PART THREE

SUGGESTIONS RELATING TO THE APPLICATION OF THE ARTICLES OF THE UN MODEL CONVENTION AND PROCEDURAL ASPECTS OF TAX TREATY NEGOTIATIONS

I. Procedural Aspects of Mutual Agreement Procedure provided for in Article 25

In order to assist the competent authorities in applying the mutual agreement procedure provided for in article 25, several possible arrangements are described below and certain factors relevant to their use are discussed. This enumeration of arrangements is not intended to be exhaustive and can be extended as appropriate in the light of experience.

A. General Considerations

The procedural arrangements should be suitable to the number and types of issues expected to be dealt with by the competent authorities and to the administrative capability and resources of those authorities. The arrangements should not be rigidly structured but instead should embody the degree of flexibility required to facilitate consultation and agreement rather than hinder them by elaborate procedural requirements and mechanisms. But even relatively simple procedural arrangements must incorporate certain minimum rules that inform taxpayers of their essential rights and obligations under the mutual agreement procedure. Such minimum rules should answer the following questions:

At what stage in a tax matter can the taxpayer invoke action by the competent authority under the mutual agreement procedure?
Must any particular form be followed by a taxpayer in invoking action by the competent authority?
Are there time-limits applicable to a taxpayer’s invocation of action by the competent authority?
If a taxpayer invokes action by the competent authority, is it bound by the decision of the competent authorities and must it waive recourse to other administrative or judicial processes?
In what manner, if at all, may a taxpayer participate in the competent authority proceedings? What requirements regarding the furnishing of information by a taxpayer are involved?

B. Mutual Sharing of Information on Adjustments

For the competent authority procedure to operate effectively, the competent authorities of a Contracting State must provide the competent authorities of the other State with certain relevant information about adjustments it has made or intends to make to the income and expenses of
taxpayers residing in that other State. The information might cover adjustments proposed or concluded, the related entities involved, and the general nature of the adjustments.

Generally, most competent authorities are likely to conclude that automatic transmittal of such information is not needed or desirable. The competent authority of the country making an adjustment may find it difficult or time-consuming to gather the information and prepare it in a form suitable for transmission. In addition, the other competent authority may find it burdensome merely to process a volume of data routinely transmitted by the first competent authority. Moreover, a tax paying corporation can usually be counted upon to inform its related entity in the other country of the proceedings, and the latter entity is thus in a position to inform its competent authority. For this reason, the functioning of a consultation system is aided if a tax administration considering an adjustment possibly involving an international aspect gives the taxpayer warning as early as possible.

Some competent authorities, while not desiring to be informed routinely of all adjustments in the other country, may desire to receive, either from their own taxpayers or from the other competent authority, early notice of serious cases or of the existence of a significant degree or pattern of activity respecting particular types of cases; similarly, they may be prepared to transmit such information to their counterpart in the other country. In this event, a process should be worked out for obtaining this information. Some competent authorities may want to extend this early warning system to less serious cases, thus covering a larger number of cases.

C. Time for Invoking Consultation Between Competent Authorities

The competent authorities must decide the stage at which the competent authority consultation process may be invoked by a taxpayer. For example, suppose an adjustment is proposed by State A that would increase the income of a parent company in State A and the adjustment would have a correlative effect on a related entity in State B. May the company go to its competent authority in State A, asserting that the adjustment is contrary to the treaty, and ask that the bilateral competent authority process commence? Must it wait until State A has actually made the adjustment? Must it wait until it has pursued any appeals that may be available to it within the tax department? Must it wait until all matters have been settled in court and an adjustment has become final?

Probably most competent authorities, at least in the early stages of their experience, prefer that the process not be invoked at the point of a proposed adjustment and probably not even at the point that the adjustment has been made by the tax department. A proposed adjustment may never result in final action, and even a concluded adjustment may or may not trigger a claim for a correlative adjustment. Even if a correlative adjustment is required to avoid double taxation, it may be provided by the other Contracting State without problems. As a consequence, many competent authorities may decide that the competent authority procedure should not be invoked until the taxpayer has claimed a correlative adjustment (or other tax consequence) in the other Contracting State and that State disposes of the claim in a manner that creates (or potentially creates) double taxation. The problem with delaying the invocation of the procedure this long is
that the State making the initial assessment may want to limit competent authority consultations to the issue of how to devise an appropriate correlative adjustment in the other State. It may not be willing to discuss modifications to the concluded adjustment, particularly if the adjustment was sustained or established after lengthy litigation. The other State, however, may wish to determine whether the initial assessment comports with its understanding of the relevant legal standard.

Thus, some competent authorities may prefer that the bilateral process be invoked earlier, perhaps at the proposed adjustment stage. Such involvement may make the process of consultation easier, in that the first country will not have an initial fixed position. Other competent authorities may be willing to let the taxpayer decide when to invoke the process and thus they may stand ready to have the process invoked at any point starting with the proposed adjustment.

At a minimum, taxpayers must be informed when they can invoke the mutual agreement procedure. They also should be given instructions on the manner in which a request for competent authority relief should be submitted. It is likely that a simple form normally would be suitable for this purpose.

D. Correlative Adjustments and Other Relief Mechanisms

The basic principle underlying correlative adjustments is that items of income and expense of a multinational enterprise should be treated consistently in the two Contracting States. Under most tax treaties, if one country makes an adjustment in the tax liabilities of an entity under the rules governing the allocation of income and expense, thereby increasing the tax liabilities of that entity, and if the effect of this adjustment, when reflected in the tax accounts of a related entity in the other country, would require a change in the tax liabilities of the related entity, then a correlative adjustment should be made by the second country at the related entity’s request if the initial adjustment is in accord with the treaty standard governing allocation of income and expense. The purpose of such a treaty provision is to avoid economic double taxation. The key aspect of a treaty provision requiring a correlative adjustment is that the initial adjustment itself must conform to the appropriate arm’s-length standard.

Although some countries generally are willing to agree that a correlative adjustment should be made, they may believe it appropriate to allow the competent authorities discretion to deny a correlative adjustment in cases that involved fraud, evasion, intent to avoid taxes or gross abuse. These countries may take the view that, if a correlative adjustment were required in such situations and the taxpayer were thus given, in effect, an almost automatic guarantee against the consequence of double taxation, the taxpayer would generally have little to lose in initially utilizing clearly improper allocations. To this effect, the United Nations Model Convention has made a special provision in paragraph 3 of article 9 that eliminates the requirement of making a correlative adjustment when the taxpayer has been found through judicial, administrative or other legal proceedings to be liable for a penalty for fraud, gross negligence or wilful default, on account of its method of making its initial allocations of income and expenses.
The merits of this rule denying a correlative adjustment are debated. On the one hand, proponents of the rule suggest that if the competent authorities possess such discretion and there is a risk to the taxpayer of economic double taxation, the taxpayer is more likely to be deterred from acting fraudulently. On the other hand, opponents of the rule suggest that it is inconsistent with the goal of eliminating double taxation — a key objective of tax treaties. In their view, matters such as fraud should be left to other provisions of law. The proponents of that latter position may concede, nevertheless, that some modicum of discretion should be available to deal with outrageous cases.

Aside from the penalty aspects of denying a correlative adjustment, some countries may be reluctant to make correlative adjustments a matter of right but would prefer that the entire matter be left to the discretionary agreement of the competent authorities. In their view, the requirement that a Contracting State grant a correlative adjustment is a strong invitation to the other State to make a large number of initial adjustments. The requirement that the initial adjustment conforms to an arm’s-length standard, however, may provide a sufficient safeguard against overly aggressive initial adjustments.

To be effective, a treaty with a correlative adjustment provision must provide that any procedural or other barriers to the making of the correlative adjustment under domestic law are to be overridden by the agreement of the competent authorities. Thus, such provisions as statutes of limitations and finality of assessments have to be adjusted to permit the correlative adjustment to be made. If a country cannot, through a treaty, override such aspects of its domestic law, it should negotiate an exception to the correlative adjustment provision in its tax treaties, or it should pursue an amendment to its domestic law to permit the correlative adjustment provision to operate.

In conjunction with providing correlative adjustment relief, a State may consider other relief mechanisms. In particular, a State may wish to mitigate or eliminate the tax effects that otherwise would result when a taxpayer is required to adjust its books of account as a result of a correlative adjustment. For example, assume that ACo., a resident of State A sells goods to BCo., a resident of State B for 3,000 when the market price is 4,000. On audit, State A increases ACo.’s income by 1,000. That 1,000, however, is held by BCo. If that 1,000 is transferred from BCo. to ACo., the 1,000 would be taxable to ACo. as a dividend, resulting in ACo. being taxed twice on that 1,000. To avoid that result, State A may wish to allow ACo. not to treat the receipt of 1,000 as a dividend. Instead, ACo. may be treated as if it has sold the goods to BCo. for 4,000, receiving 3,000 in cash and a note for 1,000. The subsequent payment of 1,000 to ACo. would be treated as a payment on that note.

The relief suggested above may be provided either under a State’s domestic tax law or through the competent authority machinery. In general, it seems more appropriate that the relief be granted through domestic legislation in that it technically is not an issue relating to double taxation. The relief is sufficiently related to the initial correlative adjustment, however, that States may wish to address the issue of relief through the competent authority mechanism. In light of paragraph 3 of article 9 of the United Nations Model Convention, this special relief
should not be granted through the competent authority mechanism if the taxpayer has engaged in fraud.

Taxpayers have sometimes suggested that they should be given relief from a transfer price adjustment if they were prevented by currency restrictions or other governmental rule from paying an arm's length price. Assume, for example, that ACo., a resident of State A, licenses valuable technology to BCo., a resident of State B for a royalty of one per cent. The arm's length price generally is 50 per cent. Under the laws of State B, however, companies are prohibited from paying royalties in excess of one per cent. ACo. increases the royalty rate to 50 per cent, resulting in an additional assessment of tax of 5 million. The question is whether ACo. should be entitled to relief, by treaty or domestic law, from that additional assessment.

The case for treaty relief in this situation depends on whether the arm's length royalty rate, under these facts and circumstances, is actually 50 per cent. If ACo. can demonstrate that an unrelated person would have licensed the valuable technology to BCo. for a royalty of one per cent, then the adjustment of 50 per cent is improper under the treaty. In reality, however, it is unlikely in the extreme that ACo. would license its valuable technology to an unrelated person at such a low rate unless it was compensated by the unrelated person in some other way. Special treaty relief in these circumstances, therefore is unwarranted. Domestic relief that had the effect of reducing or eliminating the adjustment also would seem unwarranted. It might be appropriate, however, for a State to allow deferral of payment of tax in hardship cases as long as interest at a market rate was payable currently, appropriate security for payment was established, and the related persons were required to adopt a consistent method of accounting under which a deduction for the royalty due but not paid would be deferred until the deferred tax payment was made.

E. Operating Procedures

Taxpayer participation. All Contracting States are likely to favour some degree of taxpayer participation in the competent authority procedures. At a minimum, the States would allow taxpayers to present relevant information to the competent authority of their State of residence and to respond to requests for information from their competent authority. Some States may be prepared to allow taxpayers to present legal briefs or even to make an appearance before the competent authority.

Taxpayers have sometimes sought the right to be involved directly in the actual consultations between the Contracting States. Allowing this degree of taxpayer participation is likely to extend and distort the consultative process. It will extend it because taxpayers are likely to want a solution that minimizes their current and future taxes, whereas the interests of the Contracting States may be in achieving an appropriate policy framework for settling the current matter and related future matters. It may distort the process by converting it into a quasi-judicial procedure in which alleged rights of the taxpayer are being vindicated. A tax treaty, however, is an agreement between sovereign States and should be interpreted to advance the tax policy goals
of the States, not the private interests of particular taxpayers.

The competent authorities ought to require taxpayers, as a condition for invoking the competent authority procedure, to submit the relevant information needed to decide the matter. In addition, some competent authorities may require, where appropriate, that data furnished by a taxpayer be prepared as far as possible in accordance with internationally accepted accounting standards so that the data provided will have some uniformity and objectivity. Progress has been made in developing uniform international accounting standards, and the work of competent authorities should be aided by this development.

**Timing Issues.** If a time limit on the invocation of the competent authority procedure is to be imposed, the limit should be promulgated, and the point at which the time begins to run should be defined. Article 25, paragraph 1, provides that a case "must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention." This paragraph establishes the notification date as the starting point and sets three years as the time limit. In bilateral negotiations, the Contracting States might wish to give the competent authorities the power to waive these limits in appropriate cases. The three year limit may be inappropriate if the Contracting States want taxpayers to exhaust domestic remedies before invoking the competent authority mechanism.

**Methods of Consulting.** The competent authorities must decide how their consultation is to proceed. Presumably, the nature of the consultation with respect to a particular case will depend on the character of the case and the likelihood that similar cases are forthcoming. The competent authorities should keep the consultation procedure flexible and should leave every method of communication open, so that the method appropriate to the matter at hand can be used. At the same time, they should not be so unstructured in their approach that they are required to engage in extensive negotiations over procedural matters whenever a competent authority issue arises.

Several alternative methods of consultation between competent authorities are available. They include:

1) informal consultation between the competent authorities in person or by telephone, e-mail, written letters, or other forms of communication;

2) delegation of the initial responsibility for consultation to technical personnel or auditors of each country, with an expectation that the conclusions reached by these people would be given great weight by the competent authorities;

3) the appointment of a joint commission to deal with complicated cases or with a series of related cases; and

4) formal meetings in person of the competent authorities at some appropriate forum.
Competent authorities should organize their consultative process so that they can act expeditiously and avoid undue delay. They should not set rigid time limits for action, however, because some cases are far more complex and politically sensitive than others. The method of consulting depends in part on whether the competent authorities feel compelled to reach an agreement that avoids double taxation. At a minimum, the treaty requires consultation and an endeavour to find a solution to economic double taxation. The language of article 25, nevertheless, does not require that the competent authorities actually reach agreement. If the States want to ensure that international double taxation is eliminated, they must provide in article 25 some language mandating agreement, such as a provision for binding arbitration. Alternatively, they might provide arbitration as an alternative method to be pursued at the discretion of the States. In the United Nations and OECD Model Conventions, the competent authorities are mandated to reach agreement only in the case of an individual subject to double taxation as a result of being a resident of both Contracting States.

In practice, most competent authority procedures involving developing countries have resulted in the elimination of double taxation. The solution may be a compromise, for compromise is an essential aspect of the process of consultation and negotiation. In reality, therefore, a requirement that the competent authorities reach agreement probably would not impose significant hardship on the Contracting States. Some countries, however, consider the formal adoption of a requirement to reach agreement as a step possessing significant juridical consequences and are not disposed to adopt such a requirement. In the light of the actual practice of developing countries, a mandatory-agreement rule is probably not needed to prevent international double taxation in the overwhelming majority of cases.

For some countries, the process of agreement between competent authorities might be facilitated if competent authorities could call upon outside experts to give an advisory opinion or otherwise to assist in the resolution of an extremely difficult case or a case that has reached an impasse. These experts might be persons currently or previously associated with other tax administrations and possessing the requisite experience and technical competence.

**Effect of Agreement.** In developing their competent authorities procedure, States must decide on the legal effect of a taxpayer’s invocation of that procedure. In particular, they must determine whether a taxpayer is bound by the decision of the competent authorities in the sense that it gives up rights to alternative review procedures, such as, recourse to domestic administrative or judicial procedures. Some competent authorities may desire that their actions be binding because they do not want to go through the effort of reaching agreements with their counterparts in the other State only to have the taxpayer reject the result if it feels it can do better in the courts or elsewhere. Other competent authorities may not want to bind taxpayers because they think that taxpayers might respond by unduly delaying the invocation of the competent authority process for strategic reasons. If the competent authorities want their procedure to be exclusive and binding, they must establish the necessary rules under the general delegation of authority granted to them in article 25, paragraph 4. In particular, they might require the taxpayer to waive recourse to alternative domestic procedures as a condition for invoking the competent authority procedure.
In some cases, a State wishing to make competent authority decisions final may not be in a position to do so under domestic law. Article 25, paragraph 4 gives competent authorities the power to "develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure." A State may consider, however, that its domestic law requires a more explicit statement of authority to permit the competent authority procedure to be binding. For example, the State may view article 25, paragraph 1, referring to remedies under national laws, as requiring it to give effect to those remedies if they exist. Or it may interpret its prior practices as settling the interpretation of article 25 in favour of a preservation of domestic appeal rights. In that event, the State may wish to negotiate specific language in article 25 that makes clear that it does have the authority to make the determinations of the competent authorities final. In some cases, a change in domestic legislation also may be required.

F. Publication of Competent Authority Procedures and Determinations

The competent authorities should make public the procedures they have adopted with regard to their consultation procedure. The description of the procedures should be as complete as is feasible and at the least should contain the minimum procedural aspects discussed above.

Where the consultation procedure has produced a substantive determination in an important area that can reasonably be viewed as providing a guide to the viewpoints of the competent authorities, the competent authorities should develop a procedure for publication in their countries of that determination or decision with sufficient detail to make the published decision useful to taxpayers confronting similar issues. Of course, some aspects of a competent authority procedure must be kept confidential, to protect, for example, commercial secrets. The legitimate rights of taxpayers to confidentiality with respect to their business affairs and the right of the public to understand the developing body of law can be balanced by lagging publication by some months and by editing out unnecessary details.

The competent authority procedure should not become a vehicle for developing a private body of tax law. A basic requirement of a fair legal regime is that taxpayers be informed of the laws under which they are governed. An excessive privacy with respect to the decisions of the competent authorities can result in only a favoured few understanding important aspects of the relevant tax law. In addition, excessive secrecy can create an environment in which corruption can flourish.

II. Suggestions for Transfer Pricing

This section is based in large part on transfer pricing guidelines issued by the OECD Committee on Fiscal Affairs. Organisation for Economic Cooperation and Development, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Paris, 1995).
From a financial perspective, transfer pricing is perhaps the most important tax issue in international taxation. Over 60 per cent of international trade is carried out within multinational enterprises (MNEs). The expression MNE in this context not only covers major corporate entities, but also smaller companies with one or more subsidiaries or permanent establishments in countries other than the country where the parent company or head office is located.

Parent companies of large corporate groups usually have sub-holdings and intermediary holdings in several countries. In many cases, the organizational structure of an MNE differs significantly from the way unrelated companies conduct their business. Examples include the following: (1) The research and service activities of an MNE is concentrated in a centre that operates for the benefit of some or all of the companies that make up the MNE; (2) The intangible property developed by the members of an MNE are transferred to one or more members of the MNE group and are managed on a global basis, with royalties charged to members utilizing the intangibles; (3) the MNE establishes a finance company that operates as an internal bank for allocating capital among members of the MNE; (4) The MNE establishes a company to produce parts and other intermediate goods in one country and establishes another company, operating in a different country, to assemble those parts into a final product that is sold in the marketplace.

MNEs have adopted a variety of different management systems. At one extreme, some MNEs employ a highly centralized system, with all of the important business decisions made at the head office. At the other extreme, some MNEs use a highly decentralized system, with profit responsibility allocated to individual members of the corporate group. Most MNEs have a management system that falls between these extremes. That is, they centralized some management functions in the parent corporation and allocate significant decision making authority to their subsidiaries.

According to the OECD Committee on Fiscal Affairs, transfer prices for transactions among associated enterprises "are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different jurisdictions." Over the past several decades, intra-company trade has been increasing significantly, with the result that transfer pricing has become an increasingly important issue for taxpayers and for governments. On the one hand, MNEs have become increasingly sophisticated in using transfer prices to minimize their taxes. On the other hand, many governments, individually and collectively, have become increasingly attuned to the potential revenue gains from reforming their transfer pricing rules and to the potential losses if other governments take aggressive action to deal with transfer pricing issues and they decline to act.

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2 This section is based in large part on transfer pricing guidelines issued by the OECD Committee on Fiscal Affairs, Organisation for Economic Cooperation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris, 1995).
The increased attention given to transfer pricing in recent years is due in part to changes in the way that MNEs are conducting their businesses. Those changes test the limits of the arm's length principle. For example, some MNEs engage in what is sometimes called "global manufacturing." A final product, such as an automobile, is no longer produced primarily in one country. Instead, various modules that make up an assembled product are produced in several countries. Another example, from the financial services industry, is the development of global trading in commodities and financial instruments. The trading takes place 24 hours a day in locations all over the world, with each of the locations sharing in the capital and trade name of the common enterprise. Both of these developments and many more have been made possible by technological advances in information technology and communications. Under both the United Nations and OECD Model Tax Conventions, each enterprise of a multinational enterprise (MNE) is treated as a separate entity, and the income of each enterprise is determined as though an MNE's various enterprises dealt with each other at arm's length. An enterprise located in one Contracting State is "associated" with an enterprise located in the other Contracting State if the two enterprises meet the general requirements set forth in subparagraph (a) or (b) of paragraph 1 of article 9. That provision provides that two enterprises are "associated" if:

"(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 [both enterprises]."3

An MNE may be concerned about setting appropriate transfer prices for a variety of reasons. One reason is internal allocation of resources. For example, in allocating capital within the firm and in rewarding its employees, the MNE may want to understand which parts of its business are profitable, and which of the profitable ones are most profitable. Another reason is public accountability. For example, if all of its affiliated companies are not wholly owned, it may have fiduciary duties to minority shareholders or to persons buying shares on an organized stock exchange. Of course an MNE also must determine the profits of each member of its corporate group for tax purposes.

National States care about the transfer prices set by an MNE in order to protect their source and residence jurisdiction. Whereas a particular MNE is concerned primarily about measuring accurately the profits earned by each of its members, a State's primary concern is the elimination of systemic biases in the way transfer prices are set that would work to their detriment. A State typically is not overly concerned, for example, if the MNE overstates the income subject to its tax jurisdiction. As a result, States with very low tax rates tend to be less concerned about transfer pricing than high tax states. A State should not be overly concerned with various imperfections in a pricing method, as measured by reference to the arm's length standard, if it is able, nevertheless, to obtain its proper cumulative share of income to tax from all taxpayers within its jurisdiction. For example, a pricing rule that understated the profit derived from

3 Ibid., paragraph 12.
overhead expenses might be acceptable to a State if the various errors from using that system were offsetting sometimes overstated and sometimes understated the taxable income of taxpayers subject to its tax jurisdiction.

Some sub-national jurisdictions in the United States, Canada, and elsewhere use formulas to allocate the total taxable income of an MNE group among its members. They acknowledge that the formula is not an accurate way of determining the separate accounting income of the individual members of a corporate group. The method is acceptable to them, however, because their goal is to determine their proper share of the overall taxable income of the MNE group without reference to how that income might be allocated to particular members of the group.

An MNE group is unlikely to find that a general allocation formula serves its business purposes. A formula, for example, might not be acceptable to the financial community that is monitoring the performance of individual members of a corporate group. An MNE, nevertheless, may choose to use formulas in limited circumstances. For example, it may use a general formula to allocate interest expense, research and development costs, and certain other hard-to-allocate expenses among members of the MNE group.

A common definition of a "transfer price" is "the amount charged by one segment of an organization for a product or service that it supplies to another segment of the same organization." One business reason for charging transfer prices is to permit managers of an MNE group to evaluate the performance of each member of the group. By charging prices for goods or services transferred within an MNE, the managers of the MNE are able to make efficient decisions about buying goods or services inside or outside the MNE.

Most MNEs transfer goods or services internally based on transfer prices that they set under some methodology. The choice of methods depends on the business objectives of the enterprise in allocating costs to particular members. In some cases, the best solution for business purposes may be the adoption of the market price as the transfer price, assuming there is a competitive open market for the goods or services transferred internally. If those prices do not exist, as is often the case, the MNE faces a problem similar to the problem faced by a tax department in constructing an appropriate transfer price in the absence of market prices for the same or comparable goods or services.

When the members of an MNE group are each responsible for earning a profit on their activities, they sometimes negotiate with each other in a way that is analogous to negotiations between independent parties. Those negotiated prices may be useful to a tax department in determining the proper arm's-length price for tax purposes. An MNE group, however, cannot solve all problems of income allocation through simulated bargaining. It still encounters problems relating to the allocation of various fixed costs, such as overhead, and, most importantly, relating to the use within the group of valuable intangible property that has been developed within the group. In addition, the outcomes of the simulated bargains have important career implications for individual managers, so it is to be expected that some allocations will be based on internal politics. Finally, an MNE group is primarily interested in measuring the
contribution of its members with respect to after-tax profits, whereas a tax department is primarily interested in determining the pre-tax profits of a firm. To the extent that an internal pricing mechanism takes account of tax savings, therefore, its utility to a tax department is reduced.

Tax considerations may have a major impact on the way an MNE group sets its internal transfer prices. If the commercial system is in conflict with the pertinent tax regulations, companies may either adopt the system required under those regulations, or may maintain two systems, one for commercial purposes and the other for tax purposes. Some States may require an MNE group to use the books it has kept for financial accounting purposes in reporting its taxable income, although they typically would permit or require the MNE group to make certain adjustments in those books. For internal management purposes, however, an MNE group typically is free to use whatever internal accounting mechanisms it wishes.

As used by the United Nations and the OECD, the expression "transfer pricing" is a neutral term, not expressing any pejorative meaning. Paragraph 3 of the Preface of the 1979 OECD Report on Transfer Pricing and Multinational Enterprises states: "the consideration of transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes." The 1995 report of the OECD makes this even more clear by using the title "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations."

The point is that transfer pricing is an essential element of income measurement for related entities. The fact that transfer prices may be used to shift taxable income from a high taxing jurisdiction to a low taxing jurisdiction does not mean that the setting of transfer prices is itself a suspect activity.

Tax planning is only one of a series of considerations that are relevant for MNEs in setting their transfer prices. Overly aggressive tax planning, moreover, may cause an MNE to get enmeshed in a tax fraud investigation that is harmful to its international reputation. Over the past decade, many developed countries have put considerable pressure on MNEs to provide extensive contemporaneous documentation for their transfer prices. This development has reduced some tax planning opportunities and has forced MNEs to do their tax planning before rather than after they have engaged in intra-group transfers. The manipulation of transfer prices is now considerably more sophisticated than it was in the recent past. To protect their source and residence jurisdictions, a developing country must develop in its tax department a similar sophistication. Part of that sophistication is to be able to recognize when an MNE has set its transfer prices in accord with emerging international standards.

The Arm’s Length Principle

In computing the taxable income of its members, an MNE group should be required to set transfer prices on intra-group transactions by reference to the prices that would have been applied by unrelated parties in similar transactions under similar conditions in the open market. This
The general approach to setting transfer prices is known as the "arm’s length" principle. It is currently the internationally accepted standard for setting transfer prices. Most countries have domestic tax provisions either in general terms or as specific provisions which authorize the tax authorities to adjust transfer prices that deviate from that principle. Specific transfer pricing provisions with an international focus were first introduced during the First World War in the United Kingdom and United States of America. Only in the 1960s, however, did countries develop a systematic approach towards transfer pricing in the international arena.

The verbal formula used in a tax statute to authorize use of an arm’s length standard is not very important, for it is the detailed implementation rules that actually give substance to that standard. The various statutory approaches followed by countries fall into the following four categories, namely:

1. Countries which have included a specific reference to the arm’s length principle (or to open market prices), and to adjustments in case of deviations, in their tax laws, e.g. Australia refers to considerations less than arm’s length considerations (Section 136 AD Income Tax Assessment Act) and United Kingdom mentions "the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm’s length" (Section 770 Income and Corporation Tax Act 1988 C formerly section 485).

2. Countries which permit prices to be adjusted in case of associated enterprises, without explicit references to the arm’s length principle, for example, France (Article 57 General Tax Code "transferred income") and United States (Section 482: the Secretary "may distribute, apportion, or allocate gross income, deductions, or credits, or allowances" between or among related parties to the extent necessary to "prevent evasion of taxes or clearly to reflect the income" of the related parties).


4. Countries with a broad statutory basis, which has been developed for transfer pricing purposes in case law, e.g. Germany (apart from article 1 of Foreign Relations Tax Act): excessive payments to, or understated receipts from shareholders constitute a constructive dividend which is not deductible (article 8 (3) Corporate Tax Act); and similarly the Netherlands and Switzerland.

In this connection, the OECD Committee on Fiscal Affairs observes:

"When independent enterprises deal with each other, the conditions of their commercial and financial relations (e.g., the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces. When associated enterprises deal with each other their commercial and financial relations may not be directly affected by external market forces in the same way ... [T]he need to make adjustments to approximate arm’s length dealings arises irrespective of any contractual
obligation undertaken by the parties to pay a particular price or of any intention of the parties to minimize tax. Thus, a tax adjustment under the arm’s length principle ... may be appropriate even where there is no intent to minimize or avoid tax. The consideration of transfer pricing should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes.”

The Committee cautions that:

"It should not be assumed that the conditions established in the commercial and financial relations between associated enterprises will invariably deviate from what the open market would demand. Associated enterprises in MNEs commonly have a considerable amount of autonomy and often bargain with each other as though they were independent enterprises. Enterprises respond to economic situations arising from market conditions, in their relations with both third parties and associated enterprises. For example, local managers may be interested in establishing good profit records and therefore would not want to establish prices that would reduce the profits of their own companies. Tax administrations should bear in mind that MNEs from a managerial point of view have an incentive to use arm’s length prices to be able to judge the real performance of their different profit centres ... [However,] the relationship between the associated enterprises may influence the outcome of the bargaining. Therefore, evidence of hard bargaining alone is not sufficient to establish that the dealings are at arm’s length.”

Further Consideration of Arm’s Length Principle

1. Generally

The arm’s length principle is stated, albeit obliquely, in paragraph 1 of article 9 of the United Nations Model Convention which provides that if: "conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have 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."

According to the OECD Committee on Fiscal Affairs, "A major reason [for the adoption of the arm’s length principle] is that [it] provides broad parity of tax treatment for MNEs and independent enterprises. Because the arm’s length principle puts associated and independent enterprises on a more equal footing for tax

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4 Ibid., paragraph 1.2.
5 Ibid., paragraph 1.5.
purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm’s length principle promotes the growth of international trade and investment.”6

The application of the arm’s length principle is often difficult, particularly in cases involving transfers of intangible property (e.g., patents, copyrights, know-how, trade marks, and trade names) and goods produced or marketed with the use of intangible property. Each item of intangible property is, by nature, unique. Patent licenses between unrelated persons may not provide a good indication of an arm’s length royalty for a license of a particular patent between associated enterprises because it may not be possible to establish that the usefulness and profit potential of the latter patent is similar to that of the patents licensed between unrelated persons. Sales of goods bearing no trade mark are not comparable to sales made under a trade mark because the prices in the former transactions provide no guide to the contribution of the trade mark to the profitability of the latter sales. Similarly, sales of goods made under one trade mark are not comparable to sales made under another trade mark unless it is established that the values of the two trade marks are similar.

If the owner of intangible property uses the property in transactions with both independent and associated enterprises, the transactions with unrelated persons is usually useful evidence for applying the arm’s length principle to the transactions with associated enterprises. For example, if the owner of a patent makes a license of the patent to an unrelated person for use in one market and licenses the patent to an associated enterprise for use in a similar market, the royalty rate for the former license may establish an arm’s length royalty for the latter. Similarly, if goods are sold under trade mark to both independent and associated enterprises, the application of the arm’s length principle to the latter sales is usually not difficult.

However, owners of valuable intangible property are often reluctant to transfer rights to that property to potential competitors. For example, the owner of an intangible may prefer to license the intangible to an associated enterprise, rather than to an unrelated person, in order to exercise control over the intangible’s use, and thereby reduce the risk of the intangible’s value being degraded.

Another recurring problem is that information needed for the application of the arm’s length principle is sometimes not available to either the taxpayer or the tax administration. For example, if company A licenses intangible property to a subsidiary corporation in country X, while company B licenses similar property to an independent company for use in country X, information about the company B transaction is highly relevant to the application of the arm’s length principle to company A’s license to its subsidiary. Neither company B nor its licensee may be willing to disclose this information, however, to company A or to the tax administration of country X or of company A’s home country. Also, the ability of a tax department or taxpayer

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6 Ibid., paragraph 1.7.
to use available information may be limited by the lack of other information. For example, because an arm's length royalty may depend on various aspects of the licensing arrangement (e.g., the license term, the territory covered by the license and whether the license is exclusive), knowing the royalty rate in the license made by company B in the above example may not be useful if the other terms and conditions of company B's license cannot be ascertained.

For these reasons, the OECD Committee on Fiscal Affairs warns that "transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer."\(^7\)

The traditional methods for applying the arm's length principle are the comparable uncontrolled price (CUP) method, the resale price method, and the cost plus method. Under the CUP method, the arm's length price for a transaction among associated enterprise (controlled transaction) is the price charged in comparable transactions among unrelated persons (uncontrolled transactions). Under the resale price method, which is most easily applied where the buyer in the controlled transaction resells the goods, with little or no change, in uncontrolled transactions, the arm's length price for a controlled sale is the price obtained by the buyer in its resale of the goods, less a mark-up equivalent to that obtained by comparable uncontrolled resellers. Under the cost plus method, the arm's length price for the controlled transaction is the seller's cost of producing or otherwise acquiring the goods, plus a mark-up equivalent to the mark-up earned by comparable uncontrolled producers operating under a cost-plus contract.

Some countries have developed other methods for applying the arm's length principle in cases in which neither the taxpayer nor the tax administration is able to obtain the evidence of comparable uncontrolled transactions needed to apply the traditional methods. These methods usually entail some form of profit split, established by reference to the profits of other comparable enterprises that do not engage in controlled transactions.

The various methods for applying the arm's length principle are discussed below, after a discussion of the issue of comparability, which underlies all of the methods.

2. Comparability

The arm's length principle is generally applied by comparing transactions between associated enterprises (controlled transactions) with transactions between unrelated persons. According to the OECD Committee on Fiscal Affairs:

"In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that

\(^7\) Ibid., paragraph 1.12.
reasonably accurate adjustments can be made to eliminate the effect of any such differences ...

Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive ...

[I]ndependent enterprises would generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk ...) when valuing these options. Therefore, when making the comparisons entailed by application of the arm’s length principle, tax administrations should also take these differences into account ...”

Comparability is affected by various factors, including the characteristics of the property or services, the functions performed by the participants in the transactions, contractual terms, economic circumstances, and business circumstances. These factors are discussed below.

(a) Characteristics of property or services

The importance of comparability in the nature of the products or services varies from method to method. This factor is most important under the CUP method because the arm’s length price of a good or service is rarely the same as the price of a dissimilar good or service, even if the goods or services are of the same general type. In contrast, the resale price and cost plus methods can often be applied with reference to the markups of uncontrolled producers or resellers of goods that are only of the same type as those involved in the controlled transactions. For example, although the price of a toaster cannot be expected to be comparable to that of a food processor, the markups of producers or resellers of small household appliances may be comparable, even if they do not produce or resell precisely the same items.

(b) Functions performed

The price in a transaction among independent enterprises depends on "the functions that each enterprise performs (taking into account assets used and risks assumed).” The functions of each enterprise participating in a controlled transaction must therefore be identified and contrasted with those of the participants in the uncontrolled transactions. The relevant functions include "design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing, and management.”

The nature of the assets used in performing a particular function is also relevant. For example, an enterprise that owns and uses a valuable intangible is not comparable to an enterprise that performs a superficially similar function without the use of intangible property.

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8 Ibid., paragraph 1.20.
9 Ibid., paragraph 1.21.
10 Ibid., paragraph 1.23.
Moreover, the risk borne by the various participants in a transaction must be considered because, "[i]n the open market, the assumption of increased risk will also be compensated by an increase in the expected return."\textsuperscript{11} Some of the relevant risks are "input cost and output price fluctuations; risks of loss associated with the investment in and use of property, plant, and equipment; risks of the success or failure of investment in research and development; financial risks such as those caused by current exchange rate and interest rate variability; [and] credit risks ..."\textsuperscript{12} For example, if a distributor of goods incurs substantial marketing and advertising costs, it should have a higher rate of return if it bears these costs itself than if the producer of the goods has reimbursed the costs. Similarly, an enterprise that manufactures goods for its own account should have a greater return than an enterprise that manufactures similar goods under contract for another enterprise. In controlled transactions, the parties’ conduct is usually the best evidence of how they share risks. For example, if a distributing subsidiary nominally bears the risk of fluctuations in exchange rates, but the prices in purchases from the parent corporation are regularly adjusted to reflect changes in exchange rates, currency risks are, in substance, borne by the parent, not the subsidiary.

(c) Contractual terms

In a transaction between unrelated persons, the risks, responsibilities and benefits are allocated among the parties by their contract. Thus, controlled and uncontrolled transactions are comparable only if, among other things, the contractual terms are comparable. In an arm’s length transaction, the parties normally hold each other to the terms of their contracts. Even if contractual terms are comparable, a controlled transaction is thus not comparable to an uncontrolled transaction unless the contract is adhered to in the controlled transaction or circumstances exist that would cause parties dealing at arm’s length to waive strict compliance with their contract.

(d) Economic circumstances

Since arm’s length prices may differ from market to market, controlled and uncontrolled transactions are comparable only if they take place in the same or comparable markets or reliable adjustments can be made for differences in markets.

(e) Business strategies

Enterprises dealing with others at arm’s length sometimes pursue business strategies that involve transactions at prices differing from those that would otherwise prevail. For example, an independent enterprise entering a new market might, in order to establish itself in the market, temporarily sell goods or services at prices below the market prices for comparable items, or it might incur costs for marketing or other start up expenses that are not justified by current levels

\textsuperscript{11} Ibid., paragraph 1.24.  
\textsuperscript{12} Ibid., paragraph 1.24.
of sales or profits. A controlled taxpayer may also pursue such a strategy, which may distinguish its transactions from otherwise comparable transactions among unrelated persons.

However, a claim that a business strategy justifies an off-market price or arrangement should be accepted by a tax administration only if all aspects of the parties’ conduct is consistent with the strategy. For example, if a manufacturer sells goods to a related distributor at a reduced price as part of a market penetration strategy, this reduction should be reflected either in reduced prices charged by the distributor or in extraordinary expenses incurred by the distributor. Also, the potential benefits of a business strategy should be shared consistently with the costs of pursuing the strategy. For example, if a manufacturer bears the costs of establishing its trade name in a new market, either by selling goods at reduced prices to a related distributor in that market or by directly subsidizing the distributor’s marketing costs, the manufacturer’s contribution toward the value of the trade name in that market should be recognized in any functional analysis of inter-company prices charged after the name is established.

Tax administrations also should consider whether, when the business strategy was adopted and implemented, an independent enterprise might have found the strategy sufficiently promising to justify pursuing it in the manner that it has been pursued by the associated enterprises. This inquiry should address the costs of the strategy, in relation to the reasonably expected benefits, and the time period over which the strategy was followed.

3. Role of form chosen by associated enterprises

Normally, tax administrations, in testing controlled transactions, should accept the form of those transactions. For example, if a parent corporation makes a sale to a subsidiary of all rights to a patent and the price for the sale is a lump sum payable at the time of the sale, the sale format should usually be accepted, and a tax administration should not re-characterize the transaction as a license or as a sale in exchange for a series of payments contingent on the revenues generated by the patent or the subsidiary’s use of it.

However, if the structure chosen by the associated enterprises differs from the substance of the transactions, that form may be disregarded, and the transactions may be re-characterized consistently with their substance. For example, a transfer from parent corporation to subsidiary, which the parties have characterized as a loan, may be re-characterized as a capital contribution if the substance of the transaction is equity, rather than debt.

The OECD Committee on Fiscal Affairs has also identified a second circumstance justifying disregard of the structure chosen by associated enterprises:

"where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price."13
Assume, for example, that ACo. has developed a secret process that can be used to manufacture valuable goods at low cost. ACo. decides not to patent the process, out of a fear that the disclosure required to obtain the patent would reduce the commercial value of the process. ACo. sells the secret process to HCo., an associated entity organized in a low tax country, for a lump sum payment. The tax authorities may disregard the form of this transaction and treat the arrangement between ACo. and HCo. as a license if it appears, from all the facts and circumstances, that ACo. would not have been able to sell the secret process to an unrelated party at its full value. That is, if the facts strongly suggest that ACo., in dealing with unrelated parties, could have maximized its return by entering into a license agreement rather than making a sale, the tax authorities are justified in re-characterizing the "sale" to HCo. as a license.

Moreover, even when the tax administration accepts the form in which the controlled transaction has been cast, it may examine uncontrolled transactions structured differently in order to determine whether the controlled transaction is at arm’s length. For example, if a parent corporation makes a fixed-price sale of a patent to a subsidiary, the royalty and other terms of uncontrolled licenses of comparable intangibles may be evidence relevant to whether the fixed price is an arm’s length price.

4. Arm’s length ranges

In some situations, several comparable uncontrolled transactions can be identified, and the prices at which those transactions took place differ. Such an arm’s length range may occur because various sellers charge different prices in essentially identical transactions due, for example, to their relative skill in bargaining. Indeed, in a market where buyers and sellers have imperfect information about each other, some range of prices is to be expected. A range of prices also can result from the fact that the uncontrolled transactions are not identical, either with the controlled transaction or with themselves. For example, the goods or services may differ in small ways or other terms of the transactions may not be identical.

When faced with an arm’s length range, a tax administration might first ask whether the range can be narrowed by refining comparability standards excluding, for example, all uncontrolled transactions other than those most comparable to the controlled transaction and making adjustments to the terms of the uncontrolled transactions to enhance comparability. Once the range has been sufficiently narrowed, the controlled transaction should be accepted as having occurred at arm’s length if it falls within the range. If the controlled transaction is outside the range, an adjustment is appropriate to bring it within the range. This might be done, for example, by restating the price in the controlled transaction at the median of the prices in the uncontrolled transactions. If the circumstances suggest that the taxpayer, in setting its prices outside the range, had not acted in good faith, the tax authorities might set the arm’s length price at a point within the range that would be least beneficial to the taxpayer.

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Ibid., paragraph 1.37.
Comparable transactions between unrelated parties provide only an estimate of the price for goods and services that would be set in an actual marketplace sale between a buyer and a seller acting at arm's length. Prior to an actual negotiation between unrelated parties over the price of goods or services, all that can be predicted with confidence is that any agreed price will be within some range. The bottom of that range will be set by the seller's minimum price requirements, and the top of the range will be set by the buyer's maximum price requirements. Those minimum and maximum prices may themselves be difficult to determine, but in theory at least, they are knowable. The price that goods or services will sell for within that range is theoretically unknowable in advance of the completed sale. Because of this characteristic of a priori market prices, the arm's length price set for intra-group transfers is always going to be a range of prices, although in many cases that range may be so narrow as to be equivalent to having a specific price. An effective transfer pricing system, therefore, must be designed to establish a single price when the comparable transactions have merely established a range of market prices.

5. Use of data from other years

Facts and circumstances from years prior to the taxable year are sometimes relevant to the application of the arm's length principle. For example, it may be relevant whether a loss reported by an associated enterprise for the taxable year is an isolated event or is part of a pattern of losses reported by that enterprise. It may be also relevant whether the goods or services sold by the enterprise are at the beginning, middle, or end of a product cycle.

Facts and circumstances from later years might also be relevant. However, tax administrations must be careful not to apply the arm's length principle unfairly by hindsight, basing decisions on facts and circumstances that could not reasonably have been anticipated when the controlled transactions were made. In some cases, nevertheless, hindsight may be used to set prices if it appears from the facts and circumstances that uncontrolled persons would have made use of hindsight in setting the price. Assume, for example, that PCo., a parent corporation, transfers intangible property to FCo., its foreign affiliate, at a time when the value of that property is nearly impossible to determine. It is determined that uncontrolled parties engaged in a comparable transfer would avoid the difficult pricing problem by entering into an arrangement that made the compensation for the intangible property a function of the profits derived from its future use. In that event, a price set by hindsight would be the arm's length price.

B. Traditional Methods

The arm's length principle has traditionally been applied using one of three methods: the comparable uncontrolled price (CUP) method, the resale price method, or the cost plus method. In some cases, none of these methods works well because they all depend on the availability of price and other data about comparable uncontrolled transactions. When market data needed to

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apply the traditional methods are not available, arm's length prices can sometimes be approximated using a profit split method or a transactional net margin method. These various methods are separately described below.

1. CUP method

Under the CUP method, a controlled transaction is considered to be at arm's length if the price and other relevant terms and conditions are the same as those of comparable uncontrolled transactions occurring in comparable circumstances. Under the general standards of comparability described above, controlled and uncontrolled transactions are comparable if (1) they do not differ in any way that could materially affect the price or (2) reasonably accurate adjustments can be made for any material differences.

The principal difficulty in applying the CUP method is obtaining reliable information about uncontrolled transactions that are sufficiently comparable to the controlled transaction. Close similarity in the goods or services sold in the transactions is usually required because small differences in products may have a significant effect on price. For example, if the controlled transactions are sales of un-branded Colombian coffee beans, whereas the uncontrolled transactions are sales of un-branded Brazilian coffee beans, the controlled and uncontrolled sales are not comparable unless the market makes no material distinction between Colombian and Brazilian coffee beans or reliable adjustments can be made for this difference. Similarity in the functions performed by various participants in the transactions is also important, although reliable adjustments can often be made for functional differences. For example, if the uncontrolled sales are made F.O.B. the factory and the controlled sales are made at a delivered price, this difference can be expected to materially affect the prices, but adjustments can usually be made for the shipping, insurance and other delivery costs that are included in the controlled price, but not the uncontrolled price.

The CUP method is often not usable if the price in the controlled or uncontrolled transactions is materially affected by intangible property used in producing or marketing the goods or services (e.g., a patent or a trade mark). For example, a sale of branded goods is not comparable to a sale of un-branded goods unless the brand has no material value or is owned solely by the purchaser of the goods. Similarly, a sale of goods under one trade name is not usually comparable to sales under other trade names because each trade name is unique.

However, the OECD Committee on Fiscal Affairs states:

"The difficulties that arise in attempting to make reasonably accurate adjustments should not routinely preclude the possible application of the CUP method. Practical considerations dictate a more flexible approach to enable the CUP method to be used and to be supplemented as necessary by other appropriate methods, all of which should be evaluated according to their relative accuracy. Every effort should be made to adjust the data so that it may be used appropriately in a CUP method. As for any method, the relative reliability of the CUP method is affected by the degree of accuracy with which adjustments
can be made to achieve comparability.”

2. Resale price method

Under the resale price method, the arm’s length price in a controlled sale is the price obtained by the buyer in reselling the goods or services to an unrelated person, less an appropriate mark-up (gross margin) for the buyer/reseller. For example, if a distributing subsidiary purchases goods from its parent corporation and resells them to its customers for 100 each and an appropriate gross margin for the subsidiary is 20 per cent of sales, the arm’s length price for the sale from parent to subsidiary is 80 (100, less 20 per cent thereof) under the resale price method.

The appropriate mark-up under the resale price method is the gross margin obtained in comparable circumstances by a comparable buyer/reseller who both buys from and resells to unrelated persons. For instance, if the distributing subsidiary in the example purchases goods from both its parent and from unrelated suppliers, the gross margin in the subsidiary’s resales of goods purchased from unrelated suppliers may be used in applying the resale method to its resales of goods purchased from the parent if the controlled and uncontrolled sales are comparable. Alternatively, the comparable uncontrolled gross margin may be that of an unrelated buyer/reseller.

Under this method, comparability of functions tends to be more important than product similarity. For example, if the distributing subsidiary purchases toasters from its parent and blenders from unrelated suppliers, the blender transactions might be comparable to the toaster transactions for purposes of the resale price method, but not for purposes of the CUP method, because the gross margins of all small appliance distributors in a particular market might be comparable, even though the prices for various appliances might differ substantially. On the other hand, the controlled and uncontrolled transactions may not be comparable if the subsidiary maintains a substantial inventory of blenders but has no toaster inventory because the parent corporation ships toasters directly to the subsidiary’s customers. More generally, comparability is importantly affected for purposes of this method by the assets used, risks assumed, and other material factors relating to the functions performed by the controlled and uncontrolled buyer/resellers.

The resale price method is most appropriate if the purchaser in the controlled transaction resells the goods or services without further manufacture or other transformation. If the functions performed by the purchaser go substantially beyond resale, it is not likely that the taxpayer or the tax administration can identify uncontrolled transactions in which the same or comparable functions are performed. For example, if a parent corporation partially manufactures

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goods and sells them to a subsidiary, which finishes the goods and sells them to unrelated persons, it is not likely that data can be obtained on a comparable company that performs the same functions as the subsidiary and deals solely with unrelated persons, and without this data, an arm's length mark-up cannot be determined.

Even among buyer/resellers, the functions performed can vary considerably. For example, some buyer/resellers are little more than forwarding agents, while others engage in substantial marketing activities and may, for example, provide guarantees to the ultimate consumers. These functional differences can significantly affect the gross margin that would be realized in arm's length transactions, and they must therefore be examined carefully in determining whether controlled and uncontrolled transactions are comparable for purposes of this method.

3. Cost plus method

Under the cost plus method, the arm's length price in a controlled sale is the sum of the costs incurred by the seller and an appropriate mark-up. For example, if a parent corporation produces goods at a cost of 50 and sells them to its distribution subsidiary and an appropriate mark-up for the parent is 20 per cent of costs, the price under the cost plus method for the sale from parent to subsidiary is 60 (costs of 50 per cent, plus 20 per cent thereof). The cost plus method is most commonly used where the seller in the controlled transaction produces the goods or services. It might provide the most reliable measure of arm's length results if, for example, the buyer in the controlled transaction subjects the goods to further manufacture or processing or the controlled transaction involves services, rather than goods.

The mark-up under the cost plus method should be the mark-up obtained in comparable uncontrolled transactions. The controlled seller's mark-up in comparable sales to unrelated persons is perhaps the best evidence of an arm's length mark-up, but the mark-ups of other comparable producers also may be used. The issue of comparability is essentially the same under this method as under the resale price method, described above, except that the focus is on the producer/seller in the cost plus method and the buyer/seller in the resale price method. For example, if company A produces toasters, which it sells to a distribution subsidiary, and company B produces irons, which it sells to independent distributors, the gross margin of company B might be usable in applying the cost plus method to company A's sales to its subsidiary if the gross margins of all small appliance manufacturers tend to be about the same.

In applying this method, all functional differences, including differences in assets utilized and risks undertaken, must be accounted for if they materially affect gross margin. For example, if company B manufactures its irons under long-term contracts obligating its distributors to purchase fixed quantities of irons each month, whereas company A maintains an inventory of finished goods and is subject to the vagaries of market demand, the companies' operations are not comparable because company A has assets and risks that company B does not have. Company B may not be used as an uncontrolled comparable for company A's transactions unless reliable adjustments can be made for these differences.
The relative efficiencies of the controlled and uncontrolled producers are an important consideration in this context. For example, if company B is much more efficient in its manufacturing operations than company A, it should probably enjoy higher gross margins. It is often not possible to make reliable adjustments for differences in efficiency, and when this is so, the cost plus method is usually not the best method to employ. Other differences in costs, such as differences in wage rates paid, also should be considered. For example, if the wages are much lower in the country where company B does its manufacturing than in the county where company A does its manufacturing, then the profit margin earned by company B in its sales to unrelated parties is an unreliable measure of the profits that company A should earn on its sales to a related distributor unless the effect of this wage differential on gross margins cannot be quantified accurately.

Comparability in accounting methods is also important, particularly in the classification of costs as production costs or as other costs. However, if adequate data on the uncontrolled transactions is available, adjustments can usually be made for accounting differences. For example, if company A accounts for shipping costs as production costs, whereas company B accounts for these costs as selling costs, the gross margins of the two companies are not comparable. If complete records for both companies are available, however, accurate adjustments can be made for this accounting difference.

4. Transactional profit methods

The OECD Committee on Fiscal Affairs identifies two "transactional profit methods" the profit split method and the "transactional net margin method." "[I]n those exceptional cases in which the complexities of real life business put practical difficulties in the way of the application of the traditional transaction methods," these methods "may provide [results] consistent with the arm's length principle." The Committee warns that "the transactional profit methods may not be applied automatically simply because there is a difficulty in obtaining data."

(a) Profit split method

The objective of the profit split method is to divide the aggregate profit of associated enterprises among them in the same proportions that it would have been divided by market prices if the enterprises were independent. The allocation is based on the functions performed by each of the associated enterprises. The contribution of each function is computed, to the extent possible, by reference to data on comparable enterprises dealing only with unrelated persons. Because independent enterprises rarely set their prices in order to achieve any particular split of profits, the profit split method only approximates arm's length prices and does so indirectly.

An advantage of the profit split method is that it often can be applied when no comparable uncontrolled transactions can be identified. According to the OECD Committee on Fiscal

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16 Ibid., paragraph 3.2.
Affairs, "the profit split method offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises, while still constituting an arm's-length approach to the extent that it reflects what independent enterprises reasonably would have done if faced with the same circumstances."17 Another advantage of this method is that because all parties to the controlled transactions are examined, the method is not likely to produce extreme, improbable results for any of the parties.

Tax administrations and taxpayers often face several problems in applying the profit split method. Reliable information about the transactions of foreign affiliates may be difficult to obtain, and the combined profits of associated enterprises usually cannot be determined without this information. Even if the information is obtainable, the computation of the combined profit may be impeded by accounting differences among the enterprises and by complex currency translation issues.

Moreover, if the method is applied to split actual profits, rather than projected profits, transfer prices are effectively determined with hindsight, based on the ultimate results of the controlled transactions, whereas prices in uncontrolled transactions are nearly always determined before or as the transactions occur. According to the OECD Committee on Fiscal Affairs, "the application of the profit split method [in this way] could penalize or reward a taxpayer by focussing on circumstances that the taxpayer could not reasonably have foreseen."18 The method, therefore, should be applied "in a context that is similar to what the associated enterprises would have experienced, i.e. on the basis of information known or reasonably foreseeable by the associated enterprises at the time the transactions were entered into ..."19

(b) Transactional net margin method

Under the transactional net margin method, the net profit of an associated enterprise is evaluated with reference to some base, such as sales, costs or assets. For example, the prices at which a manufacturer sells its goods to a distribution subsidiary might be found to be at arm's length if these prices leave the subsidiary with a profit of, say, 2 per cent of sales, 3 per cent of costs, or 10 per cent of the value of its assets. The percentage used in applying the method is inferred from the profitability of other enterprises that perform similar functions but deal only with unrelated persons. For example, the distribution subsidiary's profits might be computed as 2 per cent of sales if that is within the range of net profit margins of comparable independent distributors.

5. Priority of methods

In some countries, the traditional methods (the CUP, resale price and cost plus methods)
are preferred over the transactional profit methods, and the CUP method is preferred to all other methods if one or more comparable uncontrolled transactions can be identified. In other countries, no method is preferred as a general matter, and the preferred method in any situation is the method that provides the most reliable measure of arm's length results in that situation.

The United States initially developed the methods that the OECD calls the "profit split method" and the "transactional net margin method" in regulations promulgated in 1994. Under those regulations, there is no formal priority of methods. The selection of methods is made under the so-called best method rule. Under that rule, a controlled taxpayer must use the transfer pricing method that provides the "most reliable measure" of an arm's length result under the taxpayer's particular facts and circumstances. In selected a method, two important factors must be considered: compatibility and the quality of data and assumptions. Methods relying on uncontrolled transactions with the highest degree of comparability are to be preferred.

The difference in the approach of the United States and the approach advocated by the OECD may not be very different in practice. The OECD guidelines provide that the newer methods may be used only as a last resort, whereas the United States would apply a newer method whenever it constitutes the best available method. In practice, the newer pricing methods are mostly used in the United States in cases involving valuable intangible property. In those cases, the traditional methods are usually difficult or impossible to apply. If the traditional methods cannot be applied, the application of a newer method would be, in the OECD formulation, a "last resort."

Approval of the newer methods was quite controversial within the OECD. Some OECD countries resisted giving approval because they felt that the newer methods constituted an implicit sanction for using hindsight in setting arm's length prices. This objection was addressed in the OECD report on transfer pricing by specifying that the newer methods could only be used as a "last resort." Some OECD countries also were concerned that approval of the newer methods might be a step towards adoption of a world wide system of formulary apportionment—a method that is opposed by many governments and virtually all MNEs. The OECD report attempted to avoid any implicit endorsement of formulary apportionment by stressing that the newer methods have some transactional component and rely to some degree on market prices. After the publication of its transfer pricing report, the OECD seems to have softened somewhat its opposition to formulary apportionment. For example, it has endorsed the use of formulas in the case of financial institutions engaged in global trading.
III. **Suggested Arrangements between Treaty Competent Authorities Regarding Exchange of Information**

In connection with treaties for the avoidance of double taxation and tax evasion, the competent authorities might wish to provide for the exchange of such information as is necessary for carrying out the provisions of the treaty or of the domestic laws of the Contracting States concerning taxes covered by the treaty. In this regard, the following are suggested guidelines for arrangements regarding the implementation of appropriate exchanges of information. They are in the form of an inventory of possible arrangements from which the competent authorities under a tax treaty may select the particular arrangements which they decide should be utilized. The inventory is not intended to be exhaustive nor is it to be regarded as listing matters all of which are to be drawn on in every case. Instead, the inventory is a listing of suggestions to be examined by competent authorities in deciding on the matters they wish to cover.

**A. Routine Transmittal of Information**

Some competent authorities have implemented a routine or automatic flow of information from one treaty country to another. The following are various aspects that the competent authorities should focus on in developing a structure for such routine exchange. Some countries not desiring to receive such information in a routine fashion (or unable to receive it routinely because the transmitting countries do not routinely collect such information) may desire to obtain information of this type under a specific request. In these situations, items mentioned in the present section should be considered as available for coverage under the next section, "Transmittal on specific request."

1. **Items covered**

*Regular sources of income*

The items covered under a routine transmittal or exchange of information may extend to regular sources of income flowing between countries, such as dividends, interest, compensation (including wages, salaries, fees and commissions), royalties, rents and other possible items whose regular flow between the two countries is significant. It should be recognized, however, that at present many countries are not in a position to supply routine information of this type because their tax collection procedures do not provide the needed data. In most respects, information routinely provided is likely to be far more valuable to the receiving country if it is provided in electronic form.

*Transactions involving taxpayer activity*

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20 In the following, "transmitting country" refers to the country transmitting information and "receiving country" refers to the country receiving information.
A routine exchange of information may cover certain significant transactions involving taxpayer activity.

(a) Transactions relevant to the treaty itself:

Claims for refund of transmitting country tax made by residents of receiving country;
Claims for exemption or particular relief from transmitting country tax made by residents of receiving country.

(b) Transactions relevant to special aspects of the legislation of the transmitting country:

Items of income derived by residents of the receiving country that receive exemption or partial relief under special provisions of the national law of the transmitting country.

(c) Transactions relating to activities in the transmitting country of residents of the receiving country:

Opening and closing by receiving country residents of a branch, office, etc. in the transmitting country;
Creation or termination by receiving country residents of a corporation in the transmitting country;
Creation or termination by receiving country residents of a trust in the transmitting country;
Opening and closing by receiving country residents of bank accounts, money market accounts, brokerage accounts, and the like in the transmitting country;
Property in the transmitting country acquired by residents of the receiving country by inheritance, bequest or gift;
Ancillary probate proceedings in the transmitting country concerning receiving country residents.

(d) General Information:

Tax laws, administrative procedures, major relevant tax cases, etc. of the transmitting country;
Developments affecting the taxation in the transmitting country of regular sources of income flowing between countries, especially as they affect the treaty, including court decisions relating to tax treaties, administrative interpretations of court decisions on treaty provisions, and administrative practices or developments affecting application of the treaty;
Activities that affect or distort application of the treaty, including new patterns or techniques of evasion or avoidance used by residents of the transmitting or receiving country;
Activities that have repercussions regarding the tax system of the receiving country, including new patterns or techniques of evasion or avoidance used by residents of either country that significantly affect the receiving country’s tax system.

2. General operational aspects to be considered

The competent authorities should consider the following in developing an effective routine exchange programme:

(a) Countries that are more interested in receiving information on a specific request basis than on a routine basis should, in formulating specific requests, keep in mind the items mentioned in this inventory under the heading of routine information;
(b) A minimum floor amount may be fixed to exclude the exchange of data of minor importance;
(c) The routine source of income items may be rotated from year to year, e.g., dividends only in one year, interest in another, etc.;
(d) The information to be exchanged routinely need not be strictly reciprocal in all items. Country A may be interested in receiving information on some items but not others; the preferences of country B may extend to different items. It is not necessary for either country to receive items in which it is not interested. Nor should either country refuse to transmit information on certain items simply because it is not interested in receiving information on those items;
(e) Although the information to be exchanged on income items may not always be helpful in exposing tax evasion, the routine exchange may provide indications of the degree to which income flows are escaping tax;
(f) Whether the information as to income items should cover only the payee or also the payer;
(g) Whether the information should cover only residents of the receiving country or also those domiciled therein or citizens thereof, or be limited to any of these categories;
(h) The degree of detail involved in the reporting, e.g., name of taxpayer or recipient, profession, address, etc.;
(i) Whether the information is available in electronic form;
(j) The form and the language in which the information should be provided.

If the information provided by the transmitting country is available electronically and in a format that permits easy insertion into a database, the receiving country can utilize the information more readily at lower cost, and the problems of information overload from receiving too much information are radically reduced. If the receiving country is accustomed to dealing mostly with electronic data, it may have difficulty making good use of certain information provided in paper form, especially if much of that information is not particularly useful.

3. Factors to be considered by the transmitting country

The transmitting country should consider factors affecting its ability to fulfil the
requirements of a routine exchange of information. Such a consideration should lead to a more careful selection of the information to be routinely exchanged, avoiding exchanges of information that will be of little practical use to the receiving country.

Among the factors to be considered is the administrative ability of the transmitting country to obtain the information involved. This ability is a function of the general effectiveness of its administrative procedures, its utilization of withholding taxes, its utilization of information returns from payers or others and the over-all costs of obtaining the information, and the extent to which its reporting agents provide information in electronic form.

4. Factors to be considered by receiving country

The receiving country should consider factors affecting its ability to utilize the information that could be received under a routine exchange of information, such as the administrative ability of the receiving country to use the information on a reasonably current basis and effectively to associate such information with its own taxpayers, either routinely or on a sufficient scale to justify the routine receipt of the information. Again the ability to link information routinely exchanged with particular taxpayers will depend to a considerable degree on the form (electronic or paper) in which that information is transmitted.

B. Transmittal on Specific Request

A widely used method of exchange of information is that of a request for specific information made by one treaty country to another. The specific information may relate to a particular taxpayer and certain facets of his situation or to particular types of transactions or activities or to information of a more general character. The following are various aspects that the competent authorities should focus on in developing a structure for such exchanges.

1. Items covered

Particular taxpayers

The information that a receiving country may want from a transmitting country is essentially open-ended and depends on the factors involved in the situation of the taxpayer under the tax system of the receiving country and the relationship of the taxpayer and his activities to the transmitting country. A detailed enumeration of the types of information that may be within the scope of an exchange pursuant to specific request does not seem to be a fruitful or necessary task. The agreement to provide information pursuant to specific request may thus be open-ended as to the range, scope and type of information, subject to the over-all constraints to be discussed herein.

Specifically requested information may consist, for example, of:

(a) Information needed to complete the determination of a taxpayer’s liability in the
receiving country when that liability depends on the taxpayer’s world-wide income or assets; the nature of the stock ownership in the transmitting country of the receiving country corporation; the amount or type of expense incurred in the transmitting country; or the fiscal domicile of an individual or corporation;

(b) Information needed to determine the accuracy of a taxpayer’s tax return to the tax administration of the receiving country or the accuracy of the claims or proof asserted by the taxpayer in defence of the tax return when the return is either regarded as suspect or under actual investigation;

(c) Information needed to determine the true liability of a taxpayer in the receiving country when it is suspected that his reported liability is wrong.

(d) General information about the tax haven activities of an MNE group that is based in the transmitting country and is engaged in business in the receiving country, assuming that the transmitting country has in place a regime for dealing with the tax haven activities of its resident companies.

(e) Information needed to determine whether a taxpayer has reported a transaction involving both countries in a consistent manner.

Particular types of transactions or activities

The exchange on specific request need not be confined to requests regarding particular taxpayers but may extend to requests for information on particular types of transactions or activities, including:

(a) Information on price, cost, commission or other such patterns in the transmitting country necessary to enable the tax administration of the receiving country either to determine tax liability in a particular situation or to develop standards for investigation of its taxpayers in situations involving possible under or over invoicing of exported or imported goods, the payment of commissions on international transactions and the like;

(b) Information on the typical methods by which particular transactions or activities are customarily conducted in the transmitting country;

(c) Information as to whether a particular type of activity is being carried on in the transmitting country that may have effects on taxpayers or tax liabilities in the receiving country.

Economic relationships between the countries

The specific request may extend to requests for information regarding economic relationships between the countries which may be useful to a country as a check on the effectiveness of its tax administration activities, including:

(a) Volume of exports from the transmitting country to the receiving country;

(b) Volume of imports into the transmitting country from the receiving country;

(c) Names of banks and other financial institutions dealing in the transmitting country
with branches, subsidiaries, etc. of residents of the receiving country.

Since items in this category, such as the volume of exports between the countries, are presumably not regarded as secret to the tax authorities in the transmitting country, they may be disclosed generally in the receiving country, as article 26 provides.

2. Rules applicable to the specific request

The competent authorities should develop rules for the transmission of specific requests by the receiving country and the response by the transmitting country. Although the rules may be general in character in the sense that they set standards or guidelines governing the specific request procedures, the rules should also permit discussion between the competent authorities of special situations that either country believes require special handling.

The rules should specify:

(a) The amount and nature of detail that the receiving country must include in the request, the form of such request, the years covered by the request, and the language of the request and reply;
(b) The extent to which the receiving country must pursue or exhaust its own administrative processes and possibilities before making a specific request; (presumably the receiving country should make a bona fide effort to obtain the information for itself before resorting to the specific request procedure unless it is obvious that the costs of the effort are slight for the transmitting country and substantial for the receiving country);
(c) The nature and extent of the response by the transmitting country, including the form of the response if the information is intended for possible use in judicial or other proceedings that may require an authentication of any documents provided.

C. Transmittal of Information on Discretionary Initiative of Transmitting Country

The competent authorities should determine whether, in addition to the routine and specific request methods of exchange of information, they desire a transmittal of information on the discretionary initiative of the transmitting country itself. Such a transmittal could occur when, in the course of its own activities, the tax administration of the transmitting country obtains information that it considers would be of importance to the receiving country. The information may relate to facets of a particular taxpayer’s situation and the relationship of that situation to its liability in the receiving country or to the liability of other taxpayers in the receiving country. Or the information may relate to a pattern of transactions or conduct by various taxpayers or groups of taxpayers occurring in either country that is likely to affect the tax liabilities or tax administration of the receiving country either in relation to its national laws or to the treaty provisions.
In the standards governing the exchange of information developed pursuant to the treaty, the competent authorities should specify whether it is the duty of a transmitting country affirmatively to develop a procedure and guidelines governing when information has to be transmitted at the initiative of the transmitting country, whether the transmitting country has a duty to at least consider providing the information but has not obligation to actually provide it, or whether the transmitting state need not even consider providing the information. Even if it is agreed that the transmitting country has a duty to develop a system for such transmittal, presumably it would retain the right to decide when the conditions under that system have been met.

D. Use of Information Received

The permissible uses of the information received under an exchange of information agreement are largely specified in article 26 of the United Nations Model Convention. Under the article, the extent of the use of information depends primarily on the requirements of national law regarding the disclosure of tax information or on other "security requirements" regarding tax information. Consequently, the extent of the disclosure or the restrictions on disclosure may vary between the two countries. However, such possible variance need not be regarded as inappropriate or as negating exchanges of information that would otherwise occur if the countries involved are satisfied with such a consequence under article 26 as adopted in their convention.

1. Recipients of information received through exchange

The competent authorities should specify, either in detail or by reference to existing comparable rules in the receiving country, who are the qualifying recipients of information in that country. Under article 26, the information can be disclosed, for example;

(a) To administrators of the taxes covered in the convention;
(b) To enforcement officials and prosecutors for such taxes;
(c) To administrative tribunals for such taxes;
(d) To judicial tribunals for such taxes;
(e) In public court proceedings or in judicial decisions that may become available to the public;
(f) To the competent authority of another country (see section E below).

2. Form in which information is provided

The permissible extent of the disclosure may affect the form in which the information should be provided in order to be useful to the receiving country. For example, if the information may be used in judicial tribunals and if, to be so used, it must be of a particular character or form, the competent authorities should consider how to provide for a transmittal that meets this need. (See also the comment on documents under section B.2 above.)

E. Consultation among Several Competent Authorities
Competent authorities may want to consider developing procedures for consultations covering more than the two competent authorities under a particular treaty. Thus, if countries A, B and C are joined in a network of treaties, the competent authorities of A, B and C might desire to hold a joint consultation. This consultation could be desired whether all three countries are directly intertwined, for example, where there are A-B, A-C and B-C treaties, or where one country is a link in a chain but not fully joined, for example, where there are A-B and B-C treaties but not an A-C treaty. Countries desiring to have their competent authorities engage in such consultations should provide the legal basis for the consultations by adding the necessary authority in their treaties. Some countries may feel that article 26 permits joint consultation where all three countries are directly linked by bilateral treaties. However, the language of that model provision does not cover joint consultation when a link in the chain is not fully joined, as in the second situation above. In such a case, it is necessary to add a treaty provision allowing the competent authority of country B to provide information received from country A to the competent authority of country C. Such a treaty provision could include a safeguard that the competent authority of country A must consent to the action of the competent authority of country B. Presumably, he would so consent only when he was satisfied as to the provisions regarding protection of secrecy in the B-C treaty.

F. Over-all Factors

A variety of over-all factors affecting the exchanges of information should be considered by the competent authorities, either as to their specific operational handling in the implementation of the exchange of information or as to their effect on the entire exchange process itself. Among such over-all factors are:

1. Factors affecting implementation of exchange of information

(a) The competent authorities should decide on the channels of communication for the different types of exchanges of information. One method of communication that may be provided for is to permit an official of one country to go in person to the other country to receive the information from the competent authority and discuss it so as to expedite the process of exchange of information.

(b) Some countries may decide that it is useful and appropriate for a country to have representatives of its own tax administration stationed in the other treaty country. Such an arrangement presumably would rest on an authority, treaty or agreement other than that in the article on exchange of information of the double taxation treaty (although, if national laws of both countries permit, this article would be treated as covering this topic) and the arrangement would determine the conditions governing the presence of such representatives and their duties. The process need not be reciprocal, so that country A might have its representatives in country B but not vice versa if country A considered the process to be useful and country B did not. If arrangements exist for such representatives, the competent authorities may want to coordinate with those representatives when such coordination would make the
exchange of information process more effective and where such coordination is otherwise appropriate.

(c) Some countries may decide it is appropriate to have a tax official of one country participate directly with tax officials of the other country in a joint or "team" investigation of a particular taxpayer or activity. For most countries, the authority for such an arrangement probably must be an authority, treaty or agreements other than that in the treaty article on exchange of information, although, if national laws of both countries permit, article 26 could be treated by the countries as authorizing the competent authorities to make this arrangement. In either event, if the arrangement is made, it is appropriate to extend to such an investigation the safeguards and procedures developed for the exchange of information.

(d) The process of exchange of information should be developed so that it is responsive to the countries' needs in implementing substantive treaty provisions. Thus, treaty provisions regarding inter-company pricing and the allocation of income and expenses have their own informational requirements for effective implementation. The exchange of information process should reflect those requirements.

(e) The substantive provisions of the treaty should take account of and be responsive to the exchange of information process. Thus, if the exchange of information process provides an adequate information base to support one country's allowance of deductions for expenses incurred in another country, the treaty should be developed on the basis of the substantive appropriateness of such deduction.

(f) The competent authorities should determine to what extent the costs of information exchanges should be shared or reimbursed.

(g) In light of the increasing use of electronic databases by tax administrators, the competent authorities should develop guidelines governing the sharing of information in such databases and the security measures that would be imposed to prevent improper access to those databases.

2. Factors affecting structure of exchange of information process

(a) The arrangements regarding exchange of information worked out by country A with country B need not parallel those worked out between country A and country C or between country B and country C. The arrangements should be responsive to the needs of the two countries directly involved and need not be fully parallel in every case just for the sake of formal uniformity. However, prevention of international tax evasion and avoidance often requires international cooperation of the tax authorities of several countries. As a consequence, some countries may consider it appropriate to devise procedures and treaty provisions that are sufficiently flexible to enable them to extend their cooperation to multi-country consultation and exchange
arrangements.

(b) The competent authorities should weigh the effects of a domestic legal restriction on obtaining information in a country that requests information from another country not under a similar domestic legal restriction. For example, suppose country A requests information from country B and the tax authorities in country B are able to go to their financial institutions to obtain such information whereas the tax authorities in country A are generally not able to go to their own financial institutions to obtain such information for tax purposes. How should the matter be regarded in country B? Article 26 permits country B to obtain the information from its financial institutions and transmit it to country A. It thus is a matter of discretion in country B as to whether it should respond, and the matter might be an appropriate subject for negotiations between the competent authorities. Many countries in practice do respond in this situation, and such a course is useful in achieving effective exchange of information to prevent tax avoidance. However, if country A wants to obtain information in such cases from other countries, it should also recognize its responsibility to try to change its domestic laws to strengthen the domestic authority of its own tax administration and to enable it to respond to requests from other countries.

(c) The competent authorities should also weigh the effects of a possible imbalance growing out of divergences in other aspects of tax administration. For example, if country A cannot respond as fully to requests as country B can because of practical problems of tax administration in country A, should the level of the exchange of information be geared to the position of country A? Or, in general or in particular aspects, should country B be willing to respond to requests of country A even though country A would not be able to respond to similar requests of country B? This matter is similar to that discussed in the preceding paragraph and a similar response is appropriate.

(d) Article 26 authorizes a transmitting country to utilize its administrative procedures solely to provide information to the requesting country, even when the person about whom information is sought is not involved in a tax proceeding in the transmitting country. Moreover, the transmitting country can, for the purpose of exchange of information, utilize its own administrative authority in the same way as if its own taxation were involved.

(e) The competent authorities should weigh the effect on the process of exchange of information on one country’s belief that the tax system or tax administration of the other country, either in general or in particular situations, is discriminatory or confiscatory. It may be that further exploration of such a belief could lead to substantive provisions in the treaty or in national law that would eliminate the problems perceived by the first country and thereby facilitate the process of exchange of information.
Article 26 does not permit a transmitting state to refuse to exchange information required to be exchanged under the treaty in order to enhance the competitive position of its taxpayers. For example, assume that country A has a treaty with country B providing for exchange of information, but country C does not have a treaty with country B. ACo., a corporation resident in country A, and CCo., a corporation resident in country C, are competing with each other for business in country B. Country A may feel that if it provides country B with information allowing country B to tax ACo. properly and country C does not provide similar information about CCo., then ACo. may be put at a competitive disadvantage relative to CCo. Notwithstanding this concern, country A is still required to honour its obligations under Article 26. The competent authorities of country B, nevertheless, should do what they can to reassure their counterparts in country A that the tax department in country B is doing its best to collect the proper tax from taxpayers that compete with country A residents.

3. Periodic consultation and review

The competent authorities should establish efficient and expeditious provisions for consultation to address the inevitable differences that will arise on the interpretation and application of Article 26. The consultation should extend both to particular situations and problems and to periodic review of the operations under the exchange of information provision. The periodic review should ensure that the process of exchange of information is working with the requisite promptness and efficiency, that it is meeting the basic requirements of treaty implementation and that it is promoting adequate compliance with treaty provisions and the national laws of the two countries.
IV. **Procedural Aspects of Tax Treaty Negotiations**

The procedural aspects of negotiating a tax treaty include the identification of the need for a treaty, the establishment of contracts with a potential treaty partner, the appointment of a delegation, the preparations for negotiations, the conduct of the negotiations and procedures for bringing the treaty into force.

**A. Identification of Need for a Treaty**

In determining whether a need exists for a tax treaty with a particular country, a country should examine the nature and extent of the existing economic relationship between the two countries as well as the potential and desire for growth in that relationship. In particular, there should be an intelligent assessment of the nature of future economic relationship. For example, a country should consider the likelihood of foreign direct or portfolio investment from the country concerned, the possibility of the country’s technical or managerial personnel coming for employment, and the likelihood that residents of the other country will set up branches, offices or subsidiaries within its territorial jurisdiction. In addition, the country should examine whether the interrelationships between the tax systems of the two countries are inhibiting economic relationships. These inhibiting effects may, for example, be the results of excessively high levels of tax on international income flows, inadequate statutory relief from double taxation, and conflicting definitions of terms or concepts. Finally, a country should attempt to determine whether and to what extent and for what reasons the tax systems of the two countries result in double taxation on residents of the two countries.

**B. Initial Contacts**

Once a country has identified the need for entering into a treaty with a particular country, it must communicate to that country its desire to open negotiations. As a general rule, such contacts are made initially through diplomatic channels. When a personal relationship exists between tax officials in the two countries, however, it may be helpful to utilize that relationship. In that event, the official diplomatic contacts should be supplemented by informal contacts through these personal channels.

When necessary, this initial contact phase may be the appropriate time to request information or other materials on the tax system and tax treaties of the other country.

**C. Appointment of a Delegation**

A delegation typically consists of three to five individuals, although this number is by no means reflects a hard and fast rule.

The leader of the delegation should be a senior official with tax policy responsibility who has the authority to make independent policy decisions, at least on a tentative basis.
The members of the delegation should be individuals who, among them, combine most or all of the following skills:

(a) Familiarity with the administrative aspects of tax treaties and with the administration of the international aspects of internal law. An individual having such familiarity would represent, in effect, the competent authority function on the delegation;

(b) A lawyer who is familiar with domestic tax law and able to draft treaty provisions;

(c) An economist or other individual with an understanding of the economic relationships between the two countries and an ability to assess the economic impact of the decisions being made in the course of the negotiations.

If negotiations are to be held in a country's home capital, the opportunity may be taken to bring other people into the negotiations for training purposes. If this is to be done, however, care should be exercised to keep the delegations from becoming so big as to "over-power" the visiting delegation.

Finally, it is most important that one member of the delegation be assigned responsibility for taking careful notes of the discussions.

D. Preparations for Negotiations

Members of the delegation should participate, possibly along with others, in preparing for the negotiations. The preparations typically include the following steps:

(a) The tax system of the other country and its existing tax treaties must be studied. The other treaties provide an indication of the range of positions acceptable to the other country;

(b) A draft treaty or working paper should be prepared showing initial positions on the major issues in a tax treaty. This draft may be in general form, to be used for all treaty discussions, or it may be geared to the particular discussions being undertaken. This draft should be transmitted to the other delegation. Though this step is useful for advising the other delegation of positions to be taken in the negotiations, it is also useful for the members of the delegation that prepares it, in requiring them to focus clearly on their own positions;

(c) If the other delegation has prepared a similar draft or working paper, the two drafts should be compared and positions should be prepared on all points of difference;

(d) In working out a country's position the following groups should be sounded out to suggest issues from their own experience: (i) the business community in the country; (ii) that country's subjects who are in the other country (the country's embassy in the other country can carry out this function); and (iii) other government agencies (e.g., investment agencies, government marketing boards, etc.);

(e) If the country does not have any of its nationals available who are familiar with the tax laws of the other country, it may wish to engage an outside expert as a Consultant;
(f) It is most useful if at least one member of the delegation is familiar with the United Nations Model Convention, the OECD Model Convention and any relevant regional model treaties.

E. Arrangements for Meetings between Negotiating Delegations

Experience has shown that negotiations typically require at least two rounds of discussions, sometimes more, which are usually held on an alternating basis in the two capitals.

It is common experience that one week is an optimal length for a round of discussions. By the end of a week, there is usually an accumulation of issues that require careful consideration with principal officials before final decisions can be made. Furthermore, as a purely practical matter, officials frequently find that the amount of work that piles up on their desks during the discussions can become intolerable when treaty discussions extend more than a week at a time.

In arranging for the meetings, the host delegation should make certain that: (a) there is a common language for negotiations or (b) that interpreters will be available who can deal with tax concepts and terminology in both languages.

F. Conduct of the Negotiations

1. First round of negotiations

It is helpful, as a first order of business, to make certain that each side understands the tax system of the other, particularly as it relates to the taxation of international income flows. If there are particularly complex aspects of a country’s tax law that are relevant for a tax treaty, it is often helpful for that country to prepare a brief explanation in written form for the other delegation.

Once there is a general understanding of the two tax systems, the negotiations themselves can begin with an article-by-article review of the draft or drafts previously prepared. If neither side has its own model or draft, the United Nations Model Convention can be used for this purpose. During this initial article-by-article review, agreement can be reached on relatively easy points, and a clarification and, in some cases, a narrowing of the differences can be achieved on the remaining points.

If time remains after concluding one complete review of the draft, a second article-by-article review can be started. At this point, greater effort should be devoted to reaching agreement.

At the conclusion of the week’s discussions, it is useful to prepare an agreed statement of the open issues and, if possible, to schedule the next meeting.

2. Between the first and second rounds of the negotiations
It should be agreed at the conclusion of the first round that one side will prepare a draft showing agreed language and, by use of brackets and alternative language or other suitable symbols, the open issues. This document should be the discussion draft for the second round.

It is important that the notes of the discussions be recorded and distributed to members of the delegations as quickly as possible, while memories are still fresh, particularly if there is more than one treaty under negotiation at the time.

Between the two rounds, the heads of the delegations should correspond in order to exchange drafts, to indicate tentative conclusions on major open issues and to confirm the schedule for the next round of discussions.

3. Second round of negotiations

It is important to maintain both momentum and continuity in treaty negotiations. Thus, the time lag between rounds should be minimized and, to the extent possible, the composition of the delegations should be retained.

Before resuming the article-by-article or issue-by-issue review of the draft, there should be a brief discussion of changes, if any, in the tax laws of either country between the first and the second rounds.

The review of the common working draft should continue, further narrowing any differences which remained at the beginning of the second round. Although it is generally best not to reverse prior decisions, this possibility should not be ruled out if either side considers it necessary. All decisions at this stage are made subject to policy review.

On occasion, agreements are reached in the course of negotiations that do not readily lend themselves to inclusion in the treaty; but that should be made public at some time. There may be, for example, an agreed interpretation of a treaty provision, that is too detailed to go into the treaty text. This interpretation may be spelled out in an exchange of letters to be signed at the same time as the treaty. Such letters of understanding normally would not be subject to ratification, but would form part of the public record.

If full agreement has been reached by the conclusion of the second round, the treaty should be initialled by the heads of delegations. Initialling indicates that the draft reflects the agreement reached at the negotiating level.

If full agreement has not been reached, but nonetheless seems possible, the procedures suggested in the subsections F.2 and F.3 may be repeated. Although it may be possible, at this stage, to conclude an agreement by correspondence, there may be value in scheduling a third, perhaps briefer, meeting so as not to lose momentum. It is sometimes much easier to understand each other’s point of view in face-to-face discussions.
G. Preparations for the Signature of the Treaty

Once agreement has been reached at the delegation level, the draft should be reviewed by senior policy officials. At this stage, to an even greater extent than during the negotiations, frivolous or minor changes should be avoided, but if a strong policy reason for proposing a change in the initialled draft is perceived, this information should be communicated immediately to the other delegation.

Once the draft is fully agreed upon, arrangements should be made for signature at the earliest opportunity under the appropriate procedures in each country. The need to conform texts in two languages can make this stage a time-consuming process. The preparation of agreed texts is normally handled by foreign ministries.

H. Miscellaneous Considerations

Countries may find it useful to issue press releases or other public statements that negotiations are about to begin with a particular country. The purpose of such a statement is to solicit comments from interested parties. This procedure may serve two purposes. It may bring to light issues that tax officials had not previously been aware of. Also, those in the private sector appreciate the opportunity to participate in the treaty process.

The negotiations are normally treated as confidential until the treaty is signed. This requirement of confidentiality has at least two positive purposes. It avoids locking negotiators into what may have been intended as tentative negotiating positions. It also avoids subjecting negotiators to pressures from parties who would be affected by these tentative decisions.

Countries may wish to consider a procedure for reviewing the progress of negotiations, during their course, with interested parties in the private sector. This review can most profitably be done after the general pattern of the new treaty has been established but before final decisions are made. It can serve to apprise the negotiators of some issues that may have surfaced after the beginning of the negotiations, or of problems that could result from provisions already tentatively agreed to. In such meetings, however, caution must be exercised to avoid revealing negotiating positions and other confidential information.

It is useful for the negotiators to maintain contact with economic officers in their embassy in the capital of the other country and to keep them advised of the progress of the negotiations. Among other things, this facilitates the role of these officers in exchanging messages and other communications between formal negotiations sessions. These officers often will sit in on negotiations held in the country where they are assigned.

Finally, experience has shown that social contacts between delegations during the negotiations often are most helpful in maintaining a high level of good will between the delegations. The value of such social contacts is in no way correlated with their elaborateness or cost.