ENTERING A NEW DIMENSION – O.E.C.D. TRANSFER PRICING GUIDANCE AS HARD TAX LAW

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INTRODUCTION

Multilateral transfer pricing guidance from the O.E.C.D. was first released in 1979. A version of *O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*[1] (the "O.E.C.D. T.P. Guidelines") has been in print since 1995, long enough that U.S. international tax practitioners are by now accustomed to hearing foreign colleagues talk sometimes interchangeably about country transfer pricing legislation and the O.E.C.D. T.P. Guidelines.

U.S. transfer pricing regulations, the commensurate with income standard, and the economic substance doctrine are codified under Code §§482 and 7701(o) and Treas. Reg. §§1.482-1 through 1.482--9. The only external references that guide the I.R.S. and taxpayers are applicable Revenue Procedures published by the I.R.S. (such as Rev. Proc. 2007-13 concerning certain specified covered services referenced in the services regulations) and case law.

Foreign transfer pricing law, by contrast, frequently includes a provision that references the O.E.C.D. T.P. Guidelines as the guidance that must be used to interpret other provisions of relevant law. O.E.C.D. member tax administrations and other national tax administrations publish their own interpretive guides to the O.E.C.D. T.P. Guidelines and add to a body of administrative guidance over time with subject-specific bulletins or memoranda. Often, material is published by a national tax administration following a court decision or a trend in controversy. Like other wide variations in standard practices some might think should be more alike, a tax administration's deviation from the median interpretation of the O.E.C.D. T.P. Guidelines can change over time and can also differ between treaty partners. Double tax controversy leads companies and tax administrations into Competent Authority proceedings where the agreed common interpretation of the arm's length principle is none other than the same O.E.C.D. T.P. Guidelines.

The European Commission has recently proposed a Council Directive on transfer pricing released as part of the *Business in Europe: Framework for Income Taxation* ("B.E.F.I.T."). The Directive proposes to codify the arm's length principle and elements of its interpretation from the O.E.C.D. T.P. Guidelines, clarify the role of the O.E.C.D. T.P. Guidelines in Member State law, and homogenize the interpretation of the same guidelines among the tax administrations of E.U. Member States. In addition to the Directive itself, we are interested in how a new approach between E.U. members will influence each individual E.U. Member State's tax administration approach to interpreting the O.E.C.D. T.P. Guidelines when examining transactions of E.U. resident companies with group companies resident in treaty partner countries

[1] O.E.C.D. (2022), O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, O.E.C.D. Publishing, Paris.

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outside the E.U. We are further interested in how these same tax administrations will approach M.A.P. and A.P.A. matters through their respective Competent Authorities. Negotiating history is hard to ignore, and our guess is that the result will be non-uniform.

In addition, two major U.S. trading partners, the U.K. and Canada, are currently undergoing revisions to their transfer pricing legislation that contemplate references to the O.E.C.D. T.P. Guidelines. Both developments are taking place as G20 countries and others move toward variously ceding and gaining taxation rights through the labyrinthine mechanical workings of Pillars I and II as part of another O.E.C.D. digital economy project. For companies within the scope of the Pillar I rules, formulary apportionment (this time the equivalent of a complex differential equation in contrast to the simple approaches used to apportion income among U.S. states, typically involving one, two, or three factors) is intended in part to provide relief from the need to navigate through the fog and potential longer-term tax uncertainty of O.E.C.D. T.P. Guidelines interpretations.

In what follows, we begin the task of understanding the possible future role or roles of the O.E.C.D. T.P. Guidelines. The O.E.C.D. T.P. Guidelines have been classified by others as "soft law."[2] The document itself is after all written variously as a discussion of possible best practices, recommended approaches, and more definite guidance representing an incomplete consensus of O.E.C.D. Member State tax authorities, and not in the if/then form of rules governing transfer pricing positions for tax purposes. We examine recent developments to determine whether O.E.C.D. "soft law" may be hardening over time and begin by looking for clues outside of the field of transfer pricing.

U.S. CASE LAW – *TAISEI FIRE & MARINE INSURANCE CO.*

O.E.C.D. "soft law" frequently serves as a tool for interpreting multi-jurisdictional agreements, including tax treaties. Courts often rely on the O.E.C.D. Model Treaty and its commentaries to interpret provisions of bilateral income tax treaties between two countries. A notable example is found in the case of *Taisei Fire and Marine Insurance v. Commr.,*[3] where the tax court consulted the 1977 Commentary to the O.E.C.D. Model Treaty to interpret the permanent establishment article in the U.S.-Japan Income Tax Treaty.

In *Taisei Fire*, several Japanese insurance companies individually authorized a U.S. company to serve as a reinsurance underwriting manager empowered to enter into contracts on their behalf. The central issue was whether each of the Japanese insurance companies had a U.S. permanent establishment through the actions of the U.S. agent. The crucial determinant was whether the U.S. agent maintained an "independent status," as the absence of such independence would lead to the Japanese companies being deemed to have a U.S. permanent establishment.

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[2] Alberto Vega, *International Governance through Soft Law: The Case of the OECD Transfer Pricing Guidelines*, Max Planck Institute for Tax Law and Public Finance Working Paper 2012 – 05, July 2012

[3] *Taisei Fire & Marine Ins. Co. v. Commr.*, 104 T.C. 535 (1995).

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The U.S.-Japan Income Tax Treaty did not provide a definition for an “agent of an independent status.” However, the court recognized that the relevant provisions were not only based upon, but also duplicative of those found in the O.E.C.D. Model Treaty.[4] Consequently, the court turned to the commentary accompanying the O.E.C.D. Model Treaty, which articulated that the test for independent status involves both legal and economic independence. The court ultimately held that given the lack of guidance in the U.S.-Japan Income Tax Treaty, the Japanese insurance companies did not have a permanent establishment based on the approach suggested by the O.E.C.D. Model Treaty.

The role of O.E.C.D. guidance in U.S. treaty interpretation has increased since the 1995 Tax Court decision. The U.S. explicitly embraced the O.E.C.D. approach in its 2006 and 2016 Model Treaties. According to the O.E.C.D. approach, a permanent establishment is treated as a functionally distinct entity for the purpose of attributing business profits. Furthermore, the O.E.C.D. approach stipulates that business profits should be determined based on the arm’s length standard, applying transfer pricing principles to branch operations.

Taisei Fire serves as an illustration that a U.S. court can indeed draw upon O.E.C.D. guidance to aid in resolving a contentious legal issue involving a treaty provision that is based on a provision in the O.E.C.D. Model Treaty. Nevertheless, the extent to which a court will and should rely on such guidance remains a subject of uncertainty and debate.

OTHER O.E.C.D. GUIDANCE – O.E.C.D. GUIDELINES FOR MULTINATIONAL COMPANIES

Before the introduction the O.E.C.D. T.P. Guidelines, the O.E.C.D. introduced the Guidelines for Multinational Enterprises (“M.N.E. Guidelines”) in 1976, a thorough collection of government-recommended measures for M.N.E.’s to willingly embrace.[5] The purpose of the M.N.E. Guidelines is to mitigate and address potential impacts stemming from activities in foreign locations, and promoting positive contributions to economic, social, and environmental advancement. These guidelines encompass various aspects, including human rights, environmental practices, labor standards, anti-bribery measures, corporate governance, disclosure practices, supply chain management, and taxation. Internationally, these guidelines enjoy widespread support and stand as the sole multilaterally agreed-upon and comprehensive set of principles for responsible business conduct and are actively endorsed by governments.

Though widely accepted by countries throughout the world, observance of the M.N.E. Guidelines by enterprises is voluntary and not legally enforceable. The M.N.E. Guidelines do not supersede domestic law and are not designed to place enterprises in situations of conflicting requirements. Nevertheless, some matters covered by the M.N.E. Guidelines may be regulated by national law or international commitments.

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[4] See discussion by the court in the text of the case at note 5.

[5] O.E.C.D. (2023), OECD Guidelines for Multinational Enterprises on Responsible Business Conduct, OECD Publishing, Paris.

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Despite the voluntary nature of the M.N.E. Guidelines, signatory governments are required to establish a National Contact Point ("N.C.P."). Among their various responsibilities, N.C.P.'s play a crucial role in handling disputes, referred to as "specific instances." This process serves as a non-judicial grievance mechanism, activated when a party raises allegations against the operations of a multinational enterprise.

The parameters defining the legal significance of the M.N.E. Guidelines are explicitly outlined and commonly understood. This stands in contrast to the O.E.C.D. T.P. Guidelines, where the line between general guidance and legal enforceability is blurred.

E.U. B.E.F.I.T. DIRECTIVE AND THE O.E.C.D. T.P. GUIDELINES

Part of the larger B.E.F.I.T. legislative package that aims to set out rules for large companies in the E.U., a recent Council Directive on Transfer Pricing[6] ("the Directive") aims to use the O.E.C.D. T.P. Guidelines to harmonize the interpretation of the arm's length principle between E.U. Member States. Member States for the most part have legislated O.E.C.D. T.P. Guidelines the task of interpretation of the arm's length principle. The B.E.F.I.T. transfer pricing proposal goes one step further to elevate the O.E.C.D. T.P. Guidelines into E.U. law by making them more than the arm's length principle interpretive standard.

The Directive requires that Member States adopt a common definition of associated enterprises as an initial condition to delineating a controlled transaction and proposes a new fast-track and joint audit approach to facilitate corresponding transfer pricing adjustments between companies resident in E.U. Member States to minimize the risk of double taxation. One of the several positive intended effects of the Directive is to reduce or eliminate the need for transfer pricing rulings from E.U. Member State tax authorities that have historically caused significant State Aid and other controversy, especially when granted as a unilateral ruling. The remainder of the Directive concerns the identification and pricing of a controlled transaction, with the well-known "delineation of the actual transaction" O.E.C.D. T.P. Guidelines language which is taken verbatim from paragraph 1.33 without including the plural "transactions."

"The B.E.F.I.T. transfer pricing proposal goes one step further to elevate the O.E.C.D. T.P. Guidelines into E.U. law. . ."

Further use of terms from the O.E.C.D. T.P. Guidelines appears throughout the Directive, which is largely a simplified paraphrasing of the O.E.C.D. T.P. Guidelines. The 451 pages of the O.E.C.D. T.P. Guidelines are not, however, able to be collapsed into 17 pages of draft Directive like 17 clowns into a Citroën *Deux Chevaux*. The distillation effort in drafting results in certain non-subtle departures from the O.E.C.D. T.P. Guidelines, thereby creating the potential for future controversy among E.U. Member States and between E.U. Member States and non-E.U. treaty partners where the approach of the Directive becomes the rule followed by a Member State's tax administration.

The term "best evidence," for example, is used in the Directive preamble to describe the utility of an intercompany contract *for the purpose of identifying the transaction or transactions actually undertaken* between two controlled corporations. Less

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6 *Proposal for a Council Directive on Transfer Pricing*, SWD(2023) 308-309, (European Commission, September 9, 2023)

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weight is given to a written intercompany contract by the O.E.C.D. T.P. Guidelines in accurately delineating the controlled transaction at issue. Paragraphs 1.36 and 1.43 of the O.E.C.D. T.P. Guidelines indicate that a written contract is important but is not the only item of information used to identify and understand the actual controlled transaction. In the O.E.C.D. T.P. Guidelines, the "best evidence" term describes the utility of a written contract *in determining the intention of the parties* in relation to the assumption of risk.

The Directive's explanation of the sufficient conditions for determining comparability are the O.E.C.D. T.P. Guidelines conditions relevant to transactional methods only. More detailed interpretive guidance on the comparability standard relevant to the application of the transactional net margin method, or T.N.M.M., the C.P.M.'s O.E.C.D. cousin, is absent from the draft Directive and must be taken from Chapter II of the O.E.C.D. T.P. Guidelines. Absent an amendment, the O.E.C.D. T.P. Guidelines will play their historical "soft law" interpretive role in this respect.

Finally, the interquartile range that is explained as an option for summarizing a group of uncontrolled pricing or profitability statistics under the O.E.C.D. T.P. Guidelines – which is disliked by certain O.E.C.D. Member State tax administrations – defines the arm's length range under the draft Directive. This may portend a possible reduction in friction in U.S. double tax cases. Those O.E.C.D. Member State tax authorities that are not proponents of the interquartile range may experience difficult double tax case negotiations. The Canada Revenue Agency is an example.

In sum, "soft law" in the form of the O.E.C.D. T.P. Guidelines appears to harden into hard law under the language of the Directive despite paragraph 15 of the Directive's preamble that refers to the O.E.C.D. Transfer Pricing Guidelines in an interpretive capacity, consistent with the legislation of many E.U. and O.E.C.D. Member States. The Directive defines the O.E.C.D. T.P. Guidelines to mean the 2022 publication date version and incorporates subsequent amendments by statute.

LEGISLATIVE AND ADMINISTRATIVE USE OF THE O.E.C.D. T.P. GUIDELINES

Many non-E.U. Member State tax administrations have a long-standing connection to the O.E.C.D. T.P. Guidelines through their involvement with the O.E.C.D.'s tax policy and administration development work. The outcome has been direct or indirect legislative reference to the O.E.C.D. T.P. Guidelines and published administrative guidance that references or follows the O.E.C.D. T.P. Guidelines.

The U.S. does not reference the O.E.C.D. T.P. Guidelines in its transfer pricing regulations, or publish a companion interpretive document as is done by tax administrations both within and outside the E.U. As an O.E.C.D. Member State, the U.S. works with other O.E.C.D. Member States through its treaty network to resolve double tax cases. The acknowledgement of the O.E.C.D. T.P. Guidelines as an element of the *lingua franca* in these multilateral settings appears only in I.R.S. Rev. Proc. 2015-41 and select training material of the I.R.S.

In this sense, the U.S. follows an approach similar to Korea, China, Japan, and Israel (among other non-E.U. O.E.C.D. Member States) and does not specifically cite the O.E.C.D. T.P. Guidelines in country legislation as a means of interpreting the relevant provision of law. The legislation of the foregoing countries resembles the

Directive to the extent that a general claim is made concerning consistency with, or incorporation of, the basic aspects of the O.E.C.D. T.P. Guidelines.

Country decrees and administrative guidance issued as supplements to enacted legislation may incorporate or refer to the O.E.C.D. T.P. Guidelines when a tax administration explains its approach to certain aspects of its interpretation of the arm's length principle. Some tax administrations continue to roughly paraphrase the O.E.C.D. T.P. Guidelines without any citation in guidance publications. China's *Public Notice of the State Administration of Taxation [2017] No.6* is a good example. It restricts the role of the O.E.C.D. T.P. Guidelines strictly to "soft law."

"C.R.A. proposes to codify the term 'economically relevant characteristics' to mean something different than the definition in the O.E.C.D. T.P. Guidelines . . ."

U.K. AND CANADIAN CONSULTATIONS

In mid-2023, both the U.K. and Canada began consultations on amendments to specific aspects of their respective transfer pricing legislation. U.K. legislation incorporated the O.E.C.D. T.P. Guidelines (and subsequent amendments) for the purpose of interpreting the arm's length principle in 2004, while Canada's legislation has not. Both countries have issued administrative guidance that cites the O.E.C.D. T.P. Guidelines before the respective consultations commenced, though in different ways and with different points of emphasis.

The U.K. consultation question relevant to the O.E.C.D. T.P. Guidelines was relatively narrow in scope and contemplated the replacement of the term "provision" used in U.K. transfer pricing legislation to indicate the series of conditions comprising a controlled transaction with the term "conditions" for the purpose of greater consistency with the language of Article 9(1) of the O.E.C.D. Model Tax Convention.

Article 9(1) uses the term "conditions" in the following phrase:

> * * * conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises * * *.

The phrase is a critical part of the Article 9 text that is interpreted by the O.E.C.D. T.P. Guidelines. One purpose of the U.K. consultation was to solicit input on the practical implication of the proposed change in terminology for the operation of domestic legislation. H.M.R.C.'s practical concern was the over-broad scope of the term "conditions" in comparison to the term "provision" used elsewhere in legislation.

The Canada Revenue Agency ("C.R.A.") began its legislative consultation after the Federal Court of Appeal found for the taxpayer in *The Queen v. Cameco Corporation*, 2020 FCA 112 and the Supreme Court of Canada refused leave to appeal, thwarting the C.R.A.'s attempt to recharacterize a controlled transaction based on proposed series of alternate transaction circumstances. The C.R.A. consultation asked for input on the question of the codification of the term "economically relevant characteristics" used to further describe a controlled transaction. Article 9(1) of the Model Convention, with which H.M.R.C. seeks to harmonize its legislative language, refers to the actions ("conditions made or imposed") of two related parties resulting in the establishment of a series of "conditions" that define the controlled transaction. The O.E.C.D. T.P. Guidelines make it clear that contractual terms are only one of the economically relevant characteristics or comparability factors that describe or

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delineate a controlled transaction.[7] C.R.A. proposes to codify the term "economically relevant characteristics" to mean something different than the definition in the O.E.C.D. T.P. Guidelines and to define the term "conditions" broadly.

The proposed U.K. amendment retains the O.E.C.D. T.P. Guidelines as "soft law" and reduces a possible conflict between domestic law and the U.K.'s double tax treaties. The proposed Canadian amendment generally incorporates the O.E.C.D. T.P. Guidelines conditionally and proposes inexact codification of one element ("economically relevant characteristics") of the same guidelines. Whether the result is hard law on the outside and soft in the middle, or something else entirely remains to be seen in draft legislation and the litigation that will follow.

CONCLUSION

Distinct from the status of the O.E.C.D. Model Treaty and M.N.E. Guidance as non-binding guidance with well-defined parameters of legal significance, the O.E.C.D. T.P. Guidelines may be set to step out of their historical role as "soft law" and into a role as either a stronger authority on the interpretation of the arm's length principle or the source of legislative language itself. From a U.S. perspective, this signals a growing heterogeneity in transfer pricing approaches among treaty partners, and a potential hardening of treaty partner positions in double tax cases as O.E.C.D. T.P. Guidelines guidance is enacted as law in one form or another.

If we accept the proposition that the O.E.C.D. T.P. Guidelines are "soft law" and effective to the greatest extent in their current form, are the E.U. and Canada asking too much of these guidelines by proposing codification of one type or another? The positive role played by other legally non-binding O.E.C.D. guidance in fostering international cooperation and harmonized approaches suggests this may become a future concern. The current O.E.C.D.-led efforts to reform the taxation of digital commerce with the legislation of Pillar I and II by the adoption of a multilateral instrument may provide relief for large multinational groups but leave controversy for all others to resolve.

[7] O.E.C.D. TP Guidelines, para. 1.36

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