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**Developments with regard to the
OECD Transfer Pricing Guidelines ¹**

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DEVELOPMENTS WITH REGARD TO THE OECD TRANSFER PRICING GUIDELINES

This summary is a copy of the page that can be found on the OECD website.

A large share of world trade consists of transfers of goods, intangibles and services within multinational enterprises. To determine their tax liability in each jurisdiction, the right price (the arm's length price) has to be put on these transactions. To avoid double taxation and the consequent impediment to world trade, the OECD has issued guidelines on how the determination of the arm's length price should be carried out.

Commercial transactions between different parts of a multinational group may not be subject to the same market forces shaping relations between two independent firms. Transfer prices — payments from one part of a multinational enterprise for goods or services provided by another — may diverge from market prices for reasons of marketing or financial policy, or to minimise tax. To ensure that the tax base of a multinational enterprise is divided fairly, it is important that transfers within a group should approximate those which would be negotiated between independent firms. This 'arm's length principle' is set out in Article 9 of the OECD Model Tax Convention.

Guidelines as to how this principle should be put into practice were issued in 1979, and were substantially revised and up-dated in 1995. In particular, much new material was added on comparability (how to tell if a transfer between independent firms is really similar to a transfer within a group) and transfer pricing methods, including profit methods. Work continues on revising the Guidelines. In April 1996 new chapters were published looking at intangibles and services. In August 1997 a new chapter on cost contribution arrangements (CCAs) was issued. In February 1998 Annexes were published containing practical examples and procedures for monitoring the implementation of the guidelines. In October 1999 an Annex was published which covered the Guidelines for conducting advance pricing arrangements under the mutual agreement procedure ("MAP APAs")

Technological change and financial deregulation have dramatically globalised financial markets. Financial firms have organised themselves to sell financial products 24 hours a day. This phenomenon of global trading challenges taxpayers and tax administrations to come up with a fair way of allocating and taxing the profits in each country where global trading is carried on. The OECD published in April 1998 a considerably revised and updated version of the discussion draft *The Taxation of Global Trading of Financial Instruments*.

This publication thoroughly reviews the factual background to global trading, analyses the challenges posed to traditional taxation methods and discusses a range of policy options to tackle

the problems. Although the publication reviews a specific industry sector, the discussion of many of the issues raised, for example the high level of global integration of functions and intensive co-operation between different geographic locations, may be of relevance to other industries as the way they conduct their business changes as a result of the spread of globalisation and electronic commerce.

The transfer pricing guidelines

Current work focuses on four main areas.

First, providing guidance on how to apply the general principles of the guidelines to complex situations, such as permanent establishments, financial services, global trading and thin capitalisation.

Second, monitoring the practical implementation of the Guidelines and amending and updating the existing guidance given in the light of this monitoring. The business community, via the Business and Industry Advisory Committee of the OECD (BIAC), is associated with this activity. One outcome of the monitoring process is the development of further practical examples to illustrate the application of the arm's length principle. The extent to which the existing guidance on transfer pricing can be applied to electronic commerce is also being examined.

Third, the improvement of administrative procedures. The various methods of dispute resolution (advance pricing arrangements (APAs), the mutual agreement procedure and arbitration) are currently being examined. Further guidance on undertaking advance pricing arrangements, especially under the mutual agreement procedure (MAP APAs) is expected to be published in 1999.

Fourth, encouraging countries outside the OECD to associate themselves with the Guidelines. This is undertaken by means of multilateral seminars, often with appropriate regional partners, which discuss transfer pricing issues and explain the guidelines to tax officials from non-member countries.

CCA Chapter

The OECD has released the last of eight core chapters to be added to its 1995 publication *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. The Chapter that was published in 1997 covers the subject of cost contribution arrangements under the arm's length principle, which is the agreed international standard governing related party cross-border transactions. The Chapter represents the agreement of all OECD Member countries to recognise cost contribution arrangements for tax purposes, and to follow uniform principles in dealing with these arrangements in the international context.

The Chapter defines cost contribution arrangements (CCAs), noting that although such arrangements are most frequently encountered in the R&D area, they are not limited to such activities. Under the Chapter, a CCA can be used by business enterprises to share the costs and risks of developing, producing or obtaining any assets, services, or rights. A CCA will satisfy the arm's length principle provided that each participant's share of the overall contributions to the subject activity is consistent with the participant's proportionate share of the overall benefits expected to be received.

The Chapter provides guidance on determining the participants of a CCA, how their respective contributions should be valued, and whether the allocation of contributions is appropriate in light of the expected benefits to be received. The tax treatment of contributions and other payments made under a CCA is also discussed.

This Chapter of the OECD's Transfer Pricing Guidelines completes the core work begun in 1993 to provide an international consensus on the pricing of cross-border transactions among related parties. While the Chapter is being issued initially as an update for insertion into the loose-leaf Guidelines, OECD is expected now to publish a paperback version of the core chapters. Work will continue at OECD on new chapters addressing special topics such as permanent establishments and issues affecting the financial sector.

Monitoring

The OECD has also been given an explicit monitoring role. This covers the application of countries' transfer pricing rules and their consistency with the guidelines, cases where mutual agreement proceedings have not reached a satisfactory conclusion, the use of advance pricing arrangements (APA's) and the frequency with which profits methods are used by tax administrations.

The February 1998 update contains details of procedures for monitoring the application of the guidelines and the role of the business community in that process.

Advance Pricing Arrangements

In October 1999, the OECD published an update to the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter referred to as the "Guidelines"). This update is in the form of a new Annex to the Guidelines that provides guidance on conducting advance pricing arrangements under the mutual agreement procedure (MAP APAs). The Annex becomes an integral part of the Guidelines as shown by the decision of the OECD council on 28 October to amend its original recommendation concerning the Guidelines in 1995 so as to incorporate the new guidance in this Annex. It therefore has the same status as the existing eight Chapters of the Guidelines.

Discussion Draft on Attributing Profits to a Permanent Establishment

Currently, there is a lack of consensus amongst OECD Member countries as to how profits should be attributed to a permanent establishment (PE). As a first step in remedying this situation a working hypothesis has been developed as to the preferred approach for attributing profits to the PE. The basis for the working hypothesis is to examine how far the approach of treating the PE as a hypothetical distinct and separate enterprise can be taken and how the guidance in the OECD Transfer Pricing Guidelines could be applied, by analogy, to attribute profits to a PE. This discussion draft contains the results of testing the working hypothesis in general (Part I) and to

PEs of banks (Part II). Public comments are invited in order to assist in the development of an OECD consensus on the attribution of profits to a PE.

Testing is still underway for PEs of insurance companies and enterprises undertaking global trading of financial products and is about to begin in the electronic commerce sector for PE's created solely by the existence of a server (see the discussion draft published by the Business Profits TAG on the attribution of profits to a server PE).