's structure. Without knowing what feature of the multinational enterprise is the cause of an economic profit, the search for comparable data becomes exceedingly futile. As a result, tax authorities defer to the use of profit-based methods to overcome the paucity of comparable pricing data.

Third, governments have formed a perception (rightly or wrongly) that multinationals are not paying a fair share of tax. One of the causes of this perception is the fundamental interest of a multinational in maximising global after-tax profits. Another cause is that the 2010 OECD transfer pricing rules place too much emphasis on  
30 rules, rather than on the economic substance of profit that should be subject to tax. The two causes are leading governments to provide their tax authorities with more flexibility when applying the arm's length principle (as is already evident in Australia and the United States). A necessary consequence of flexible approaches to the arm's  
35 length principle is that transfer pricing rules will inevitably diverge across different jurisdictions.

The combined effect of these three obstacles is that the complete harmonisation of transfer pricing rules with the arm's length

principle is unattainable. The obstacles have resulted in a divergence from the OECD transfer pricing framework. Such divergence is not wholesale, because any approach to transfer pricing is still informed by an overarching principle. Harmonisation may be attainable if

5 consensus is reached on what the most appropriate way to apply the arm's length principle should be. The 2010 guidelines do not reflect such a consensus, but future guidelines may do so. Indeed, in 2013 the OECD began work on fashioning a new consensus on the application of the principle. That work may be the beginning of a more successful

10 process of transfer pricing harmonisation.

## **VI Bibliography**

### **A Cases**

#### **1 Australia**

*Federal Commissioner of Taxation v SNF (Australia) Pty Ltd* [2011] FCAFC 74, [2011] 193 FCR 149.

*SNF (Australia) Pty Ltd. v Federal Commissioner of Taxation* [2010] FCA 635, (2010) 79 ATR 193.

#### **2 Canada**

*Alberta Printed Circuits Ltd v The Queen* 2011 TCC 232.

*GlaxoSmithKline Inc. v R* 2008 TCC 324.

*GlaxoSmithKline Inc v R* 2010 FCA 201.

*GlaxoSmithKline Inc v R* 2012 SCR 3 at [20].

#### **3 United States of America**

*National Semiconductor Corporation and Consolidated Subsidiaries v Commissioner of Internal Revenue* 67 TC 2849 (1994).

### **B Legislation**

#### **1 Australia**

Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974.

Income Tax Act 1986 (Cth).

Income Tax Assessment Act 1936 (Cth) (repealed).

International Tax Agreements Act 1953 (Cth).

Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013 (Cth).

2 Canada

Income Tax Act RSC 1985.

Income Tax Act RSC 1998.

3 United Kingdom

Finance Act 1998.

Income and Corporation Taxes Act 1988.

4 United States

Code of Federal Regulations Title 26.

Internal Revenue Code 23USC.

**C Journal Articles**

“Multinational Corporation and Income Allocation under Section 482 of the Internal Revenue Code” (1976) 89 Harv L Rev 1202.

Michael Auramovich “Intercompany Transfer Pricing Regulations Under Internal Revenue Code Section 482: The Noose Tightens On Multinational Corporations” (1995) 28 J Marshall L Rev 915.

Reuven S Avi-Yonah “The Rise and Fall of Arm’s Length: A Study in the Evolution of U.S. International Taxation” (1995) 15 Va Tax Rev 89.

Reuven S Avi-Yonah “International Tax as International Law” (2003) 57 Tax L Rev 483 at 498

Reuven S Avi-Yonah *International Tax as International Law* (Cambridge University Press, New York, 2007).

Kevin A Bell “Australia Welcomes OECD BEPS Report, Introduces Transfer Pricing Legislation” (2013) 21 Tax Management International Pricing Report 1035.

Duncan Bentley “International Constraints on National Tax Policy” (2003) 30 Tax Notes Int’l 1127.

Jose Calderon “The OECD Transfer Pricing Guidelines as a Source of Tax Law: Is Globalisation reaching the Tax Law?” (2007) 35(1) IT Rev 4.

Allison Christians “Hard Law, Soft Law, and International Taxation” (2007) 25 Wis Int’l LJ 325.

Elizabeth Chovrat “Forcing Multinationals to Play Fair” (2003) 54 Ala L Rev 1251.

Ronald Coase “The Nature of the Firm” (1937) 16 *Economica* 386.

Arthur Cockfield “International Tax Competition: The Last Battleground of Globalisation” (2011) 63 Tax Notes Int’l 867.

Graeme S Cooper “Skinning the Tax Avoidance Cat” (2001) 30 AT Rev 26.

Kevin Dolan “Intercompany Transfer Pricing for the Layman” (1990) 49 Tax Notes 211.

Robert H Frank and Ben Bernanke *Principles of Economics* (4<sup>th</sup> ed, McGraw Hill, New York, 2009).

Michael Graetz “Taxing International Income – Inadequate Principle, Outdated Concepts, and Unsatisfactory Policy” (2001) 26 Brook J Int’l L 1417.

Robert Green “The Future of Source-Based Taxation of the Income of Multinational Enterprises” (1993) 79 Cornell L Rev 18.

Julie Harrison and Mark Keating “New Zealand’s General Anti-Avoidance Provisions: A Domestic Transfer Pricing Regime by Proxy?” (2011) 17 NZ J Tax & Policy 419.

D Hay, F Homer and J Owens “Past and Present Work in the OECD on Transfer Pricing and Selected Issues” (1994) 9 Tax Notes International 249.

Anthony Hayley and Scott Smith “Australian Court Rejects ATO’s Transfer Pricing Approach” (2011) 22 JIT 59.

Dixon Hearder “New Transfer Pricing Legislation” (2012) Asia-Pacific Tax Bulletin 367.

Dixon Hearder “New Transfer Pricing Legislation – Phase Two” (2013) 19 Asia-Pacific Tax Bulletin 136.

Nicholas Kaldor “The Equilibrium of the Firm” (1934) 173 *The Economic Journal* 60.

Christopher Kotraba “Better than the “Best”: Transfer Pricing Methodology in the Wake of *Roche*” (2009) 48 *Colum J Transnat’l L* 140.

Stanley Langbein “The Unitary Method and the Myth of Arm’s Length” (1986) 30 *Tax Notes* 625.

Brian D Lepard “Is the United States Obligated to Drive on the Right? A Multidisciplinary Inquiry into the Normative Authority of Contemporary International Law Using the Arm’s Length Standard as a Case Study” (1999) 10 *Duke J Comp & Intl L* 43.

Jian Li “Transfer Pricing and Double Taxation: A Review and Comparison of the New Zealand, Australia and the OECD Transfer Pricing Rules and Guidelines” (2005) 31 *Int’l Tax J* 49.

Leo Martinez “Tax Collection and Populist Rhetoric: Shifting the Burden of Proof in Tax Cases” (1988) 39 *Hasting L J* 239.

Charles McLure “State Taxation of Foreign-Source Dividends: Starting from First Principles” (1986) 30 *Tax Notes* 475.

John Neighbour and Jeffrey Owens “Transfer Pricing in the New Millennium: Will the Arm’s Length Principle Survive?” (2002) 10 *Geo Mason L Rev* 951.

Nabil Orow “Comparative Approaches to the Interpretation of Double Tax Conventions” (2005) 26 *Adel L Rev* 73.

Jeffrey Owens “The Taxation of Multinational Enterprises: An Elusive Balance” (2013) 67(8) *BFIT*.

Rebecca Prebble and John Prebble “Does the Use of General Anti-Avoidance Rules to Combat Tax Avoidance Breach Principles of the Rule of Law?” (2010) 55 *Saint Louis University Law Journal* 21.

Martin Przysuski and others “Developed-Country Transfer Pricing Comparison” (2005) 6 *Corporate Business Taxation Monthly* 11.

Nick Raby and others “US: Transfer Pricing Strategies” (2002) 3 *Int’l Tax Rev* 19.

David Rosenbloom “From the Bottom up: Taxing the Income of Foreign Controlled Corporations” (2001) 26 *Brook J Int’l L* 1525.



Kerrie Sadiq “The Traditional Rationale of the Arm’s Length Approach to Transfer Pricing – Should the Separate Accounting Model be Maintained for Modern International Entities?” (2004) 7 J Aust Tax 196.

Kerrie Sadiq “The Inherent International Tax Regime and its Constraints on Australia’s Sovereignty” (2012) 31 UQLJ 131.

John Simpson “Do You See ‘Convergence’? Examples of Real-World Data and the Comparable Profit Interval Of Proposed Regulation Section 1.482” (1992) 4 Tax Notes Int’l 1311.

Jesper Solgaard and Peter Austin “Australia’s Retroactive Transfer Pricing Bill” (2012) 67 Tax Notes Int’l 708.

Louise Tasse “Lessons From the GreatWhite North and Down Under —Thoughts on Recent Transfer Pricing Decisions” (2009) 54 Tax Notes Int’l 1027.

Chantal Thomas “Customary International Law and State Taxation of Corporate Income: The Case for the Separate Accounting Method” (1996) 14 Berkeley J Int’l L 99.

Terry Thompson “Canada’s Transfer Pricing Laws” (1998) 11 Transnat’l Law 311.

Jean-Pierre Vidal “The Achilles’ Heel of the Arm’s Length Principle and the Canadian *GlaxoSmithKline* Case” (2009) 37 Intertax 512.

Atilla Uyanik “Tax Avoidance and Evasion with Transfer Pricing” (2010) 14 The Business Review 91.

Francois Vincent “Glaxo at the Supreme Court: Not the Final Word, But Some Fine Words for Transfer Pricing in Canada” (2012) 21 Tax Management Transfer Pricing Report 835.

Jens Wittendorf “The Transactional Ghost of Article 9(1) of the OECD Model” (2009) 63 BFIT 107.

## D Texts

1963 and 1977 OECD Model Income tax Treaties and Commentaries: a comparative presentation (Kluwer Law, Deventer, 1987).

Anthony A D'Amato *The Concept of Custom in International Law* (Cornell University Press, London, 1971).

Philip Baker *Double Taxation Conventions and International Tax Law* (2<sup>nd</sup> ed, Sweet Maxwell, London, 1994).

J L Brierly *The Law of Nations* (6<sup>th</sup> ed, Clarendon Press, Oxford, 1963) at 59.

Ian Brownlie (ed) *Basic Documents in International Law* (3<sup>rd</sup> ed, Oxford University Press, New York, 1983).

R W Burchfield *Fowler's Modern English Usage* (3<sup>rd</sup> ed, Oxford University Press, New York, 2000).

Andrew Clapham *Brierly's Law of Nations* (Oxford University Press, Oxford, 2012).

James Crawford *Brownlie's Principles of Public International Law* (8th ed, Oxford University Press, Oxford, 2012).

Robert L Deutsch (ed) *Australia's Double Taxation Agreements* (Legal Books, Sydney, 2000).

Lorraine Eden "The Microeconomics of Transfer Pricing" in Alan M Rugman and Lorraine Eden (eds) *Multinational and Transfer Pricing* (Croom Helm, London, 1985).

Jamie Elliot and Clive Emmanuel "International Transfer Pricing" in Andrew Lymer and John Hasseldine (eds) *The International Taxation System* (Kluwer Academic Publishers, Dordrecht, 2002) 157.

Lon Fuller *The Morality of Law* (2<sup>nd</sup> ed, Yale University Press, New Haven, 1969).

HLA Hart *The Concept of Law* (Oxford University Press, London, 1961).

Jörg Kammerhofer *Uncertainty in International Law: A Kelsenian perspective* (Routledge, New York, 2011).

Paul Kirchhof and others (eds) *International and Comparative Taxation: Essays in Honour of Klaus Vogel* (Kluwer Law, London, 2002).

Stephen D Krasner (ed) *International Regimes* (Cornell University Press, London, 1983).

Richard Krever and Jiaying Zhang “Australia: Resolving the Application of Competing Treaty and Domestic Law Transfer Pricing Rules” in M Lang and others *Tax Treaty Case Law Around the Globe* (Linde, Vienna, 2011) 199.

Richard Krever and Yuri Grbich *Australian International Tax: Recent Development and Future Directions* (The Law Book Company, Sydney, 1994).

Walter O’Connor “The Role of Tax Treaties in International Taxation” in Andrew Lymer and John Hasseldine (eds) *The International Taxation System* (Kluwer Academic Publishes, Massachusetts, 2002) 123.

Nicholas Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World* (Bodley Head, London, 2011).

Ian Sinclair *The Vienna Convention on the Law of Treaties* (2<sup>nd</sup> ed, Manchester University Press, Dover, 1984).

Kees van Raand (ed) *1963 and 1977 OECD Model Income Tax Treaties and Commentaries* (2<sup>nd</sup> ed, Kluwer Law, Deventer, 1990).

Alan M Rugman and Lorraine Eden (eds) *Multinational and Transfer Pricing* (Croom Helm, London, 1985).

Joseph Raz *Practical Reasons and Norms* (Hutchison, London, 1975).

Klaus Vogel *Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD-, UN- and US-Model Conventions for the Avoidance of Double Taxation of Income and Capital with Particular Reference to German Treaty Practice* (Kluwer Law, Deventer, 1990).

TW Vogelaar “The OECD Guidelines: their philosophy, history, negotiation, form, legal nature and follow up procedures and review” in Norbert Horn (ed) *Legal Problems of Codes of Conduct for Multinational Enterprises* (Springer, Frankfurt, 1980).

David A Ward and others *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model* (IBFD Publications, Amsterdam, 2005).

## **D Parliamentary and Government Materials**

### **1 Australia**

Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013.

Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2012 (No 1).

Tax Laws Amendment (Cross-Border Transfer Pricing) Bill 2012 (No 1) (explanatory memorandum).

Australian Tax Office *Income tax: application of the Division 13 transfer pricing provisions to loan arrangements and credit balances* (Taxation Ruling TR 92/11, October 1992).

Australian Tax Office *Income tax: arm's length transfer pricing methodologies for international dealings* (Taxation Ruling TR 97/20, November 1997).

Australian Tax Office *Income tax: application of Division 13 of Part III (international profit shifting) - some basic concepts underlying the operation of Division 13 and some circumstances in which section 136AD will be applied* (Taxation Ruling TR 94/14, December 2011).

## 2 United Kingdom

Select Committee on Economic Affairs (United Kingdom) *Tackling corporate tax avoidance in a global economy: is a new approach needed?* (31 July 2013).

## 3 United States

*A Study of Intercompany Pricing* (Treasury Department, Discussion Draft, October 1988).

## **E International Materials**

Statute of the International Court of Justice.

OECD *Addressing Base Erosion and Profit Shifting* (2013).

OECD *Insights Debate the Issues: Price fixing* (March 2012) <[www.oecdinsights.org](http://www.oecdinsights.org)>.

OECD *Model Tax Convention on Income and in Capital* (OECD, Paris, 1977).

OECD *Model Tax Convention on Income and in Capital* (OECD, Paris, 1963).

OECD *Model Tax Convention on Income and in Capital* (OECD, Paris, 2010).

OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995).

*OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (July 2010).

Vienna Convention on the Law of Treaties 1155 UNTS 331 (opened for signature 23 May 1969, entered into force 27 January 1980).

*Work of the Group of Experts on Tax Treaties Between Developed and Developing Countries* ESC Res 1765 (LIV) E/1978/36 (1978).

## **F Internet Resources**

“Treasury should undertake review to ensure multinationals pay their fair share” (31 July 2013) <[www.parliament.uk](http://www.parliament.uk)>.

Deloitte “2013 Global Transfer Pricing Country Guide” (2013) <[www.deloitte.com](http://www.deloitte.com)>.

Peter Dunne “Multinational investors – paying fair share of tax” (16 May 2013) The official website of the New Zealand Government <[www.beehive.govt.nz](http://www.beehive.govt.nz)>.

Pricewaterhouse Coopers “*Roche Products Pty Limited v The Commissioner of Taxation: a bitter pill to swallow, but for whom?*” (May 2008) TaxTalk Electronic Bulletin of Australian Tax Developments <[www.pwc.com.au](http://www.pwc.com.au)>.

Tax Justice Network Australia “Tax Dodging within Multinational Companies” <[www.taxjustice.org](http://www.taxjustice.org)>.

Greg Thompson “Federal Court decides in favour of taxpayer in transfer pricing case” (September 2010) Chartered Secretaries Australia <[www.csaust.com/knowledge-resources/journal.aspx](http://www.csaust.com/knowledge-resources/journal.aspx) at 494>.

## **G Papers**

John Prebble *Composing Research Papers* (Victoria University Faculty of Law, March 2013).

Lindsay Rollo and John Prebble *Word Processing: Layout of Text for Optimum Comprehension* (Victoria University Faculty of Law, October 1996).

Richard Schmalbeck “*Opinio Juris* in International Tax” (paper presented to The Role of *Opinio Juris* in Customary International Law, Duke-Geneva Institute in Transnational Law conference, Geneva, July 2013).

## **H Other Resources**

Bill Shorten “Robust Transfer Pricing Rules for Multinationals” (press release, 1 November 2011).