Associated enterprises

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Document version:
Publisher's PDF, also known as Version of record

Publication date:
2011

ASSOCIATED ENTERPRISES

A Concept Essential for the Application of the Arm's Length Principle and Transfer Pricing

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ISBN: 978-90-817824-0-1

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Website: www.dwarkasing.com
Website: www.transferpricing.eu

Printed by: Wolf Legal Publishers, the Netherlands.

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Proefschrift ter verkrijging van de graad van doctor aan Tilburg University, op gezag van de rector magnificus, prof. dr. Ph. Eijlander, in het openbaar te verdedigen ten overstaan van een door het college voor promoties aangewezen commissie in de aula van de Universiteit.

op maandag 28 november 2011 om 16.15 uur

door

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geboren op 1 mei 1978 te Nijmegen.

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Acknowledgements

I am deeply indebted to my *promotores*, Professor Peter Essers and Professor Hubert Hamaekers for their continued support, encouragement, guidance and comments, all of which inspired me to conduct this study. Professor Hubert Hamaekers' support and guidance was more than one could ever ask for. His academic support and warm personal friendship are of inestimable value for me. Professor Peter Essers has given me valuable guidance, comments and support. He provided me with the great opportunity to write the dissertation in the inspirational environment of the Fiscal Institute Tilburg of the Tilburg University, the Netherlands. It was a privilege to have discussions with both *promotores* in an open academic atmosphere. In promptly reading my drafts, submitting numerous comments and providing practical advice, they have contributed more than anyone else to the realisation of this book.

I would like to thank Professor Luís Eduardo Schoueri (Brazil), T.P. Ostwal (India), Professor Walter Hellerstein (USA), Axel Eigelshoven and Dirk Langkau (Germany) for their comments on the country sections. I am also grateful for the helpful comments of Dr Phat Tan Nguyen and I thank Margaret Nettinga for her linguistic editing of this book.

I would also like to thank Professor Charles Gustafson, Professor Eric Kemmeren, Professor Rainier Prokisch and Professor Theo Raaijmakers for their kind willingness to serve as member of the dissertation committee.

Finally, my special thanks must go to my loving family, for without their patience and understanding this study could never have been completed. Without their infinite support this book would never have been written.

Needless to say, the views expressed in this book and any mistakes are my own.

Tilburg (the Netherlands), November 2011

Ramon S.J. Dwarkasing

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List of Abbreviations

Art.	Article
Arts.	Articles
BNB	Beslissingen in Belastingzaken / Nederlandse Belastingrechtspraak
CCCTB	Common Consolidated Corporate Tax Base
CFC	Controlled Foreign Companies
CFR	Code of Federal Regulations (US)
Cir.	Circuit
CTA	Corporate Tax Act
DStR	Deutsche Steuerrecht: Wochenschrift für Steuerrecht, Wirtschaftsrecht und Betriebswirtschaft
DTC	Double taxation convention
ECJ	European Court of Justice
Ed.	Editor
Edn.	Edition
Eds.	Editors
EU	European Union
F.2d	Federal Reporter, Second Series (US)
F.3d	Federal Reporter, Third Series (US)
HMRC	Her Majesty's Revenue and Customs (UK)
HR	Hoge Raad (Dutch Supreme Court)
ICC	International Chamber of Commerce
I.C.J. Reports	Reports of Judgments, Advisory Opinions and Orders (International Court of Justice)
ICTA	Income and Corporation Tax Act (UK)
IFZ	Internationale Fiscale Zaken (International Fiscal Matters, the Netherlands)
INTM	International Manual (UK)
IRC	Internal Revenue Code (US)
IRS	Internal Revenue Service (US)
ITA	Income Tax Act
ITR	Income Tax Reports
MNE	Multinational enterprise
OECD	Organisation for Economic Co-operation and Development
OECD Model	OECD Model Tax Convention on Income and Capital 2010
OEEC	Organisation for European Economic Co-operation
Para.	Paragraph
Reg.	Regulations
Sec.	Section

Sess.	Sessions
UK	the United Kingdom of Great Britain and Northern Ireland
UN	the United Nations
US	the United States of America
VCLT	Vienna Convention on the Law of Treaties
Vol.	Volume

Chapter 1: Introduction

1.1. Introduction

The number of multinational enterprises (MNEs) and their cross-border intra-group investments and transactions has increased significantly since the 1960s. This is the result of the process of economic globalisation. As early as the 1970s, several studies showed that a significant part of the cross-border trade around the world was carried out within multinational enterprises.[1] In 2001 the European Commission published a report stating that multinational enterprises account for about one-tenth of the global gross domestic product, compared to one-twentieth in 1982.[2] In 1979 the Organisation for Economic Cooperation and Development (hereinafter: OECD) stated that the significant amount of intra-group cross border sales was clearly sufficient to render the proper assessment of the profits arising from transnational intra-group trade a matter of considerable importance. The OECD confirmed that special problems may arise for tax authorities from the fact that the terms and conditions of the sales of goods or services between members of a multinational enterprise are not necessarily governed by economic factors alone. They may be used as a means of profit shifting to alleviate the overall tax burden of the group. Therefore, the proper assessment of these profits is important. It is not only important for the tax authorities, but also for the multinational enterprises themselves, because they "may suffer unrelieved double taxation if different tax authorities take different views on the adjustments which ought to be made for the purposes of computing tax liability."[3]

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[1] See United Nations, *Transnational Corporations in World Development: A Re-examination*, (New York: United Nations, 1978); OECD, *Measuring Globalisation: Economic Globalisation Indicators* (Paris: OECD, 2005); United Nations, *World Investment Report 2007* (New York: UNCTAD, 2007.

[2] European Commission, *Towards an Internal Market without tax obstacles: A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities*, COM (2001) 582 final; United Nations, *World Investment Report 2000* (New York: UNCTAD, 2000), pp. 9-13.

[3] OECD, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises*, adopted by the Committee on Fiscal Affairs in January 1979, approved by the Council of the OECD for publication (Paris: OECD, 1979).

The growth of MNEs presents increasingly complex taxation issues for both tax administrations and the MNEs themselves. Separate domestic rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in a broad international context.[4] According to the OECD, this should be based upon income and expenses that can reasonably be considered to arise within their territory, with the need to avoid the taxation of the same item of income by more than one tax jurisdiction. Double or multiple taxation may create an impediment to cross-border transactions and the movement of capital. The OECD states that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries.

The explosive growth of international trade in an era of globalisation, together with the fact that two-thirds or more of that trade is generally considered to take the form of transactions between associated enterprises, has contributed to the importance of transfer pricing.[5]

Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises.[6] For managerial purposes transfer pricing may be used by MNEs to measure and evaluate the business performance of specific individual units of an MNE. By evaluating the transfer prices charged for intra-group transactions, a manager can decide whether to buy or sell products and services internally or externally. This can lead to maximising the profits of the individual units and of the MNE as a whole.[7] Therefore, from an economic and business perspective, transfer pricing can be used as a managerial tool.

From a tax perspective, prices of transactions between related enterprises (transfer prices) are important for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore

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[4] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), Preface, para. 1.

[5] At the OECD Conference *Transfer Pricing and Treaties in a changing World*, September 2009, CTPA Director Jeffrey Owens stressed the importance of transfer pricing today. According to Owens, recent surveys show that multinational enterprises rank transfer pricing as their single most important international tax issue.

[6] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), Introduction, para. 11.

[7] Horngren, T., Sundem, L. and Stratton, O., *Introduction to Management Accounting*, Thirteenth Edition (New Jersey: Pearson Prentice Hall Inc., 2004), p.440.

the taxable profits of the associated enterprises in different tax jurisdictions.[8] Any adjustment made by tax authorities to the transfer price in one jurisdiction would cause (economic) double taxation, seen from the perspective of the MNE concerned, unless a corresponding adjustment in the other jurisdiction is made. If the other jurisdiction does not agree to make a corresponding adjustment, the MNE group will be taxed twice on this part of its profits.

The arm's length principle is the internationally recognised standard for transfer pricing for tax purposes. The arm's length principle is the underlying principle of Art. 9 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Cooperation and Development (hereinafter: OECD Model)[9] and of the transfer pricing laws of many countries. Virtually all tax treaties are based on the arm's length principle. It requires that prices set for transactions between associated enterprises should - for tax purposes - be derived from prices which would have been applied by unrelated parties in similar transactions under similar conditions in the open market.[10] The arm's length principle is applied by virtually all countries and has been included in many bilateral and multilateral tax treaties. In many countries strict transfer pricing rules have been introduced since the mid-nineties. Almost all of these transfer pricing laws and rules are based on the OECD Transfer Pricing Guidelines (hereinafter: OECD TP Guidelines), which are developed on the basis of Art. 9 OECD Model.[11] The transfer pricing legislation of many non-OECD countries, such as China and India, has also been strongly influenced by the OECD TP Guidelines. In addition to the OECD Model 2010, the United Nations Model Double Taxation Convention between developed and developing countries (hereinafter: 2001 UN Model) allows the tax authorities to adjust the profits of associated enterprises if the transactions or profits are not at arm's length. Application of transfer pricing rules may result for instance in penalties when prices are not at arm's length and go together with (heavy) documentation or other compliance requirements.

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[8] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), Preface, para. 12.

[9] OECD, *OECD Model Tax Convention on Income and Capital* (Paris: OECD, 2010), Art. 9.

[10] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), Chapter I, paras 1.1 and 1.2.

[11] OECD, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises*, adopted by the Committee on Fiscal Affairs in January 1979, approved by the Council of the OECD for publication (Paris: OECD, 1979), para. 32.

1.2. Problem area

The arm's length principle is applied to *associated* enterprises. Art. 9 OECD Model provides that associated enterprises exist when one enterprise has a direct or indirect participation in the management, control or capital of another enterprise in the other State, or when the same persons participate directly or indirectly in the management, control or capital of an enterprise of one State and of an enterprise of the other State.

Art. 9 OECD Model reads as follows:

ASSOCIATED ENTERPRISES
"*Paragraph 1:*
Where
a. An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
b. the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent 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."
Paragraph 2:
"Where a Contracting State includes in the profits of an enterprise of that State and taxes accordingly profits on which an enterprise of the other Contracting State has been charged to tax in that other Contracting State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount for the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provision of this Convention and the competent authorities of the Contracting States shall if necessary consult each other."

The expression "participation in management, control or capital" is used by many OECD and non-OECD countries. For instance, Schedule 28AA of the UK Income Tax Act (ICTA88/SCH28AA) reads as follows:

"(1) this Schedule applies where –
(a) Provision ('the actual provision') has been made or imposed as between any two persons ('the affected persons') by means of a transaction or series of transactions, and
At the time of making or imposition of the actual provision-
-1 One of the affected persons was directly or indirectly *participating in the management, control or capital* of the other; or
-2 The same person or persons was or were directly or indirectly *participating in the management, control or capital* of each of the affected persons [...]"

Section 92 A of the Indian Income Tax Act reads as follows:

"Sec. 92A – Meaning of associated enterprise

1. [...] associated enterprise, in relation to another enterprise, means an enterprise:
a) which participates, directly or indirectly, or through one or more intermediaries, in the *management or control or capital of the other enterprise*; or
b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in *its management or control or capital*, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise."

The problem on which this thesis focuses is twofold. First, different interpretations and applications of the concept of associated enterprises may result in economic double taxation, in particular where in a country with a relatively broad concept of associated enterprises (for instance, with a participation-in- capital criterion of over 20%) a transfer pricing adjustment is made and the other country involved refuses to apply a corresponding adjustment referred to in the above paragraph 2 of Art. 9 OECD Model, having a narrow concept of associated enterprises (for instance, with a 51%

participation-in-capital criterion as a minimum).[12] The fact that one country interprets "associated enterprises" in a relatively restricted sense, while another country interprets the concept of "associated enterprises" in a broader sense, may cause serious problems in the field of international taxation. For instance, Germany requires a minimum shareholding of 25% in order to conclude the existence of associated enterprises, whereas Denmark considers companies to be associated enterprises when one company owns more than 50% of the share capital in another company.

Secondly, in various countries the concept of associated enterprises may even cover relationships between independent enterprises, for instance where a foreign buyer has a strong negotiating power. For example, an Indian software development company has a customer in the Netherlands which is responsible for more than 90% of the turnover of the Indian software developer. The Dutch customer is able to dictate the prices of the Indian software developer. The Indian software developer is therefore only able to charge a price with a 1% margin/mark-up, which is very low compared to his Indian competitors (which apply for instance 6% as average mark-up).
According to Indian transfer pricing law, if the goods or articles manufactured or processed by one enterprise, are sold to another enterprise abroad or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise, the two enterprises shall be deemed to be associated enterprises.[13]
The Indian tax authorities consider the Indian software developer and its Dutch customer to be associated. They may adjust the prices and tax an unrealised profit, i.e. the difference between the real result and a result based on prices derived from other software developers in India. The Netherlands does not consider the companies to be associated as it applies a narrow concept of associated enterprises that does not include "*de facto* control" as a criterion for association.[14] "Control" in the absence of a company law-based relationship or in the absence of any formal right to exercise control can be described as "de facto" control. Participation in capital and management can be characterised as "de jure" concepts: concepts covered by company law.

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[12] A corresponding adjustment is an adjustment to the tax liability of the associated enterprise in a second tax jurisdiction made by the tax administration of that jurisdiction, corresponding to a primary adjustment made by the tax administration in a first jurisdiction, so that the allocation of profits by the two jurisdictions is consistent.

[13] Sec. 92 A (2) (i) Indian Income Tax Act 1961

[14] See also section 3.4.4.

Although both companies are unrelated and the prices are a result of open market negotiations, the arm's length principle is applied by the Indian tax authorities, *because of their domestic concept of associated enterprises*. As a result, the Indian company has to pay taxes over profits that have not been made, it faces heavy documentation requirements, other transfer pricing compliance requirements and moreover it faces a penalty for not applying the "correct" prices.

Countries apply various definitions and interpretations of the notion "associated enterprises", some based on Art. 9 OECD Model. In particular the element "control" in the above description of "associated enterprises" seems to have resulted in varying interpretations.
It is expected that the problems caused by various different interpretations of the concept of associated enterprises will increase. Important emerging economies, such as Brazil, China, India, Mexico and Vietnam, and important traditional industrialised countries, such as the United States, Germany, the Netherlands and the United Kingdom apply different concepts of associated enterprises. Brazil, China, India and various other emerging economies such as Vietnam apply broad concepts of "associated enterprises". As the volume of business transactions between the upcoming economies, in particular Brazil, India and China, and the European countries and the United States increases, the problems caused by different interpretations of "associated enterprises" will also increase. Furthermore, only recently have developing countries and emerging economies introduced concepts of associated enterprises in their tax legislation or regulations. As a consequence, problems caused by these newly introduced concepts of associated enterprises will only occur after some years of application.
The importance of a common interpretation of "associated enterprises" does not yet seem to have been recognised by the OECD. Also, in 2001 the European Commission found the concept of associated enterprises of a more "theoretical importance" and thought that the problems caused by the concept of "associated enterprises" were limited. However, in 2010 the EU Working Group on the Common Consolidated Corporate Tax Base stated:

"An important feature of corporate tax systems relates to the concept of 'association' between taxpayers, companies, entities etc. The content of these rules is critical, because, in practice, it also delineates the scope for the application of transfer pricing rules."[15]

1.3. Research Question

The above examples illustrate the lack of clarity on the concept of "associated enterprises" in international tax law. This study therefore aims at finding an appropriate interpretation of the concept of "associated enterprises" in the OECD Model in the light of its history and its purposes, which is able to remedy the above problems. While recognising the importance of the UN Model, the focus of this study is on the OECD Model and the OECD TP Guidelines because of their leading role in transfer pricing all over the world. Accordingly, the research question can be formulated as follows:

How should the concept of "associated enterprises" be interpreted under Art. 9 OECD Model in order to avoid non-application of a corresponding adjustment and to avoid incorrect application of the arm's length principle?

This research question can be subdivided into the following more specific sub-questions:

- Do the historical development and the purposes of the arm's length principle provide clues as to how to interpret the concept of "associated enterprises"?
- How is the concept of "associated enterprises" interpreted in Art. 9 OECD Model?
- Should an *autonomous* interpretation of "associated enterprises" be applied under the OECD Model?
- How is the concept of "associated enterprises" interpreted in the domestic tax legislation of the United Kingdom, the United States, Germany, Sweden, India, the Netherlands, China and Brazil?
- How is the concept of "associated enterprises" interpreted and applied in customs regulations, CCCTB and IFRS?

[15] European Commission, *Working Paper Workshop on the Common Consolidated Corporate Tax Base: Transactions and Dealings between the Group and Entities outside the Group*, CCCTB\RD\003\doc\en (Brussels: 20 October 2010), p. 3.

In order to answer these questions, the meaning and purpose of Art. 9 OECD Model will be scrutinised in the light of the purposes of the arm's length principle. The concept of "associated enterprises" in the current Art. 9 OECD Model and the various domestic interpretations of this concept will be investigated. The historical developments of the arm's length principle and of the concept of "associated enterprises" are central in the analysis that will be undertaken. The interpretation of tax treaties will be discussed in order to examine whether domestic concepts of associated enterprises should be accepted or rejected, and whether reference to the context must be made. The concept of "associated enterprises" in company law and IFRS will be analysed as to find out whether this provides clues as to how to interpret the concept of "associated enterprises". The concept of "associated enterprises" in customs and CCCTB will be analysed to find out whether the concept in customs and CCCTB is a source of inspiration for the interpretation of "associated enterprises" in the context of the OECD Model.

1.4. Methodology

This study will undertake an historical analysis of Art. 9 OECD Model. This historical analysis consists of two parts. The first part of the historical analysis (Chapter 2) focuses on the introduction and development of the *arm's length principle* in the early Reports of the League of Nations and in the Drafts and Models of the OEEC/OECD. It analyses whether the historical development and the purposes of the arm's length principle provide clues as to how to interpret the concept of "associated enterprises".
The second part of the historical analysis of the OECD Model (Chapter 5) focuses on the development of the notion of "*associated enterprises*" in the early Reports of the League of Nations and in the Drafts and Models of the OEEC/OECD. This second part aims to find a definition of or indications for an interpretation of the concept of "associated enterprises". The historical analysis is an important part of this study.

A legal analysis of the concept of associated enterprises in the current Art. 9 OECD Model will be made in the light of the purposes of the arm's length principle.

An analysis will also be made of the domestic interpretations of "associated enterprises" and "control" for transfer pricing purposes in an effort to determine whether they provide important clues for the interpretation of "associated enterprises" under the OECD Model. This comparative research is limited to the following countries: the United Kingdom, the United States, Germany, Sweden, India, the Netherlands, China and Brazil. The comparative study made in Chapter 6 does not claim to be exhaustive. The selected countries are OECD countries and non-OECD countries. The selected non-OECD Member countries are emerging economies: Brazil, China and India. It is expected that the transactions between those emerging economies and the traditionally industrialised countries will increase, which makes this research even more relevant.

One of the early laws dealing with transactions between associated enterprises is found in the UK Finance Act of 1915. The development of UK transfer pricing regulations started in as early as the early 1900s. The United Kingdom applies a very detailed "control" concept. The UK concept of "associated enterprises" and "control" may provide important clues for the interpretation of "associated enterprises" under the OECD Model. The relevance of analysing the United Kingdom becomes even greater because of the prominent role the United Kingdom has played in the development of the first Models and Draft Conventions of the League of Nations and the OECD. Hence, the United Kingdom is included in the comparative study.

The second country in this comparative research is the United States. The United States, an OECD Member country, has played a very important role in the field of international transfer pricing since many years. To achieve a good understanding of the arm's length principle and the notion of "associated enterprises" under the OECD Model, it is necessary to examine the development of the arm's length principle and the concept of "associated enterprises" and "control" in US tax law.

The third country in the comparative study is Germany. Germany is also an OECD Member country and the most important economy in the EU. Germany has a detailed transfer pricing legislation. Therefore, the German concept of associated enterprises will be scrutinised in Chapter 6.

The fourth selected country is Sweden. Sweden is an OECD Member state and, as will be shown in Chapter 6, applies a concept of "associated enterprises" similar to that of the OECD but with a specific formula (the community of economic interest). Because of this specific element, Sweden is included in this selection.

The fifth selected country is India. India is one of the most important emerging economies and a non-OECD Member country. India is an example of an emerging economy that recently has introduced a broad concept of associated enterprises in its tax legislation and regulations. As will be discussed in Chapter 6, prior to the introduction of the Finance Act 2001, India did not have specific transfer pricing regulations. As indicated in the example provided in section 1.2, the Indian definition of "associated enterprises" illustrates the problem on which this thesis focuses. Therefore, the Indian concept of associated enterprises is included in this comparative study.

The sixth selection is the Netherlands. Since the early 1920s, the Netherlands has played an important role in the preparation of the precursors of the OECD Model and the Model itself. As from 2002, the arm's length principle is codified in Netherlands tax law. As the Netherlands follows the OECD Model, the Netherlands interpretation of "associated enterprises" and "control" may provide clues as to how to interpret the concept of "associated enterprises" under the OECD Model.[16]

The seventh selected country is Brazil, a non-OECD Member country and one of the most important emerging economies. The Brazilian transfer pricing rules include methodologies that dramatically differ from the OECD TP Guidelines. The introduction of transfer pricing rules, effective as from 1 January 1997, aimed at preventing income tax evasion through price manipulation. Due to the lack of domestic comparables and limited resources of the tax authorities for administering transfer prices, Brazil has opted to apply a simplified approach to the arm's length principle, using fixed margins.[17] For the above reasons, the Brazilian concept of "associated enterprises" will be analysed in Chapter 6.

Finally, the concept of associated enterprise in China will be discussed. China is one of the largest economies in the world and a non-OECD Member country. China has had comprehensive transfer pricing legislation since 2009. It has based its transfer pricing system on the arm's length principle and applies a concept of "related parties" based on *de jure* and *de facto* control.

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[16] The Netherlands is also the author's residence state.

[17] See section 6.8.

Because of the important role China plays in the world economy, the Chinese concept of "associated enterprises" is included in this comparative study.

This study is also comparative in the sense that it analyses and compares the concept of "associated enterprises" in company law, IFRS, customs and CCCTB with the concept of "associated enterprises" for direct tax purposes. It is important to note that the purpose and meaning of company law, IFRS and customs may differ from the purpose and meaning of direct tax law. The concepts of "associated enterprises" in these different areas of law may not necessarily apply to Art. 9 OECD Model. However, these concepts may provide clues how to interpret the concept of "associated enterprises" in Art. 9 OECD Model and may also form a source of inspiration for the interpretation of "associated enterprises" under Art. 9 OECD Model.

1.5. Scientific relevance

The scientific relevance of this study is twofold. Despite the increasing importance of transfer pricing and the fact that virtually all tax treaties are based on the arm's length principle, tax literature on the subject of the interpretation of "associated enterprises" is very scarce and does not provide a solution to the above-mentioned problems.[18] Therefore, in the first place, this study attempts to contribute to the academic discussion on this important concept of Art. 9 OECD Model.

[18] In 1987 De Hosson published an article on the concept of "associated enterprises", see De Hosson, F."Het begrip 'gelieerde ondernemingen' in het nationale en internationale recht", Weekblad Fiscaal Recht (1987), 5799 (1421). In 1999/2000 the International Transfer Pricing Journal published an article on the concept of associated enterprises. See Rotondaro, C., "The Notion of 'Associated Enterprises'; Treaty Issues and Domestic Interpretations – An Overview", 7 *International Transfer Pricing Journal* 1, (January/February, 2000); Hamaekers, H., "Introduction to Transfer Pricing", *Tax Treatment of Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), Chapter 5: Associated Enterprises. See also Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61, (Jönköping: Jönköping University, 2009) and Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997).

In the second place, the importance of a common interpretation of "associated enterprises" does not yet seem to have been recognised by the OECD. Despite the importance of the concept of "associated enterprises" for the application of Art. 9 OECD Model and the allocation of income, the OECD has not yet made a study with respect to the concept of "associated enterprises". The view of the European Commission illustrates the lack of interest in this topic. As stated in section 1.2, in 2001 the European Commission found the concept of "associated enterprises" of a more "theoretical importance" and thought that the problems caused by the notion of "associated enterprises" were limited. However, in 2010 this view changed as the EU acknowledged that the concept of "associated enterprises" delineates "the scope for the application of transfer pricing rules".

As the OECD has not yet made a study on the concept of "associated enterprises", an in-depth examination of this concept is justified. This study is in the centre of the important field of international tax law and may hopefully have an impact on science and practice.

1.6. Delimitations

The study is limited to the concept of associated enterprises for corporate tax purposes. Matters related to indirect taxes, such as Value Added Taxes (VAT), excise tax and withholding taxes on dividends, interest, royalties and their relief, are not covered. The Anti-Dumping Agreement is not analysed because of the limited scope and size of this study. The comparative research on domestic concepts of associated enterprises is limited to the United States, the United Kingdom, Germany, Sweden, India, the Netherlands, China and Brazil. An analysis of other countries would make the study too extensive.

The study is also limited to the analysis of the concept of associated enterprises in EU company law, customs, IFRS and CCCTB.

1.7. Outline of this thesis

In order to answer the research questions, this thesis and its underlying research is structured as follows:

Chapter 1 provides an introduction to the subject of the study. This chapter addresses the purposes of this study, the research questions and the methodology.

Chapter 2 provides an analysis of the arm's length principle. This chapter aims to analyse whether the arm's length principle provides clues as to how to interpret the concept of associated enterprises in the context of Art. 9 OECD Model. It describes the relationship between the concept of associated enterprises and the arm's length principle. The chapter provides an historical overview of the development of the arm's length principle since its introduction in the Reports of the League of Nations, focusing on the purposes of the arm's length principle at the time of its introduction in the League of Nations. This chapter discusses the development and legal background of the arm's length principle in the Reports and Models of the League of Nations and the OECD. Chapter 2 examines the definition of the arm's length principle, the relevant economic theories and the grounds for applying this principle. Chapter 2 also provides an analysis of Art. 9 (2) OECD Model; it examines the history of Art. 9 (2) OECD Model and the relationships between Art. 9 (2) OECD Model, the concept of associated enterprises and the arm's length principle. Chapter 2 also discusses the comments on the arm's length principle. Furthermore, this chapter briefly examines conceptual shortcomings of the arm's length principle. A fundamental understanding of the purposes of the arm's length principle and its development is crucial for the analysis of the concept of associated enterprises.

Chapter 3 provides an analysis of Art. 9 OECD Model (2010) and its Commentary. The first part of this chapter focuses in particular on the concept of associated enterprises of Art. 9 OECD Model. Analysing whether Art. 9 OECD Model provides a definition of "associated enterprises", the chapter discusses company law aspects that may be relevant for the criteria of "associated enterprises". Chapter 3 examines the term "enterprises" and the three criteria of Art. 9 OECD Model: participation in management, control and capital. Chapter 3 discusses relevant EU Company Law Directives and control concepts in company law. It analyses economic theories on the separation of shareholding and control. Furthermore, Chapter 3 discusses the minority and majority shareholders' position in the light of the application of Art. 9 OECD Model. Chapter 3 also analyses the control criterion with respect to joint ventures.

The second part of Chapter 3 provides an analysis of the concept of associated enterprises for financial accounting purposes. This part gives a brief historical analysis of international accounting standards (IAS) and the qualitative characteristics that make information provided in the financial statements useful to users. The chapter deals with main features of IAS 27 and its definition of "control" and "subsidiary". It also discusses IAS 24 concerning related party disclosures and the IASB Project on Consolidation, a project that aims to replace IAS 27 by a new IFRS that includes a control concept.
Finally, the characteristics of the IFRS concept of control are compared to those of the OECD concept of associated enterprises. I will use the findings of this analysis to investigate whether the concept of associated enterprises in IFRS is a source of inspiration for the interpretation of "associated enterprises" in Art. 9 OECD Model.
The analytical findings of Chapter 3 will be used for the final conclusions in Chapter 9.

Chapter 4 discusses the interpretation of tax treaties. Besides providing a brief analysis of the Vienna Convention on the Law of Treaties, this chapter discusses the legal status of the OECD Commentaries and Art. 3 (2) OECD Model. It analyses the expression "unless the context otherwise requires" in Art. 3 (2) OECD Model. The legal findings in this chapter are used to determine whether an autonomous interpretation of the concept of "associated enterprises" should apply or that reference should be made to the domestic concepts of countries.

Chapter 5 examines the historical development of Art. 9 OECD Model and its precursors. It analyses the introduction of its precursors in the Drafts of the League of Nations as from the early 1920s so as to find an *autonomous interpretation* of the concept of "associated enterprises".
This chapter provides the reasons for the introduction of the article on taxation of related companies in the early reports of the League of Nations. It also analyses the Commentaries on these reports. This chapter examines the views the Fiscal Committee held when introducing the precursor of Art. 9 in the League of Nations' Reports and Models, in particular with respect to the concept of "associated enterprises". The chapter provides an analysis of the criteria of associated enterprises in the League of Nations Draft Models and Reports. It also deals with the development of Art. 9 OECD Model after 1946 and discusses the various criteria of associated enterprises provided in the OECD Draft Convention of 1963 and the later Models. Chapter 5 also deals

with various OECD reports after 1976 which are relevant for the interpretation of the concept of "associated enterprises".

Chapter 6 discusses the different concepts of associated enterprises in the United Kingdom, the United States, Germany, Sweden, India, the Netherlands, Sweden, China and Brazil. The purpose of this chapter is to analyse whether these domestic interpretations may provide clues for an appropriate OECD interpretation of the concept of "associated enterprises". Moreover, Chapter 6 provides an historical analysis of the concept of associated enterprises in the United Kingdom and the United States, as these two countries have played a prominent role in the development of the first Models and Draft Conventions of the League of Nations and the OECD.

Chapter 7 examines the concept of related persons for customs purposes and compares this concept with the concept of associated enterprises for direct tax purposes. Chapter 7 discusses whether the differences between these two concepts of association are fundamental obstacles to a possible convergence between valuation for transfer pricing and valuation for customs. This chapter provides a brief historical analysis of the World Customs Organization and an analysis of the objectives and principles of customs valuation. The chapter analyses Art. 15 of the Customs Valuation Agreement and the criteria for association in the context of customs. Differences and similarities between the both concepts will be discussed.

Chapter 8 deals with the concept of associated enterprises under the CCCTB. It provides briefly the reasons for the introduction of the CCCTB and analyses the development of the CCCTB and its "group" and "associated enterprises" definition. The chapter compares the CCCTB concept of associated enterprises with the concept of associated enterprises under Art. 9 OECD Model.

Chapter 9 draws final conclusions on the basis of the analyses and discussions in the above chapters. It summarises problems that may arise when the concept of associated enterprises is incorrectly interpreted because of unclear elements. Finally, in order to avoid incorrect application and interpretation of the arm's length principle, a distinction between the arm's length principle and anti-avoidance measures is made and a definition of "associated enterprises" both for OECD Model Convention and domestic tax law purposes is given.

Chapter 2: The arm's length principle

2.1. Introduction

One of the main questions of this thesis is whether the currently applied interpretations of the notion of "associated enterprises" by Member countries are in conformity with the general principle of Art. 9 OECD Model, which is the arm's length principle.
In this chapter I will take the opportunity to explore this fundamental principle of Art. 9 OECD Model. First, this chapter provides an analysis of the arm's length principle. It provides the definition of "arm's length principle" and gives a brief analysis of the economic model underlying the arm's length principle. Then this chapter discusses the basic reasons for the application of the arm's length principle and the main purposes of this principle. It continues with an analysis of the specific elements of the arm's length principle under Art. 9 OECD Model in section 2.3.3 and provides an analysis of formulary apportionment, an alternative to the arm's length principle, in section 2.3.4.
Section 2.4 gives an in-depth analysis of the historical development of the arm's length principle in the Drafts and Model Conventions of the League of Nations and the OECD. The findings in this part are used for further analyses regarding the interpretation of the concept of "associated enterprises".

The arm's length principle is introduced after the introduction of the separate accounts principle in order to provide a principle of tax equality and neutrality. To understand why the arm's length principle was introduced in the early 1920s and 1930s, it is necessary that this chapter describes the development of the separate accounts principle. It is important to understand that during these years permanent establishments included both branches and subsidiaries. In the light of the aforesaid, I will therefore also briefly analyse the introduction of the article regarding the taxation of permanent establishments.
Section 2.4.2 deals with the period as from the Second World War until the 1970s. It is in this period that a general consensus was developed on the application of the arm's length principle. In this period the Fiscal Committee of the OECD considered the separate accounts principle and the arm's length principle, as introduced by the League of Nations, to be principles underlying the allocation of income to permanent establishments and associated enterprises. The Fiscal Committee readopted them and tried to formulate the principles as clearly as possible on a basis which would be acceptable to all

Member countries. This part also provides an analysis of Art. 9 (2) OECD Model; it examines the history of Art. 9 (2) OECD Model and the relationship between Art. 9 (2) OECD Model and the purposes of the arm's length principle.
Section 2.4.3 researches the ongoing process of making the arm's length principle the worldwide standard, from the early 1970s until today. This section discusses also the OECD TP Guidelines.
Section 2.5 discusses the comments on and disadvantages of the arm's length principle. Conclusions are drawn in section 2.6.

2.2. Definition of the arm's length principle

The authoritative statement of the arm's length principle is set forth in paragraph 1 of Art. 9 OECD Model, which forms the basis of virtually all bilateral tax treaties involving OECD Member countries and non-Member countries. Art. 9 OECD Model and the glossary of the OECD TP Guidelines provide the following description of the arm's length principle:

"(When) conditions are made or imposed between the 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."[19]

An arm's length transaction may be defined as "a transaction negotiated by unrelated parties, each party acting in his or her own self-interest", or "the basis for a fair market value determination" or "a transaction in good faith in the ordinary course of business by parties with independent interests".[20]

Art. 9 OECD Model provides that the tax authorities of a State may, for the purpose of calculating tax liabilities of associated enterprises, re-write the accounts of the enterprises, if, as a result of the special relations between the enterprises, the accounts do not show the true taxable profits arising in that

[19] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), Glossary.
[20] Maisto, G., "Transfer pricing in the Absence of Comparable Market Prices", *Cahiers de droit fiscal international*, LXXXVII (1992), p. 28.

State. This provision applies *only* if special conditions have been made or imposed between the two enterprises. No re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms. The Commentary on Art. 9 OECD Model explains the phrase "on normal open market commercial terms" as *on an arm's length basis*:[21]

"[...] No rewriting of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's length basis)."

Associated enterprises may have a considerable amount of autonomy within the group. They may be allowed to bargain with each other as though they were independent enterprises. From a managerial point of view, MNEs have an incentive to use arm's length prices to be able to judge the real performance of their different profit centres. Therefore, tax authorities should not automatically assume that associated enterprises have sought to manipulate their profits. The OECD TP Guidelines state that there may be a genuine difficulty in accurately determining a market price in the absence of market forces when adopting a particular commercial strategy.[22]
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. Enterprises respond to economic situations arising from market conditions in their relations with both third parties and associated enterprises.[23] For example, managers of a unit of an MNE may seek to establish good profit records for their own unit, regardless whether they buy products or services at independent companies or at other units of the MNE.
More importantly, 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.[24] This is confirmed by the OECD in the OECD TP Guidelines. One of the main questions is then whether the arm's length principle, as incorporated in Art. 9 OECD Model, is

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[21] OECD, *Commentary on the OECD Model Tax Convention on Income and Capital* (Paris: OECD, 2010), Art. 9 (1).
[22] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.2.
[23] Ibid.
[24] Ibid.

an anti-tax avoidance and anti-evasion measure (this view is held by the United States) or a general principle of taxation (thus, not an anti-tax avoidance measure). This will be discussed in the next sections of this chapter and conclusions will be drawn in Chapter 9.

2.3. The arm's length principle

2.3.1. Economic theories

As already stated by Coase in 1937, the existence of MNEs can be explained by the concept of economies of integration. This means that associated enterprises benefit from higher overall profits than comparable independent enterprises.[25] In most of the economic literature, the MNE is modelled as an integrated business.[26] The goal of the MNE is to maximise profits for the enterprise as a whole. The existence of MNEs can be explained by the OLI paradigm. Multinational enterprises are the most successful form of business organisation because of their ownership, locational and internalisation (OLI) advantages.[27]

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[25] Coase, R., "The Nature of the Firm", 4 *Economica* (1937).

[26] See Batra, R. and Hadar, J., *Theory of the Multinational Firm: Fixed versus Floating Exchange Rates*, Oxford Economic Papers, Vol. 31 (Oxford: Oxford University Press, 1979), pp. 258-269; Besanko, D. and Sibley, D., "Compensation and Transfer Pricing in a Principal-Agent Model", 32 *International Economic Review* 1 (1991), pp. 55-68; Bond, E., "Optimal Transfer Pricing when Tax Rates Differ", *Southern Economic Journal* 47 (1980), pp. 191-200; Chalos, P. and Haka, S., "Transfer Pricing under Bilateral Bargaining", 65 *Accounting Review* (1990), pp. 624-641; Copithorne, L., "International Corporate Transfer Prices and Government Policy", 4 *Canadian Journal of Economics* (August 1971), pp. 324-341; Das, S., "Multinational Enterprise under Uncertainty", 16 *Canadian Journal of Economics* (1983), pp. 420-428; Diewert, E., "Transfer Pricing and Economic Efficiency", in: Eden, L. and Rugman, A. (eds), *Multinationals and Transfer Pricing* (Kent: Croom Helm Ltd., 1985), pp. 47-81; Eden, L., *Transfer Pricing and Corporate Income Taxation in North America* (Toronto: University of Toronto Press, 1998); Gould, J.R., "Internal Pricing in Firms when There are Costs of Using an Outside Market", 37 *Journal of Business* (1964), pp. 61-67; Grace, M. and Berg, S., "Multinational Enterprises, Tax Policy and R&D Expenses", 57 *Southern Economic Journal* (1990), pp.125-138.; Horst, T., "Theory of the Multinational Firm: Optimal Behaviour under Differing Tariff and Tax Rates", 79 *Journal of Political Economy* (October 1971), pp. 1059-1072; Horst, T., "The Simple Analytics of Multinational Firm Behaviour", in: Connolly, M. and Swoboda, A., *International Trade and Money* (London: Allen and Unwin, 1973), pp. 72-84.

[27] See Caves, R.E., *Multinational Enterprise and Economic Analysis*, 2nd ed. (Cambridge: Cambridge University Press, 1996).

The OLI paradigm explains why these three types of advantages cause the success of an MNE. The first advantage deals with ownership. The MNE owns firm-specific advantages, such as technology, monopolistic advantages and economies of scale. This advantage explains why a firm goes abroad. These firm-specific advantages result in a higher marginal return or lower marginal costs than its competitors. Vertical integration may be considered to be a response to the market imperfection of transaction costs, such as transaction costs of seeking a trading partner or negotiating.

The second advantage is the country-specific advantage. This includes economic advantages, such as the economic advantages of size, social and cultural advantages and political advantages. This advantage explains where the MNE decides to operate. The internalisation advantage refers to the existence of a special know-how or core skill that is an asset that can generate economic rents for the firm. This advantage explains how the MNE will penetrate the market.[28]

An MNE simultaneously combines these three advantages to design its operations and structure in order to maximise its market share and profits.

The OLI paradigm predicts that an MNE will internalise markets in order to reduce natural market imperfections. However, such internalisation creates market failures. As noted by Dunning and Eden, internalisation has both an efficiency-enhancing effect because natural market failures are reduced, and an efficiency-reducing impact because structural imperfections are increased. The MNE creates structural market failures as it exploits its monopoly power in domestic and international markets.[29] MNEs are "powerful, non-state actors in the global economy" who have the ability to move assets and income. States fear that MNEs can and will abuse their relative bargaining power in ways that benefit the MNEs at the expense of host-countries citizens, businesses and governments.[30] Because of its international oligopolistic nature, the MNE causes endogenous market imperfections. For example, as described by Eden,

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[28] Eden, L., *Transfer Pricing and Corporate Income Taxation in North America* (Toronto: University of Toronto Press, 1998), p. 135. Dunning, J.H., "Governments and Multinational Enterprises: From Confrontation to Cooperation?", 20 *Millenium: Journal of International Studies* 2 (1991), pp. 225-244.

[29] Eden, L., *Transfer Pricing and Corporate Income Taxation in North America* (Toronto: University of Toronto Press, 1998), p. 135.

[30] Eden, L., *Transfer Pricing and Corporate Income Taxation in North America* (Toronto: University of Toronto Press, 1998), p. 133. See also Hymer, S., "The Efficiency Contradictions of Multinational Corporations", 60 *American Economic Review* (1970), pp. 441-448; Murray, R. (ed.), *Multinationals beyond the Market: Intra-Firm Trade and the Control of Transfer Pricing* (New York: 1981).

MNEs can raise global profits by segmenting domestic markets and price discriminating, erecting entry barriers to limit competition from domestic firms and restricting the decision-making and research activities of its subsidiaries by centralisation within the parent firm, using transfer pricing to shift rents out of host countries.[31] Furthermore, specific government regulations, such as tariffs, taxes and other additional costs for firms reduce profits. From the MNEs point of view, these are "exogenous factors distorting international markets".[32] Independent enterprises with cross-border transactions must pay these government regulations such as taxes. An MNE can, through transfer pricing, at least partly arbitrage these exogenous market imperfections.[33]

For both horizontally integrated MNEs as well as vertically integrated MNEs an efficient pricing policy should be based on opportunity cost. Opportunity cost represents the value of a resource in its next-best alternative use. A normal profit return is included in opportunity cost since the entrepreneur must receive a return sufficient to compensate for his or her investment and risk taking in the business. As explained by Eden, "the efficient transfer price, therefore, in the absence of government regulation, is the shadow price on intrafirm transfers."[34]

One of the microeconomic models of how a horizontally or vertically integrated MNE sets its efficient transfer price is according to the Hirshleifer rule. Hirshleifer proved that if an exact comparable uncontrolled price (CUP) existed in the open market, an MNE should use it as long as there are no interdependencies between the divisions.[35] As also illustrated by Eden, where an exact comparable uncontrolled price (CUP) exists in the external market, and there are no interdependencies within the MNE, the Hirshleifer rule implies that the MNE will select that price as the efficient transfer price. If the costs or demands of the affiliates are interdependent, then the external price either does not exist or cannot be used without modification.

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[31] Eden, L. and Rugman, A. (eds), *Multinationals and Transfer Pricing* (Kent: Croom Helm Ltd., 1985), Chapter 1.

[32] Eden, L., *Transfer Pricing and Corporate Income Taxation in North America* (Toronto: University of Toronto Press, 1998), p. 133.

[33] Ibid., p. 134.

[34] Ibid., p. 277.

[35] See also Hirshleifer, J., "On the Economics of Transfer Pricing", 29 *Journal of* Business (1956), pp. 172-183.

Eden developed a general microeconomic theory of transfer pricing behaviour by MNEs in response to taxes and trade barriers. She showed that a profit-maximising MNE will attempt to arbitrage the imperfections in product and factor markets induced by government regulations. Eden mentions tariffs, profit and corporate income taxes and minority shareholder requirements as examples of these government regulations.

2.3.2. Broad parity of tax treatment

The arm's length principle stems from the approach of treating –for tax purposes- permanent establishments and their head offices as operating as separate entities rather than as inseparable parts of a single unified business. This approach is the separate entity approach. Members of an MNE group are generally separate tax subjects, being legal entities themselves.
The arm's length principle and the separate entity approach are the underlying principles of Arts. 7 and 9 OECD Model.[36] These international taxation principles have been chosen by the OECD as serving the dual objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation. For tax treaties, each company is a separate taxable entity regardless of who owns its shares. The provisions of Art. 9 OECD Model confirm that a country may adjust the profits of associated enterprises in the event of non-arm's length transfer pricing. Paragraph 2 of Art. 9 OECD Model provides for relief of the double taxation through a corresponding adjustment of the profit of the related company in the other country.

The OECD has continuously worked to build a consensus on international taxation principles, thereby avoiding unilateral responses to multilateral problems. The above-mentioned international taxation principles concerning the taxation of multinational enterprises are incorporated in the OECD Model, which forms the basis of the extensive network of bilateral income tax treaties between OECD Member countries and between OECD Member and non-

[36] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.1 and Art. 9 OECD Model: "*and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent 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.*"

Member countries. These principles are also incorporated in the Model United Nations Double Taxation Convention between Developed and Developing Countries.

The basic reason for the application of the arm's length principle is that when independent enterprises deal with each other, the conditions of their commercial and financial relations are usually established by open market forces.[37] However, 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 as independent parties might be because of the existence of internal relationships. When transfer prices do not reflect market prices, the tax liabilities of the associated enterprises and the tax base of the countries concerned could be distorted.[38] From Art. 9 OECD Model it follows that associated enterprises are required to apply the arm's length principle when dealing with each other. The effects and distortions of their special commercial and financial conditions on the levels of profits should be eliminated.[39] If controlled transactions do not reflect arm's length terms and conditions, the tax authorities of the relevant country may adjust the transfer prices to arm's length prices and tax accordingly.

Already in 1992 Hamaekers argued that the arm's length principle is based on the neutrality principle:

"A tax system which embraces the neutrality principle is one that does not influence taxpayer's decisions or choices: in other words, a system that makes the tax burden independent of choices made or actions taken by the taxpayer. Taxpayers with a controlling interest in a company are placed in the same position as other taxpayers through the application of the arm's length principle which neutralizes the advantage of the former."[40]

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[37] See also Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61, (Jönköping: Jönköping University, 2009) p. 119; see also OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.2.

[38] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.3.

[39] Ibid., para. 1.6.

[40] Hamaekers, H., "The Arm's Length Principle and the Role of Comparables", 12 *Bulletin of International Fiscal Documentation* (1992), p. 602.

In the OECD TP Guidelines 1995 reference is made to a basis for the arm's length principle:

"A major reason is that the arm's length principle 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 purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity."[41]

The arm's length principle seeks to avoid a distortion of the relative competitive positions between associated and independent enterprises, and therefore promotes international trade and investment.[42] In this context, the arm's length principle itself can be considered a general principle of taxation. The arm's length principle contains features which are based on general principles of tax law recognised in most industrialised countries.

Eden states the following:

"A neutral tax system for business income would leave business decisions unaffected by the tax. This means that governments should levy taxes in a manner that does not affect the taxpayer's choice of corporate form, location of the tax base, debt-equity level, choice of pricing policy, and so on, within domestic borders."[43]

Eden describes that equity or fairness in taxation has several dimensions. According to this author, fairness means that two taxpayers in similar economic circumstances should pay the same tax (known as horizontal equity), and that

[41] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.7.

[42] Ibid., para. 1.3

[43] Eden, L., *Transfer Pricing and Corporate Income Taxation in North America* (Toronto: University of Toronto Press, 1998), p. 74. Eden points out the difference between the principle of tax neutrality and the principle of economic efficiency:

"A neutral tax system means that tax does not affect private decisions, whether or not these decisions are efficient. The principle of economic efficiency, on the other hand, requires intervention by the government so as to ensure that private decisions equate market price with marginal social cost. Tax neutrality, therefore, is a weaker condition than economic efficiency. It implies a less interventionist government, one that desires only to avoid distorting private decisions and does not correct for private inefficiencies."

vertical equity, the appropriate treatment of unequal persons or things, should also be addressed by the tax.

This also serves one of the main purposes of the OECD:

"In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment."[44]

The choice to use an associated enterprise as preferred entity should be driven by economic decisions or economic theories and not by tax considerations. The arm's length principle provides a concept that treats all the transactions neutrally. It applies the open market as a benchmark:

"This [...] reflects the economic realities of the controlled taxpayers particular facts and circumstances and adopts as a benchmark the normal operation of the market."[45]

Despite the aforesaid, the arm's length principle is not always recognised as a general principle of international tax law in Europe. For instance, in his opinion in case C-524/04 (EC Court of Justice, *Test Claimants in the Thin Cap Group Litigation v Comissioners of Inland Revenue,* 13 March 2007), the Advocate General states in paragraph 66:

"It seems to me that the arm's length principle, *accepted by international tax law as the appropriate means of avoiding artificial manipulations of cross-border transactions,* is in principle a valid starting point for assessing whether a transaction is abusive or not."[46] *(Italics, RD)*

From the above it seems that the Advocate General considers the arm's length principle not to be a general principle of international tax law, but as the "appropriate means of avoiding artificial manipulations".
However, the OECD states in the OECD TP Guidelines that the consideration of transfer pricing should not be confused with the consideration of problems

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[44] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.8.
[45] Ibid., para. 1.14.
[46] EC Court of Justice, 13 March 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v Comissioners of Inland Revenue* (Thin Cap GLO) with opinion of A-G Geelhoed.

of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes:[47]

"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."

In the above case, the EC Court of Justice was of the opinion that the arm's length principle constitutes an appropriate test by which to distinguish artificial arrangements from genuine economic transactions.[48]
In case C-311/08 (EC Court of Justice, *Société de Gestion Industrielle SA v Belgium*, 21 January 2010), the Belgian Government disregarded the arm's length principle as a general principle of international taxation:[49]

"58. The Belgian Government states that the legislation at issue in the main proceedings *seeks to combat tax avoidance* by making it possible to adjust, for taxation purposes, situations in which the companies concerned apply conditions to their relationships which go beyond what would have been agreed under fully competitive conditions. At the hearing, the Belgian Government stated that the system in question was *based on Article 9* of the model tax convention on income and on capital drawn up by the Organisation for Economic Cooperation and Development (OECD) and Article 4 of the Arbitration Convention, which provide for similar adjustments to profits when transactions between associated companies are inconsistent with the arm's length principle." *(Italics, RD)*

The Court did not ignore the anti-avoidance and/or anti-evasion potential of the Belgian rules and justified these in paragraph 71:

"71. National legislation which provides for a consideration of objective and verifiable elements in order to determine whether a transaction represents an artificial arrangement, entered into for tax reasons, is to be regarded as not going beyond what is necessary to attain the objectives relating to the need to

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[47] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.2.
[48] EC Court of Justice, 13 March 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v Comissioners of Inland Revenue* (Thin Cap GLO), para. 81.
[49] EC Court of Justice, 21 January 2010, Case C-311/08, *Société de Gestion Industrielle SA v Belgium* (SGI), para. 58.

maintain the balanced allocation of the power to tax between the Member States and to prevent tax avoidance where, first, on each occasion on which there is a suspicion that a transaction goes beyond what the companies concerned would have agreed under fully competitive conditions [...]".

The following sections will also show that the arm's length principle is a general principle of tax law and not an anti-tax avoidance or anti-tax evasion measure.

2.3.3. The arm's length principle and Art. 9 OECD Model

As mentioned above, one of the main purposes of the arm's length principle is to place associated enterprises and independent enterprises on a more equal footing for tax purposes.[50] The arm's length principle seeks to remove the effect of any association or relationship on the determination of transfer prices. It does so by relying on comparables of independent enterprises to determine transfer prices or profit returns of controlled transactions.[51]
Therefore, attention is focused on the nature of the dealings between those members, and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions.[52]
In the revised Chapters I-III of the OECD TP Guidelines, it is stated that such an analysis of the controlled and uncontrolled transactions, the comparability analysis, is "at the heart of the application of the arm's length principle".[53] This comparability aspect of the arm's length principle is set forth in paragraph 1 of Art. 9 OECD Model:

ASSOCIATED ENTERPRISES
Paragraph 1:
[...] and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises [...]"

[50] Ibid., para. 1.6.
[51] Ibid., para. 1.7.
[52] Ibid., para. 1.6.
[53] Ibid., para. 1.6.

Controlled transactions are the transactions between associated enterprises and uncontrolled transactions are transactions between independent enterprises. Paragraph 1 of Art. 9 OECD Model introduces the need for:

- a comparison between conditions made or imposed between associated enterprises and those which would be made between independent enterprises, in order to determine whether a re-writing of the accounts of associated enterprises is authorised under Art. 9 OECD Model, and
- a determination of the profits which would have accrued at arm's length, in order to determine the quantum of any re-writing of accounts.[54]

When independent enterprises deal with each other, the conditions of their commercial and financial relations are ordinarily determined by market forces. Although associated enterprises often seek to replicate the dynamics of market forces in their dealings with each other, the commercial and financial relations between associated enterprises may not be directly affected by external market forces, as is the case with independent enterprises.[55] When transfer prices do not reflect the market forces and the arm's length principle, the tax liabilities of the associated enterprises and the tax revenues of the host countries could be distorted.[56]
Therefore, OECD Member countries and non-OECD Member countries have agreed that for tax purposes, the profits of associated enterprises may be adjusted as necessary to correct any such distortions and thereby ensure that the arm's length principle is satisfied.[57] The appropriate adjustment is achieved by establishing the conditions of the commercial and financial relations that

[54] Ibid., para. 1.6.
[55] Ibid., para. 1.2.
[56] Ibid., para. 1.3. However, factors other than tax considerations may distort the conditions of commercial and financial relations established between associated enterprises. The OECD TP Guidelines give as examples enterprises which may be subject to conflicting governmental pressures relating to customs valuations, anti-dumping duties, and exchange or price controls. In addition, cash-flow requirements of enterprises within an MNE group may cause distortions of transfer prices. An MNE group that is publicly held may feel pressure from shareholders to show high profitability at the parent company level, particularly if shareholder reporting is not undertaken on consolidated basis. See also OECD TP Guidelines para. 1.4.
[57] Ibid., para. 1.3.

would have been expected between independent enterprises in similar transactions under similar circumstances.

Art. 9 (1) OECD Model provides that the tax authorities of a Contracting State may, for the purpose of calculating tax liabilities of associated enterprises, rewrite the accounts of the enterprises if, as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that State.
In its Commentary the OECD states that no rewriting of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on an arm's length basis, and thus on normal open market conditions.[58]

The first paragraph of Art. 9 OECD Model contains two criteria. The first criterion is the existence of associated enterprises and the second is the application of the arm's length principle. The concept of associated enterprises is included in the following phrase of Art. 9 OECD Model:

"Where
a. An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
b. the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State"

The authoritative statement of the arm's length principle is set forth in the next phrase:

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

[58] OECD, *Commentary on the OECD Model Tax Convention on Income and Capital* (Paris: OECD, 2010), Art. 9 (1) para.2.

The *combination* of those two concepts is essential for the application of Art. 9 OECD Model. The application of the arm's length principle and the concept of associated enterprise suggest a two-step analysis. This can be concluded from the use of the word "and" in paragraph 1.[59] Tax authorities of a Contracting State are only allowed to adjust the income of an enterprise if special conditions in the commercial or financial relationship have been applied or imposed between two *associated* enterprises. The adjustment of the income of associated enterprises is not authorised if transactions between associated enterprises have taken place under normal open market commercial terms.[60] From this two-step analysis it may be concluded that the concept of associated enterprises indicates the boundaries of the application of the arm's length principle.

In Chapter 3 I will discuss the elements of "associated enterprises" given in Art. 9 OECD Model: "participation in management", "participation in control" and "participation in capital". In this chapter I will provide a basic analysis of the other conditions of Art. 9 OECD Model.

One of the main elements of the arm's length principle is comparison. The application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions of transactions between independent enterprises.[61] In cases where 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 a profit adjustment may be made. *Only* when the conditions of the transactions between associated enterprises would differ from those that would be made between enterprises independent of each other, only then will the arm's length principle justify an adjustment.

In order to put associated enterprises on the same footing for tax purposes as independent enterprises, it is necessary to analyse whether the conditions of the transactions between associated enterprises differ from those that would be made between independent enterprises. Therefore, the comparison of conditions is at the heart of the arm's length principle. In order for such

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[59] See the wording of Art. 9 (1) OECD Model: "[...] Contracting State, *and* in either case conditions are made [...]".

[60] OECD, *Commentary on the OECD Model Tax Convention on Income and Capital* (Paris: OECD, 2010), Art. 9.

[61] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), Chapter I.

comparisons to be useful, the economically relevant characteristics of the situations compared must be identified. To be comparable entails that none of the differences, if any, between the situations being compared could materially affect the condition being examined in the methodology, or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. This follows from the OECD TP Guidelines paragraph 1.33. The OECD TP Guidelines provide guidance regarding the comparability analysis.

As indicated before, for the application of the arm's length principle in Art. 9 OECD Model the following conditions should be met:

- Conditions are made or imposed
- Between two associated enterprises
- In their commercial or financial relations
- These conditions differ from those which would be made between *independent* enterprises

According to Vogel, the term "conditions" comprises in particular the agreements governing the valuation elements. Conditions *made* are those that come into being as a result of either enterprise exercising its own free will, or both of them exercising their own free will. This also includes mutually agreed practices.[62] The term "conditions" should be given a wide interpretation. The OECD TP Guidelines explain the term conditions as " (e.g. the price of goods transferred or services provided and the conditions of the transfer or provision)".[63] It particularly comprises the agreements governing the valuation elements and the actual pricing or valuation of goods, services, etc. under the transaction. According to Schaumberg and Vogel, conditions that are *imposed* are those that result from the influence that stems from company law and that is exercised by a person or persons participating in both enterprises, as envisaged in Art. 9 (1) (b) OECD Model. According to these authors, this also includes conditions that are adopted by following concern guidelines.[64]

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[62] Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 527.

[63] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.2.

[64] See also Schaumburg, H. in: Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation*

The expression "in either case" in Art. 9 OECD Model refers to the requirement of association to be the cause of conditions differing from the arm's length conditions. This can also be concluded from the words "[...] as a result of the special relationship [...]" in the Commentary on Art. 9 OECD Model.[65] The arm's length principle requires causality between the existence of associated enterprises and a deviation from the arm's length price.

In this context, Vogel states:

"Participation in management, control, or capital must be the *cause* of the conditions made or imposed. Actually, no more than a hint of this requirement is to be found in the wording of Art. 9 (1) ('and in either case'), but it is only where it is the cause of conditions differing from those that are normal that participation can be justified as a reason for rewriting accounts. [...] As a rule, causality should be assumed to exist where there is an association under company law and at the same time a deviation from the arm's length price."[66]

The evaluation of the conditions of a transaction is essential for the application of the arm's length principle. When evaluating the terms of a potential transaction, independent enterprises will compare the transaction to the other options realistically available to them. They will only enter into the transaction if they do not see an alternative that is clearly more attractive.[67] When making the comparisons entailed by the application of the arm's length principle, tax administrations should also take these differences into account when establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability.[68] Independent enterprises consider the options available to them and when comparing those options they consider any differences between the options that would significantly affect their value.

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of Income and Capital. With Particular Reference to German Tax Treaty Practice, 3rd ed. (London: Kluwer Law International, 1997), p. 527.

[65] See OECD, *Commentary on the OECD Model Tax Convention on Income and Capital*, (Paris: OECD, 2010), Art. 9 (1).

[66] See also Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 527.

[67] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.34.

[68] Ibid.

It is difficult to draw a line between commercial relations and financial relations. Financial relations are primarily relationships that exist between associated enterprises and evolve from company law. They extend to cover situations like the payment of constructive dividends and concealed equity contributions.[69] Commercial relations exist between enterprises if they deal with one another as participants in a competitive economy. The relations must be cross-border.[70] Relations between a domestic company and its related enterprise in the same State do not fall within the scope of the treaty provisions as Art. 9 OECD Model only concerns situations of two Contracting States.

2.3.4. The arm's length principle versus global formulary apportionment

An alternative to transfer pricing applying the arm's length principle is what is known as the formulary apportionment approach. This system takes the consolidated income of the associated entities within a group, or of associated enterprises within one jurisdiction, as a basis.[71] Then, specific factors are

[69] See also Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 526.

[70] It should be noted that after Case C-324/00 (*Lankhorst-Hohorst*), where German legislation on thin capitalisation was regarded as being in breach of the EU law, even though it included an arm's length escape clause, EU Member States considered their transfer pricing legislation also applicable to domestic relationships. According to the European Court of Justice, domestic legislation on thin capitalisation constitutes a restriction on the right of establishment if it only applies to cross-border transactions. Wittendorff analyses this case and states that such legislation can be justified by the need to ensure the balanced allocation of taxing rights and to combat tax avoidance taken together. "The arm's length principle is considered to be an objective rule that is suitable for determining whether a transaction is wholly or partly a purely artificial arrangement which does not reflect economic reality (objective test). If the arm's length principle is not observed, the domestic legislation must provide an opportunity for the taxpayer to show evidence of a commercial justification for the transaction (subjective test). Thus, the arm's length principle does not in itself justify either discrimination or a restriction." See Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Series on International Taxation, Vol. 35, (The Netherlands: Kluwer Law International, 2010) p. 270.

[71] Hamaekers, H., "Introduction to Transfer Pricing", *Tax Treatment of Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), Chapter 4: Other approaches for Apportioning Taxable Income to Associated Enterprises.

selected (generally the joint sales, the joint value of assets and the joint payroll). A certain weight may be given to the individual factors. Those factors are added up. Next, the same factors are taken for the entity of which the taxable income must be calculated. The resulting fraction is applied to the consolidated income, producing the taxable income of the entity concerned.
In federal countries, such as Canada and the United States, formulary apportionment is used to apportion taxable income of associated enterprises among the members of the federation for provincial, cantonal and state tax purposes.[72]
For example, California applies formulary apportionment on a worldwide basis, rather than only within the United States ("unitary taxation"). This US state levies a corporate franchise tax, using worldwide combined reporting as a basis for taxing foreign MNEs active in that state.
In the literature, authors reject unitary taxation because it is unconstitutional, it taxes profits not earned in that state and it results in double taxation. The OECD rejects worldwide ("global") formulary apportionment as an alternative to arm's length pricing.[73] However, several scholars have argued to use the formulary apportionment approach.[74] They are also supported by the European Commission's proposal for the use of formulary apportionment as a means of dividing the consolidated corporate tax base for companies' EU-wide activities among the Member States (CCCTB).[75]

However, the revised Chapters I-III of the 2010 OECD TP Guidelines reaffirm the arm's length principle's status as the international standard. The arm's length principle provides the closest approximation of the workings of the open market in cases where goods and services are transferred between associated enterprises. According to the OECD, the arm's length principle generally produces appropriate levels of income between members of MNE groups, acceptable to tax administrations.[76]

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[72] Ibid.

[73] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.32.

[74] Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* 7 (17 February 1986), pp. 625-681; Hellerstein, W., "Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment", 12 *International Transfer Pricing Journal* (May/June 2005); Bird, R., "Shaping a New International Tax Order", 42 *Bulletin for International Fiscal Documentation* 7 (1988).

[75] See Chapter 8 for an analysis of the CCCTB.

[76] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.14.

Although the arm's length principle has been found to work effectively in the vast majority of cases, the arm's length principle has both conceptual and practical disadvantages. In the literature, authors are of the opinion that only when the arm's length principle is understood and applied in a uniform manner at an international level, and there is a mutual administrative assistance, will it be possible to reduce the diverse conflicts on double taxation significantly.[77] On the other hand, several authors point out the shortcomings of the arm's length principle. There are many cases in which the arm's length principle is difficult and complicated to apply, for example in cases where there is no comparable transaction to be found, or in MNE groups dealing in the integrated production of highly specialised goods or in unique intangibles. Francescucci concludes that three problems result from the conceptual shortcomings: the lack of an arm's length benchmark problem, the functional adjustment problem and the continuum price problem.[78]
Also, the arm's length principle is viewed by some authors as inherently flawed, because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses.[79]

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[77] Rosenbloom, H.D., "Arbitrage and Transfer Pricing", *2000 World Tax Conference Report* (Toronto: CTF, 2000), p. 35; Calderon, J., "The OECD Transfer Pricing Guidelines as a Source of Tax Law: Is Globalization Reaching the Tax Law", 35 *Intertax* (2007).

[78] Francescucci, D.L.P., "The Arm's Length Principle and Group Dynamics", 11 *International Transfer Pricing Journal* 2/6 (2004). According to Francescucci, as a primary solution, a correct interpretation of the arm's length principle (and the comparability analysis it relies upon) requires a group dynamics adjustment so as to consider all the economically relevant characteristics of the controlled transaction. Should this solution prove impracticable or inadequate given the circumstances of the case, the use of a residual profit split method should mitigate several conceptual shortcomings, but may still fall short of properly allocating the MNE efficiency premium or network profit among the core segments of the integrated MNE. Francescucci describes also a composite approach which relies on the distinction between core and satellite segments of an integrated MNE. This approach mandates the application of one-sided transfer pricing methods to transactions between the latter segments, and the use of a multilateral residual profit split method for the transaction between core segments of the integrated MNE. According to Francescucci, the main attractiveness of the use of the multilateral residual profit split method, in addition to the fact that it greatly mitigates the conceptual shortcomings of the arm's length principle, is that it is arguably already contemplated by the arm's length principle.

[79] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para.1.10. See also Hellerstein, W., "Income Allocation in the 21st Century: The End of Transfer Pricing? The Case for Formulary Apportionment", 12 *International Transfer Pricing Journal* (May/June 2005); Owens, J., "Income Allocation in the 21st Century: The End of Transfer Pricing? Should the Arm's Length Principle Retire",

Another practical difficulty in applying the arm's length principle, is that associated enterprises may engage in transactions that independent enterprises would not undertake. Members of an MNE may face different commercial circumstances than independent enterprises would. Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there are hardly any direct indications or little or no evidence of what conditions would have been established by independent enterprises.[80]
Another disadvantage is that the arm's length principle may result in a heavy administrative burden for both the taxpayer and the tax administration, because of the requirement to evaluate significant numbers and types of cross-border transactions. Transfer pricing regulations constantly require taxpayers to comply with the requirements of producing contemporaneous documentation, supporting the determination of arm's length prices. Tax administrations also have to engage in this verification process perhaps some years after the transactions have taken place, resulting in a high administrative burden for both the tax authorities and the taxpayers.
Both tax administrations and taxpayers often have problems in obtaining adequate information to apply the arm's length principle. The arm's length principle may demand a substantial amount of data in order to verify whether transactions are at arm's length. Therefore, the OECD confirms that "transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayers".[81] In section 2.5 I will continue to analyse the criticism on the arm's length principle more in-depth.

Despite the disadvantages of the arm's length principle, the OECD maintains the arm's length principle as the international consensus. The arm's length principle is sound in theory since "it provides the closest approximation of the workings of the open market in cases where property (such as goods, other types of tangible assets, or intangible assets) is transferred or services are rendered between associated enterprises".[82]

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12 *International Transfer Pricing Journal* (May/June 2005); Hamaekers, H., "Income Allocation in the 21st Century: The End of Transfer Pricing? Introductory Speech" 12 *International Transfer Pricing Journal* (May/June 2005).

[80] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.11.

[81] Ibid., para. 1.13.

[82] Ibid., para. 1.14.

In this context, I must make a comment on the following remark which the OECD has made in the OECD TP Guidelines:

"[...] the view of the OECD Member countries continues to be that the arm's length principle should govern the evaluation of transfer prices among associated enterprises"[83]

By making this remark the OECD does not take into account that there is no other principle for the evaluation of transfer prices than the arm's length principle. For instance, a formulary apportionment approach does not evaluate transfer prices. The only principle to govern the evaluation of transfer prices is the arm's length principle. The former director of the OECD CTPA, Jeffrey Owens, argued that the arm's length principle "will survive as the principle on which the necessary international consensus is based."[84] According to Owens, one way to answer the question whether there is a better alternative to the arm's length principle would be to evaluate any alternative by reference to well established tax policy benchmarks such as neutrality, fairness, certainty, ease of administration, simplicity and robustness. In Owens' view, the arm's length principle has proven itself sufficiently flexible to cope with the enormous changes in the global economy that took place in the 20th century. [85]
The arm's length principle reflects the economic realities of the controlled taxpayer's particular facts and circumstances, and adopts as a benchmark the normal operation of the market. In the OECD TP Guidelines, the OECD states that "a move away from the arm's length principle would abandon the sound theoretical basis described above and threaten the international consensus, thereby substantially increasing the risk of double taxation".[86]
International experience with the arm's length principle has become sufficiently broad and sophisticated. This has established a "substantial body of common understanding among the business community and tax administrations".[87] According to the OECD, this experience should be drawn on to elaborate the arm's length principle further, to refine its operation, and to improve its

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[83] Ibid.
[84] Owens, J., "Income Allocation in the 21st Century: The End of Transfer Pricing? Should the Arm's Length Principle Retire", 12 *International Transfer Pricing Journal* (May/June 2005).
[85] Ibid.
[86] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.15.
[87] Ibid.

administration by providing clearer guidance to taxpayers and more timely examinations.
The arm's length principle is also being applied on the EU level. For instance, the Code of Conduct on transfer pricing documentation for associated enterprises in the EU reinforces the uniform application of the arm's length principle as embodied in the OECD TP Guidelines within the EU. The EC Directive 2003/49 on a common tax system for payments of interest and royalties between associated enterprises also focuses on the application of the arm's length principle.[88]

In the 2010 revision of Chapters I-III of the OECD TP Guidelines, the OECD reaffirmed that there are no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises. From the above, it may be concluded that the arm's length principle is indeed the international standard for transfer pricing. Although alternatives for the arm's length principle are currently being discussed or are planned to be implemented, such as the CCCTB, the international consensus on the arm's length principle remains. The arm's length principle is the underlying principle of Art. 9 OECD Model. Some of the main grounds for applying the arm's length principle to transfer prices are to ensure the correct application of the separate entity approach, to realise a broad parity of tax treatment for MNEs and independent enterprises, to put associated enterprises and independent enterprises on a more equal footing for tax purposes in order to avoid the creation of tax advantages or disadvantages, to avoid a distortion of the relative competitive positions of either type of entity and to promote international trade and investment.

It should be noted that although one of the main purposes of the arm's length principle is to put associated enterprises and independent enterprises on an equal footing for tax purposes, in order to create equality between those two types of enterprises, different treatments continue to exist. For example, associated enterprises have to meet more requirements for tax purposes than independent enterprises. The onerous documentation requirements lead to high compliance costs which are normally not incurred in the case of transactions between independent enterprises. For example, in many countries the burden of proof may be reversed if the taxpayers (the associated

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[88] European Commission, *Council Directive 2003/49/EC* (Brussels: Official Journal L 157, 2003), Art. 4.2.

enterprises) do not comply with the documentation requirements. For instance, associated enterprises in the Netherlands, failing to comply with the documentation requirements, will prejudice their evidentiary position.
In that case, the burden of proof with respect to the arm's length nature of the transfer price is shifted to the taxpayers. The documentation requirements do not contribute to a parity of treatment between associated enterprises and independent enterprises.

2.4. The development of the arm's length principle as a principle

2.4.1. The period until 1940 – League of Nations

2.4.1.1. Introduction

Until some 30 years ago, transfer pricing received little attention internationally. In most countries there were no specific transfer pricing rules, regulations or case law. In practice, companies used traditional pricing methods and these were usually acceptable for tax authorities.[89] In some countries the pricing methods were accepted after negotiation with the tax authority.[90] One of the first pieces of legislation in the field of transfer pricing could be found in the United States. The War Revenue Act of 1917 authorised the Commissioner of Taxation to allocate income and deductions among affiliated corporations.[91] At that time, however, there was no statutory benchmark for this allocation. A provision with a similar purpose was also introduced in the UK tax legislation

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[89] See Sections 2.4.3.2- 2.4.3.4 for a description of the transfer pricing methods.

[90] However, in the United States the Internal Revenue Service had been active for some time in auditing transfer pricing practices relating to the foreign operations of US taxpayers. See Hamaekers, H., "Arm´s Length; How Long?", 8 *International Transfer Pricing Journal* (March/ April 2001).

[91] 1917 War Revenue Act, Regulation 41, Arts. 77-78; see also Hamaekers, H., "Arm´s Length; How Long?", 8 *International Transfer Pricing Journal* (March/ April 2001); Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", *30 Tax Notes* 7 (17 February 1986) p. 625; Robinson, P.H., "The Globally Integrated Multinational, the Arm's Length Standard and the Continuum Price Problem", 9 *Tax Management Transfer Pricing*, Special Report, No. 13 (November 2000); Francescucci, D.L.P., "The Arm's Length Principle and Group Dynamics", 11 *International Transfer Pricing Journal* 2/6 (2004).

in 1918.[92] These rules were introduced to prevent profits being moved to lower tax jurisdictions. The United States considered the arm's length principle to be an anti- tax avoidance and anti-tax evasion measure.[93] Because of the US's 1918 Act, the owners of closely held corporations soon became aware of the tax advantages available by creating two or more corporations to carry on the business formerly conducted by only one corporation, or to shift income or deductions between two or more such corporations to reduce high income corporations into lower tax brackets, or to transfer income from a profit corporation to a loss corporation. The first authority for attacking associated enterprises was granted to the Commissioner by the US Congress in the 1921 Act, when the forerunner of Section 482, Section 240, was enacted.[94] Chapter 6 will discuss the historical development of the arm's length principle in the United Kingdom and the United States.

The phrase "at arm's length dealing" had no significance in common law. According to some American authors, the notion of arm's length dealing was related to the doctrine of "undue influence" that was developed by the courts of equity.[95] A description of the doctrine is given by Lord Penzance in *Parfitt v. Lawless* (1872), L.R.2 P & D. 462, 468, where he says:

"In equity persons standing in certain relations to one another - such as parent and child, man and wife, doctor and patient, attorney and client, confessor and penitent, guardian and ward - are subject to certain presumptions when transactions between them are brought in question; and if a gift or contract made in favour of him who holds the position of influence is impeached by him who is subject to that influence, the Courts of equity cast upon the former the burthen of proving that the transaction was fairly conducted as if between strangers."[96]

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[92] General Rule 7, Income Tax Act, 1918. See also Hamaekers, Hamaekers, H., "Arm´s Length; How Long?", 8 *International Transfer Pricing Journal* (March/ April 2001).

[93] See 6.2.

[94] According to Hamaekers, the application of the arm's length principle as international tax concept probably started in the United States. Hamaekers describes that the use of the arm's length principle as tax principle is likely to have started in the US Treasury, probably around the year 1930, appearing officially for the first time in the US Treasury Regulations of 1935. Hamaekers, H., "Arm´s Length; How Long?", 8 *International Transfer Pricing Journal* (March/ April 2001), p. 32.

[95] Baker, R. and Baker, D., "The Pricing of goods in International Transactions between Controlled Taxpayers", 10 *Tax Executive* 23 5 (1957-1958), pp. 247-248.

[96] *Parfitt v. Lawless* (1872), L.R.2 P & D. 462, 468.

This doctrine of "undue influence" and/ or arm's length dealings was relevant to conflicts between private persons who stood in a certain relationship to each other. It was invoked only when fraud was apparent.

2.4.1.2. The 1927 Report: the separate accounts approach

The problem of international double taxation became critical when taxes were substantially increased during the First World War. Shortly after the First World War, initiatives were taken by the recently established International Chamber of Commerce and the League of Nations to find solutions for the growing problem of double taxation.[97] The Economic and Financial Committee of the League of Nations established a committee of economists to study the problem of double taxation. In April 1927 the Committee presented a report with a draft model treaty assigning the taxing rights of business profits to the state where the enterprise had a permanent establishment.[98] For the further analysis and findings of this research, it is important to note the following. At that time, the term "permanent establishment" included head offices and *affiliated companies*. Article 5 of the 1927 Report reads:

"Income from any industrial, commercial or agricultural undertaking and from any other trades or professions shall be taxable in the State in which the persons controlling the undertaking or engaged in the trade or profession possess permanent establishments.
The real centres of management, *affiliated companies*, branches, factories, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a bonafide agent of independent status (broker, commission agent, etc.), shall not be held to mean that the undertaking in question has a permanent establishment in that country.
Should the undertaking possess permanent establishments in both Contracting States, each of the two States shall tax the portion of the income produced in its territory.
In the absence of accounts showing this income separately and in proper form, the competent administrations of the two Contracting States shall come to an arrangement as to the rules for apportionment.

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[97] Hamaekers, H., "Arm´s Length; How Long?", 8 *International Transfer Pricing Journal* (March/ April 2001).
[98] See also Chapter 5.

Nevertheless, income from maritime shipping concerns shall be taxable only in the State in which the real centre of management is situated."[99] *(Italics, RD)*

States with a "permanent establishment" were allowed to tax the part of the profits arising within their territory. Therefore, the analysis of principles underlying the permanent establishment article of the League of Nations Models is relevant for this study. To understand the development of the current Art. 9 OECD Model and the arm's length principle, it is important to analyse the development of the permanent establishment article until 1933. As from 1933 a separate article concerning the taxation of associated enterprises was introduced.

In the letter addressed to the Chairman of the Financial Committee by the chairman of the Committee of Technical Experts on Double Taxation and Tax Evasion, Pasquale d'Aroma wrote:

"The Committee on Double Taxation and Tax Evasion is fully conscious that the work which it has just concluded is imperfect in that it does not provide solutions for all the difficulties which may arise in this very complex question. But, having regard to the diversity of the legislative systems represented in the Committee, and the necessity for finding formulae capable of acceptance by everyone, it will be recognised that the experts were bound to confine themselves to indicating *general rules*, leaving particular points of difficulty to be dealt with – in the spirit of the accepted *general principles* - by those on whom the task of negotiating the bilateral conventions will ultimately fall."[100] *(Italics, RD)*

One of the general rules and accepted general principles to which Pasquale d'Aroma referred to could be found in the following phrase of the above mentioned Art. 5 of the 1927 Draft of a Bilateral Convention for the Prevention of Double Taxation. I quote this specific part of Art. 5:

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[99] League of Nations, *Report on Double Taxation and Tax Evasion, presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, C.216.m.85, 12 April 1927, (4125) p.11.

[100] Letter signed by Pasquale d'Aroma in League of Nations, *Report on Double Taxation and Tax Evasion, presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, C.216.m.85, 12 April 1927 (4115).

"[...] Should the undertaking possess permanent establishments in both Contracting States, each of the two States shall tax the portion of the income produced in its territory.
In the absence of accounts showing this income *separately* and in proper form, the competent administrations of the two Contracting States shall come to an arrangement as to the rules for apportionment." (*Italics, RD*)

Apparently, the Committee of Technical Experts on Double Taxation and Tax Evasion took accounts of permanent establishments -including associated enterprises- that were shown separately and in proper form as a starting point. This is a reference to the separate accounts approach. Accounts should be drafted and shown "separately". The meaning of the words "in proper form" is unclear; this term may refer to the requirement that the accounts should be correctly presented in a specific form acceptable for both States, or that the accounts should contain correct information.

It seems from the wording of the above-mentioned Art. 5 that it is only when the enterprises do not use the separate accounts approach and do not show the income in proper form, that *only then* must the two Contracting States come to an arrangement regarding the rules for apportionment. However, by *correctly* using the separate accounts approach there is no basis for two Contracting States to apportion the income in a different way. This is one of the general rules to which Pasquale d'Aroma referred to: a general principle underlying Art. 5. To support my view, I also refer to the Commentary of the 1927 Draft of a Bilateral Convention for the Prevention of Double Taxation, which states that:

"[...] the explanations given in the introduction to this report [...] indicate the essential principles by which the Committee was guided in framing the draft Convention on Double Taxation".[101]

Apparently, the separate accounting approach was a general principle underlying the Report as early as 1927.[102] According to the Commentary on

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[101] League of Nations, *Report on Double Taxation and Tax Evasion, presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, C.216.m.85, 12 April 1927, (4126) p. 12.

[102] In the literature after the 1960s the terms "separate entity approach", "separate entity principle" or "separate accounts approach" were used. In my research, starting from the early reports of the League of Nations in the 1920s, I found the term "separate accounts" but no reference to the term "separate entity". The principle of "separate entity" very likely

this Report, profit allocation should have primarily taken place on the basis of the separate accounting approach. In the absence of accounts showing this income separately and in proper form, the competent administrations of the two Contracting States had to come to an arrangement as to the rules for apportionment:[103]

"Paragraph 2 and 3 of this clause govern the case in which the undertaking possesses permanent establishments in both contracting States; in that event, 'each of the two States shall tax the portion of the income produced in its territory'. This is an application of the so-called system of apportioning the income according to its source. 'In the absence of accounts showing this income separately and in proper form, the competent administrations of the two contracting States shall come to an arrangement as to the rules for apportionment.' These rules will vary essentially according to the undertakings concerned; in certain States account is taken, according to the nature of the undertakings, of the amount of capital involved, of the number of workers, the wages paid, receipts etc.[...] These criteria are, of course merely given as indications."[104]

If an enterprise did not apply the separate accounts principle, then, as an alternative approach, the formulary apportionment should be applied. That there was no international consensus on the method of allocation can be concluded from the words "in certain States".

The above expression seems to refer to the formulary apportionment approach. Apparently, the Commentary on this Report only indicates that the rules of apportionment to be applied could differ in the absence of accounts showing the income separately and in proper form. With the words "these rules will vary" the Committee accepted and recognised the different profit allocation approaches or principles. This also supports the view that at that time there was no international consensus on a specific allocation approach.

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originates from the principle of "separate accounts". However, due to the limited scope of this research I was unable to analyse the theoretical fundaments of the "separate entity" approach and whether there are any differences between the "separate accounts principle" and the "separate entity principle".

[103] League of Nations, *Report on Double Taxation and Tax Evasion, presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, C.216.m.85, 12 April 1927, (4129).

[104] League of Nations, *Report on Double Taxation and Tax Evasion, presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, C.216.m.85, 12 April 1927 (4126), p. 15.

However, from the example provided by the Committee in the Commentary, it can be concluded that the Committee focussed on a formulary apportionment as an alternative approach. In the above report the arm's length principle was not explicitly mentioned.

2.4.1.3. The 1928 Report

In 1928 a general meeting of tax representatives of the member countries was called, which adopted the formulation of the 1927 Report in three versions of a Draft model treaty for the avoidance of double taxation.[105]

Art. 5 of the 1928 Draft reads:

"Income, *not referred to in Article 7*, from any industrial, commercial or agricultural undertaking and from any other trades or professions shall be taxable in the State in which the *permanent establishments are situated.*

The real centres of management, branches, *mining and oilfields,* factories, *workshops,* agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a bona-fide agent of independent status (broker, commission agent, etc.), shall not be held to mean that the undertaking in question has a permanent establishment in that country.

Should the undertaking possess permanent establishments in both Contracting States, each of the two States shall tax the portion of the income produced in its territory.

The competent administrations of the two Contracting States shall come to an arrangement as to the *basis for apportionment.*

Nevertheless, income from maritime shipping and air navigation concerns shall be taxable only in the State in which the real centre of management is situated."[106]

Art. 5 of the 1928 Report differed from the 1927 Report on two important points.[107]
First, it was no longer stated that "affiliated companies" were considered to be permanent establishments. Secondly, the reference to the separate accounts as an approach for allocating business profits was removed from Art. 5 of the

[105] League of Nations, *Report on Double Taxation and Tax Evasion, presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, C.216.m.85, 12 April 1927 (4162).
[106] League of Nations, *Report on Double Taxation and Tax Evasion, presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, C.216.m.85, 12 April 1927 (4125), p. 11. The italic words are new in this Report.
[107] See also Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* 7 (17 February 1986) p. 631 and Francescucci, D.L.P., "The Arm's Length Principle and Group Dynamics", 11 *International Transfer Pricing Journal* 2/6 (2004), p. 63.

1928 Report. This indicates a preference for some type of fractional apportionment rules to allocate business profits and a departure from the separate accounting principle. The Commentary on this Report reads as follows:

"Paragraphs 2 and 3 of this clause govern the case in which the undertaking possesses permanent establishments in both Contracting States; in that event, 'each of the two States shall tax the portion of the income produced in its territory'. This is an application of the so-called system of apportioning the income according to its source.
'The competent administrations of the two Contracting States shall come to an arrangement as to the bases for apportionment.'
These bases will vary essentially according to the undertaking concerned; in certain States account is taken, according to the nature of the undertakings, of the amount of capital involved, of the number of workers, the wages paid, receipts, etc. [...] These criteria are, of course, merely given as indications. [...]"[108]

Interestingly, the words "in the absence of accounts showing this income separately and in proper form" were removed from the text of Art. 5 of the 1928 Draft. In the 1927 Report this phrase was used to indicate that the standard approach for income allocation was the approach based on separate accounts. *Only* when this approach was *not* applied in *proper* form, should a formulary apportionment approach be used. In that case, the two Contracting States would come to an arrangement as to the bases for apportionment. By deleting the words "In the absence of accounts showing this income separately and in proper form" in the 1928 Draft, it became clear that this draft no longer considered the apportionment based on separate accounts to be the main approach for international income allocation. The Commentary did refer to the source principle by using the words "this is an application of the so-called system of apportioning the income according to its source"; however, there was no longer any reference to the separate accounts. Apparently, the Committee was fully aware of the consequences of removing the phrase "in the absence of accounts showing this income separately and in proper form", because a preliminary discussion was held shortly after the presentation of the 1928 Draft.

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108 League of Nations, *Report on Double Taxation and Tax Evasion, presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, C.562.m.85, 31 October 1928 (4166), at 11.

In the light of the 1928 Draft, the Fiscal Committee held a preliminary discussion on the matter and came to the conclusion that, in order to do useful work, it would be essential to have a detailed knowledge of the present practice in the various countries. Therefore, the Committee sent out a letter to all its members, requesting them to supply it with detailed information on the subject. The Committee also asked the International Chamber of Commerce to give its opinion as to what would be the best methods of apportionment. The removal of *affiliated companies* from Art. 5 in 1928 was also examined by the Committee, though it was decided to postpone the consideration at this point.[109] The Committee did not provide answers to the question whether permanent establishments still included subsidiaries, despite the removal of the term "affiliated companies" from the text of Art. 5. Furthermore, the report shows that in 1928 major doubts existed on the preferred income allocation approach. The arm's length principle was not mentioned in this draft.

2.4.1.4. The 1930 Report: Adams' Questionnaire

In Appendix II of the 1930 Report, Professor Adams, who was entrusted with this enquiry, analysed the replies received to the questionnaire regarding the apportionment of profits or capital from enterprises operating in several countries.[110] Adams concluded that:

"Nevertheless, on one or two points of importance, the replies reveal a close approach to uniformity of law and practice. It appears clear, for instance, that, in assessing the profits of a branch of a foreign company and more particularly in assessing the profits of a subsidiary or filial of a foreign holding company, *a large majority of States* avowedly seek to determine the profits of the branch *separately* and for that purpose pay regard only to the accounts of the branch itself, without reference to the accounts of the foreign company."[111] *(Italics, RD)*

This is a clear indication that the separate accounts principle was generally used by States during the 1930s. Furthermore, Adams also concluded that in the absence of separate accounts, or where the separate accounting is

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[109] See also Sections 6.1. and 6.2.

[110] League of Nations, Fiscal Committee, *Report to the Council on the work of the second session of the Committee*, held on Geneva from 22 May to 31 July 1930, C.340. M.140, (4212-4214) Appendix II.

[111] Ibid.

unsatisfactory, various methods of approximation were widely used.[112] Only in a small minority of States was preference given to the method of apportionment by which the income of the branch or subsidiary is computed as a fraction of the entire income of the foreign corporation or holding company. Although there was no separate article regarding taxation of associated enterprises (subsidiaries), it seems that subsidiaries were still considered to be permanent establishments. Adams' study reveals that the tax treatment of subsidiaries was based on separate accounts. As in the majority of the countries, subsidiaries were separate legal entities and tax assessments were -as a principle- based on separate accounts. In Appendix II, Adams also wrote that the approach of separate accounts was used for branches too (not being subsidiaries).

In Adams' questionnaire question B reads as follows:

"What are the methods for determining the income of branches of foreign business concerns doing business in your countries?" [113]

The method most countries followed at first was to base the assessment on the separate accounts of the branch which is taxable only on income derived within the taxing State. If the special accounts of the branch establishments were inadequate or misleading, they could be *corrected* to reflect the true income, or various empirical methods may be employed to estimate the taxable profit.
The following principal methods were employed:

a. The accounts of the entire undertaking are requested in order to determine the amount of profit allocable to the branch. This amount may be determined by an apportionment taking into account the assets, turnover, expenditure or number of employees of the branch as compared with the assets, turnover, expenditure, or number of employees of the undertaking.
b. The income of the branch may be determined by basing the assessment on a comparison with the earnings of local undertakings engaged in similar business.
c. The income of the local establishment is estimated by reference to a certain extent to external indications, such as salaries of employees, rent paid for the premises and other expenditure.

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[112] Ibid.
[113] Ibid.

d. The income may be assessed in a lump sum which serves as the basis for taxation for several years.

It may be argued that method b refers to the application of the arm's length principle in cases when the special accounts of the branch establishments are inadequate or misleading. Based on method b, a State could correct the income by applying an arm's length method, "by basing the assessment on a comparison with the earnings of local undertakings engaged in similar business".[114] However, it may also be argued that Adams did not refer to the arm's length principle, but to an empirical approach, as he did not mention the comparison of *conditions*, but he used the words "comparison with the earnings".
Question C was identical with question B; however, it concerned affiliated corporations. In his comments on question C, Adams wrote:

"Practically all the replies state categorically that the local company, which is a subsidiary of a foreign corporation, is a separate legal entity and enjoys the same treatment as other national companies. It is therefore taxed on the basis of its own accounts. A number of replies mention measures that may be taken to assess the profits of a subsidiary company correctly when its accounts are inadequate or misleading [...]"[115]

Then, Adams summarised the measures that were taken when the accounts were inadequate or misleading:

"(a) A profit may be ascribed to the subsidiary company based on a comparison with the profits of other companies engaged in a similar business.
(b) Where the subsidiary is rendering services to the foreign parent, its profit may be fixed on a commission basis.
(c) When the subsidiary and the foreign parent constitute a 'single economic unit', the subsidiary may be treated as a branch.
(d) In order to prevent evasion or show true income, the fiscal authorities may allocate income as between the foreign parent company and the local subsidiary

[114] Ibid.
[115] League of Nations, Fiscal Committee, *Report to the Council on the work of the second session of the Committee*, held on Geneva from 22 May to 31 July 1930, C.340. M.140, (4214) Appendix II.

(e) Where the profits of a subsidiary are artificially concealed, a charge may be made upon the parent company based upon the true profits of the subsidiary."[116]

From Adams' questionnaire it may be concluded that in these early years profits may be ascribed to the subsidiary based on a *comparison* with the profits of other companies. This indicates the use of an empirical approach. Under this approach, the income was estimated on the basis of the income of similar enterprises in the country concerned.

In the same analysis, Adams reconfirmed that "practically all the replies state categorically that the local company, which is a subsidiary of a foreign corporation, is a separate legal entity and enjoys *the same treatment as other national companies*".[117]

This is a first indication that the principle of equality and a "same treatment" were applied by States in the context of taxation of subsidiaries. Adams' quote stresses the neutral tax treatment between foreign companies and domestic companies.[118]

The above-mentioned study confirms that, even before 1930, a majority of countries were aware of the separate accounting principle or applied a form of income allocation based on separate accounts. Adams also concluded that one of the methods used by countries to determine the income of a branch or subsidiary was an assessment based on a comparison with the earnings of local undertakings engaged in similar business. In my view, this is not a reference to the arm's length principle. The arm's length principle focuses on the conditions among unrelated parties, not on the profits or income of independent competitors. Adams described an approach that can be identified as an empirical approach. This approach is not the same as the formulary apportionment approach or the arm's length principle.

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[116] Ibid.

[117] Ibid.

[118] Ibid.

2.4.1.5. The 1933 Report: study made by Mitchell B. Carroll

The Fiscal Committee urged that a study should be made of the question of the apportionment of profits.[119]
It appointed a Subcommittee to conduct the enquiry to be undertaken for this purpose and to take the necessary action. The Subcommittee entrusted this enquiry to Dr. Mitchell B. Carroll, a former legal adviser to the Treasury Department in Washington. As the assistant to Adams he had been connected for some years with the work of the Government Experts and the Fiscal Committee.[120]
The enquiry began in five countries.[121] In each of these countries a special report was drawn up. Carroll supplemented this work by a general report, in which he had endeavoured to indicate the principal rules of apportionment employed in those five countries. The Subcommittee decided that the five reports should be published together with Carroll's general report.

2.4.1.6. Mitchell B. Carroll: Taxation of Foreign and National Enterprises

In 1933 Carroll presented a report on approaches to allocate income. The title of this report reads "Taxation of Foreign and National Enterprises".[122] This

[119] This was a recommendation by the Fiscal Committee concerning the employment of the fund of USD 90,000 from the Rockefeller Foundation. See League of Nations, Fiscal Committee, *Report to the Council on the work of the third session of the Committee*, held on Geneva from 29 May to 6 June 1931, C.415.M.171, (4229) p. 5.
[120] Mitchell B. Carroll is also one of the founders of the International Fiscal Association (IFA) and the International Bureau of Fiscal Documentation (IBFD).
[121] Those countries were France, Germany, Great Britain, Spain and the United States.
[122] League of Nations, *Taxation of Foreign and National Enterprises*, Volume I (France, Germany, Spain, the United Kingdom and the United States of America) (Geneva: League of Nations Document No. C.73.M.38. 1932.II.A., 1932); League of Nations, *Taxation of Foreign and National Enterprises*, Volume II (Austria, Belgium, Czechoslovakia, Free City of Danzig, Greece, Hungary, Italy, Latvia, Luxembourg, The Netherlands, Romania and Switzerland). (Geneva: League of Nations Document No. C.425.M.217.1933.II.A., 1933); League of Nations, *Taxation of Foreign and National Enterprises*, Volume III (British India, Canada, Japan, Mexico, Netherlands East Indies, Union of South Africa, States of Massachusetts, New York and Wisconsin), (Geneva: League of Nations Document No. C.425 (a).M.217 (a).1933.II.A., 1933); League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425 (b).M.217 (b).1933.II.A., 1933); League of Nations, *Taxation of Foreign and National Enterprises-*

report forms the conclusion of a long enquiry into the taxation of foreign and national enterprises in 35 countries. Taking into account both the legitimate requirements of tax administrations and the needs of industry and international trade, Carroll endeavours to formulate a system of allocating or apportioning the income of business enterprises which would be fair, practical, logical and suitable for all types of enterprises.[123]

In the draft convention on allocation, drawn up at its last session, the Fiscal Committee relied largely upon Carroll's work.[124] As that draft only prescribes general principles, the Committee stated that Carroll's report might "usefully be consulted as a guide in applying those principles to the complex cases that arise in practice".[125]

In 1933 Carroll identified the following problem with respect to international taxation:

"The general tendency of international business enterprises is towards a more complex structure. It becomes more and more frequent for a large enterprise to produce its own material which is used in manufacture. Moreover, the number of articles which the enterprise itself produces usually becomes more and more varied in order to meet the needs or tastes of customers in different countries. The existence of tariff walls often makes it expedient to assemble within the country partially manufactured goods, or even to manufacture the entire factory. Because of legal requirements or expediency, or merely to facilitate the segregation of activities within the country, foreign enterprises often form a local subsidiary company. Although many large enterprises scrupulously treat such subsidiary companies as independent entities, *it is the practice of (the) other to regard them in fact as mere branches of the entire concern* and to incorporate their earnings in the annual accounts of the entire enterprise, just as if they accrued directly to it. Tax collectors complain that sometimes enterprises take the rate of tax in various countries into consideration, and fix the transfer price from the factory to a selling establishment at so high a figure as to show little or no profit in the books of the sales branch. Through the arbitrary fixation of

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Allocation Accounting for the Taxable Income of Industrial Enterprises, Volume V (Geneva: League of Nations Document No. C.425(c).M.217 (c).1933.II.A., 1933).

[123] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425 (b).M.217 (b).1933.II.A., 1933); p. 9.

[124] Ibid.

[125] Ibid., p. 9. See also League of Nations, *Report of the Fiscal Committee to the Council*, fourth Session, (Geneva: League of Nations Document No. C.399.M.204.1933.II.A.).

inter-establishment billing prices or charges for interest, royalties, services etc., *profits can be shifted from place to place, the purpose frequently being to transfer them to the country with a low rate of tax or no income-tax at all.*" [126] (*Italics, RD*).

Carroll's survey of the law and practice concerning the taxation of foreign and national enterprises reveals the scope and complexity of the problem of formulating a regime for the prevention of double taxation of the income of business enterprises. Although MNEs treated subsidiaries as independent entities, it "was the practice of other[s]" to regard them in fact as mere branches of the entire concern. Apparently, "other[s]" should be interpreted as the tax authorities. As a consequence, the earnings of the subsidiary were incorporated in the annual accounts of the entire enterprise.
Carroll was of the opinion that the contention was unfounded that uniform principles of allocation are impossible because of tax regimes having to conform to the different economic circumstances of the various States. [127] Carroll wrote:

"This survey reveals that the essential legal principles of allocation are much the same in most countries, although the methods used in applying them reflect the distinctive nature of their people." [128]

According to Carroll, it is impossible to formulate a general regime of allocation without establishing uniform principles of jurisdiction. This involves the modification of the fundamental provisions regulating liability in some tax laws and the placing of limitations on such provisions in other laws. As described by Carroll in his report, it entails abandoning all precepts of liability other than those of fiscal domicile and source, and it requires that the concept of fiscal domicile and the concept of source should be uniformly defined and strictly limited to sources obviously within the jurisdiction of the State.

The above-mentioned quote shows that Carroll recognises profit shifting through transfer pricing in transactions between permanent establishments

[126] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217 (b).1933.II.A., 1933); p. 9.
[127] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217 (b).1933.II.A., 1933); p. 169.
[128] Ibid.

and head office and between associated enterprises. As there was not much legislation and even less jurisprudence concerning allocation, tax administrations were inclined to broaden the basis of assessment of foreign and national enterprises to the largest extent possible. They thereby encroached upon the jurisdiction claimed as well by other States.[129] This resulted in the accumulation of high rates upon the same profits. Carroll concluded that "the fiscal administrations thus combine to impose a crushing burden upon the very commerce which other Government departments and business groups are endeavouring to encourage".[130]
Carroll was also aware that the tax official in the country of the subsidiary or branch was at a disadvantage. All that the tax official had at hand was the accounting of the local subsidiary and the data pertaining to the income of similar enterprises, if any. Even if the tax official secured statements as to the concerns of the entire enterprise as shown in the books of the head office in another country, they were usually in such an abbreviated form that it was almost impossible for him to compute accurately, or even to estimate, the profit allocable to the local establishment. According to Carroll, this was one of the main reasons why administrations developed methods of assessment on empirical or fractional bases.[131]

Due to the lack of legislation and jurisprudence, Carroll found it necessary to carefully study the practices followed by the various administrations in allocating income to national or foreign sources. Carroll analysed three methods of allocation which were employed in the various countries. The main method was the approach of separate accounting, followed by empirical approaches and the fractional apportionment approach. With respect to the separate accounting approach, Carroll stated the following:

"The method of separate accounting means taking the declaration of income, supported by the accounts of the local branch, as a basis of assessment. This may entail a verification of the accounts and enquiry into the relations between the local branch and other establishments (branches or subsidiaries) of the parent enterprise, which involve, for example, consideration of the price at which goods have been invoiced to the branch and their original cost, and the amounts charged to the branch for services or representing a portion of general overhead expenses."

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[129] Ibid., p. 13.
[130] Ibid., p. 13.
[131] Ibid., p. 16.

As will be shown later, Carroll found the allocation problem to be of main importance in the relationship between permanent establishments and head offices. Subsidiaries were mostly required by domestic law to have their own accounts. However, this was not the case for permanent establishments. Until 1933 no separate article existed concerning the taxation of associated enterprises in the drafts of the League of Nations. Affiliated companies were even considered to be permanent establishments. In his report, Carroll found that the enterprises with internationally operating branches presented the most difficult problems in the whole field of allocation. According to Carroll, the general practice of the administrations throughout the world was to first look at the accounts of the local establishment of the foreign industrial or commercial enterprise in verifying its tax declaration, and then, if necessary, to adjust the declaration and accounts, or to make an assessment by applying one of the empirical or fractional methods. Carroll stated:

"The difficulties arise because of the fact that most countries do not have in their laws any clear-cut precepts as to how much of the profit of the foreign enterprise should appear in the books of the local establishment, other than the fundamental principle that they should reflect the true income attributable to the activities of the establishment. On the other hand, companies, in the absence of guiding precepts, generally conduct their inter-establishment transactions as best suits their convenience. As a matter of fact, the principles of allocation in some countries are so grasping that foreign companies feel justified in resorting to measures which will limit the profits subject to tax therein."[132]

Broadly speaking, the objectives of the separate accounting approach are as follows:

- To maintain accounts for the establishment (or establishments considered to be an accounting unit) in each jurisdiction which reflect the items of taxable income and related expenses directly allocable thereto, and provide the essential data for apportioning items of joint income and expenses which cannot be directly allocated;
- To preclude taxing the establishment in so far as possible on unrealised profits;

[132] Ibid., p. 116.

- To fulfil these objectives by the use of data pertaining directly to the establishment which can be verified in the country of the branch establishment with the minimum use of data pertaining to the enterprise as a whole.

Carroll considered it undesirable to endeavour to prescribe detailed rules of separate accounting, as the enterprises were so varied in their nature. Each enterprise was likely also to change its methods of operation so frequently in order to meet changing conditions, that it would be unwise, if not impossible, to lace them all in the same accounting corset.[133]

Carroll showed in his report that a predilection for the separate accounting approach is evinced by the great majority of countries.[134] The taxpayer should

[133] Ibid., p. 190. A detailed discussion of various methods of accounting during the 1930s which may be used to reflect separately the income of a branch of an industrial or mercantile enterprise is to be found in League of Nations, *Taxation of Foreign and National Enterprises-Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425 (b).M.217 (b).1933.II.A., 1933).

[134] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217 (b).1933.II.A., 1933), p.88. Carroll made some pronouncements in favour of separate accounting in his report:

"295 "The separate accounting method is considered to be the most satisfactory. Where there are no interlocking transactions between the main enterprise and the branch establishment, no difficulty is experienced in determining the profits from the accounts. Where there are interlocking transactions, it is necessary to have a clear understanding of the course of business between the head office and branch and to know the basis adopted in transactions between them (*e.g.*, on what basis goods have been invoiced between them, how head-office expenses have been allocated, etc.). Given this information, it is usually possible for the authorities and the taxpayer to reach agreement as to the treatment of these transactions, and the profits can then be satisfactorily ascertained from the accounts" (United Kingdom). [...]

300. "The profits should, in principle, be determined on the basis of the signed declaration and with the help of the separate accounts of the French establishment" (France).

301. "The method of independent determination is the best for fixing the income of an Italian branch or subsidiary of a foreign company, because this method conforms to the fundamental principle of the territoriality of the income, its purpose being to ascertain the exact figure of income realised in the Kingdom. It therefore obviates having to establish the total income that the enterprise realises as the result of its various activities in different States. The determination of total income is difficult, but it is less difficult than apportioning it between the head office and the various branches or subsidiaries" (Italy).

302. "The most satisfactory method is that of separate accounting. Empirical or arbitrary methods have only one advantage: their simplicity. As for the method of fractional apportionment, it appears adequate for financial and banking enterprises and insurance

submit a declaration supported by separate accounts reflecting clearly the profits of the establishment within the jurisdiction of the taxing State, resulting from its own separate activities or its joint relations with other establishments of the same enterprise.[135]

Carroll explained in his report that it was significant that separate accounting should be the method that was normally used in the country that has the most experience in the taxation of income and, at the same time, has accountants of the highest professional standing.[136] For example, the standards of accounting

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companies, especially where the last-mentioned have in the Netherlands an important branch and not a mere agency." (Netherlands). [...]

306. "From the viewpoint of normal use and prevention of tax evasion, the method of separate accounting is considered to be the most satisfactory. Although it is not easy for the administration to check the accounts where there are interlocking transactions, most of the difficulties can be overcome by a clear understanding of the course of the business and a study of the internal accounting method" (Japan).

307. "The method of separate accounting is the one intended by the law and is always employed unless the insufficiency of the declaration and accounts of the taxpayer force the assessment board to resort to an empirical assessment" (Mexico).

308. "The method of separate accounting, subject to verification, is the preferred method" (United States).

[135] The preference for this method was declared by the following countries: the United Kingdom, the Irish Free State, British India , South Africa, Belgium, France, Italy, the Netherlands, Germany and Danzig, Austria, Czechoslovakia, Hungary, Denmark, Sweden, Estonia, Latvia, Poland, Bulgaria, Greece, Romania, Yugoslavia, Japan, Cuba, Mexico and the Federal Government of the United States of America. See also League of Nations, Taxation of Foreign and National Enterprises Volume IV, Mitchell B. Carroll, Geneva 1933, at 88. For example, the United Kingdom stated the following in Carroll's report: "The separate accounting method is considered to be the most satisfactory. Where there are no interlocking transactions between the main enterprise and the branch establishment, no difficulty is experienced in determining the profits from the accounts. Where there are interlocking transactions, it is necessary to have a clear understanding of the course of business between the head office and branch and to know the basis adopted in transactions between them. Given this information, it is usually possible for the authorities and the taxpayer to reach agreement as to the treatment of these transactions, and the profits can then be satisfactory ascertained from the accounts." See League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217 (b).1933.II.A., 1933), p. 88.

[136] In this respect, Carroll also points out the following:

"The taxation of the local establishment on a separate basis prevails primarily in countries where the art of accounting is highly developed – for example, the British Commonwealth of Nations and the United States; or in countries where at least the principle of territorial jurisdiction is impregnated in fiscal law- for example, France, in respect of its tax on industrial and commercial profits. Italian officials declare that they must always apply the method of a in the United Kingdom have been carried abroad because of the fact that the leading accounting firms in the United Kingdom have followed their clients to all parts of the world to audit their branch accounts. Similarly, the branches in the United States of these same accounting firms and similar American firms have developed accounting practices to keep abreast of the complex structure of business organisations and methods in that country, and they in turn have followed their clients abroad.[137] As stated by Carroll, the use of accounting as the primary approach coincides fairly closely with the field of operation of these reputable firms.

Carroll describes in his report that, in general, income tax laws merely provide that the tax is on the net income attributable to their jurisdiction, which is to be declared by the taxpayer.[138] The income tax laws give the administration full discretionary powers to resort to whatever measures are necessary to make an assessment. Carroll writes in his report:

"As any enterprise of importance keeps accounts, often in accordance with the requirements of the commercial or fiscal law of the country, it is customary for the tax authorities to require that the declaration is to be supported by a balance-sheet and profit-and-loss statement *pertaining to the local establishment*, and in some instances, other pertinent data, including the balance-sheet and profit-and-loss statement, together with other pertinent accounts of the entire enterprise." [139] *(Italics, RD)*

By using a separate accounting approach permanent establishments are required to keep accounts. And based on these accounts, tax administrations

separate determination of the profits of the local establishment on the basis of accounts. Other administrations which pronounce themselves as being bound primarily to a separate determination of profits on the basis of accounts include Estonia, Latvia, Poland, Romania, Sweden, Japan, Cuba and Mexico. Those which indicate a greater freedom of selection include British India, Canada, Belgium, Luxemburg, France, the Netherlands, Netherlands East India, Germany, Danzig, Austria, Czechoslovakia, Hungary, Bulgaria, Greece and Yugoslavia. Austria and Czechoslovakia, however, are bound by their law to apply certain minima, and the Austro-Czechoslovak and Austro-Hungarian treaties require the fractional apportionment of the joint profits of enterprises operating in the territories of the contracting States." League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217 (b).1933.II.A., 1933), pp. 87-89.

[137] Ibid., p. 48.

[138] Ibid., p. 87.

[139] Ibid.

are able to determine the taxable income. Carroll continues with the following phrase:

"The assessment procedure in most instances begins with an examination of the declaration and supporting accounts, and, if they are adequate and accurate enough to reflect clearly the taxable income of the local establishment of the foreign enterprise, no further enquiry will be made."[140]

The important question arises how tax administrations could check whether accounts are adequate and accurate to reflect clearly the taxable income of the local establishment of the foreign enterprise. Carroll provided the following answer, which may reveal a connection between the separate accounting approach and the arm's length principle:

"In default of such accounts, they exercise their discretionary powers to arrive at an assessment on the basis of the best information available. As a rule, they first turn to that which is locally obtainable, requiring the taxpayer to reveal all its accounts and correspondence with the head office or other establishments of the parent enterprise. *If necessary, the authorities resort to an estimative assessment, based on a comparison with the profits of similar enterprises*, or by using the methods previously described."[141]

Carroll refers to the application of an empirical method, by comparing *profits* of similar companies. As will be shown later in this chapter, the step from comparing profits to comparing prices, and thus from an empirical to an arm's length method, was also made by Carroll in a next phase. In order to apply correctly the separate accounting approach, and therefore to reflect adequately and accurately the taxable income, associated enterprises and permanent establishments are required to use the fiction of the arm's length principle. Those two principles are fundamentally linked to each other. As companies are able, because of a controlling relationship, to influence the taxable accounts and to manipulate the accounts of the other associated enterprise or permanent establishment, the application of the separate accounts approach would not avoid the manipulation of the accounts itself. The arm's length principle supported the separate accounts approach. Application of the arm's length principle tends to avoid abuse or manipulation of the separate accounts

[140] Ibid., p. 88.
[141] Ibid., p. 88.

approach. The burden, as described in Carroll's report, is upon the taxpayer to keep its accounts and to carry on "intra-establishment transactions" in such a way as to effect a fair allocation to the establishment which is being subjected to taxation.

The first reason to implement the arm's length principle was to secure a correct application of the separate accounts principle. This should result in a fair allocation of taxable income between States. The equality and neutrality effects for a taxpayer were in fact being realised by the application of the combination of the separate accounts principle and the arm's length principle, in such a way that unrelated enterprises were not in a disadvantage position in comparison with related enterprises (including permanent establishments and subsidiaries) because the latter had the possibility to influence the pricing.

Carroll also rejected the fractional apportionment because of the difficulties in verifying the accounts prepared at the head office or even in understanding them when they are prepared in a foreign language, in a different currency and possibly in accordance with a different system of accounting. However, he stated:

"Such, briefly, is the average practice – complete liberty of methods of assessment, but recourse in the first instance to the declaration and separate accounts; subject to verification and adjustment, or, if this is impossible, to the making of an assessment by employing empirical approaches or the approach of fractional apportionment."[142]

2.4.1.7. Foreign enterprise with local subsidiary: allocation criteria

Although until 1933 there was no specific article concerning the taxation of associated enterprises in the draft conventions, Carroll did write a specific chapter in his report that dealt with associated enterprises.[143]
The report recognises that enterprises carrying on business in two or more countries, especially if countries have different language, currency and economic conditions, very frequently organise a company in each country in conformity with the requirements of its commercial or company law. Carroll

[142] Ibid., p. 87.
[143] Ibid., pp. 109-116.

noted that instead of extending its operations into each country through a branch of its own organisation, the parent enterprise conducts its operations through a subsidiary, which, in law, is a separate legal entity.[144] In this respect, Carroll wrote:

"The parent must therefore, in strict law, *deal with the subsidiary company as if it were a separate legal person.* In other words, the legal transactions between the parent and the subsidiary should be conducted in the *same manner as similar transactions between independent legal persons.*"[145] *(Italics, RD)*

In this report, the conclusion was drawn that as long as the inter-company transactions are carried out under the same circumstances and conditions and on the same terms as they would be between two entirely separate and independent persons, dealing with each other in an open market, and in a manner which is generally described as at "arm's length", the tax authorities generally respect the separate legal existence of the subsidiary company. As a result, the taxation will be based on its own declaration as supported by its properly kept *separate accounts.*[146] In this context, the difference between branches and subsidiaries was the existence of separate legal entities and therefore separate accounts. As long as the *arm's length principle* was applied by carrying on inter-company transactions under the same conditions and circumstances and on the same terms as they would have been between unrelated enterprises, tax authorities would respect these accounts.

In Chapter IV concerning the Foreign Enterprise with Local Subsidiary, there was a remarkable phrase. Carroll wrote there:

"To verify this declaration and accounts, the tax authorities may enquire into the current of business between the local subsidiary and the parent company or other subsidiary companies of the parent, which may *for convenience be termed associated companies.*"[147]

At this point, Carroll introduces -for convenience purposes- the term "associated companies". Before that time, the term "affiliated companies" was used in the reports of the League of Nations. In the light of the discussion

[144] Ibid., pp. 109.
[145] Ibid.
[146] Ibid., pp. 109-110.
[147] Ibid., p.109.

whether Art. 9 OECD Model also deals with *persons* or only with companies, the above quote and the title of this chapter in Carroll's report supports the view that Art. 9 OECD Model deals with companies and not with persons.

If the relations between the local subsidiary and the foreign parent are not carried on at arm's length, with the result that the profits are diverted from the local subsidiary to the foreign parent, Carroll summarised three general categories of allocation methods to be applied:

1. Readjustment on the basis of independent persons; for instance, the legal fiction is respected, but the relations between the two are examined in order to divide the joint profit between them in the measure that each would have earned had the two been dealing with each other as independent persons;[148]
2. Assessment of the parent in the name of the subsidiary as agent;
3. Assessment on basis of economic unity, for instance merging the subsidiary with the parent on the theory that they both constitute a single economic unit, or that the subsidiary is merely an organ of the parent.

This first method is in accordance with the United States Revenue Act of 1932, Section 45. Langbein states that when one looks at the date this Act was introduced in the United States and the year when Carroll wrote his Report, it may be argued that Carroll was influenced by the developments in the United States. Under the United States Revenue Act of 1932, Section 45, the Commissioner of Internal Revenue may request of the local subsidiary company all accounts and information necessary to allocate or apportion the income or deductions between the two companies in such a manner as to *prevent evasion* by shifting of profits, in order to arrive at the true tax liability of the local company.[149]

The Committee highly appreciated the value of the studies submitted to it by Carroll. The Committee deemed the material contained in the report to be by itself adequate to facilitate the conclusion of international agreements, and with that object in view, it endeavoured to formulate in a draft convention the essential provisions such agreements might contain. Based on Carroll's finding, the Committee drafted a new multilateral treaty on the allocation of business

[148] Ibid., p.110.
[149] Ibid.

profits in 1933.[150] In view of the diversity of national laws and the extreme complexity and variety of the individual cases that arose, the Committee thought it was advisable to prescribe only general principles. The fundamental principle was that, for tax purposes, permanent establishments must be treated in the same manner as *independent enterprises operating under the same or similar conditions*, with the corollary that the taxable income of such establishments is to be assessed on the basis of their separate accounts.[151]
It is in the 1933 Report that a clear reference is made to the arm's length principle and the separate accounting principle, by stating that for tax purposes permanent establishments should be treated in the same manner as independent enterprises which operate under the *same or similar conditions*:

"The fundamental principle laid down is that, for tax purposes, permanent establishments must be treated in the same manner as independent enterprises operating under the same or similar conditions, with the corollary that the taxable income of such establishments is to be assessed on the basis of their separate accounts."[152]

By using the words "same or similar conditions", the Committee is referring directly to the application of the arm's length principle. By adding these words to the words "as *independent* enterprises operating under [...]" the Committee introduces the requirement for a comparative analysis, which is the fundament of the arm's length principle. This quote sets forth the comparability aspect of the arm's length principle. To determine whether there is deviation of dealings of an independent enterprise operating under the same or similar conditions, one needs to perform a comparison between conditions made or imposed between associated enterprises and those which would be made between independent enterprises. This comparability aspect is also set forth in the current Art. 9 OECD Model paragraph 1. Therefore, although not mentioned explicitly by name, the arm's length principle can be considered as one of the essential principles in the 1933 Report quoted above. In this context, I refer also to the revised Chapter I of the OECD TP Guidelines, where it is stated that the

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150 League of Nations, Fiscal *Committee, Report to the Council on the fourth session of the Committee*, held on Geneva from 15 June to 26 June 1933, C.399. M.204. (4242) p. 2.
151 Ibid.
152 Ibid.

comparability analysis "is at the heart of the application of the arm's length principle".[153]

A survey of the legislation and administrative practice of 35 countries was carried out by Carroll. The stated objective of Carroll's report was to "formulate a system of allocating or apportioning the income of business enterprises which would be fair, logical and suitable for all types of enterprises".[154] The country reports that Carroll received, were included in three volumes; a fourth volume included a report by Carroll and a fifth summarised accounting issues pertinent to the allocation question.[155] He concluded that in most of the countries reviewed, the separate accounting approach had been generally adopted as the primary approach for allocating profits to local establishments of foreign enterprises. By way of conclusion, he endeavoured to extract the general rules observed in the majority of countries, on the basis of which an international agreement might be secured. Carroll stated:

"This may entail [...] an enquiry into the relations between the local branch and other establishments (branches or subsidiaries) of the parent enterprise, which involve, for example, consideration of the price at which goods have been invoiced to the branch [...] and the amounts charged to the branch for services or representing a portion of general overhead expenses."[156]

Carroll described the separate accounting approach as the approach that takes the declaration of income, supported by the account of the local branch, as a

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[153] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.6.

[154] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425 (b).M.217), p. 9.

[155] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425 (b).M.217).

[156] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425 (b).M.217). See also Hamaekers, H., "Arm´s Length; How Long?", 8 *International Transfer Pricing Journal* (March/ April 2001), p. 32 and Francescucci, D.L.P., "The Arm's Length Principle and Group Dynamics", 11 *International Transfer Pricing Journal* 2/6 (2004), p. 63.

basis for assessment.[157] This declared income entailed a verification of the accounts and the relations between the local branch and other establishments of the parent enterprise. For example, the price at which goods have been invoiced to the branch and their original cost, and the amounts charged to the branch for services or representing a portion of general overhead expenses, should be taken into account.[158] This means that permanent establishments and subsidiaries of the enterprise should keep accounts for their own business activities from its head office, and probably, however not clearly expressed in the quote, should deal at *arm's length* with each other.[159] A consideration of the price is only possible if one looks to prices applied by (independent) other companies.

However, Carroll drew no conclusion as to the preferred systems of profit allocation in the context of associated enterprises. Instead, he drew a conclusion in the context of a head office and its permanent establishments, and he only recommended the arm's length principle as the system for allocating profits between the parent company and its subsidiaries. Thus, the transactions between the parent and its subsidiary should be conducted in the same manner as similar transactions between independent legal persons.[160]

Another conclusion of Carroll was that tax administrations frequently applied an empirical approach. If tax administrators had reason to believe that the declaration of income based on the accounts of an enterprise was insufficient or false, the tax administrators in many cases used an empirical approach. Under this approach, the income was estimated on the basis of the income of similar enterprises in the country concerned. In some countries, like Spain and Switzerland, the formulary apportionment approach was the primary approach used.[161]

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[157] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425 (b).M.217), p. 9.

[158] Ibid., p. 45.

[159] Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61, (Jönköping: Jönköping University, 2009) p. 138.

[160] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217), p. 109. See also Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61 (Jönköping: Jönköping University, 2009), p. 139.

[161] With this method, the income of the establishment concerned was determined on the basis of the total income of the whole enterprise (or on the basis of the joint income of the

Carroll indicated that the extent of the application of the different systems varies greatly from country to country. In the US Federal Administration, the separate accounting system was generally used as the primary system.[162] However, there was no country that followed one specific system.
A combination of systems was usually used by the tax authorities in various countries.[163]
Carroll concluded that the separate accounting system was preferred by the majority of countries and enterprises represented in the International Chamber of Commerce, as well as by other authoritative groups.[164]

The Committee was of the opinion that the general principle of separate accounting for permanent establishments would "enable all the special problems to be solved with the necessary flexibility".[165]
The Committee presented a draft convention as an annex, which in the Committee's opinion may form the basis of a (multilateral) Convention.[166] Art. 3 of this 1933 Draft Convention contained the separate accounting principle and introduced the arm's length principle. Art. 3 of the 1933 Draft Convention reads:

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local establishment and the related establishment abroad) applying a ratio consisting of certain factors, such as assets, turnover and payroll. See Hamaekers, H., "Arm's Length; How Long?", 8 *International Transfer Pricing Journal* (2001), p. 33.

[162] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217), p. 45.

[163] Picciotto, S., *International Business Taxation- A study in the Internationalization of Business Regulation* (New York: Quorum Books, 1992), p. 31. See also Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61 (Jönköping: Jönköping University, 2009), p. 138.

[164] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217), p. 88. Carroll based his conclusion on the specific national reports produced by governments on the system of allocation of profits of an enterprise to its permanent establishment.

[165] League of Nations, Fiscal Committee, *Report to the Council on the fourth session of the Committee*, held on Geneva from 15 June to 26 June 1933, C.399. M.204, (4242) p. 2.

[166] Ibid. The Committee proposed to the Council that the draft convention should be transmitted to governments, with a request that they expressed their opinion thereof, made suggestions as to any amendments they considered desirable, and also stated whether they would be prepared to enter into negotiations for the conclusion of a multilateral convention on the basis of this text, subject to amendment on the lines which they would indicate. States which were not in a position to accede to a multilateral Convention could utilise this draft as a model for bilateral conventions with other States.

"If an enterprise with its fiscal domicile in one contracting State has permanent establishments in other contracting States, there shall be attributed to each permanent establishment the net business income which it might be expected to derive if it were *an independent enterprise engaged in the same or similar activities under the same or similar conditions*. Such net income will, in principle, be determined on the basis of the separate accounts pertaining to such establishments. Subject to the provisions of this Convention, such income shall be taxed in accordance with the legislation and international agreements of the State in which such establishment is situated.

The fiscal authorities of the contracting States shall, when necessary, in execution of the preceding paragraph, rectify the accounts produced, notably to correct errors or omissions, or to re-establish the prices or remunerations entered in the books at the value which would prevail between independent persons *dealing at arm's length*.

If an establishment does not produce an accounting showing its own operations, or if the accounting produced does not correspond to the normal usages of the trade in the country where the establishment is situated, or if the rectifications provided for in the preceding paragraph cannot be effected, or if the taxpayer agrees, the fiscal authorities may determine empirically the business income by applying a percentage to the turnover of that establishment. This percentage is fixed in accordance with the nature of the transactions in which the establishment is engaged and by comparison with the results obtained by similar enterprises operating in the country.

If the methods of determination described in the preceding paragraphs are found to be inapplicable, the net business income of the permanent establishment may be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment has participated. This determination is made by applying to the total income coefficients based on a comparison of gross receipts, assets, number of hours worked or other appropriate factors, provided such factors be so selected as to ensure results approaching as closely as possible to those which would be reflected by a separate accounting."[167] *(Italics, RD)*

The phrase "*if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions*" is again a reference to the arm's length principle, and specifically a reference to the comparability aspect of the

[167] League of Nations, Fiscal Committee, *Report to the Council on the fourth session of the Committee*, held on Geneva from 15 June to 26 June 1933, C.399. M.204, (4244) p. 4.

arm's length principle. This phrase requires associated enterprises or permanent establishments to be put on the same footing for tax purposes as independent enterprises. By doing so, a comparison should be made between the activities and conditions of transactions of the independent companies and the related companies or permanent establishment and its head office.

The Committee used the expression "dealing at arm's length" in this article. However, in the 1933 Commentary the Committee did not elaborate on this expression. In the Commentary, the independent enterprise approach /separate accounts approach and the power of correction by the tax authorities upon a deviation from this approach was emphasized without examining the new term "dealing at arm's length". It is possible that Carroll, whose principal position was with the US Treasury, had already included in the draft treaty a concept which was being discussed within the US Treasury at that time.[168] The United States published the first regulations under Sec. 45 which contained the arm's length principle:

"The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer".[169]

Furthermore, Art. IV of the US- France tax treaty signed in 1932 (and negotiated in 1930) also contained a similar provision. Carroll was involved in the negotiations of this treaty.
Some authors believe that Carroll's conclusions that the arm's length principle was the generally applied principle in order to secure a correct application of the separate accounts principle, were incorrect. In the next section I will deal with some comments on Carroll's research.

2.4.1.8. Comments on Carroll's research

In 1986 Langbein wrote a special report in *Tax Notes* dealing with the arm's length principle.[170] Langbein believed that a careful review of the rather extensive history on the development of Arts. 7 and 9 OECD Model raises

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[168] See also Hamaekers, H., "Arm´s Length; How Long?", 8 *International Transfer Pricing Journal* (March/April 2001), p. 33.
[169] US Treas. Regs. 86, Art. 45-1(b) (1935)
[170] Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* 7 (17 February 1986), pp. 625-681.

serious questions about whether and in what way the arm's length principle represents a true, comprehensive, accepted international norm. Langbein was of the opinion that the practical difficulties of the application of the arm's length principle were theoretically predictable and hence inevitable.[171]

According to Langbein, prior to Carroll's report, the community of experts designing the models appeared to be going in the direction of adopting some form of formula apportionment rules for allocating business profits.[172]
He argues that the reference to separate accounting in the original draft of the model was dropped in the final version and that the pre-existing conventions, mainly the ones among the Central European countries, included an allocation provision that called for formulary apportionment.[173] Langbein states that the formulary or empirical methods suggested in the Commentary on the 1928 Models were to predominate in making allocations under the model provisions.[174]
He writes in his article that Carroll's report changed this direction. In Langbein's view, Carroll's report advocated "a separate accounting, independent enterprise approach, and that approach became the precursor of the contemporary model convention provisions".[175]
Contemporaneous with the developments in the League of Nations, in 1934 the United States published the original regulations under section 482 of the Code. These regulations introduced the "arm's length standard" in the United States.[176] Langbein notes that this temporal coincidence is striking. Langbein concludes that the report discusses separately the manner in which tax authorities assessed a local branch or subsidiary of a foreign enterprise from that in which they assessed a local enterprise with respect to its foreign branches or subsidiaries. Langbein is of the opinion that Carroll's view was that the local branch of the foreign-controlled enterprise represented the more important problem. Because of the principle that the home enterprise could always tax the residue of profits of an enterprise, Carroll tended to ignore the

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171 Ibid., p. 627.
172 Ibid., p. 631.
173 Ibid., p. 632. Langbein refers to Carroll's analysis in League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217), pp. 74-77.
174 Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* 7 (17 February 1986), p. 676.
175 Ibid., p. 632.
176 Treasury Regulations 86, Sec. 45-1 (1934).

fact that this was true in the case of an enterprise with foreign branches, but not one with foreign subsidiaries.[177] According to Langbein, Carroll also distinguished among different types of businesses, holding that industrial or commercial enterprises presented the most serious problems of allocation; banks, second; and that other enterprises, such as shipping and insurance companies, presented only limited problems.[178] Carroll focused heavily on selling establishments as presenting the most important "substantive" problems.

In Langbein's view, Carroll was concerned extensively with the relative contributions of production and sales activities to total profit in such enterprises, although the system of allocation he ultimately recommended did not really mean that profits should be allocated strictly based on precisely determined relative contribution.[179]

With respect to the taxation of associated enterprises, Carroll described the problem as one which occurred when arrangements were made other than at arm's length.[180] Carroll's analysis contained four ways in which the subsidiary's jurisdiction could reach the parent. The first way was by re-adjusting the price to an arm's length price and taxing the subsidiary. Carroll cited the predecessor of section 482 in the United States as an example. The second way was by taxing the parent directly, for which express statutory provision was required. The third way was by making an assessment of the entire enterprise on the basis of economic unity. Finally, the fourth way was by assessing on the basis of consolidated accounts.[181] Langbein notes that a United Kingdom Statute

[177] Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* 7 (17 February 1986), p. 632. Langbein refers to Carroll's analysis in League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217), p. 14.

[178] Ibid. Langbein refers to Carroll's analysis in League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217), p. 11 and p. 116.

[179] Ibid. Langbein refers to Carroll's analysis in League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217), p. 189.

[180] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217), p. 110.

[181] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217), pp. 110-114; see also Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* 7 (17 February 1986), p. 633.

represented the only instance in which the second method was used; the practices of the American states represented the primary instance of the fourth method.[182] In his report, Carroll expressed no conclusion as to preferred methods for allocation in the associated enterprise context. However, in his general discussion of a preferred allocation system, Carroll expressed an unqualified preference for *separate accounting*. According to Langbein, this preference was more a consequence of Carroll's objections to fractional apportionment than to commendations of a "separate enterprise" standard.[183] Langbein based this conclusion on the following phrases from Carroll's report:

"A state's jurisdiction [...] should be restricted to income from property or other sources within its territory [...], it would appear inconsistent to incorporate in the regime a provision permitting any country in which the enterprise has a branch establishment to take jurisdiction over the total net income in order to determine what part thereof might be attributable to the local establishment."

Secondly, Carroll was of the opinion that there would be administrative difficulties in determining the income of foreign branches under the law of the local branch. The foreign branches might not even have information readily translated into the terms and categories imposed by the law of the state of the local branch.[184]
Carroll also concluded that the differences under fiscal or commercial law for maintaining accounts, the differences in accounting methods, in language, in currency and the incidental problems of evaluation and exchange would cause problems in the application of formulary apportionment. Another main issue, as highlighted by Carroll, were the generally prevailing differences in "profit-making capacity" among different jurisdictions which fractional apportionment would eviscerate. In this context, Langbein quotes the following phrase from Carroll's report:

[182] Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* 7 (17 February 1986), p. 632

[183] Ibid., p. 633.

[184] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217), p. 188; see also Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* 7 (17 February 1986), p. 633.

"Will the countries in which profits have clearly accrued agree to giving up a part or all of such profits as a result of an apportionment of the total net income or loss of the enterprise?"[185]

According to Carroll, there would be intractable difficulties securing agreement as to the total net income and the basis for apportionment.[186] Finally, as Langbein correctly notes, Carroll does provide a justification for the use of separate accounting without referring to a defect of fractional apportionment:

"(*separate accounting was*) preferred by the great majority of governments, and business enterprises represented in the International Chamber of Commerce, as well as by other authoritative groups".[187]

It should be noted that beyond this general recommendation, Carroll considered it "undesirable to endeavour to prescribe detailed rules of separate accounting",[188] although Carroll stressed the need for treaties to provide definite and precise rules for application where to parties claimed a right to tax the profits of one enterprise.[189]

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185 Ibid. Quote from League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217), p. 189.

186 League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217), p. 189.

187 Ibid. see also Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* 7 (17 February 1986), p. 633.

188 League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217), p. 189.

189 Ibid., p. 191; see also Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* 7 (17 February 1986), p. 633. Langbein states the following regarding this matter:

"In approaching the question of allocation rules, Carroll identified a problem with the separate accounting / separate enterprise method, which is interesting because it finely adumbrates, even if at the same time it greatly oversimplifies, what to my mind has ultimately emerged as the fundamental defect of the approach. Carroll states that "in the alchemy of a successful business, the intangible, immeasurable element of brainwork is a very important factor, if not the most vital factor". Carroll then identifies two distinct methods for allocating profits to a branch – the first the 'remuneration for services' criterion, the second the 'sale between independents' criterion. The difference was that the former allocated to a branch only profits strictly imputable to the services the branch performed; the latter involved a fictional transfer of title to the goods and allotted to the branch capital it would need to carry

Langbein is of the opinion that in his investigation into legislation and practice Carroll had drawn the wrong conclusions.[190] The legislation at that time, according to this author, contained in most cases either formulary apportionment or no specific allocation rule. In practice, if possible, the bookkeeping of the permanent establishment itself was used as a basis. Langbein argued that Carroll was inspired by the US Treasury, where in 1935 the arm's length principle was explicitly included as a basic principle in transfer pricing regulations.[191] According to Langbein, Carroll managed to have this "modern" method internationally accepted via the League of Nations. It was incorrect to proclaim a non-legal method as the standard. Langbein noted that Carroll's "general justification had more to do with objections to fractional apportionment than to commendations of a 'separate enterprise' standard".[192]

Langbein also criticises Carroll on the following important issue. According to Langbein, Carroll fails to emphasise "a fact he clearly identifies, a fact which greatly qualifies his conclusions concerning the widespread for, and the normal usage of, separate accounting".[193] Langbein describes in his analysis of Carroll's report that the separate accounting approach was almost nowhere statutory. It was rather the product of *administrative practice*. In the cases where Carroll did find a statutory system, this system usually involved fractional apportionment. Langbein is of the opinion that it was unprecedented during that time for model conventions to be based on administrative practices, rather than tax laws. If only administrative practices were involved, according to Langbein one could solve the problem by coordinated international statutory development.

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on its operations and to losses or risks of losses that would be carried by a similar independent enterprise."

190 Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* 7 (17 February 1986), pp.625-681.

191 Treasury Regulation 86, Sec. 45-1(b): "The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer".

192 See also Francescucci, D.L.P., "The Arm's Length Principle and Group Dynamics", 11 *International Transfer Pricing Journal* 2/6 (2004). Francescucci comments that the only justification of the separate accounting method put forward by Carroll that is not the flip side of a shortcoming of the fractional apportionment method is that it is "preferred by the great majority of governments, and business enterprises represented in the International Chamber of Commerce, as well as by other authoritative groups". See also Carroll in League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217), p. 189.

193 Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* 7 (17 February 1986), pp.625-681.

Therefore, the appropriate course might have been to recommend statutory provisions, rather than bilateral or multilateral international agreement.

However, looking at the timeframes in which the Models were written and discussed, I am of the opinion that it would be very difficult to have these "recommended statutory provisions" implemented in the laws of the Member countries. The model tax conventions have not only been *models*, but they also provide the common understanding and consensus of allocation methods between Member countries. Furthermore, the League of Nations only started in 1923, some years before Carroll's report, to find solutions for the problems of double taxation and profit allocation.

In my opinion, the possibility that Carroll based his findings and conclusions on a method of assessment should not influence the practical outcome, which is the writing of a draft model. The fact that today the arm's length principle is still one of the main principles used by the OECD shows that an assessment method used in practice can develop into a legislative principle.

Whether or not Langbein's conclusion is correct, it is apparent that the arm's length principle has developed from being an approach of supporting the separate accounts principle which prevented manipulation of accounts of permanent establishments, into an international principle underlying Art. 9 OECD Model. It was not a big step from separate accounts to separate entities/independent enterprises and dealing as independent enterprises with each other is, in fact, the same as the arm's length principle.[194]

However, further guidance on how to establish transfer prices in compliance with the arm's length principle was not provided in the 1933 Report.[195] Nevertheless, the terminology of the allocation article (Art. 3) had been improved. For example, the term "permanent establishment" no longer comprised subsidiary companies. Rules for the taxation of subsidiary companies were now laid down in a separate article, Art. 5 of the 1933 Draft Convention. Profit allocation took place on the basis of the separate accounting

[194] Hamaekers, H., "Arm´s Length; How Long?", 8 *International Transfer Pricing Journal* (March/April 2001), p. 34.

[195] US Treasury Department, "A Study of Intercompany Pricing under Section 482 of the Code", Notice 88-123, 1988-2 CB 458 (the White Paper), p. 459. See also See also Francescucci, D.L.P., "The Arm's Length Principle and Group Dynamics", 11 *International Transfer Pricing Journal* 2/6 (2004), p. 64.

principle. Remarkably, the Commentary on the 1933 Draft Convention did not use the existing expression of the separate entity approach or separate accounting principle, but referred to this principle by using the term "independent enterprise".[196]
If there was inferior or no bookkeeping present in the permanent establishment, the tax authorities could apply the empirical method or the formulary apportionment, in the latter case, provided that the result was as close as possible to separate accounting.[197]

As shown in the analysis above, Carroll's report contributed significantly to the implementation of the arm's length principle in the Reports of the League of Nations. From a principle supporting the separate accounts principle, the arm's length principle turned into a principle underlying the article concerning transactions between associated enterprises. By becoming the main principle for taxation of associated enterprises, the arm's length principle not only had the function of preventing the manipulation of accounts, it also aimed to create a broad parity of tax treatment for associated and independent enterprises operating internationally. It became a general principle of international taxation.

2.4.1.9. Article 5 of the 1933 Draft Convention

In 1933 the arm's length principle was introduced in the newly introduced Article 5. This article dealt with the taxation of associated enterprises. This Art. 5, which is crucial for this study, reads:

"When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and as the result of such situation there exists, in their commercial or financial relations, conditions different

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[196] League of Nations, Fiscal Committee, Report to the Council on the fourth session of the Committee, held on Geneva from June 15nd to 26th, 1933, C.399. M.204, (4246) p. 6. The Commentary referred to the separate accounting principle with the words "Under Article 3, the fiscal authorities must, in principle, treat a permanent establishment situated in their territory as an independent enterprise." See also Hamaekers, H., "Arm´s Length: How Long?", 8 *International Transfer Pricing Journal* (March/April 2001), p. 34.
[197] See Hamaekers, H., "Arm´s Length: How Long?", 8 *International Transfer Pricing Journal* (March/April 2001), p. 33.

from those which would have been made between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the law of the State of such enterprise."[198]

This article, which is the forerunner of the current Art. 9 OECD Model, states that tax authorities may make adjustments in situations where related enterprises used "conditions different from those which would have been made by independent enterprises". This is the case when transactions were not at arm's length. Although Art. 5 did not explicitly mention the term "dealing at arm's length", the arm's length principle was applied as underlying principle.
The words "*any item of profit or loss which should normally have appeared in the accounts of [...]*" limit the rewriting of the accounts by a tax authority.
The tax authorities could *only* make an adjustment when conditions differ from those which would have been made between independent enterprises. These adjustments are limited to the amount of these profits or losses which should normally have appeared in the accounts. Thus, a tax authority could not, for example, rewrite the accounts to a higher amount profits than which would be made in the case of an independent situation.[199]

2.4.1.10. The 1935 Report

During the fifth session of the Fiscal Committee in 1935, minor amendments and additions were made to the 1933 Draft Convention. The arm's length principle and separate accounts principle remained the main principles of Art. 3. The first paragraph of Art. 3 reads:[200]

"If an enterprise with its fiscal domicile in one contracting State has permanent establishments in other contracting States, there shall be attributed to each permanent establishment the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Such net income will, in

[198] League of Nations, Fiscal Committee, *Report to the Council on the fourth session of the Committee*, held on Geneva from June 15nd to 26th, 1933, C.399. M.204, (4245) p. 5.
[199] See also Chapter 4 *Tax Treaty Interpretation*.
[200] Ibid.

principle, be determined on the basis of the separate accounts pertaining to such establishment. Subject to the provisions of this Convention, such income shall be taxed in accordance with the legislation and international agreements of the State in which such establishment is situated."

Again, there was clear reference to both the arm's length principle and the separate accounts principle. The separate accounts principle can be found in the phrases "attributed to each permanent establishment the net business income which it might be expected to derive if it were an independent enterprise" and "on the basis of the separate accounts pertaining to such establishment". This phrase may explain the use of the term "separate entity approach". In the early League of Nations reports the term "separate accounts" was used. The term "independent enterprise" was used in this article of the 1935 Report. Today the term "separate entity principle" is frequently used. In my view, this principle is derived from the early "separate accounts principle" as applied in the Reports of the League of Nations before 1935. The step from separate accounts to separate entity is not a difficult step. This may explain why the principle of separate accounts was replaced in the literature by the separate entity principle/approach.

For tax purposes the permanent establishment is treated as a separate, independent enterprise as may be concluded by the words "on the basis of separate accounts". To calculate the attributable net business income, the arm's length principle is used.

The second paragraph of Art. 3 reaffirms the application of the arm's length principle:

"The fiscal authorities of the contracting States shall, when necessary, in execution of the preceding paragraph, rectify the accounts produced, notably to correct errors or omissions, or to re-establish the prices or remunerations entered in the books at the value which would prevail between independent persons *dealing at arm's length*."[201]

The forerunner of Art. 9 of the OECD Model, Art. VI of the 1935 Model Convention, also applies the arm's length principle:

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[201] League of Nations, Fiscal Committee, *Report to the Council on the fifth session of the Committee*, held on Geneva from 12 June to 17 June 1935, C.252. M.124, (4254) p. 6.

"Art. VI
When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and as the result of such situations there exists, in their commercial or financial relations, *conditions different from those which would have been made between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been , in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise,* subject to the rights of appeal allowed under the law of the State of such enterprise." [202] *(Italics, RD)*

The application of the arm's length principle is provided for in the italicised phrase. In Art. VI the explicit term "at arm's length" is not used and the article is not very clear on the use of other allocation approaches such as the empirical and fractional apportionment approaches. Apparently, Art. VI, as quoted above, prefers the arm's length principle *exclusively* as the main allocation approach. This can be concluded from the italicised words. The article consists of two main parts. The first part contains an analysis of whether associated enterprises exist. One has to establish the existence of association between enterprises. *Only after* this first question has been answered affirmatively may the fiction of the arm's length principle be applied. This can be concluded from the words "and of the *result* of *such* situations". The expression "*such situations*" refers to the existence of associated enterprises. The words "*as the result*" refer to the requirement of association to be the *cause* of conditions differing from those that would be made between independent companies. There should be causality between the existence of associated enterprises and a deviation from the arm's length price to justify re-writing accounts.

That the arm's length principle is the exclusive allocation approach in this article can also be seen from the words "*conditions different from those which would have been made between independent enterprises*". In case there is a deviation between the conditions of the associated enterprises and the independent enterprises, any items of profit or loss resulting from this deviation from those conditions, must be diverted to the other enterprise. The amount to be diverted is only that profit or loss resulting from this deviation. Hence, this concerns *only* the profit or loss which deviates from the arm's length price.

[202] Ibid.

However, Art. III provides that "[...] the fiscal authorities may determine *empirically* the business income by applying a percentage to the turnover of that establishment" and " [...] the net business income of the permanent establishment may be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment has participated."[203] This indicates that an empirical approach is also allowed for the income allocation of permanent establishments. The Reports did not elaborate on why Art. VI only used the arm's length principle and Art. III also included the option to use the empirical approach.

As shown above, Art. VI of the 1935 Report included the arm's length principle. The introduction of the arm's length principle in the League of Nations Model conventions and, later, its articulation in Arts. 7 and 9 of the OECD Model, also lead to the incorporation of the arm's length principle into the domestic legislation of many OECD Member countries.

Up to now, I have discussed the introduction of the arm's length principle in the 1920s and 1930s. I also elaborated on the link between the associated enterprise concept and the arm's length principle.
In the next sections, I will describe the development of the arm's length principle after the Second World War.

2.4.2. The period 1940 – 1970/League of Nations/OEEC/OECD

2.4.2.1. The Mexico and London Drafts

After the Second World War, the OEEC/OECD continued to develop the arm's length principle and its application through the Model Tax Conventions. The Fiscal Committee still considered the separate accounts principle and the arm's length principle to be valid principles underlying the solution of allocation. The Committee readopted them and tried to formulate the principles as clearly as possible on a basis which would be acceptable for all Member countries. The Committee analysed in-depth the arm's length principle and its application. Under the auspices of the Fiscal Committee of the League of Nations in June 1940 and July 1943, conferences were held in

[203] Ibid.

Mexico leading to a new model treaty.[204] A non-European influence was clearly apparent in this Mexico Draft Convention, which was drafted by a group that included two members from the U.S. and Canada and nine from Central and South America. In this draft the source principle, attractive to debtor states, took a prominent place. At the last meeting of the Fiscal Committee, which was held in London in March 1946, a new model treaty was drawn up. The European concept again dominated.[205] The Committee wrote that it was:

"desirable to arrive at a comprehensive set of rules regarding the determination and allocation of taxable income in the case of business enterprises carrying on their activities in more than one country. The provisions suggested by the Fiscal Committee for that purpose embody principles that are generally recognised as sound."[206]

Art. VI of the Protocol to both the Mexico and London Drafts confirmed the pre-eminence of the independent enterprise approach for the profit allocation to permanent establishments, referring to the arm's length principle in this context. In addition, the empirical and formulary apportionment approaches were mentioned as secondary and tertiary methods.[207]
Art. VII of the Protocols to the Mexico and London Drafts included a similar provision on related companies. However, an explicit reference to the arm's length principle was not made in this article.
The Commentaries of the London and Mexico Drafts refer to the separate article of associated enterprises:

"Paragraph 8 of Article V of the Protocol refers to subsidiary companies. It states that a subsidiary cannot be regarded as a permanent establishment of the parent enterprise. This provision has two main effects. In the first place, the country where the subsidiary is situated is not entitled to tax the parent

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[204] Ibid., (4321) et seq.
[205] Van den Tempel, A.J. , "Relief from Double Taxation, A comparison of the work of the League of Nations and of the Organisation for Economic Cooperation and Development", in: Van den Tempel, A.J., *Seventh Chapter of the Book Developments in taxation since World War I* (Amsterdam: IBFD, 1967), p. 9.
[206] League of Nations, Fiscal Committee, *Report on the Work of the tenth session of the Committee*, held in London from 20 March to 26 March 1935, C.37. M.37, (4308) p. 10.
[207] The empirical method was now referred to as presumptive method. Remarkable in Art. VI is the provision for a corresponding adjustment, which returns much later in Art. 9 (2), 1977 OECD Model. See also Hamaekers, H., "Arm´s Length; How Long?", 8 *International Transfer Pricing Journal* (March/April 2001).

company except, of course, on the dividends which the parent company may receive from its subsidiary, in accordance with the provisions of Article IX of the Mexico draft and Article VIII, paragraph 2, of the London Model Convention, to which reference is made on page 25.
Secondly, in taxing the parent company, the authorities of the country in which such company is situated may not take into account the actual profits made by the subsidiary company in the other country, but only the dividends and other income paid by the subsidiary to the parent company. *These rules follow the principle that a subsidiary constitutes a distinct legal entity and should therefore be taxed separately*."[208] *(Italics, RD)*

The Commentary confirmed that the use of the separate accounting approach as the fundamental procedure for the determination of the profits attributable to each country in which an enterprise has an establishment, is intended to serve four purposes.

1. By treating a branch establishment not as a part of an enterprise but as a self-contained unit and thus generally avoiding reference to results or data outside the country concerned, it gives the taxation of branch establishments a strictly territorial scope, not extending beyond the boundaries of the countries concerned.
2. The method of separate accounting helps to enforce the principle of equality of treatment of foreigners by placing, in principle, branches of foreign enterprises *on the same footing as similar establishments of domestic enterprises* as regards the computation of receipts and expenses, which once they have been allocated or apportioned by separate accounting, are to be treated in accordance with the tax law of the country to which they have been attributed.
3. The use of separate accounting as a basis for the assessment of income tax conforms to the usual practice among *concerns* engaged in international business of keeping separate accounts for each of their establishments.
4. Separate accounting serves the revenue interests of the country concerned, since, when it is properly applied and supervised, it prevents the concealment of profits or their diversion from one country to another.[209] *(Italics, RD)*

[208] League of Nations, Fiscal Committee, *London and Mexico Draft Model Tax Conventions, Commentary and Text* (Geneva, November 1946), C.88.M.88.1946 II.A., (4337) p. 17.
[209] Ibid., (4338 and 4339) pp. 18 and 19.

In connection with the fourth point, Art. VI (1b) of the Protocol specifically foresees the possibility of a rectification by the taxing authorities of the *"accounts produced, especially in order to correct errors or omissions, or to re-establish the prices or remuneration entered in the books at the value which would prevail between independent persons dealing at arm's length"*.[210] Thus, the assessment for tax purposes of the profits of an establishment or a subsidiary according to the method of separate accounting implies that the arm's length principle should be applied. A very important aspect in the light of this study is the second point. The use of the separate accounting approach and therefore the use of the arm's length principle *"helps to enforce the principle of equality"*. By placing branches of foreign enterprises *on the same footing as similar establishments of domestic enterprises*, the principle of equality is served. The objective of separate accounting and the arm's length principle is to place branches of foreign enterprises on the same footing as domestic concerns. This can be found in the following text which the Committee provided:

"[...] There are [...] certain items of expenses that must necessarily be apportioned in order to achieve the *object of separate accounting*, which is *to place branches of foreign enterprises on the same footing as domestic concerns*."[211]

From the text of the Commentary of the London and Mexico Drafts it is apparent that the arm's length principle supported the separate accounts principle:

"At the same time, Article VII of the Protocol indicates the criteria according to which the correctness of the mutual relations between parent and subsidiary companies can be checked so as to avoid abuse resulting in the diversion of profits or losses from one company to another."[212]

The arm's length principle forms not only the basis on which profits and losses should be allocated, it requires also that it should be *correctly* allocated by comparing the transactions with those between independent enterprises. After all, enterprises can influence accounts of their subsidiaries (or permanent establishments) in order to shift profits or losses from one jurisdiction to another.

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[210] Ibid., (4339, 4398 and 4399) pp. 19, 78 and 80.
[211] Ibid., (4341) p. 21.
[212] Ibid., (4337) p. 17.

These criteria as mentioned in the above text of the Commentary refer to the arm's length principle. Art.VII of the Mexico Draft only reads:

"When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and, as the result of such situation, there exist in their commercial or financial relations conditions different from those which would have existed between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the laws of the State of such enterprise."[213]

Art. VII of the London Draft reads:

"When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and, as the result of such situation, there exist in their commercial or financial relations conditions different from those which would have existed between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise"

The criteria according to which the correctness of the mutual relations between parent and subsidiary companies can be checked, are to be found in the phrase "there exist in their commercial or financial relations conditions different from those which *would have existed between independent enterprises*" of article VII. With the word "criteria" the Committee is referring to the arm's length principle.

According to the Fiscal Committee, the principles underlying Art.V of the Protocol to both the London and Mexico Drafts had been widely accepted by Member countries. The work done by the League of Nations had greatly

[213] Ibid., (4402) p. 82.

furthered the making of agreements based on a common view of the problems involved.[214]

In the ten years that have elapsed since those Drafts Model Conventions were published many bilateral Double Taxation Conventions had been concluded both within OEEC and outside it which differ in smaller or greater degree from the version recommended by the League of Nations.

2.4.2.2. The 1958 and 1959 Reports

The Fiscal Committee of the OEEC continued the work of the Fiscal Committee of the League of Nations. In the 1958 Report of the Fiscal Committee on the Elimination of Double Taxation the Committee wrote that in order to remove a great many of the taxation obstacles to the expansion of intra-European trade, payments and investments, the first step required consisted of applying a less ambitious programme which would be restricted to solving taxation problems that had an international aspect, and in particular, to *delimiting taxation powers* uniformly between the Member countries.[215] The delimiting of powers is reconfirmed in the second report of the Fiscal Committee of the OEEC in July 1959. The Fiscal Committee confirmed that the object of the articles of the Model Convention is to delimit taxation powers uniformly between the Member countries in a certain number of cases where liability to tax arises.[216] The Committee sought to settle and co-ordinate the principles, definitions and methods in order to establish uniform solutions, which are acceptable to all Member countries and correspond to the existing conditions of the problems in question.

2.4.2.3. The 1960 Report

In 1960 a report was published which included a draft article on the profit attribution to permanent establishments and related companies (Art. XV), which later turned up as Arts. 7 and 9 in the OECD Model of 1963.[217]

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[214] OEEC, Paris, 29th August, 1957, FC/WP1(57)2, p. 2.

[215] Fiscal Committee, *Report to the OEEC - The elimination of double* taxation, (Paris: OEEC, September 1958), p. 12.

[216] Fiscal Committee, *Second Report to the OEEC - The elimination of double taxation*, (Paris: OEEC, July 1959), p. 7.

[217] See also OEEC FC(60), p. 13, para. 18, (Paris 25 May 1960), FC(60)2.

The Fiscal Committee continued on the works of the League of Nations, as laid down in the Mexico and London Draft Model Conventions. The Fiscal Committee stated:

"The rules proposed by the Fiscal Committee in these Articles are not an innovation. Most of the existing double taxation agreements contain solutions based on the Mexico and London Model Conventions of the League of Nations, and are thus to some extent uniform. The Fiscal Committee considered that the principles underlying those solutions are still valid. It has, therefore, readopted them, formulating them as clearly as possible and defining their practical application on a basis which is acceptable to all Member countries. The Fiscal Committee, however, has not entered in detail into all the problems which can arise when an enterprise in one country makes profits in another, or to draw up precise rules for each individual case. Indeed, this would not have been possible in the relatively restricted scope of an Article to a Convention, in view of the very many forms that international business assumes nowadays. Moreover, the settlement of any special cases which may arise should not give rise to insuperable difficulties when satisfactory general directives have been established and agreed by all concerned."[218]

The Committee wrote in this report that Art. XV prescribes the permanent establishment test for determining which State has the right to tax industrial or commercial profits. It "formulates *the basic principle* which must govern the calculation of the profits of the permanent establishment, namely, that the permanent establishment must be regarded as an *enterprise entirely distinct and separate* from the head office."[219]

The separate accounts principle was, more and more, being transformed into the separate entity principle, and continued to be the standard. Also, from the following quote it can be concluded that the separate accounts principle was a basic principle, used in the precursors of the current Arts. 7 and 9 OECD Model. Regarding the taxation of associated enterprises the Committee wrote:

"The Article provides that, in calculating the taxable profits, the taxation authorities may rewrite the accounts of such enterprises if, as a result of their special relationship, those accounts do not disclose the true profits which are

[218]See also OEEC FC(60), p.13, para. 18 (Paris 25 May 1960), FC(60)2.
[219] Ibid., p. 14, para. 19.

properly taxable in each of the countries concerned on the *separate enterprise principle set out in Article XV*."[220] *(Italics, RD)*

In the paragraph quoted above, the Committee explicitly confirmed the application of the separate enterprise approach and the arm's length principle. In its Commentary on the articles concerning the allocation of profits to permanent establishments and associated enterprises, the Committee stated that it was necessary, in order to prevent double taxation, to supplement the definition of permanent establishment by adding to it an agreed set of rules for profit allocation. This included not only an allocation of profits made by the permanent establishment, but also by an enterprise trading with a foreign member of the same group of enterprises.
In Annex A of this same report, the Committee also provided a definition regarding the profit determination of permanent establishments:[221]

"Article XV
[...]
2. Where an enterprise of a Contracting State carries on business in the other State through a permanent establishment situated therein, there shall in each State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and *dealing quite independently* with the enterprise of which it is a permanent establishment." *(Italics, RD)*

The explicit mention of the arm's length principle with the words "dealing at arm's length" had disappeared and did not return in later models.[222] The arm's length principle was recognised as a standard international principle, as can be concluded from the following text of the Fiscal Committee:

"It should perhaps be said at this point that neither Article is strikingly novel or particularly detailed. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of European double taxation Conventions concluded

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[220] Ibid.
[221] Ibid., annex A, p. 17, para. 2.
[222] See Hamaekers, H., "Arm´s Length; How Long?", 8 *International Transfer Pricing Journal* (March/April 2001), p. 33.

since the war, and it is fair to say *that the solutions adopted have generally conformed to a standard pattern*. It is generally recognised *that the essential principles on which this standard pattern is based are well founded*, and it has been thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater clarity."[223]

Apparently, the Committee is confirming that the solutions for allocating profits between associated enterprises have conformed to a standard pattern. The essential principles underlying this standard pattern are the separate accounts approach and the arm's length principle. As subsidiaries and other associated enterprises are generally separate legal entities, the requirement of separate accounts is automatically met. There was an international consensus on the use of these two principles. This "standard pattern" also strongly indicates the existence of an "autonomous interpretation" of the concept of "associated enterprises". Chapter 5 will look into this further.

The Commentary on Art. XV of the 1960 Report indicates in paragraph 2 that business profits should be allocated according to the arm's length principle:

"The paragraph incorporates the view, which is generally contained in bilateral agreements that have been concluded since the war, that the profits to be attributed to a permanent establishment are those *which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market.*"[224]

This would be the same profit that one would expect to be reached by the *"ordinary process of good business accountancy"*. The words "ordinary process of good business accountancy" is a new expression used by the Fiscal Committee in its 1960 Report.[225] The Committee did not elaborate further on the link between arm's length dealing and such an "ordinary process of good business accountancy".
Also interesting is the use of the words "separate enterprise". As I have already mentioned in this chapter, in the literature the term "separate accounts" approach or principle is not much used with regard to the profit allocation between permanent establishments and head offices. The term "separate

[223] See also OEEC, FC(60), annex E, p. 22, para. 2, (Paris: 25 May 1960) FC(60) 157.
[224] Ibid., p. 36, para. 2.
[225] Ibid., p.36, para. 2.

entity" approach or principle is used more frequently. Going from separate accounts to separate entities/independent enterprises was apparently not a big step in these 1960s reports and dealing as independent enterprises with each other under conditions and at prices prevailing in the ordinary market is, in fact, the same as the arm's length principle. I was unable to find an explanation by the Committee why the expression "separate entity approach" replaced the "separate accounts approach" and what the exact conceptual differences were between these two principles.

I noticed that in the same paragraph examples are provided by the Committee, where different factors have to be taken into account when comparing the prices between related companies or permanent establishment and head office, and between prices established between unrelated parties. For example, the Committee writes that there may be perfectly good commercial reasons for an enterprise invoicing its goods at prices less than those prevailing in the ordinary market. This might be a normal commercial method of establishing a competitive position in a new market and should not then be taken as evidence of an attempt to divert profits from one country to another. This reasoning is also used by the OECD in the OECD TP Guidelines. It confirms that the consideration of transfer pricing should not be confused with the consideration of tax fraud or tax avoidance. The 1960 statement of the Fiscal Committee may be taken as evidence that the arm's length principle was not an anti-avoidance or anti-evasion measure.
As concluded by the Committee in the 1960 Report, if available accounts do not represent the real facts, then new accounts will have to be constructed, or the original ones re-written. And for this purpose the figures to be used will be those prevailing in the open market.[226]

Although it seems that there was no explicit use of the term "arm's length" in the reports of the OEEC, there are some references to this term. Paragraph 3 of the Commentary on Art. XV of the 1960 Report reads:

"[...] Even where such a course has not been customary, it may, exceptionally, be necessary for practical reasons to estimate the *arm's length* profits."[227]

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[226] Ibid., p. 37, para. 2.
[227] Ibid., p. 40, para. 3.

Though the term "arm's length principle" was not explicitly mentioned in the reports, the Fiscal Committee used the principle actively in its reports. In the Commentary on Art. XVI, the Fiscal Committee writes that "no rewriting of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms", and thus at arm's length. This expression indicates the essence of the arm's length principle. The conditions being applied in the normal open market are the conditions which should not be adjusted by tax authorities, as no rewriting of such transactions is authorised.

There are also other references to the notion of "at arm's length". In annex E of the report of the Fiscal Committee of 1960, the Committee writes:

"[...] estimate the arm's length profit of a permanent establishment [...] it may, exceptionally, be necessary for practical reasons to estimate the arm's length profits."[228]

Another main reference to the arm's length principle was given by the Committee in the Commentary on the articles concerning taxation of dividend, interest and royalties. For example, in the Commentary on Art. XXI concerning the taxation of interest, the Committee states that the purpose of paragraph 2 of this article is to restrict the operation of the provisions in cases where the interest paid exceeds the amount which would have been agreed upon by the payer and the recipient *had they stipulated at arm's length*.[229]

Though the arm's length principle is commonly used in the OEEC/OECD Model Conventions, only few times is the explicit name of this principle - *arm's length* principle - used.

The empirical method for the profit determination of permanent establishments, which occurred in the Mexico and London models, was not included in the OECD Model Conventions.

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[228] See also OEEC, FC(60) 157, annex E, p. 31, para. 21 (Paris: 13 July 1960), FC(60) 157.

[229] OEEC, FC(1961)97, p. 58, para. 32 (Paris: August 1961) 1961 FC(61) 97. Similar p. 65, Commentary text on art XXII concerning the taxation on royalties.

2.4.2.4. The 1963 OECD Model Draft Convention

By the end of its fourth year of work, the Fiscal Committee had almost been able to draft a set of nineteen articles in all, constituting the foundations of the draft Convention which it was appointed to prepare by the Council.
Finally, the OEEC published twenty-five articles under the title "The Elimination of Double Taxation" which constituted the basis of the Model Convention. After the establishment of the Organisation for Economic Co-operation and Development (OECD) in September 1961 under which its mandate was confirmed, the Fiscal Committee agreed upon six new articles and had included all the articles in a draft convention.
In the General Remarks of the Draft Convention the Committee stated that the phenomenon of international double taxation has harmful effects on the exchange of goods and services and movements of capital and persons.[230] In its brief analysis of the articles of the draft convention, the Committee wrote that Art. 7 concerning the taxation of business profits provides that the permanent establishment must be treated as an enterprise distinct and separate from the head office of the enterprise. This article provides that profits are to be calculated by a consistent method. This refers directly to the separate accounts/entity approach and the arm's length principle.

The international consensus on the application of the arm's length principle is also described in the 1963 Commentary on Art. 7 regarding the taxation of business profits. The question of which criteria should be used in attributing profits to a permanent establishment and how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of (European) conventions. The Committee stated that it is fair to say that the solutions adopted "have generally conformed to a standard pattern". According to the Committee, it has been generally recognised that the *essential principles* on which this standard pattern is *based* were well founded.[231]

In its Commentary on the 1963 OECD Model Convention, the Committee reconfirmed the preferred use of the arm's length principle. The Committee held the view that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of

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[230] OEEC, FC(63)87, p. 9.

[231] OECD, *Commentary on the 1963 OECD Draft Double Taxation Convention on Income and Capital* (Paris: OECD, 1963), p. 79.

dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. Hence, the determination of the profits to be attributed to a permanent establishment should be on the basis of separate accounts and at arm's length.[232]

The 1963 OECD Commentary on Art. 9 also points out that the arm's length principle was generally accepted by Member countries. It describes that for the purpose of calculating tax liabilities, the tax authority may re-write the accounts of the enterprises if as a result of the special relations between the enterprises the accounts do not show the true taxable profits. This might be the case when conditions are made or imposed between associated enterprises in their commercial or financial relations, which differ from those which would be made between independent enterprises.[233] However, if the transactions between the associated enterprises have taken place on normal open market commercial terms, in other words, if the transactions are *at arm's length*, then no re-writing of the accounts of associated enterprises is authorised.

At the same time, in 1962, the US House of Representatives passed a bill that for the first time would apply formulary apportionment to address profit allocation at the federal level.[234] The enactment of Subpart F and some specific cases, such as the Dupont case, raised the US transfer pricing concerns.[235]

However, the Assistant Secretary for US Tax Policy, Stanley Surrey, preferred the arm's length principle as a better approach to address transfer pricing issues. Thus, the ultimate legislation authorised the Treasury to write regulations under IRC 482 implementing the arm's length principle.[236]

Surrey authored regulations, which were finalised in 1968. These regulations imbued the arm's length principle with practical meaning by formulating the three classical methods of comparable uncontrolled price (CUP), cost-plus and resale price. These methods all depend on finding comparable uncontrolled

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[232] Ibid., 1963 Commentary on Art. 7 para. 4, p. 86.

[233] Ibid., 1963 Commentary on Art. 9, p. 93.

[234] Avi-Yonah, R.S., "Between Formulary Apportionment and the OECD Guidelines: A proposal for Reconciliation", *University of Michigan Legal Working Paper Series: The John M. Olin Center for Law and Economics Working Paper Series*, Working Paper 102 (May 2009).

[235] The DuPont case began in the 1950s and was decided in 1979. See *E.I. DuPont de Nemours and Company v. United States*, 608 F. 2d 445, 454-55 (1979), cert. denied, 445 US 962 (1980).

[236] Avi-Yonah, R.S., "Between Formulary Apportionment and the OECD Guidelines: A proposal for Reconciliation", *University of Michigan Legal Working Paper Series: The John M. Olin Center for Law and Economics Working Paper Series*, Working Paper 102 (May 2009).

transactions to those engaged in by the related parties. These regulations were the basis for the US transfer pricing litigation in the 1970s and 1980s.

The United States tried to "export" its new transfer pricing regulations, as can be concluded from the text below, derived from a speech appearing in Secretary Surrey's Reports on Developments in Treasury's Foreign Tax Program:

"All of the above relates to the proper formulation of our unilateral rules of allocation with respect to international transactions. But since they are international transactions, a unilateral approach by the United States, or any country, is not sufficient. For if our unilateral rules do not mesh with those of other countries the result will be double taxation, the tax burden of which will be borne either by one government through the foreign tax credit or by the taxpayer, with the other government obtaining an unwarranted benefit. [...] For it is clear that this must be the ultimate goal, an internationally acceptable set of rational rules to govern the allocation of international income arising through these transactions.
The United States believes that the OECD Fiscal Committee is the proper body to undertake the task of establishing the allocation standards to guide countries in reaching accommodations with each other. The OECD Fiscal Committee appointed a Working Party for this purpose. We intend, as a measure of assistance to that Working Party, to lay before it our proposed section 482 regulations as they are developed. *It is quite likely that these regulations may represent a more structurally developed and detailed framework of allocation rules than has been formulated elsewhere, and hence may prove helpful as a starting point and as a way of focusing attention on a wide range of issues.* We would, of course, welcome the analysis and discussion which we expect this would stimulate. We would be ready to make modification in these proposed rules if such changes are seen to be appropriate as a result of this international discussion. [...] The Treasury is finding other countries receptive to this approach, and has already included such a provision in several treaties."[237] (*Italics, RD*)

From the US perspective, the arm's length principle had to be considered an anti-tax avoidance and anti-tax evasion measure.[238] However, as will be shown in the next section, the arm's length principle in the OECD Model has obtained a different status.

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[237] Excerpt of the speech in *Secretary Surrey Reports on Developments in Treasury's Foreign Tax Program*, 24 J. Taxation 54, 56 (1966).
[238] See also Section 6.3 of this study.

2.4.3. The period after 1970: the arm's length principle is the international standard

2.4.3.1. Introduction of Art. 9 (2) OECD Model

After the 1970s the OECD continued to broaden the consensus on the application of the arm's length principle. Due to the economic development in the 1970s, a reconciliation of the different national policies with the general objectives of the OECD was required. The objectives of the OECD were, generally speaking, greater freedom of commerce and movement of capital and payments. According to the Member countries, there should be an elaboration of rules and procedures to avoid competition between States when attracting foreign investment and an elimination of the discriminatory treatment of foreign investment.[239] The various applications of these rules were laid down in the OECD Report on Multinational Enterprises.[240] The arm's length principle was also one of these important principles on which the Committee focused. In the 1976 OECD Declaration on International Investment and Multinational Enterprises, the governments of the OECD Member countries declared that enterprises should apply prices that conform to an arm's length standard:

"Enterprises should refrain from making use of the particular facilities available to them, such as transfer pricing which does not conform to an arm's length standard, for modifying in ways contrary to national laws the tax base on which members of the group are assessed."[241]

In 1977 the OECD introduced Art. 9 (2) OECD Model. This paragraph reads as follows:

"Where a Contracting State includes in the profits of an enterprise of that State and taxes accordingly profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State

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[239] See also Calderon, J., "The OECD Transfer Pricing Guidelines as a Source of Tax Law: Is Globalization Reaching the Tax Law", 35 *Intertax* (2007), p. 9.
[240] OECD,Committee on Fiscal Affairs, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises*, (Paris: OECD, 1979).
[241] OECD, *Declaration on International Investment and Multinational Enterprises*, (Paris: OECD, 21 June 1976), p. 4.

if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other."[242]

The 1977 Commentary states that the rewriting of transactions between associated enterprises may give rise to economic double taxation, insofar as an enterprise of State A, whose profits are revised upwards, will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State B. Paragraph 2 provides that in these circumstances, State B shall make an appropriate adjustment so as to relieve the double taxation.

Art. 9 (2) OECD Model is designed to eliminate economic double taxation: taxation of the same income in the hands of different persons. Art. 9 (2) OECD Model is an integral part of the arm's length principle. The application of the arm's length principle may cause economic double taxation when adjustments are made to correct the prices of the transaction. For example, if as a consequence of special conditions within the meaning of Art. 9 (1) OECD Model, the profits of one associated enterprise are increased in one of the two Contracting States, application of Art. 9 (2) OECD Model results in a corresponding decrease in the profits of the associated enterprises in the other Contracting State. The first-mentioned State makes an upward adjustment of the profits of the enterprise resident in this State and imposes tax on the increased profits. The increased element of profit bears tax in both Contracting States, albeit in the hands of different taxpayers.[243] This is the result of the arm's length principle. Art. 9 (2) OECD Model was introduced in order to eliminate this effect of the principle.
This paragraph tries to balance the increase in profits in one Contracting State by providing that the other State shall make an appropriate adjustment so as to relieve the double taxation. Therefore, Art. 9 (2) OECD Model must be considered as an integral part of the arm's length principle.

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242 Art. 9 (2) OECD Model 1977.

243 Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 553.

The purpose of Art. 9 (2) OECD Model indicates that the arm's length principle is not an anti-tax avoidance or anti-tax evasion measure. It is a general principle of taxation, which prevents double taxation and achieves an equitable inter-nation allocation of taxing rights.[244]

2.4.3.2. The 1979 OECD Report on Transfer Pricing and Multinational Enterprises

There are two documents issued by the OECD that can be considered to be the most important reports for transfer pricing purposes. These are the 1979 OECD Report on Transfer Pricing and Multinational Enterprises and the 1995 OECD TP Guidelines.

The requirement to use the arm's length principle for transactions between associated enterprises and for transactions between permanent establishments and their head office was the main topic of the 1979 OECD Report on Transfer Pricing and Multinational Enterprises (hereinafter: the 1979 Report). With the introduction of the 1979 Report, the application of the arm's length principle was explicitly recognised as the international principle for transfer pricing. The 1979 Report constitutes a set of internationally agreed upon principles, which were applied by most of the OECD Member countries and many non-OECD Member countries when establishing the arm's length principle at domestic level and international level. The main objectives of the report are to set out as far as possible the considerations to be taken into account and to describe generally agreed practices in determining transfer prices for tax purposes. The aim of this report is to provide guidance of universal validity. The basic point of reference in the report is the arm's length principle. The 1979 Report explains arm's length prices as follows:

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[244] See also Carroll, M.B., "International Tax Law", 2 *International Lawyer* 692 (1968), p. 129; Eigelshoven, A. in: Vogel, K. and Lehner, M., *Doppelbesteuerungsabkommen*, 5th edition (Münich: C.H. Beck, 2008), Art. 9, marginal number 6; Wassermeyer, F., "Art. 9 MA", in: *Doppelbesteurung* (München, Verlag H.C. Beck, 2008), Art. 9, marginal number 1; Becker, H., "Art. 9", in: Becker, H., Gosch, D., Kroppen, H.K. and Grotherr, S. (eds.), *DBA-Kommentar Loseblatt* (Herne and Berlin, Verlag Neue Wirtschafts-Briefe, 1997 loose-leaf), Sec. 2, Art. 9, marginal numbers 1 and 8 et seq.; Schaumburg, H., *Internationales Steuerrecht, Außensteuerrecht Doppelbesteuerungsrecht*, 2nd ed. (Köln: Verlag Dr. Otto Schmidt, 1998), marginal number 16.288; Wittendorf, J., "The Transactional Ghost of Art. 9 (1) of the OECD Model", 63 *Bulletin for International Taxation* 3 (March 2009), p. 109.

"prices which would have been agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions in the open market".[245]

In this Report the Committee on Fiscal Affairs confirms that profits of MNEs should be calculated by applying the arm's length principle:

"The profits should be calculated on the assumption that the prices charged in these transactions are arm's length prices."[246]

Based on the words "[...] arm's length approach, which underlies this report [...]" it can be concluded that the arm's length principle is without doubt the underlying principle of Art. 9 (1) of the OECD Model Convention of 1977 on transactions between associated enterprises.[247] In this context, the OECD also notes that the arm's length principle has also been endorsed by the United Nations Group of Experts on Tax Treaties between Developed and Developing Countries. This can be concluded from the following phrase:[248]

"The Group of Experts had unanimously recognised the validity of the arm's length principle and that governments should apply arm's length pricing wherever appropriate."

The statement of the United Nations Group of Experts on Tax Treaties quoted above also confirms the worldwide consensus on the application of the arm's length principle.

The 1979 Report states that there is a broad consensus among governments of developed and developing countries and MNEs that the arm's length pricing is the *appropriate approach* to adopt in arriving at profits for tax purposes.[249] But in this report the Committee also states that the need to adjust the actual price to an arm's length price, in order to arrive at a proper level of taxable profits,

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[245] OECD,Committee on Fiscal Affairs, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979), para. 2.
[246] Ibid., para. 3.
[247] Ibid.
[248] U.N. Department of Economic and Social Affairs, *Tax Treaties between Developed and Developing Countries: Seventh Report*, U.N. Document ST/ESA/78 (Geneva: 1978), p. 62.
[249] OECD,Committee on Fiscal Affairs, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises*, (Paris: OECD, 1979), para. 3.

arises *irrespective* of any contractual obligation undertaken by the parties to pay a particular price or of any intention of the parties to *minimise tax*. Hence, 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. This may be taken as evidence that the arm's length principle of Art. 9 OECD Model is not an anti-tax avoidance measure.

In the 1979 Report the Committee identifies problems in the field of transfer pricing and describes several methods to ascertain arm's length prices. A special section in the report describes the arm's length principle and its application in special situations. In this section, the Committee explains the arm's length principle by stating that prices paid for goods transferred between associated enterprises should be, for tax purposes, those which would have been paid between unrelated parties for the same or similar goods under the same or similar conditions.[250] The 1979 Report specifies the following three transfer pricing methods:

- The comparable uncontrolled price method;
- The resale price method; and
- The cost-plus method.

Under the comparable uncontrolled price method (hereinafter: CUP method) transfers of the same or very similar goods, the provisions of the same or similar services and the transfer of the same or very similar intangible property in transactions between unrelated parties is taken as a basis for establishing a transfer price between two related parties. An external CUP exists when the comparable transaction takes place between two unrelated parties outside the MNE concerned. An internal CUP exists when there is a comparable transaction between one of the related parties concerned and an unrelated party. The degree of comparability depends on various factors, such as the characteristics of the product, the contractual terms, the volume of the transactions, etc.
Under the resale price method an arm's length price for the transfer between a manufacturer and a related reseller (distributor) is determined by subtracting a gross margin (the "resale price margin) of the reseller from the resale price of the product concerned charged to an unrelated party. Under this method the

[250] Ibid., para. 37.

resale price margin is the most important element, as the resale price itself is uncontrolled and therefore not subject to comparison. Out of the resale margin the reseller must cover its selling and operating costs and derive its profit. The resale margin earned by an independent reseller with similar functions and risks in comparable transactions is compared.[251]
Under the cost-plus method a transfer price is produced by adding a markup to the direct and indirect production costs (costs of goods sold). The markup is derived from a comparison with uncontrolled transactions, in particular of the controlled producer with unrelated parties. The markup may have to be adjusted to take differences in functions and production aspects into account.[252]

2.4.3.3. The 1995 OECD Transfer Pricing Guidelines

In 1995 the Committee on Fiscal Affairs issued the OECD TP Guidelines that were intended to be a revision and a compilation of previous reports by the OECD Committee on Fiscal Affairs, addressing transfer pricing and other related tax issues with respect to multinational enterprises.[253]
The OECD TP Guidelines draw upon the discussion undertaken by the OECD on the proposed transfer pricing regulations in the United States.[254] As described in the Preface of the OECD Transfer Pricing Guidelines, the context in which the Report *Tax Aspects of Transfer Pricing within Multinational Enterprises: the United States Proposed Regulations* was written, was very different from that in which the OECD TP Guidelines have been undertaken.[255] The scope of that report was far more limited and it specifically addressed the US proposed regulations.

The OECD TP Guidelines focus on the application of the arm's length principle to evaluate the transfer pricing of associated enterprises. The OECD

[251] Hamaekers, H., "Introduction to Transfer Pricing", *Tax Treatment of Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), Chapter 7: The 1979 and 1984 OECD Reports on Transfer Pricing and Their Impact.
[252] Ibid.
[253] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 2009 version), Preface, para. 13
[254] See also the OECD Report *Tax Aspects of Transfer Pricing within Multinational Enterprises: the United States Proposed Regulations* (Paris: OECD, 1993).
[255] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 2009 version), Preface, para. 14.

TP Guidelines are intended to help tax administrations and MNEs by indicating ways to find mutually satisfactory solutions to transfer pricing cases, thereby minimising the conflict among tax administrations and between tax administrations and MNEs and avoiding costly litigation.[256]

According to the OECD, the arm's length principle should be considered to be the international consensus on the valuation for tax purposes of cross-border transactions between associated enterprises. The consistent application of the arm's length principle helps to ensure that the taxable profits reported by MNEs in the countries where they operate reflect the economic activity undertaken there. Taxpayers can avoid the risk of double taxation that may result from a dispute between two countries about the determination of the arm's length remuneration for their cross-border transactions.[257]

Chapter II of the OECD TP Guidelines describes the above-mentioned three classical transfer pricing methods: the CUP method, the resale price method and the cost-plus method. The OECD TP Guidelines consider these three "traditional transaction methods" to be the most preferable transfer pricing methods. Other methods may only be used where sufficient reliable data is lacking and therefore the traditional transaction methods cannot be applied.
The OECD TP Guidelines distinguish two other methods, which are based on the profits that arise from transactions between associated enterprises: the profit split method and the transactional net margin method (TNMM). It is important to note that according to the OECD TP Guidelines, in no case are such methods to be applied to impose additional tax on enterprises which make lower profits than average.[258]
The profit split method may be applied where transactions are strongly interrelated. After the profit to be split has identified, the profit is split between the related enterprises on economically valid basis that approximates a division of profits in an arm's length situation. The combined profit may be the total profit from the transaction or a residual profit which remains after the division of profits that can easily be divided between the parties. According to the

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[256] Ibid., para. 15.
[257] See also http://www.oecd.org/document/20/0,334, press release "OECD approves updates to Model Tax Convention, Transfer Pricing Guidelines and Report on Attribution of Profits to Permanent Establishments."
[258] Hamaekers, H., "Introduction to Transfer Pricing", *Tax Treatment of Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), Chapter 10: The OECD Guidelines 1995.

OECD TP Guidelines, the division should take place on the basis of a functional analysis comprising assets used and risks assumed.
The transactional net margin method (hereinafter: TNMM) examines the net profit margin in relation to the costs, sales or assets, which a taxpayer realises from a transaction or aggregated transactions with a related party. The net margin of the TNMM should be established by reference to the net margin that the same enterprise earns in comparable transactions with unrelated enterprises. A functional analysis of both the related enterprise and the unrelated enterprise is required to determine the degree of comparability. The TNMM replaces the comparable profits method included in the draft OECD TP Guidelines. The US comparable profits method is based on the level of net operating profits of uncontrolled taxpayers engaged in similar transactions under similar circumstances. The TNMM is related to specific transactions.[259]

In 2010 the Committee on Fiscal Affairs issued a revision of the OECD TP Guidelines. This revision will be discussed in the next section.

2.4.3.4. The 2010 OECD Transfer Pricing Guidelines

In 2010 the OECD Council approved the new version of the OECD TP Guidelines. This revision of the OECD TP Guidelines is the first major revision of the OECD TP Guidelines since its first release in 1995. The 2010 version of the 1995 OECD TP Guidelines contains new, more detailed guidance on how to perform comparability analyses in practice in order to compare the conditions of transactions between associated enterprises with those of transactions between independent enterprises.[260] The 2010 version of the OECD TP Guidelines also provides new guidance on how to select the most appropriate transfer pricing method for the circumstances of the case and on how to apply in practice two of the OECD-approved transfer pricing methods, referred to as the transactional profit methods. Furthermore, the 2010 version of the OECD TP Guidelines includes a new chapter providing detailed guidance on the transfer pricing aspects of business restructurings.

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[259] Ibid.

[260] See also http://www.oecd.org/document/20/0,334, press release "OECD approves updates to Model Tax Convention, Transfer Pricing Guidelines and Report on Attribution of Profits to Permanent Establishments."

The OECD TP Guidelines examine the methods for evaluating whether the conditions of commercial and financial relations within an MNE satisfy the arm's length method. The comparability elements of the arm's length principle are analysed in detail. The OECD also mentions in the OECD TP Guidelines the main reasons for applying the arm's length principle.

A foundation for the arm's length principle is provided in the OECD TP Guidelines. The basis for the application of the arm's length principle is the equal treatment of MNEs and independent enterprises, and therefore the avoidance of the distortion of competition:[261]

"There are several reasons why OECD member countries and other countries have adopted the arm's length principle. A major reason is that the arm's length principle provides broad parity of tax treatment for members of MNE groups and independent enterprises. Because the arm's length principle puts associated and independent enterprises on a more equal footing for tax 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."[262]

In the Glossary of the OECD TP Guidelines the arm's length principle is defined as follows:

"The international standard that OECD Member countries have agreed should be used for determining transfer prices for tax purposes. It is set forth in Article 9 of the OECD Model Tax Convention as follows: where '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, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not

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[261] See Hamaekers, H., "Arm´s Length; How Long?", 8 *International Transfer Pricing Journal* (March/April 2001), p. 34 and Hamaekers, H., "The Arm's Length Principle and the Role of Comparables", 12 *International Tax Bulletin* (1992), p. 602. Hamaekers indentified the neutrality principle and equal treatment of controlled and uncontrolled enterprises as the basis for the arm's length principle.

[262] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.8.

so accrued, may be included in the profits of that enterprise and taxed accordingly.'"[263]

The OECD TP Guidelines also reaffirm the acceptance of the separate accounting principle as being the most reasonable means for achieving equitable results and minimising the risk of unrelieved double taxation.[264]
In order to apply the separate entity approach to intra-group transactions, associated enterprises must be taxed on the basis that they act at arm's length in their dealings with each other.[265] However, the OECD TP Guidelines state that relationships among associated enterprises may permit the group members to establish special conditions in their intra-group relations that differ from those that would have been established had the group members been acting as independent enterprises operating in open markets. To ensure the correct application of the separate accounts/entity approach, the OECD Member countries have adopted the arm's length principle. According to the OECD TP Guidelines, the effect of special conditions on the profit level should be eliminated.[266]
The OECD TP Guidelines explain why these international taxation principles have been chosen by OECD Member countries. These principles serve both the dual objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation, thereby minimising conflicts between tax administrations and promoting international trade and investment.[267] The arm's length principle puts associated and independent enterprises on a more equal footing for tax purposes. It avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. By removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment.[268] From the above it can be concluded that the arm's length principle is a general principle of taxation.

Although the OECD confirms that arm's length transfer pricing is the international standard, the OECD notes that the arm's length principle is

[263] Ibid., Glossary.
[264] Ibid., Preface para. 5.
[265] Ibid., para. 5.
[266] Ibid.
[267] Ibid., para. 7.
[268] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.6.

viewed by some as inherently flawed, because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses.[269] However, as stated in the OECD TP Guidelines, the OECD is of the opinion that there are no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises. The arm's length principle is sound in theory since it provides the closest approximation of the workings of the open market in cases where goods and services are transferred between associated enterprises. According to the OECD, a move away from the arm's length principle would abandon this sound theoretical basis and threaten the international consensus.[270] Therefore, the view of the OECD continues to be that the arm's length principle should govern the evaluation of transfer prices among associated enterprises.
The OECD TP Guidelines state that there is sufficiently broad experience under the arm's length principle to establish a body of common understanding among the business community and tax administrations. The OECD is of the opinion that this experience should be drawn on to elaborate the arm's length principle further, to refine its operation, and to improve its administration by providing clearer guidance to taxpayers and more timely examinations.[271]

In the revised Chapters I-III of the OECD TP Guidelines the Committee also reaffirms the arm's length principle as the international transfer pricing standard.[272]

The Committee states:

"By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances, the arm's length principle follows the approach of treating the members of an MNE group as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the dealings between those

[269] Ibid., para. 1.9.
[270] Ibid., para. 1.13.
[271] Ibid., para. 1.14.
[272] Ibid., paras 1.1. and 1.2.

members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions."[273]

Essentially, one of the main justifications for the use of the arm's length principle is that the arm's length principle works well in numerous cases. According to paragraph 1.14 of the OECD TP Guidelines, the arm's length principle is sound in theory since it provides the closest approximation of the workings of the open market in cases where goods and services are transferred between associated enterprises.[274]

The unilateral and divergent position that the US authorities held in the 1988 White Paper and the proposed regulations on transfer pricing elaborated by the US Treasury Department in the 1990s resulted in problems in the international transfer pricing area. The OECD TP Guidelines tried to recover the international consensus. Several authors have stated that serious economic problems and conflicts that would block commerce and transnational investment would result from an application of the arm's length principle in a non-uniform or asymmetrical way by countries.[275] [276] As shown in Chapter 1,

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[273] Ibid., para. 1.6. It is interesting to note, according to the new Article 7 of the OECD Model Tax Convention, that paragraph 2 provides the basic rule for the determination of the profits that are attributable to a permanent establishment. These profits "are the profits that the permanent establishment might be expected to make if *it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions*, taking into account the functions performed, assets used and risks assumed through the permanent establishment and through other parts of the enterprise".[273] *(Italics, RD)* The basic approach incorporated in this paragraph for the purposes of determining which profits are attributable to the permanent establishment is therefore to require the determination of the profits under the fiction that the permanent establishment is a separate enterprise. The second part of that fiction corresponds to the arm's length principle which is also applicable, under the provisions of Article 9, for the purpose of adjusting the profits of associated enterprises. Any transactions with associated enterprises attributed to the permanent establishment have to be priced according to the OECD TP Guidelines. According to the OECD, this process involves the pricing on an arm's length basis of these recognised dealings.

[274] Ibid., para. 1.14.

[275] Guttentag, J.H., "Passing the Torch on Transfer Pricing', in: Andersson, K., Melz, P. and Silfverberg, C., (eds.), *Liber Amicorum Sven-Olof Lodin* (London: Kluwer Law International, 2001), p. 121.

[276] According to Calderon, the only way for the OECD to eliminate the serious conflicts that may arise from an asymmetrical interpretation or application of the arm's length principle by different states was through the "articulation of guidelines that would shape the arm's length principle in a uniformed and internationally agreed form". The main strategy to guarantee their international expansion is via tax conventions. Calderon concludes that the integration

the different non-uniform interpretations of the concept of associated enterprises in the context of Art. 9 OECD Model may indeed frustrate transnational investments.

2.5. Comments on the arm's length principle

Although arm's length transfer pricing is the international standard and the arm's length principle is the underlying principle of Art. 9 OECD Model, this principle has both practical and conceptual disadvantages. I have already mentioned some criticism on the arm's length principle in section 2.3.4. In the following sections, I will discuss some other main disadvantages of the arm's length principle.

2.5.1. The arm's length principle and economic reality

According to a number of economists, the arm's length principle is contrary to economic reality.[277]
The basis of the arm's length principle is that every subsidiary and permanent establishment within a group is a separate entity which conducts trade under free-market conditions with other entities in the group. However, the main reason for the existence of an MNE is the potential to act as one entity in the world market and so to gain competitive advantages this way.[278] An integrated MNE is generally able to operate its business activities through an efficient combination and coordination of economic functions of various entities located in different jurisdictions. From a business and economic perspective, the profit or return of an MNE is an overall profit arising from the results of the business performance of all its individual members. MNEs exist because they avoid the inefficiencies that arise when unrelated companies must transact with one another. The generated advantages mean that within MNEs profit is generated in part by internalising transactions within the firm. The arm's length principle

of the OECD TP Guidelines in Art.9 OECD Model implied that these Guidelines operated as the 'legal context' of Art. 9 and in the articles of conventions based on this article. See Calderon, J., "The OECD Transfer Pricing Guidelines as a Source of Tax Law: Is Globalization Reaching the Tax Law", 35 *Intertax* (2007), p. 14.

[277] Cauwenbergh, P., *International Transfer Pricing*, (Oxford: Intersentia, 1998), p. 285 et seq.

[278] Bird, R., "Shaping a New International Tax Order", 42 *Bulletin for International Fiscal Documentation* 7 (1988), p. 292.

generally treats enterprises of an MNE as separate from each other. It does not take into account the economic capacity and real business results of the MNE as a single economic organisation.[279] Despite this shortcoming of the arm's length principle, the view of the OECD Member countries continues to be "that the arm's length principle should govern the evaluation of transfer prices among associated enterprises."[280]

2.5.2. Continuum price problem/synergy- effects not recognised

This higher efficiency usually realised within MNEs is not recognised by the arm's length principle. Advantages of scale and synergy effects which are inherent in MNEs cannot be divided amongst the group in an objective way via the arm's length principle. This objection seems to apply, in particular, to transfer pricing within an integrated group, but less to the decentralised group with profit centres, to which, from a business economics point of view, the transfer pricing method of free-market prices (CUP) may be appropriate. The arm's length principle does not take into account the economic capacity and real business results of the MNE as a single economic organisation. The "continuum price" problem is one of the main theoretical objections to the arm's length principle.[281] The continuum price problem exists when the aggregate returns on a remuneration of services basis are less than the actual combined return of the integrated group. This applies not only to subsidiaries but also to permanent establishments of one group company.[282] The allocation of taxable profits based on the arm's length principle may result in profits for a

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[279] Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61 (Jönköping: Jönköping University, 2009), p. 120.

[280] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.13.

[281] See also Francescucci, D.L.P., "The Arm's Length Principle and Group Dynamics", 11 *International Transfer Pricing Journal* 2/6 (2004).

[282] See also Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61 (Jönköping: Jönköping University, 2009), p. 120. Langbein noted that the arm's length principle is unsound in theory. Langbein thinks "[...] the problems are theoretically predictable, and hence inevitable, consequences of any effort to use the 'arm's length' system to allocate the profits of any unified international corporate group- that is I believe that the method is unsound in theory." See Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* 7 (17 February 1986), p. 627.

permanent establishment, while the head office and the other parts of the same enterprise have no profits. As a result, by applying the arm's length principle and therefore the separate entity approach, an enterprise in one country may be taxed on deemed profits in another country in which its permanent establishment is located even when the enterprise itself makes no profits. Several scholars therefore strongly support the application of the formulary apportionment approach. According to those scholars, the formulary apportionment approach is an alternative to the arm's length principle since it may have considerable advantages over the arm's length approach in the current international tax environment.[283] This approach would provide greater administrative convenience and certainty for taxpayers, and may also remove or reduce tax planning through transfer pricing and the risk of double taxation. However, the OECD rejects the application of the formulary apportionment approach on the ground that this approach does not reflect the economic reality of members of an MNE.[284]

2.5.3. Scarcity of market-based comparables and high administrative burden

The scarcity of market-based comparables is also seen as a disadvantage of the arm's length principle. Lebowitz is of the opinion that the dissatisfaction among some taxpayers and government officials with "the burdens of administering transfer pricing enforcement and the difficulty of knowing when it has been properly applied" is caused by the arm's length approach, "which is economically illogical and inherently unadministrable".[285]

[283] For instance Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* 7 (17 February 1986), pp. 625-681;Robinson, P. H., "The Globally Integrated Multinational, the Arm's Length Standard, and The Continuum Price Problem", *Tax Management Transfer Pricing*, Special Report, Vol. 9, No. 13 (November 2000); Amerkhail, V., "Price Methodology: Arm's Length or Formulary Apportionment? Sometimes the Best Choice is Both", *Tax Management Transfer Pricing Special Report*, Vol. 9, No. 13 (November 2000); see for an in-depth analysis of formulary apportionment also Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61, (Jönköping: Jönköping University, 2009) pp. 120- 122.

[284] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.14.

[285] Lebowitz, B.E., "Transfer Pricing and the End of International Taxation", 9 *BNA Tax Management Transfer Pricing* 13 (1 November 2000), p. 1.

Another disadvantage of the application of the arm's length principle is the high administrative burden for taxpayers and tax authorities. Many countries apply strict documentation requirements which lead to a high administrative burden for taxpayers and in some case penalties. Documentation obligations may be affected by rules governing burden of proof in the relevant jurisdiction.

2.5.4. Other conceptual shortcomings of the arm's length principle application

The OECD TP Guidelines do not approach the arm's length principle in a fundamental way.[286] This is a consequence of the fact that the situation of the enterprise itself is not sufficiently taken as basis. The emphasis is on anti-avoidance and the preference of tax authorities for checking transfer prices via comparables, in particular comparable profits.[287]
In the revised Chapters I-III of the Transfer Pricing Guidelines, the Committee states in para. 1.6:

"By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances, the arm's length principle follows the approach of treating the members of an MNE group as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the dealings between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions. Such an analysis of the controlled and uncontrolled transactions, which is referred to as a comparability analysis, is *at the heart of the application of the arm's length principle.*"[288]

The essence of the arm's length principle is not comparability of prices and results as described in paragraph 1.6 of the revised OECD TP Guidelines as quoted above, but *dealing* with each other as independent parties would. If it is

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[286] Hamaekers, H., "Arm´s Length; How Long?", 8 *International Transfer Pricing Journal* (March/April 2001), p. 34.
[287] Ibid.
[288] OECD, *Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines* (Paris: OECD, 2009), para 1.6.

clear that the managers of two related enterprises negotiate (or negotiated) with each other in such a way, then the result should be characterised as an arm's length result. Factors, such as the organisational structure of the group (profit centres), the absence of instructions or interventions by a central management, the dependence of the manager's remuneration on profits and being allowed to buy from and sell to parties outside the group are all evidence of arm's length negotiating. Fundamental for dealing at arm's length is negotiating at arm's length.

However, the negotiated price method is not recognised by the OECD as an arm's length method. On the one hand, the Guidelines in Chapter I, paragraph 5, recognise that associated enterprises in MNEs may act as autonomous entities in their relationships with each other:

"Associated enterprises in MNEs *sometimes*[289] 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. [...] 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. Tax administrations should keep these considerations in mind to facilitate efficient allocation of their resources in selecting and conducting transfer pricing examinations."[290]

On the other hand, the OECD continues paragraph 1.5 with the following phrase:

"*Sometimes*, it may occur that 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."

The OECD confirms in the OECD TP Guidelines that associated enterprises have a considerable amount of autonomy and often bargain with each other as though they were independent enterprises. However, because it may occur that

[289] In the revised Chapters I-III of the OECD Transfer Pricing Guidelines the term "commonly" was replaced by the word "sometimes".

[290] See OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.5. and OECD, *Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines* (Paris: OECD, 2009), para 1.5.

in *some* situations relationships between associated enterprises may influence the outcome of the bargaining, the negotiated price method is not recognised as an arm's length method. The replacement of the word "*commonly*" in the phrase "associated enterprises in MNEs commonly have a considerable amount of autonomy" with the word "*sometimes*" in the revision of Chapter I of the OECD Transfer Pricing Guidelines is remarkable.

From a theoretical point of view, I disagree with the view of the OECD as laid down in para. 1.6 of the OECD TP Guidelines that evidence of hard bargaining alone is not sufficient to establish that the dealings are at arm's length. From a theoretical point of view, evidence of hard bargaining would be sufficient to conclude that there were dealings at arm's length. Therefore, in my opinion, despite the outcome of the bargaining, as long as the negotiations and dealings are at arm's length –and this should be proven by documents of the parties concerned-, the transaction should be recognised as a valid arm's length transaction. Apparently, political considerations have dominated the outcome of this discussion by stating that negotiating is not sufficient to reach a valid at arm's length result.

The emphasis in the legislation and regulations of many countries and in the OECD TP Guidelines is no longer on the taxpayer itself (the enterprise), but on comparables, i.e. external factors and data, which are usually difficult to obtain and apply.

Avi-Yonah is of the opinion that in the light of the application of the arm's length principle the transfer pricing problem is growing.[291] According to Avi-Yonah, the porosity of current transfer pricing rules creates an artificial tax incentive to locate profits in low-tax countries. This is done by locating real economic activities in such countries and by shifting profits toward more lightly taxed locations.[292] Avi-Yonah proposes the use of formulary apportionment in the context of the arm's length principle. He suggests using formulary apportionment to allocate the residual profit in the profit split. He concludes that the problem which has gradually become evident was that the traditional methods like the CUP, cost-plus and resale price did not work in the majority of transfer pricing cases. The arm's length principle and the above-mentioned

[291] Avi-Yonah, R.S., "Between Formulary Apportionment and the OECD Guidelines: A proposal for Reconciliation", *University of Michigan Legal Working Paper Series: The John M. Olin Center for Law and Economics Working Paper Series*, Working Paper 102 (May 2009).
[292] Ibid., p. 3.

three classical methods were imbued with the US transfer pricing regulations of the 1970s and 1980s.[293] Avi-Yonah refers to a study which was conducted by the General Accounting Office in 1992.[294] This study indicates that in over 90% of the cases the three traditional methods could not be applied because comparables could not be found. Moreover, after winning the *Dupont* case in 1979, the IRS lost every single major transfer pricing case it litigated between 1980 and 1995. This includes cases against all the US pharmaceutical companies and many other US multinationals. The major reason for these losses was that the courts refused to accept the comparables used by the IRS under the traditional methods, and either accepted bogus comparables manufactured by the taxpayers, or more frequently simply made up a transfer price that also favoured the taxpayer.[295] In 1995 the United States adopted new transfer pricing regulations. These regulations incorporated two new methods, the comparable profit method (CPM) and the profit split, which relied much less on comparables. The OECD also introduced the profit split and the transactional net margin method (TNMM) in the OECD TP Guidelines. The OECD rejected the formulary apportionment and emphasised that TNMM does not involve a global profit allocation but rather allocation for the particular transaction, since the former is closer to formulary apportionment. Avi-Yonah argues that it is clear that by moving beyond traditional comparability, the OECD was moving closer to accepting formulary apportionment. He states that "once you do not base the arm's length standard on finding comparables, then it is not very meaningful to say that a particular method is or is not compatible with the arm's length standard, because if there are no comparables you cannot prove that the result reached by that method was not what unrelated parties would have done at arm's length." According to Avi-Yonah, this is why it is possible to argue that formulary apportionment is compatible with Art. 7 of the OECD Model, which focuses on the results that unrelated parties would have reached, and permits in Art. 7(4) the use of formulas as long

[293] Avi-Yonah, R.S., "Between Formulary Apportionment and the OECD Guidelines: A proposal for Reconciliation", *University of Michigan Legal Working Paper Series: The John M. Olin Center for Law and Economics Working Paper Series*, Working Paper 102 (May 2009), p. 1.
[294] General Accounting Office, *International Taxation Problems Persist in Determining Tax Effects of Intercompany Prices*, GAO/GGD, Document GGD-92-89 (Washington D.C.: 1992).
[295] Avi-Yonah, R.S., "Between Formulary Apportionment and the OECD Guidelines: A proposal for Reconciliation", *University of Michigan Legal Working Paper Series: The John M. Olin Center for Law and Economics Working Paper Series*, Working Paper 102 (May 2009), note 4.

as the result is compatible with the arm's length standard.[296] Avi-Yonah proposes a compromise to use formulary apportionment to allocate the residual profit in the profit split method.

Other authors have put forth the inadequacy of the arm's length principle in respect to economic models for multinational enterprises. They focus on the way the arm's length principle responds to a neoclassical understanding of the multinationals in accordance with which there is little difference between the operations or contracts between independent enterprises and between associated enterprises within an MNE. They argue that the arm's length principle was developed by the OECD during the 1960s and 1970s when the neoclassical theory prevailed over the business groups. The theory of economic transaction costs was hardly developed. The transaction costs economic theory explains how, due to the transaction costs of some operations, these enterprises are coordinated efficiently within the group, while others are coordinated externally or by the market. This would especially be the case if the transactions costs are derived from the market operations and are comparatively lower than coordinating the operations at an internal level.[297]

Some authors also point out the practical problems which arise with the application of a principle which is based on a hypothetical and speculative test, how the parts of the related transactions would act if they were not related. According to these authors, a principle which is not perfectly defined in non-ambiguous or objective terms might permit asymmetric and disperse views over the specific reach of such a principle in a specific operation.[298]

Also, the European Commission has considered in its Report on company taxation that the application of the arm's length principle causes problems within the internal market. According to the Commission, the OECD TP Guidelines are configured in such a way that they admit that different interpretations or solutions are possible, which depend concretely on the

[296] Ibid., p. 2.

[297] Brem, M., "A new approach to transfer pricing for Multinational Corporations", 33 *Tax Notes International* 11 (2004), p. 1005; see also Calderon, J., "The OECD Transfer Pricing Guidelines as a Source of Tax Law: Is Globalization Reaching the Tax Law", 35 *Intertax* (2007).

[298] Rosenbloom, H.D., "Banes of an Income Tax: legal fictions, elections, hypothetical determinations, and related-party debt", *Tax Notes International* (December 2003), pp. 995-996.

national tax policies of the different states.[299] However, the concept of associated enterprises remains relevant for alternatives such as CCCTB or formulary apportionment.

[299] Commission of the European Communities, *Commission Staff Working Paper: Company Taxation in the Internal Market*, COM 582 (Brussels: 2001), p. 263.

2.6. Conclusions

The arm's length principle is set out in Art. 9 OECD Model. Arm's length transfer pricing is the international standard according to the OECD. The inclusion of the arm's length principle in the OECD Model Tax Convention, OECD TP Guidelines and virtually all double tax conventions demonstrates that it is the fundamental international tax principle underlying the allocation of taxing rights on business profits of enterprises between Contracting States. Although the arm's length principle has disadvantages, such as difficulties in finding comparables and a continuum price problem, the 1979 OECD Report confirms and the OECD TP Guidelines reconfirm explicitly that arm's length pricing is the international standard. If enterprises are deemed to be associated and the transactions between those enterprises are not at arm's length, then tax authorities may adjust the prices of the transactions under the arm's length principle. As a consequence, the interpretation of the concept of associated enterprises is essential for the application of the arm's length principle. The concept of associated enterprises delimits the application of the arm's length principle. Therefore, the purposes of the arm's length principle are relevant for the interpretation of the concept of associated enterprises and these provide clues as to how to interpret the concept of associated enterprises.

In as early as 1872 descriptions were provided of the doctrine of arm's length dealing. In the United States courts related the notion of arm's length dealing to the doctrine of "undue influence".[300]
The arm's length principle was introduced in the early reports of the League of Nations to support the separate accounts principle. The separate accounts principle was introduced for the allocation of taxable income of permanent establishments, which at that time included branches and subsidiaries.
Since its introduction in the early reports of the League of Nations, the separate accounts principle and the arm's length principle have become the fundaments of Art. 7 and Art. 9 of the OECD Model.
When a separate article was introduced in the League of Nations reports regarding the taxation of affiliated companies (associated enterprises) in 1933, the arm's length principle became the underlying principle of this article. In this context, Carroll wrote:

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[300] Baker, R. and Baker, D., "The Pricing of Goods in International Transactions between Controlled Taxpayers", 10 *Tax Executive* 235 (1957-1958), pp. 247-248; see also *Parfitt v. Lawless* (1872), L.R.2 P & D. 462, 468.

"The legal transactions between the parent and the subsidiary should be conducted in the same manner as similar transactions between independent legal persons."[301]

With respect to the tax treatment of permanent establishments, Carroll also referred to the arm's length principle:

"The fundamental principle laid down is that, for tax purposes, permanent establishments must be treated in the same manner as independent enterprises operating under the same or similar conditions, with the corollary that the taxable income of such establishments is to be assessed on the basis of their separate accounts."[302]

As elaborated by the League of Nations and the OECD, the application of the arm's length principle has the following main purposes:

- To make the correct application of the separate entity approach possible and therefore secure the appropriate tax base in each jurisdiction involved;
- To eliminate effects and distortions of the associated enterprises' special commercial and financial conditions on the levels of profits;
- To provide broad parity of tax treatment for MNEs and independent enterprises, that is to provide a tax treatment which is neutral towards the type of entity;
- In the light of the previously mentioned purposes: to put associated enterprises and independent enterprises on an equal footing for tax purposes;
- To serve the general principles of equality and neutrality in tax law;
- To avoid a distortion of the relative competitive positions between associated and independent enterprises;
- To promote international trade and investment by removing tax considerations from economic decisions.

[301] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217 (b).1933.II.A., 1933), p. 109.

[302] League of Nations, Fiscal Committee, *Report to the Council on the fourth session of the Committee*, held on Geneva from June 15[nd] to 26[th], 1933, C.399. M.204, (4242) p. 2.

The arm's length principle generally requires that transactions between associated enterprises should have the same outcome as the dealings between independent enterprises. However, the price charged by one independent enterprise does not need to be necessarily or usually *similar* to prices charged between other independent parties in the open market. There are valid reasons for the existence of differences with respect to commercial and financial conditions in business transactions between different independent parties. A deviation from the open market price does therefore not automatically imply that this deviation is caused by the relationship of the associated enterprises involved.

Whereas the arm's length principle is considered by some countries to be an anti-tax avoidance and anti-tax evasion measure, for instance by the United States, under the OECD Model the arm's length principle must be considered a general principle of international tax law. The OECD states that 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.[303] Also the purpose of Art. 9 (2) OECD Model indicates this. Art. 9 (2) OECD Model is an integral part of the arm's length principle and its purpose is to avoid economic double taxation. Anti-tax avoidance measures generally do not require measures for the prevention of economic double taxation.

Looking also at the above-mentioned purposes of the arm's length principle, it can be concluded that the arm's length principle is a general principle of international taxation.

In the 1960s the Fiscal Committee of the OEEC stated that with regards to the question of how to allocate profits to a permanent establishment and how to allocate profits from transactions between enterprises under common control, it was fair to "say that the solutions adopted have generally conformed to a standard pattern. It is generally recognized that the essential principles on which this standard pattern is based are well founded".[304]
Apparently, there was an international consensus on the arm's length principle itself. As the concept of "associated enterprises" in the OECD Model "triggers"

[303] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.2.
[304] See also OEEC, FC(60): annex E, p. 22, para. 2, (Paris: OEEC, 25th May1960), FC(60) 157.

the application of the arm's length principle it is important to analyse whether a similar consensus existed –in the absence of an explicit and appropriate explanation- on the meaning of "associated enterprises". This will be done in Chapter 3 part I and Chapter 5.

Chapter 3: Part I - the concept of associated enterprises in the current Art. 9 OECD Model

3.1. Introduction

The purpose of this chapter is to explore the concept of "associated enterprises" in Art. 9 OECD Model. I will discuss the various criteria for "associated enterprises" as laid down in Art. 9 OECD Model and the OECD Commentary in an effort to determine the interpretation of the concept of "associated enterprises". The analytical findings and concluding remarks in this chapter will serve as a basis for a final analysis and conclusion in Chapter 9.

Art. 9 (1) OECD Model reads as follows:

ASSOCIATED ENTERPRISES
Paragraph 1:
"Where
a. An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
b. the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent 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."
Paragraph 2:
"Where a Contracting State includes in the profits of an enterprise of that State and taxes accordingly profits on which an enterprise of the other Contracting State has been charged to tax in that other Contracting State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount for the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provision of this

Convention and the competent authorities of the Contracting States shall if necessary consult each other.

As already mentioned in Chapter 2, Art. 9 OECD Model suggests a two-step analysis. Art. 9 OECD Model provides that tax authorities first should determine the existence of "associated enterprises" in order to apply the arm's length principle. If the existence of associated enterprises can be established, then it should be analysed whether the conditions which are made or imposed between those two enterprises are at arm's length. Because of this two-step analysis as included in Art. 9 OECD Model, the concept of associated enterprises indicates the boundaries of the application of the arm's length principle.

3.2. Art. 9 OECD Model: enterprises

Art. 9 OECD Model only deals with profit adjustments between *enterprises*.[305] According to Art. 3 (1) (c) OECD Model, the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State, respectively. The question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has generally been interpreted according to the provisions of the domestic laws of the Contracting States.[306] Therefore, no exhaustive definition of the term "enterprise" is provided in this article. Hence, it is provided that the term "enterprise" applies to the carrying on of any business. The performance of professional services or other activities of an independent character must be considered to constitute an enterprise regardless of the meaning of that term under domestic law.[307] The legal form of the enterprise is irrelevant. However, Art. 9 OECD Model is inapplicable if one

[305] Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 524.

[306] OECD, *Commentary on the OECD Model Tax Convention on Income and Capital*, (Paris: OECD, 2010), Art. 3 (4).

[307] The OECD Commentary confirms that States which consider that such clarification is unnecessary are free to omit the definition of the term "enterprise" from their bilateral conventions.

of the parties to the business relationship fails to carry on an enterprise. This is also the case if the income concerned is not classified as business income when in their hands.[308] According to Vogel, an enterprise carried on by a partnership, even if the partnership is a "person" within the meaning of Art. 3 OECD Model, is not automatically considered an "enterprise of a Contracting State" within the special meaning that term has under Art. 9 OECD Model. It is so considered only if the partnership is characterised as a separate taxable entity and if the other State applying the convention is bound by that characterisation.[309]

From the OECD Commentary on Art. 9 OECD Model it may also be concluded that Art. 9 OECD Model only covers transactions between *enterprises*. This follows from the "bracket definition" of associated enterprises (see section 3.3). The Commentary defines associated enterprises as "parent and subsidiary *companies* and *companies* under common control".[310]

The findings and conclusions of the 1933 Report, written by Mitchell B. Carroll, have led to the introduction of the current Art. 9 OECD Model. A specific phrase from Chapter IV concerning the Foreign Enterprise with Local Subsidiary of this Report supports the conclusion that Art. 9 OECD Model only covers transactions between *enterprises*. Carroll wrote in this Report:

"To verify this declaration and accounts, the tax authorities may enquire into the current of business between the local subsidiary and the parent company or other subsidiary companies of the parent, which may *for convenience be termed associated companies.*"[311]

At this point, Carroll introduces the term "associated companies" for convenience purposes. He did not refer to *persons*, but only to companies and subsidiaries. The OECD TP Guidelines refer to enterprises: "Transfer Pricing

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[308] In the OECD Commentary of 1977, paragraph 12, the USA had reserved that Art. 9 should apply to all related persons and not just enterprises of the contracting States. In the OECD Commentary of 1992, the USA did not maintain this reservation.

[309] See also Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 524.

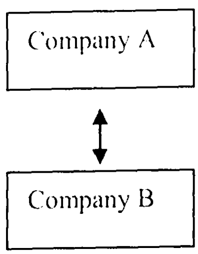
[310] OECD, *Commentary on the OECD Model Tax Convention on Income and Capital*, (Paris: OECD, 2010), Art. 9 (1).

[311] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217), p. 109.

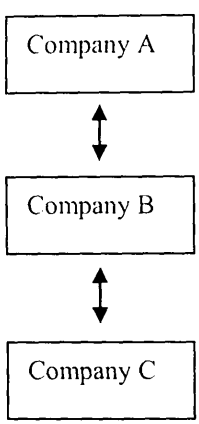
Guidelines for *Multinational Enterprises* and Tax Administrations". It may therefore be concluded that Art. 9 OECD Model only covers transactions between enterprises.[312]

Taking the above-mentioned points into account, the following situations are covered by Art. 9 (1) (a) OECD Model:

Situation 1(direct participation): Company A and B are associated enterprises. Transactions between A and B can be adjusted in case they are not at arm's length.



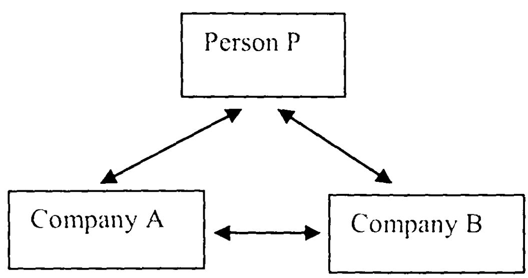
Situation 2 (indirect participation): Company A, B and C are associated enterprises. Transactions between A and C can be adjusted in case they are not at arm's length.



[312] Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 524.

However, from the wording of Art. 9 (1) (b) OECD Model it seems that Art. 9 OECD Model does not cover the following situation:

Situation 3: Person P is not an enterprise. Person P participates directly or indirectly in e.g. the capital of companies A and B.
Transactions between company A or company B and Person P are not covered by Art. 9 (1) (b) OECD Model. Transactions between company A and company B are covered by Art. 9 (1) (b) OECD Model. If P is an enterprise, its relationship with A and B is covered by Art. 9 (1) (a) OECD Model.



Art. 9 (1) (b) OECD Model provides that if the *same persons* (in the case at hand P) participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and the transactions between company A and B are not at arm's length, then the tax authorities involved could adjust the profits of A and B.
From the words "and in either case conditions are made or imposed *between the two enterprises*" (*Italics, RD*) it may be concluded that an adjustment is only allowed with regard to transactions between enterprises and not between an enterprise and a person who is not carrying on a business.

The term "persons" in Art. 9 (1) (b) OECD Model has a broader meaning than the term "enterprise". Hamaekers states that it remains unclear why Art. 9 (1) (b) refers to "persons" in the plural, since the term "common control" in the Commentary on Art. 9 OECD Model (the "bracket definition", see section 3.3) particularly seems to cover one entity holding or managing two or more companies. I note that according to Art. 3 (1) (a) OECD Model the term "person" includes an individual, a company and any other body of persons. The term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes. The term "enterprise" applies to the carrying

on of any business. According to the Commentary, the term "business" includes the performance of professional services and of other activities of an independent character.[313]
The use of the plural form of the word "person" indicates that it should be two or more persons, so a group of persons. P must in that case consist of two or more persons, or in the words of the OECD, P must be "a body of persons". However, assuming that Art. 9 (1) (b) OECD Model would deal with "persons" (plural), situation 3 would not be covered by Art. 9 OECD Model. In my opinion this is unlikely. This issue will be further discussed in Chapter 5, which provides a historical analysis of this article.

It can be concluded from the wording of Art. 9 OECD Model that this article can only be applied to transactions between enterprises of two Contracting States. If the foreign enterprise's place of effective management is situated within the domestic territory of the other enterprise, then Art. 9 OECD Model is not applicable.[314]

3.3. Art. 9 OECD Model: a definition of associated enterprises?

Art. 9 OECD Model does not provide a clear definition of the notion of "associated enterprise". The article only gives two forms of association:

- One enterprise participates directly or indirectly in the management, control or capital of the other enterprise (Art. 9 (1) (a) OECD Model); or
- The same persons participate directly or indirectly in the management, control or capital of both enterprises (Art. 9 (1) (b) OECD Model).

The Commentary on Art. 9 OECD Model provides an explanation of "associated enterprise" between brackets:

"This Article deals with [...] associated enterprises (*parent and subsidiary companies and companies under common control)* [...]"

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[313] Art. 3 (1) OECD Model.
[314] Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 524.

Hamaekers notes the following in his analysis of what he calls the "bracket definition":[315]

"However, taking the above clarification between brackets in the Commentary as an attempt to define associated enterprises, the conclusion may be drawn – although the wording of Art. 9 (1) (a) OECD Model is broader- that Subpara. (a) only covers parent-subsidiary relationships, in practice probably meaning controlling shareholdings, and that Subpara. (b) only covers relationships between sister companies and companies managed by the same party."

Hamaekers is of the opinion that if the "bracket definition" cannot be considered a proper definition, it must be assumed that participation in "management, control or capital" is not defined in the OECD Model. This would trigger the rule of Art. 3 (2) OECD Model, stating that any term not defined in the convention will have the meaning under the domestic tax laws of the country applying the convention, *unless the context requires otherwise*. It is therefore necessary to analyse the meaning of "associated enterprises" in domestic tax laws and check whether those meanings "make sense in the context of tax treaties and the OECD Model".[316]

Art. 9 (1) OECD Model mentions participation in capital as the last criterion for the existence of associated enterprises. The first criterion that is mentioned is the participation-in-management-criterion, followed by the participation-in-control-criterion and finally the participation-in-capital-criterion. Why the OECD has used this specific order is unclear and not logical. A participation in capital (wholly-owned subsidiary) is by far the most common form of being associated. Therefore, one would expect that participation in capital would be the first criterion mentioned for associated enterprises in Art. 9 OECD Model.
I note that the Commentary on Art. 10 OECD Model also deals with the term "capital" and refers to company law for an interpretation. Art. 10 (2) (a) OECD Model (dividends) states as follows:

[315] Hamaekers, H., "Introduction to Transfer Pricing", *Tax Treatment of Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), Chapter 5: Associated Enterprises.
[316] Ibid.

"5 percent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends"[317]

The Commentary on Art. 10 (2) (a) OECD Model clarifies the term "capital" as follows:

"15. In sub-paragraph (a) of paragraph 2, the term "capital" is used in relation to the taxation treatment of dividends, i.e. distributions of profits to shareholders. The use of this term in this context implies that, for the purposes of sub-paragraph (a), it should be used in the sense in which it is used for the purposes of distribution to the shareholder (in the particular case, the parent company).
(a) As a general rule, therefore, the term "capital" in sub-paragraph (a) should be understood as it is understood in *company law*. (*Italics, RD)* Other elements, in particular the reserves, are not to be taken into account.
(b) Capital, as understood in company law, should be indicated in terms of par value of all shares which in the majority of cases will be shown as capital in the company's balance sheet.
(c) No account need be taken of differences due to the different classes of shares issued (ordinary shares, preference shares, etc.), as such differences relate more to the nature of the shareholder's right than to the extent of his ownership of the capital.
(d) when a loan or other contribution to the company does not, strictly speaking, come as capital under company law but when on the basis of internal law or practice ("thin capitalisation", or assimilation of a loan to share capital), the income derived in respect thereof is treated as dividend under Article 10, the value of such loan or contribution is also to be taken as "capital" within the meaning of sub-paragraph (a).
(e) In the case of bodies which do not have a capital within the meaning of company law, capital for the purpose of sub-paragraph (A) is to be taken as meaning the total of all contributions to the body which are taken into account for the purpose of distributing profits. In bilateral negotiations, Contracting States may depart from the criterion of "capital" used in sub-paragraph (a) of paragraph 2 and use instead the criterion of "voting power"."[318]

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[317] Art. 10 (2) (a) OECD Model.

[318] OECD, *Commentary on the OECD Model Tax Convention on Income and Capital*, (Paris: OECD, 2010), Art. 10 (2) (a).

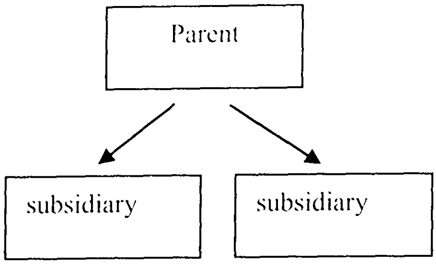
Art. 9 OECD Model covers both direct as indirect forms of participation in capital. This means that Company A has a shareholding in Company B, and Company B has a shareholding in Company C. Company A has an indirect participation in the capital of Company C. However, Art. 9 OECD Model does not explicitly mention what "level" of participation in the capital is required to establish that there is a participation in capital for the purpose of the concept of associated enterprises. From the words "participation in capital" one might conclude that even a shareholding of 1% could result in the existence of associated enterprises.

According to Vogel, interconnection based on a participation in capital is not sufficient to justify the rewriting of accounts. It is only allowed if such an interconnection was the cause of special conditions being set or imposed and beyond that only according to arm's length criteria. The fact that the OECD does not elaborate on the meaning of "participation in capital" can lead to situations of double taxation.
Assume State A considers associated enterprises to exist when there is a minimum of 25% participation in capital. State B considers associated enterprises to exist when one company holds a minimum of 50% shares in the capital of another (foreign) company. In case company Y in State A holds 25% of the shares of company Z in State B, then the tax authority of State A considers enterprises Y and Z to be associated enterprises, whereas the tax authorities in State B consider enterprises Y and Z to be independent enterprises. This can lead to double taxation if State A were to adjust the transactions between Y and Z, considering that Art. 9 OECD Model would be applicable.

Paragraph 7 of the Commentary on the 1979 Report on Transfer Pricing and Multinational Enterprises provides the following phrase with respect to the term "under common control":

"The report covers not only transfers between parent and subsidiary companies but also between companies under common control though the problems arising specifically from transactions between companies under common control have not been dealt with and indeed some countries would regard such transactions as passing through the common parent insofar as the price deviates from arm's length."[319]

From the words "as passing through the common parent" it seems that the Committee had the following situation in mind with the term "under common control":



According to the text of the 1979 Report on Transfer Pricing and Multinational Enterprises, this means that the expression "under common control" refers to a relationship based on company law (parent – subsidiary relationship).

Art. 5 (7) OECD Model uses the words "the fact that a company [...] controls or is controlled by a company". Also, the Commentary on this paragraph refers to subsidiary companies and parent companies:

"This follows from the principle that [...] such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company."[320]

The reference made in the above Commentary only refers to subsidiary companies and parent companies. As stated in the previous paragraphs, according to Vogel direct or indirect participation in the management, control

[319] OECD, Committee on Fiscal Affairs, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises*, adopted by the Committee on Fiscal Affairs in January 1979, approved by the Council of the OECD for publication. The Council of the OECD adopted the Recommendation annexed to it on 16 May 1979.

[320] OECD, *Commentary on the OECD Model Tax Convention on Income and Capital*, (Paris: OECD, 2010), Art. 5 (7), para. 40.

or capital of an enterprise covers only cases of interconnection or exercise of influence under company law. According to Vogel, whether there is a case of participation in the management, control or capital of an enterprise is a matter to be decided by reference to (domestic) company law.[321] What forms of participation are covered by Art. 9 OECD Model is a question of treaty law.
Vogel also refers to paragraph 7 of the OECD Report on Transfer Pricing and Multinational Enterprises. This Report states that it was not thought to be necessary to define such expressions as "associated enterprises" or "under common control".[322] The Report states that there was a *broad basis of common understanding* of what was meant.[323] I will analyse this so-called "broad basis of common understanding" in Chapter 5, as this phrase indicates the existence of an autonomous interpretation of "associated enterprises".

The question of how to determine the possibilities of influence being exercised under company law on which a rewriting of accounts should be based, should be left to the law of the Contracting States.
Vogel concludes that adjustments envisaged by Art. 9 OECD Model may only be carried out if:

- domestic provisions permit profit adjustment; and
- the profit adjustment should be subject to the existence of interconnection or to the exercise of influence; and
- this existence of interconnection or exercise of influence should exist under company law; and
- such interconnection was the cause of special conditions being made or imposed; and
- profit adjustments may be carried out only according to arm's length criteria.

To the extent that domestic provisions permit profit adjustment subject to the existence of interconnection, or to the exercise of influence, under company law, adjustments envisaged by Art. 9 OECD Model may be carried out. This

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[321] Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, Third Edition (1997: Kluwer Law International), p. 524.
[322] OECD,Committee on Fiscal Affairs, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises*, (Paris: OECD, 1979)
[323] Ibid.

can only be done if such an interconnection was the cause of special conditions being made or imposed and only according to arm's length criteria. Therefore, Vogel is of the opinion that interconnection under company law itself is not sufficient to justify the rewriting of accounts.

Whether Vogel's view is correct or not, I note that an argument to support Vogel's view can also be found in the distributive rules on interest (Art. 11 OECD Model) and royalties (Art. 12 OECD Model). Vogel states that the application of these rules presupposes that, between the payer and the beneficial owner or between both of them and some other person, there was *no special relationship* which caused the payment of interest or royalties to be excessive.[324] The Commentary on these articles states that such special relationships cover situations of dependency *similar* to those dealt with in Art.9 OECD Model[325] and "*also*, relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the interest or royalties".[326] *(Italics, RD)*

This phrase is important as it refers to the concept of association of Art. 9 OECD Model ("such relationships cover situations of dependency similar to those dealt with in Art. 9 OECD Model"). The Commentary then continues by referring to situations that are *not* covered by Art. 9 OECD Model: "*also* any community of interests *as distinct from the legal relationship*". It may be argued that the expression "as distinct from the legal relationship" indicates that only "legal relationships" are covered by Art. 9 OECD Model. The question arises how the expression "legal relationship giving rise to the payment of the interest" should be interpreted. It seems that "legal relationship giving rise to interest payment" is a relationship that follows from company law.

Paragraphs 33 and 34 of the Commentary on Art. 11 OECD Model read as follows:

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[324] Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 526.

[325] OECD, *Commentary on the OECD Model Tax Convention on Income and Capital*, (Paris: OECD, 2010), Art. 11, paras. 33 and 34.

[326] Ibid. and OECD, *Commentary on the OECD Model Tax Convention on Income and Capital*, (Paris: OECD, 2010), Art. 12, para. 24.

"Paragraph 33. There may be cited as examples cases where interest is paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having a common interest with him. These examples, moreover, *are similar or analogous* to the cases contemplated by Article 9.
Paragraph 34. *On the other hand*, the concept of special relationship also covers relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the interest." (*Italics, RD*)

Therefore, a relationship by blood or marriage, or "*any community of interests*" can by itself not constitute an "association" within the meaning of Art.9 OECD Model.[327] Hamaekers also concludes that the "latter kind of relationship", that is the relationship by blood and marriage, is not covered by Art. 9 OECD Model.[328]

Vogel is of the opinion that the term "special relationship" mentioned in Art. 11 OECD Model and Art. 12 OECD Model covers a wider area than the concept of associated enterprises in Art. 9 OECD Model. The Commentary draws a clear line between the concept of associated enterprises and relationships of a payer and beneficial owner that cause a divergence from arm's length standards. This can be concluded from the words "on the other hand" in the Commentary. It provides in paragraph 33 examples of a relationship that are "similar or analogous to the cases contemplated by Article 9".

In paragraph 34, the Commentary continues with examples of relationships which are covered by Art. 11 (and Art. 12) OECD Model, but that are not covered by Art. 9 OECD Model. According to this paragraph, the special relationship as mentioned by Art. 11 OECD Model covers also relationships by blood or marriage. With the words "on the other hand" it confirms that the relationship by blood and marriage is not covered by Art.9 OECD Model.

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[327] Cf. Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 526.
[328] Hamaekers, H., "Introduction to Transfer Pricing", *Tax Treatment of Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), Chapter 5: Associated Enterprises.

However, it should be noted that domestic transfer pricing regulations may cover also relationships by blood and marriage.

It appears that Art. 9 OECD Model itself does not give guidance on how to interpret and apply the criteria of participation by an entity in the management, control and capital in another company or other companies. Neither does Art. 9 OECD Model give guidance on how these criteria relate to each other. Art. 9 OECD Model does not indicate a priority between the three criteria of association (participation in *management*, *control* and *capital*), even though participation in capital, for instance a wholly owned subsidiary, can be considered by far the most common form of association.

3.4. Art. 9 OECD Model and company law

3.4.1. Introduction

As indicated above, the participation-in-capital criterion is the most important criterion for association. The most common relationship in the business world seems to arise through a sole or majority participation in the capital (including voting rights) of one or more companies, for instance a parent/subsidiary relationship or a relationship between two companies with the same parent.[329] As shown in section 3.3, the Commentary on Art. 10 (2) (a) OECD Model shows why company law is important for the interpretation of "associated enterprises":

"As a general rule, therefore, the term "capital" should be understood as it is understood in company law [...]"

This raises the question what is meant by the term "company law". As will be shown in these sections, company law provides several important aspects that are relevant for the interpretation of the concept of associated enterprises in Art. 9 OECD Model. These aspects are discussed in the next sections.

Also in tax literature reference to company law is made. Vogel states that the expression "direct or indirect participation in the management, control or capital of an enterprise" should be explained as follows:

[329] Ibid.

"direct or indirect participation in the management, control or capital of an enterprise covers only cases of interconnection, or exercise of influence, under *company law*."[330]

Although Vogel does not explain in detail why Art. 9 OECD Model covers only cases of interconnection under company law, he supports his view by referring to an important phrase in the Commentary on Art. 9 OECD Model. The Commentary on Art. 9 OECD Model defines - between brackets - associated enterprises as "parent and subsidiary companies and companies under common control".[331] According to this "bracket definition", associated enterprises exist when there is a relationship between a parent and a subsidiary. This relationship is based on shareholding, hence a participation by the parent in the capital of the subsidiary. Company law covers these shareholders' relationships and the relationships between management, shareholders and the company. Company law rules deal with the capital stock of the company and with the relationship between the investor and the managers as the two key players in the company. Capital is raised by companies in the form of equity or financing through borrowings.[332] In the case of equity, the issuer issues shares for the contribution received. In the case of borrowings, the transaction is a loan, generally in the form of a security, such as bonds.[333] Both cases deal with valuable rights: rights based on membership of a limited liability company (shares) and loans.

The natural starting point for company law is the law on organisation.[334] Grundmann states that company law rules deal primarily with:

- the formation of the organisation;
- the existing organisation, for instance the allocation of powers, the distribution of economic results and liability towards third parties;

[330] Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 525.

[331] Ibid.

[332] Pettet, B., *Company Law*, 2nd ed. (Essex: Pearson Education Ltd., 2005), pp. 270-280.

[333] See also Ferran, E., *Company Law and Corporate Finance* (Oxford: Oxford University Press, 1999), pp. 457-564.

[334] Grundmann, S., *European Company Law*, IAS Communitatis I (Oxford: Intersentia, 2007), p. 4.

- fundamental changes in the organisation, including decision-making powers and the protection of pecuniary rights and third parties; and
- the winding up and dissolution of the organisation.[335]

It should be noted that US corporation law (or US corporate law) is strongly focused on "control", compared to European company law. Blumberg states that from its beginning, corporation law deemed each corporation by virtue of its creation through a royal or state charter to be an independent juridical entity with its own rights and duties, separate and distinct from those of its shareholders.[336] With the Industrial Revolution and the increasing need for more corporate capital, this doctrine of corporate personality was strongly reinforced by the political decision in the early nineteenth century of legislatures to provide limited liability for shareholders.[337] Some fifty years later corporations were allowed to own shares of other corporations. Blumberg describes that in 1890 New Jersey enacted path-breaking legislation that earned it the appellation of "New Jersey- The Traitor State".[338] For the first time, corporations were generally allowed to acquire shares in other companies. Major businesses of that time, led by Standard Oil and United States Steel, took advantage of this new law and reorganised as corporate groups.[339] In the United States, this new legislation led to tremendous growth in size, scope and complexity of American enterprises, to continuing mergers and acquisitions, and -as also noted by Blumberg- to an increase in industrial concentration.[340]
Hansmann and Kraakman also mention that the law of business corporations had already achieved a remarkable degree of worldwide convergence at the end

[335] Ibid.

[336] See Blumberg, Ph., "The Transformation of Modern Corporation Law: the Law of Corporate Groups", 37 *Connecticut Law Review* 3 (Spring 2005), p. 606. See also Blackstone, W., "Commentaries on the Law of England", reprinted in: Berkowitz, D.S. and Thorne, S.E. (eds.), *Classics of English Legal History in the Modern Era*, 9th ed. (New York: Garland, 1978). pp. 467-474, 478.

[337] Blumberg, Ph., "The Transformation of Modern Corporation Law: the Law of Corporate Groups", 37 *Connecticut Law Review* 3 (Spring 2005), p. 607; see also Dodd, E.M., *American Business Corporations Until 1860* (Cambridge: Harvard University Press, 1954), pp. 1-9.

[338] Blumberg, Ph., "The Transformation of Modern Corporation Law: the Law of Corporate Groups", 37 *Connecticut Law Review* 3 (Spring 2005), p. 607. See also Act of April 4th, 1888, Ch. 269, Section 1, 1888 N.J. Laws 385-386; Act of Apr. 17, 1888 ch 295, Section 1, 1888 N.J. Laws 445-446; Act of May 9, 1889, Ch 265, Section 4, 1889, N.J. Laws 412-414.

[339] Ibid., see also Keasbey, E.Q., "New Jersey and the Great Corporations", *13 Harvard Law Review* (1899-1900).

[340] Blumberg, Ph., "The Transformation of Modern Corporation Law: the Law of Corporate Groups", 37 *Connecticut Law Review* 3 (Spring 2005), p. 608.

of the nineteenth century. By that time, large-scale enterprises had come to be organised in the corporate form, and the core functional features of that form were essentially identical across these jurisdictions. Those features are:[341]

- Full legal personality, including well-defined authority to bind the firm to contracts and to bond those contracts with assets that are the property of the firm;
- Limited liability for owners and managers;
- Shared ownership by investors of capital;
- Delegated management under a board structure; and
- Transferable shares.

The above-mentioned five basic characteristics of the corporate form result in a company that is strongly responsive to shareholder interests.[342] Hansmann and Kraakman refer to the view of the corporation that comprises these elements as the "standard shareholder-oriented model".[343]

As a consequence of the increase of MNEs, the Franklin Roosevelt administration abandoned the "entity-standard" in 1933. The draftsmen of the "New Deal" statutes and regulations turned away from traditional corporate theory and adopted enterprise concepts and the functional standard of "control".[344] In US legislation, "control" became firmly established as "the model for assuring expansive statutory scope in American regulatory law".[345] Blumberg describes that numerous subsequent federal and state statutes in the United States have similarly focused on "control", particularly in the banking, insurance and financial service areas. US law incorporated "control" as the foundation of regulatory programs dealing with the key industries of the economy. Blumberg states:

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[341] Hansmann, H. and Kraakman, R., "*The End of History for Corporate Law*" (Cambridge, Harvard University Press, 2000).
[342] Ibid.
[343] Ibid.
[344] See Blumberg, Ph., "The Transformation of Modern Corporation Law: the Law of Corporate Groups", 37 *Connecticut Law Review* 3 (Spring 2005), p. 608.
[345] This legislation includes the Emergency Transportation Act, the Securities Acts of 1933 and 1934, the Public Utility Holding Company Act, the National Labor Relations Act and the Investment Company Act of 1940. See Blumberg, Ph., "The Transformation of Modern Corporation Law: the Law of Corporate Groups", 37 *Connecticut Law Review* 3 (Spring 2005), p. 609.

"Influenced by the success of American statutory regulation of industry based on the encompassing standard of "control", the same standard has been utilized by governments throughout the world".[346]

In the next sections I will briefly discuss several aspects of EC company law in relation to the terms "participation in capital" and "participation in management". It must be emphasised that these sections do not purport to give a comprehensive overview of the large amount of legal writings on the topic of company law. However, a general overview of company law is required for the purpose of this study.

3.4.2 Company law: EU directives

According to Grundmann, the underlying theory in company law is the principal agent theory.[347] [348] This theory deals with the opposition of interests between different interest groups in companies: suppliers of capital (owners, shareholders) and decision-makers (management or controlling shareholders).[349] The principal agent theory asks how conflicts of interests in *symbiotic* contracts or relations can be treated. This includes conflicts of

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[346] Blumberg provides a list of non-US examples of the use of "control" or its cognate "dominant influence as the linchpin of statutory scope. See Aktiengesezt of 6 September 1965 (BGBl. I, 291); Companies Act, 1989, C. 40, Sec. 21; Council Regulation 2157/2001 on the Statute for a European Company, art. 6, 2001 O.J. (L 294) 4; Council Directive 2001/86/EC, art. 2 (c), 2001 O.J. (L 294) 22; Council Directive 94/45/EC, Art. 2(b), 3, 1994 O.J. (L. 254) 64; Canadian Business Corporations Act, R.S.C., ch. C-44, Sec. 2(3) (1985). According to Blumberg, "control" is predominant in judge-made as well as statutory law in the United States. See Blumberg, Ph., "The Transformation of Modern Corporation Law: the Law of Corporate Groups", 37 *Connecticut Law Review* 3 (Spring 2005), p. 609. In the modern economy mid-size and large businesses are generally conducted by a group of affiliated enterprises under the "control" of a parent corporation. According to the US Supreme Court, this parent corporation operates "with a unity of purpose" and a "common design". See *Copperweld Corp. v. Indep. Tube Corp.*, 467 U.S. 752, 771-72 (1984)

[347] See Grundmann, S., *European Company Law*, IAS Communitatis I (Oxford: Intersentia, 2007), note 42.

[348] See Grundmann, S., *European Company Law*, IAS Communitatis I (Oxford: Intersentia, 2007), p. 41. See also Furubotn, E. and Richter, R., *Institutions and Economic Theory- The Contribution of the New Institutional Economics* (Michigan: University of Michigan Press, 2000).

[349] Grundmann, S., *European Company Law*, IAS Communitatis I (Oxford: Intersentia, 2007), p. 44.

interests between owners and management or minority and majority shareholders.[350] The principal agent theory takes the individual preferences of the parties concerned as the point of departure.[351] According to Grundmann, the instrument for a mutual discourse on these individual preferences is the exchange, the contract, the market:[352]

"Therefore, nowadays the law of the public liability company and private liability company and its problems are understood as being based on networks of contracts (relations) by which the different parties concerned specify their contributions and fix their return: the owners, the managers, possible also other stakeholders, i.e. persons concerned in a more long-term way (employees, creditors, suppliers)."

According to European company law (Art. 44 (2) (g) EC), all rules protecting concerned parties form part of European company law.[353] These parties include shareholders, investors and creditors. The system of European company law applies generally to companies limited by shares. The list of companies limited by shares is provided in the first European Company Law Directive (which was amended in 2003). This includes the public limited company (PLC), the private limited company and the partnership limited by shares and the parallel forms of these companies, such as the Dutch "naamloze vennootschap (NV)" and the German "Aktiengesellschaft (AG)".[354] However, there is a two-level system of legislation: European company law and company law set by the national legislature.[355] For instance in Great Britain, company law is based on the Companies Act of 1985.[356] Between 1992 and 1998 three committees conducted various investigations and this led to a Combined Code and a Code of Best Practice, which is particularly important for the PLC.[357] In Germany, the Aktiengesetz (AktG) deals with company law rules for PLCs. In France company law is consolidated in the Nouveau Code de Commerce.

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350 Ibid., p. 41.
351 Ibid., p. 42.
352 Ibid.
353 Ibid., p. 4.
354 Ibid., p. 10.
355 Ibid., p. 13.
356 Reforms to this Act were made in 1989. Companies Act 1985, 8 *Statutes* 104; Amendment: Companies Act 1989, 8 *Statues* 819
357 Grundmann, S., *European Company Law*, IAS Communitatis I (Oxford: Intersentia, 2007), p. 39 and note 19.

Looking at the European Company Law Directives, it can be concluded that the private and public limited company are the two most important types of company for European company law. In some countries both types of companies are regulated by separate legislation (for instance in Germany), and in other countries they are regulated by the same legislation (this is the case in the United Kingdom).

The first European Company Law Directive applies only to limited liability companies. It has been considered of key importance for the internal system for a European company law.

Art. 1 of the first European Company Law Directive states that the co-ordination measures prescribed by this Directive applies to the laws, regulations and administrative provisions of the Member States relating to specific limited liability companies, such as the French la société anonyme and the Dutch naamloze vennootschap. The domestic company laws are therefore important.

The first European Company Law Directive is also known as the Disclosure Directive.[358] This directive is aimed at the third-party relationships: cases are minimised where action taken by the board is not binding on the company. For example, Art. 2 (1) (d) of the First Directive states that it must be clear from the disclosure whether the board as a whole has power of representation or each single member. Subparagraph (e) states that subscribed or authorised capital may have to be named in the statutes or the instrument of constitution.

"Section I Disclosure

Art. 2

1. Member States shall take the measures required to ensure compulsory disclosure by companies of [...]

(d) the appointment, termination of office and particulars of the persons who either [...]

(i) are authorized to represent the company in dealings with third parties and in legal proceedings;

(ii) take part in the administration, supervision or control of the company."[359]

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[358] Ibid., p. 151. Grundmann writes that information rules dominate in European Company Law and states that there is virtually no legislative measure in European Company Law which is not primarily about information.

[359] First Council Directive 68/151/EEC of 09 March 1968 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty. Official Journal L 065, 14/3/1968, Article 2, pp. 8-12.

Art. 8 of the first EU Company Law Directive provides that a third party can already be confident that there is power of representation if the formalities - such as if both registration and publication name the person acting as the (member of the) board to be competent- are satisfied.[360]
Art. 9 of this directive deals with the power of representation based on membership in a company organ. The German model of unrestricted power or representation of the (members of the) board was adopted.[361] Action taken by the board or its members is to be considered action taken by the company itself. According to Grundmann, this represents a legal regime that safeguards the contracting partner's confidence independently of the law applicable: "he could be sure that any limited liability company would be bound if he had contracted with the (member of the) board which was formally legitimated".[362]

The Second Directive regulates the protection of capital and the equal treatment of shareholders.[363]
In its introduction the Second Directive states:

"Whereas in order to ensure the minimum equivalent protection for both shareholders and creditors of public limited liability companies, the coordination of national provisions relating to their formation and to the maintenance, increase or reduction of their capital is particularly important;
Whereas in the territory of the Community, the statutes or instrument of incorporation of a public limited liability company must make it possible for any interested person to acquaint himself with the basic particulars of the company, including the exact composition of its capital."[364]

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[360] Ibid..
[361] Grundmann, S., *European Company Law*, IAS Communitatis I (Oxford: Intersentia, 2007), p. 143.
[362] Ibid.
[363] Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent. Official Journal L 026, 31/1/1977, pp. 0001-0013. See for an overview: Grundmann, S., *European Company Law*, IAS Communitatis I (Oxford: Intersentia, 2007), p. 187.
[364] Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of

Art. 2 of the Second Directive provides that the statutes or the instrument of incorporation of the company must give specific information, such as the extent to which they are not legally determined, the rules governing the number of and the procedure for appointing members of the bodies responsible for representing the company with regard to third parties, administration, management, supervision or control of the company and the allocation of powers among those bodies.[365]
Furthermore, Art. 3 of this directive provides that information about the subscribed shares, such as special conditions limiting the transfer of shares and the nominal value of shares subscribed, and information about the identity of the natural or legal persons or companies by whom or in whose name the statutes or the instrument of corporation have been signed, must appear in either the statutes or the instrument of incorporation. Arts. 7 et seq. provide rules about the (subscribed) capital and shares of a company.
Also, Art. 42 provides an important rule:

"For the purpose of the implementation of this Directive, the laws of the Member States shall ensure equal treatment to all shareholders who are in the same position."[366]
With respect to the above-mentioned, Grundmann comments:

"There is shareholder protection in two respects: administration rights are guaranteed [...] as is also, and very prominently, equal treatment and thus mainly the content of pecuniary rights. The principle of equal treatment is to be found in Art. 42, but is also the basis of the rules on capital protection: a number of rules in the Directive are aimed at minimising the risk of the proportionate share of the shareholder being reduced and also diluted in value. Such a principle which is binding for all potential agents (managers or other shareholders having decision making power) can easily be justified by principal agent considerations: the open-ended decision making power which has to be given to the agent has its corollary in rules which exclude action in respect of which it can be foreseen that the principal would not accept it. The principle of equal treatment is a limit to the agent's action, a 'constitutional' minimum

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the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent. Official Journal L 026, 31/1/1977, introduction.

[365] Ibid., at 2.

[366] Ibid., at 12.

guarantee for any principal who entrusts decision making power to managers or dominant shareholders. It is aimed at reducing the risk of the agent making use of his decision making power – conferred upon him for a specific use in the interest of the principal- for another purpose."

The principle of equality only applies to the extent that shareholders are "in the same position", and this seems to indicate that only arbitrary discrimination is excluded.[367]

In September 2001 the European Commission set up a Group of High Level Company Law Experts with the objective of "initiating a discussion on the need for the modernization of company law in Europe".[368] According to the High Level Group of Company Law Experts the primary purpose of company law was:

"to provide a legal framework for those who wish to undertake business activities efficiently, in a way they consider to be best suited to attain success. Company law should first of all facilitate the running of efficient and competitive business enterprises. This is not to ignore that protection of shareholders and creditors is an integral part of any company law."[369] [370]

In response to the above-mentioned report, the European Commission stated as follows:

"Ensuring effective and proportionate protection of shareholders and third parties must be at the core of any company law policy. A sound framework for protection of members and third parties, which properly achieves a high degree of confidence in business relationships, is a fundamental condition for business efficiency and competitiveness."[371]

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[367] Grundmann, S., *European Company Law*, IAS Communitatis I (Oxford: Intersentia, 2007), p. 194.
[368] A modern Regulatory Framework for Company Law in Europe: A consultative document of the High Level Group of Company Experts (Brussels: September 2001), p. 1.
[369] Ibid., p. 2.
[370] Report of the High Level Group of Company Experts on a modern regulatory framework for company law in Europe (Brussels: November 2002).
[371] Communication from the Commission to the Council and the European Parliament, *Modernising Company Law and Enhancing Corporate Governance in the European Union – A plan to Move Forward*, COM (2003) 284 Final (Brussels: 21 May 2003), p. 6.

The High Level Group of Company Law Experts (hereinafter: the Group) believed that the primary focus of the European Union should be to develop and implement company law mechanisms that enhance the efficiency and competitiveness of business across Europe.[372] Part of the focus is to eliminate obstacles for cross-border activities of business in Europe.
The Group pointed out that groups of companies may present specific risks for shareholders and creditors in various ways. However, the European Commission held the view that there was no need to revive the draft Directive on group relations. This draft was intended to provide a framework in which groups can be managed on a sound basis whilst ensuring that interests affected by group operations are adequately protected.[373] Some of the main features of the proposal were a definition of a "subsidiary undertaking" which would oblige Member States to provide for "control contracts" and detailed rules applicable when the parent undertaking had entered into a "control contract" with a public liability company.[374]

The Group stated in its consultative document that in many Member States the creation and functioning of groups of companies is complicated by the fact that the management of the subsidiary may not take into consideration the economic interest of the group as a whole unless this is in the own particular interests of the subsidiary.[375] The Group focused on problems for the creation and functioning of groups of companies. The Group was of the opinion that tensions existed between the interests of the group and its parts:
"The fact that in reality the interests of the subsidiary are often sacrificed to the interests of the parent or the group as a whole, amounts to a wide-spread disregard of corporate law which has elements of hypocrisy and may weaken the authority and credibility of corporate law more generally."[376]

The German "Konzernrecht" allows steering a group independently of the interests of the subsidiaries, but only at the price of specific protection of the

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[372] A modern Regulatory Framework for Company Law in Europe: A consultative document of the High Level Group of Company Experts (Brussels: September 2001), p. 2.
[373] Communication from the Commission to the Council and the European Parliament, *Modernising Company Law and Enhancing Corporate Governance in the European Union – A plan to Move Forward*, COM (2003) 284 Final (Brussels: 21 May 2003), p. 18, note 21.
[374] Ibid.
[375] A modern Regulatory Framework for Company Law in Europe: A consultative document of the High Level Group of Company Experts (Brussels: September 2001), p. 28.
[376] Ibid., p. 29.

shareholders and creditors of the subsidiary by regular compensation of disadvantages incurred by the subsidiary. Another concept, the so-called "Rozenblum"- concept, has been developed by French penal courts in order to mitigate the severity of the criminal law on the breach of trust. As described in the consultative document of the Group, it strikes a reasonable balance between the interest of the individual companies within a group and the overall interest of the group. Under certain conditions, it is considered to be legitimate for the directors of the associated enterprises to act in the overall interest of the group as such. Those conditions are a firm structural establishment of the group, a coherent group policy and balanced distribution of benefits and burdens. UK law represents a third approach. Wholly-owned subsidiaries are to be run in the interest of the parent company, as companies formed under the law of these Member States are to be run in the interests ultimately of their shareholders as a whole. Directors are bound to ensure that the subsidiary is operated to serve the parent company's objectives or fairly for the benefit of the shareholders (when the company is only partly owned by the parent) as a whole.[377] If a fair balance is not maintained in their favour, the minority or outside shareholders have remedies for breach of this duty, by derivative action to enforce the fiduciary duty to act fairly on their behalf, or through the general "oppression" remedy. As also stated in the consultative document of the Group, the Modern Company Law Review undertaken in the United Kingdom in recent years considered whether these rules required changes in the group context but concluded that they provided the appropriate balance between freedom to operate the group enterprise and the protection of creditors and outside shareholders. This so-called "oppression" remedy in the context of minority shareholders is relevant for the concept of Art. 9 OECD Model as it may restrict the "control" of a majority shareholder. I will deal with this issue in the following sections of this chapter.

3.4.3 Shareholding and management

Company law deals with the different aspects of "capital" and "management". The Second Company Law Directive adopted by the European Council on 13 December 1976 in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, is one of the

[377] Ibid.

cornerstones of European company law.[378] This directive concerns the securing of a stock of capital for creditors and providing a guarantee of rights of shareholders protecting them against dilution of their stock. The coordination measures prescribed by this Directive apply to the provisions laid down by law, regulation or administrative action in Member States relating to the several types of companies, such as the Dutch "naamloze vennootschap" and the PLC of the United Kingdom. Art. 2 of this Directive provides that the statutes or the instruments of incorporation of the company must always give at least the following information:

- The type and name of the company;
- The objects of the company;
- When the company has no authorised capital, the amount of the subscribed capital;
- When the company has an authorised capital, the amount thereof and also the amount of the capital subscribed at the time the company is incorporated or is authorised to commence business;
- In so far as they are not legally determined, the rules governing the number of and the procedure for appointing members of the bodies responsible for representing the company with regard to third parties, administration, management, supervision or control of the company and the allocation of powers among those bodies.[379]

The Second Company Law Directive also deals with the concept of legal capital. The concept of legal capital is generally seen as one of the cornerstones of European company law. The fundamental function of this concept is protecting creditors' and shareholders' interests.[380] The rules on capital formation and maintenance have an impact on the cost of capital and credit, although, as stated by the EU High Level Group of Company Experts, that impact may be extremely difficult to assess.[381]

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[378] Communication from the Commission to the Council and the European Parliament, *Modernising Company Law and Enhancing Corporate Governance in the European Union – A plan to Move Forward*, COM (2003) 284 Final (Brussels: 21 May 2003), p. 17. See Second Council Directive of 13 December 1976 (77/91/EEC).

[379] Second Council Directive of 13 December 1976, Art. 1.

[380] Report of the High Level Group of Company Experts on a modern regulatory framework for company law in Europe (Brussels: 4 November 2002), p. 78.

[381] Ibid.

The shareholders of a company are the residual claimholders: they only receive payment once all creditors have been satisfied. The most important contractual right that shareholders have is widely taken to be their right to vote on important corporate matters.[382] Shareholders need to be able to ensure that management pursues -and remains accountable to- their interests.[383] Shareholders focus on wealth creation.

The term "participation in capital" as provided in Art. 9 OECD Model refers to shareholding.

It is possible for the shareholders to influence the decisions of the company. This influence can be exercised through the shareholders meeting, where shareholders can debate with management and with each other, and vote on resolutions put forward to them. At first glance, it seems that the one share- one vote principle should apply. This means that shareholders who supply equal amounts of capital or hold equal claims should have equal opportunity to influence decisions. However, in 2007 external studies were undertaken on behalf of the European Commission, by ISS and by Burkart and Lee, among others.[384] These studies dealt with the violation of the one share-one vote principle:

"Among the top 300 European companies 35 % deviated in 2005 from the one share – one vote principle (Deminor Rating 2005). In North America, such deviations are less frequent but still common (Chemmanur and Jiao, 2006). The fraction of listed firms with dual-class shares is about 10% in the US and about 22 percent in Canada (Toronto Stock Exchange Index)."[385]

The above-mentioned study by Burkart and Lee focuses on how the allocation of voting rights across share classes, henceforth the security-voting structure, affects the dynamics of control allocation and the incentives of those entrusted

[382] Manne, H.G., "Mergers and the Market for Corporate Control", 73 *Journal of Political Economy* (1965), pp.110-120; Easterbrook, F. and Fischel, D., "Voting in Corporate Law", 26 *Journal of Law and Economics* (1983); Fischelt, D.R., "Organized Exchanges and the Regulation of Dual Class Common Stock", 54 *Chicago Law Review* (1987), pp. 119-152; Burkart, M. and Lee, S., "The One Share- One Vote Debate: A theoretical Perspective", *ECGI Working Paper Series in Finance, No. 176/2007* (May 2007).

[383] Report of the High Level Group of Company Experts on a modern regulatory framework for company law in Europe (Brussels: 4 November 2002), p. 47.

[384] Burkart, M. and Lee, S., "The One Share- One Vote Debate: A theoretical Perspective", *ECGI Working Paper Series in Finance, No. 176/2007* (May 2007).

[385] Ibid.

with managing the firm.[386] Allocation of control rights is important with respect to the conflict of interests (or to the presence of an agency problem). According to Burkart and Lee, control rights are modelled as the power to choose among alternative actions. Each action entails two kinds of benefits: security benefits or cash flows that can be shared between entrepreneur and investor, and non-transferable private benefits that accrue exclusively to the entrepreneur.[387] As stated by these authors, the existence of these private benefits creates a potential conflict and hence a role for control rights. In this context, voting rights are also valuable in the presence of conflicting interests.[388] Burkart and Lee refer to the "free-rider problem" identified by Grossman and Hart in 1980.[389] Dispersed shareholders as a group may bargain too aggressively because each of them perceives its decision as negligible for a takeover outcome. These authors discuss mechanisms to allocate voting power disproportionately among shareholders, such as voting and ownership ceilings, priority shares, depositary certificates and double voting shares. Voting rights ceilings limit the number of votes that a shareholder can cast irrespective of the number of voting shares he owns. Ownership ceilings prohibit shareholders from owning more shares than a certain threshold:[390]

"The ownership ceilings prevent individual shareholders from accumulating a substantial stake and voting power, thereby limiting the ability to influence corporate decisions."[391]

Voting and ownership ceilings can be considered as diluting rather than leveraging shareholders' ability to concentrate control.[392] Franks and Mayer conclude that voting ceilings have been justified on grounds that they protect minority shareholders from parties who seek to gain control with the purpose of "looting the firm".[393]

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[386] Ibid., p. 2.
[387] Ibid., p. 5.
[388] Ibid., p. 6.
[389] Grossman, S.J., and Hart, O. D., "Takeover Bids, the Free-Rider Problem and the Theory of the Corporation", 11 *Bell Journal of Economics* 1 (1980), pp. 42-64.
[390] Burkart, M. and Lee, S., "The One Share- One Vote Debate: A theoretical Perspective", *ECGI Working Paper Series in Finance, No. 176/2007* (May 2007), p. 33.
[391] Ibid.
[392] Ibid.
[393] Ibid. Franks, J. and Mayer, C., "Ownership and Control in Europe" in Newman, P. (ed.), *New Palgrave Dictionary of Economics and the Law* (Hampshire: Palgrave Macmillan Limited, 2002), pp. 772-730.

Shareholders who control a proportion of total voting rights much larger than their ownership (and therefore dividend) rights have an incentive to extract value from the company at the expense of non-controlling shareholders. According to the EU Commission, such an incentive acts as a multiplier with respect to the general fact that parties in control of a corporation are in a position to enjoy private benefits of control that do not accrue to non-controlling shareholders.[394] A study made by ISS Europe shows that corporate control-enhancing mechanisms are relatively common across the European Union.[395]

Control-enhancing mechanisms should be explained as the institutional arrangements creating a discrepancy in the relation between financial ownership and voting power with the result that a shareholder can increase his or her control without holding a proportional stake of equity. They are included in the constitutional documents of the company (the articles of association or statutes). Examples of control-enhancing mechanisms are corporate institutional arrangements directly affecting voting rights attached to shares and corporate institutional mechanisms that reduce or inhibit the exercise of control through voting rights, such as ownership ceilings.

In the case of Telecom Italia, one of the world's largest telecom companies with a market capitalisation of USD 40 billion, in 2001 a single shareholder controlled 18% of the votes by making recourse to a pyramid group, although he held only 0.7% of the cash flow rights.

Some shareholders may own priority shares with extraordinary decision-making power, for instance to be entitled to appoint board members. Burkart and Lee state:

"For instance, priority shares in the Netherlands are usually sold to foundations that are controlled by management-friendly parties or even the company directors themselves. This endows the board with substantial powers, notably to appoint its own members. As a result, an unwanted large shareholder cannot

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[394] Commission of the European Communities, Commission Staff Working Document, *Impact Assessment on the Proportionality between Capital and Control in Listed Companies*, SEC (2007) 1705 (Brussels: 12 December 2007), 1705, p. 4.

[395] Ibid. Of all the 464 European companies considered, 44% have one or more corporate control-enhancing mechanisms. The mechanisms mostly used are pyramid structures, *multiple* voting rights shares and shareholders agreements.

easily obtain control of the firm's key positions, and insiders are insulated from outside monitoring and hostile takeovers."[396]

This is an example that although a shareholder is a majority shareholder, and thus holding a major participation in the capital of another enterprise, his or her "control" is limited (or "*bound*") by specific structures based on company law (in this example the existence of priority shares owned by other (minority) shareholders). Therefore, control-enhancing mechanisms available in company law may limit the control of an enterprise participating in the capital of another enterprise.

Also, Adams and Ferreira have analysed the disproportional ownership in 2007. They focused on the explicit mechanisms that allow some shareholders to acquire control with less than proportional economic interest in the firm (dual-class equity structures, stock pyramids, cross-ownership, etc). These mechanisms deviate from the "one share-one vote" principle. They state:

"One complication in trying to assess the effects of disproportional ownership is that a divergence between voting control and cash flow rights can arise in many ways. It is easiest to identify when explicit mechanisms, such as shares with differential voting rights, pyramidal structures and cross-holdings, have been put in place to retain control. Such mechanisms are prevalent in many countries around the world. But a wedge between votes and cash flow rights can also arise in more indirect ways, for example due to takeover defenses or fiduciary voting."[397]
According to the EU Report of the High Level Group of Company Law Experts of 2002, proportionality between ultimate economic risk and control means that share capital should normally carry control rights, in proportion to the risk carried. The holders of these rights are best equipped to decide on the affairs of the company as the ultimate effects of their decisions will be borne by

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[396] Burkart, M. and Lee, S., "The One Share- One Vote Debate: A theoretical Perspective", *ECGI Working Paper Series in Finance, No. 176/2007* (May 2007), p. 35.
[397] Adams, R. and Ferreira, D., "One Share, One Vote: The Empirical Evidence", *ECGI Working Paper Series in Finance 177/2007* (2007). The authors provide examples in the literature that argue that concentrated control in the hands of a few leads to agency and entrenchment problems. These can take the form of distortions in investment decisions, tunnelling, inefficiencies in the market for corporate control and formation of monopolies.

them.[398] Control-enhancing mechanisms (common deviations from the principle) are essentially the following:

- Multiple-voting rights;
- Voting-rights ceilings;
- Ownership ceilings;
- Non-voting shares;
- Other instruments such as non-voting preferential shares and company pyramids.

From a company law perspective, the difference between a participation in capital and a participation in management can be explained as follows. In all European countries, powers are split between the shareholders' meeting and the (two-tier) board. Some countries, such as Germany, follow a two-tier board model: a supervisory board exists besides the managing board. In Germany membership of one organ is incompatible with membership of the other.[399] The Netherlands follow a one-tier and two-tier board model. It must be noted that the supervisory board co-opts its new members itself. Recently, two bills that specifically aim at making Dutch companies more flexible and attractive were passed by the Dutch parliament: a bill on reform of the law applicable to Dutch private limited liability companies (BVs) and a bill that provides for a new legal framework for the one-tier board within both private limited liability and public companies (NVs).[400]

There is a division of powers between the board and the shareholders' meeting. Current business operations fall within the board's competence, while amendments to the company statutes fall within the meeting's competence.[401] In almost all EU Member States the constitution of the company remains within the power of the shareholders' meeting.

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[398] European Commission, *Memo 07/222: External Study on proportionality between capital and control in EU listed companies* (Brussels: 4 June 2007).

[399] Grundmann, S., *European Company Law*, IAS Communitatis 1 (Oxford: Intersentia, 2007), p. 225.

[400] See Verkerk, B., 'Modernizing of Dutch Company Law: Reform of the Law Applicable to the BV and a New Legal Framework for the One-Tier Board within NVs and BVs', 7 *European Company Law* (2010), pp. 113-119.

[401] Grundmann, S., *European Company Law*, IAS Communitatis 1 (Oxford: Intersentia, 2007), p. 237.

From a company law perspective, the duties of the management can be identified as follows. First, there is a duty of care. A high level of professional care necessary for properly facing the challenge of directing the company is needed.[402] Secondly, there is the "duty of loyalty". Conflicts of interest are given special treatment.[403]

For instance, among the preventive company law rules are prohibitions on loans to managers. However, transactions that are at arm's length are excluded. Grundmann notes that if no such preventive rule applies, all jurisdictions apply at least the general duty of loyalty saying that the "interests of the principal (the company) must be the sole guideline for actions taken. Exploitation of corporate opportunities is allowed at most (if at all) when there is no interest of the company at stake".[404] Executive managers manage the company ultimately on *behalf* of the shareholders.

The power of a shareholder is related to his vote: the extent to which this vote can influence a decision taken by shareholder under majority voting is relevant for the control this shareholder can exercise. As also stated by Leech, the concept of control and power is related to the structure of decision-making within the company and not to the preferences or behaviour of any individual.[405]

The important question is whether a shareholder has enough (voting) power or rights to determine the strategic financial and operating decisions of an enterprise.[406]

From an economic perspective, power and control may be considered to be two different terms. According to some economists, power is the capacity to influence strategic decisions to some degree. However, control is absolute. In their view, methods of measuring control or power deriving from share ownership must therefore be neutral regarding the issue to be decided. There are several economic models that measure voting power. In 1954 Shapley and Shubik proposed the use of power indices to measure power within a committee system that used weighted voting. The Banzhaf-Coleman index is an alternative model to the Shapley model and is based on the idea of counting swings in relation to all the possible voting outcomes. In 1983 Cubbin and

[402] Ibid., p. 233.

[403] Ibid.

[404] Ibid., p. 236.

[405] See also Leech, D., "Power Indices in Large Voting Bodies", *Warwick Economic Research Papers no. 942* (2010).

[406] Leech states that power is the capacity to influence those decisions to some degree and that control is an absolute property while power exists to a greater or lesser degree.

Leech proposed a model of control based on a measure of the formal voting power of the largest block of shares.[407]
Due to the limited size of this study, these economic control/voting models will not be discussed. However, the voting power indices of these models may be used to measure the formal shareholder's voting power and to identify whether these (minority or majority) shareholders have control.[408]

The relationship between major shareholdings and the factual control of the company is relevant for the interpretation of Art. 9 OECD Model. Shareholders may behave as active owners rather than as passive investors. A shareholder may have the incentive to take part in the strategic decisions of a company. The question then arises whether this shareholder has sufficient voting power to be able to influence or control this company, or in the context of Art. 9 OECD Model, whether this shareholder is able to control the transfer prices. In this context, control can be defined as the power to direct the strategic financial or operating activities of an entity, and thus the right to exercise whatever discretion in strategic decision-making exist.
Control-enhancement mechanisms may result in minority shareholders who *control* enterprises or majority shareholders that do not possess control over an enterprise because a minority shareholder does. Although Art. 9 OECD Model does not provide any minimum amount of participation in capital, many countries do mention in their domestic legislation specific percentages for the existence of associated enterprises. It can be argued that by applying specific thresholds for participation in capital, the influence of control-enhancement mechanisms laid down in the statutes or articles of association is ignored.

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[407] See also Leech, D., "Power Indices in Large Voting Bodies", *Warwick Economic Research Papers no.* 942 (2010); Leech, D., "An empirical comparison of the performance of classical power indices.", 50 *Political Studies* 1, pp. 1-22; see also Felsenthal, D. and Machover, M., *The Measurement of Voting Power* (Cheltenham: Edward Elgar Publishing, 1998); Dubey, P. and Shapley, L.S., "Mathematical properties of the Banzhaf power index", *Mathematics of Operations Research* (1979),
pp. 99-131.

[408] See Banzhaf, J., "Weighted voting doesn't work: a mathematical analysis", 19 *Rutgers Law Review* (1965), pp.317-343; Coleman, J.S., "Control of collectives and the power of a collectivity to act", in: Lieberman, B. (ed), *Social Choice* (New York: Gordon and Breach, 1971), pp. 277-287; Cubbin, J.S. and Leech, D., "The Effect of shareholding dispersion on the degree of control: theory and evidence", 37 *Economic Journal* (1983), pp. 351-369.

In 1932 Berle and Means published the book *The Modern Corporation and Private Property*.[409] The most enduring theme of this book is the "divorce of ownership from the control of the modern corporation".[410] Berle and Means hold the view that shareholders have traded their legal position of private ownership for the role of recipient of capital returns. The interests of the directors and managers can diverge from those of the owners of the firm. This separation between ownership and control of an enterprise through expanded ownership of the enterprise creates what those authors call the "quasi-public" corporation.[411] Berle and Means describe the concept of "control" of the corporation. They refer to a subgroup of shareholders who have the actual power to select the board of directors (management) in any of the following ways:[412]

- Complete ownership of common stock;
- Majority control;
- Legal devices;
- Minority control;
- Management control.

Berle and Means note that the interests of those in "control" differ from the profit-maximising desires of the other owners. According to Berle and Means, control will ultimately lie in the hands of the management. An early reference to corporate governance can be found in their book:[413]

"Those who control the corporation, even if they own a large block of stock, can serve their own pockets better by profiting at the expense of the company than by making profits for it".

This indicates the problem of the incentives for managers of the modern enterprise to conduct business in accordance with the welfare of the owners. As also described in the introduction to the Berle and Means book, boards today have responded to these concerns in a variety of ways. Bonuses in the form of shares aim to ensure that the recipients will start to think like shareholders.

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[409] Berle, A. and Means, G., *The Modern Corporation and Private Property*, (United States:Transaction Publishers, 1932)
[410] Ibid., p. ix
[411] Ibid., p. xii
[412] Ibid., p. xiii
[413] Ibid., p. xiii

Granting options to purchase the shares may also be a strong incentive for management to maximise share performance.
In 2003 the European Commission acknowledged that corporate governance has become a major issue. Corporate governance essentially focuses on the problems that result from the separation of ownership and control, and addresses in particular the principal-agent relationship between shareholders and directors.[414]

Both in legal theory and business practice, the board is the link between the shareholders who own the enterprise and the executives who manage it. The role of non-executive directors in one-tier board structures and supervisory directors in two-tier board structures is to fill the gap between uninformed shareholders as principals and the fully informed executive managers as agents by monitoring the agents more closely.[415] Those two systems have been developed along their specific paths of legal and cultural development. In this respect, credit institutions may play different roles with regards to supervision:

"It is true that credit institutions can play virtually all the roles mentioned: that of a (controlling) shareholder and member of the supervisory board or as an outside director, but also as an executive director, with this position possibly even being strengthened by receiving proxies; that of an investor and at the same time intermediary on capital markets, the latter both at the time of initial placement of the shares (issue) and in secondary markets (trade in shares) and also in takeovers as an extraordinary transaction."[416]

From a company law perspective, both the Art. 9 criteria "participation in capital" and "participation in management" refer to the controlling power that shareholders have and management has over the enterprise. Company law generally identifies two types of shareholder: a passive, non-controlling shareholder and a shareholder that has sufficient voting power to be able to influence or control this company. The latter has the power to direct the strategic financial or operating activities of an entity, so the right to exercise

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[414] Communication from the Commission to the Council and the European Parliament, *Modernising Company Law and Enhancing Corporate Governance in the European Union – A plan to Move Forward*, COM (2003) 284 Final (Brussels: 21 May 2003), p. 10.
[415] Report of the High Level Group of Company Experts on a modern regulatory framework for company law in Europe (Brussels: 4 November 2002), p. 59.
[416] Grundmann, S., *European Company Law*, IAS Communitatis I (Oxford: Intersentia, 2007), p. 291.

whatever discretion in strategic decision making exists. Looking at the analysis of the arm's length principle (Chapter 2), it seems that Art. 9 OECD Model focuses on those "participants in capital and management" who are able to influence the transfer prices, so those that have sufficient voting power to be able to influence or control the company.
For instance, in case of share certificates holders, the important question arises whether those holders have sufficient *voting power* to influence or control the company. If they do not have sufficient voting power or *a controlling participation in the capital*, then the share certificate holders will not qualify as associated enterprises for the purpose of Art. 9 OECD Model.

The term "foreign portfolio investment" (FPI) refers to passive investments in which the owner of the bond or stock does not exercise any control over the firm. Foreign direct investment (FDI) is interpreted differently by countries: generally the minimum is an ownership level of 10% of equity assets in the firm, with some exercise of control.[417]
If in the domestic (tax) legislation of countries a required percentage for the existence of FDI is quantified and mentioned, then this may cause problems for the purpose of Art. 9 OECD Model. As shown above, in the economic literature several models have been created in order to (try to) measure minority control. Special factors may be important and must be studied on an individual, ad hoc, basis. For example, an enterprise may effectively be controlled by a group which owns a small equity stake, such as a descendant of the company's founder. Despite his or her small shareholding, this minority shareholder can have considerable influence, for instance because he or she is a board member.
Control of the enterprise by means of formal voting power is measured through power indices. For instance, a shareholder with a 20% participation in capital could be regarded as controlling in some cases but not in others on the basis of power indices. Large companies can have very dispersed ownership. In some cases, a 5% shareholder may have sufficient voting power to be able to influence or control the enterprise, and according to Art. 9 OECD Model, this shareholder can be considered to be associated.

If an investor does not possess any element of control or participation in the management in a company, then it may be argued that this investor is not

[417] Eden, L., *Transfer Pricing and Corporate Income Taxation in North America* (Toronto: University of Toronto Press, 1998), p. 126.

associated for the purpose of Art. 9 OECD Model.[418] Apparently, an entity must hold at least a significant amount in the capital of another company or in two companies to be able to control or to manage that company or the two companies. Looking at the context of the arm's length principle, it can be argued that it is not the percentage amount of the participation in capital which is decisive to determine whether there is an association for the purpose of Art. 9 OECD Model. The main question is whether the participation in capital offers possibilities to influence the transfer prices of transactions between the two enterprises for the benefit of one of the enterprises. For example, when shareholder A holds 10% of the capital and shareholder B holds 90% of the capital of one company, it is unlikely that shareholder A would be able to shift profits to its own benefit. However, in a situation where shareholder A holds 10% of the capital and the other shareholdings are very small and those shareholders are not able to form an alliance against the decisions of the 10% shareholder, control may be possible and therefore association for the purpose of Art. 9 OECD Model can be established.[419]

By providing minimum thresholds (with regard to a participation in capital) for the existence of associated enterprises, tax authorities may confuse foreign portfolio investment (FPI) with foreign direct investment (FDI) and vice versa. Holding a specific amount of shares does not always imply that the holder has the power to control the company.

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[418] Easson, A., *Taxation of Foreign Direct Investment: An Introduction*, Series on International Taxation, Vol. 24 (London: Kluwer Law International, 1999), p. 2. See also Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61 (Jönköping: Jönköping University, 2009), p. 167.

[419] Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61 (Jönköping: Jönköping University, 2009), p. 167.

3.4.4 Control concept in company law and in Art. 9 OECD Model

In 1976 the EC Commission submitted a first Proposal for a Directive on Consolidated Accounts.[420] Consolidated accounts are the part of accounting law which is primarily affected by the uniform international sets of IAS/IFRS accounting standards. These are the standards in accordance with which, under EC law, consolidated accounts have to be prepared as of 2005 if one member of the group raises capital on regulated capital markets.[421] The Seventh Directive (Directive on Consolidated Accounts) provides conditions for consolidation. Instead of a domination concept it applies a control concept. According to the domination concept that prevails under German law, the criterion is whether a company in fact influences/dominates the management of another company. The means used for this purpose are, in principle, not important, nor is the percentage of its participation.[422] This influence should be exercised and not just be possible. In the case of the control concept the mere possibility of exercising control is sufficient and clear criteria are established that all have in common the fact that decision-making power in "the operative business is legally guaranteed on their basis."[423] Grundmann concludes that the gap between the two concepts has been reduced by the fact that, under German law as well, there is a presumption of domination when certain thresholds are reached. Grundmann concludes that the "domination concept has the advantage of directly addressing the really decisive aspect -the power to influence the operative business- but the control concept is easier to apply".[424]
Art. 1 (1) of this Directive defines the control concept as follows:

"(a parent undertaking)
(a) has a majority of the shareholders'or members'voting rights in another undertaking (a subsidiary undertaking); or

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[420] Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts, Official Journal L 193, 18/7/1983, pp. 1-17.
[421] Grundmann, S., *European Company Law*, IAS Communitatis I (Oxford: Intersentia, 2007), p. 340. Grundmann notes that the gap between consolidated accounts under IFRS and under the Directive on Consolidated Accounts, the Seventh Directive, has even been greatly reduced, because the latter can still be applied under national law when no member of the group raises capital on regulated capital markets.
[422] Cf. Grundmann, S., *European Company Law*, IAS Communitatis I (Oxford: Intersentia, 2007), p. 342.
[423] Ibid.
[424] Ibid.

(b) has the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another undertaking (a subsidiary undertaking) and is at the same time a shareholder in or member of that undertaking; or
(c) has the right to exercise a dominant influence over an undertaking (a subsidiary undertaking) of which it is a shareholder or member, pursuant to a contract entered into with that undertaking or to a provision in its memorandum or articles of association, where the law governing that subsidiary undertaking permits its being subject to such contracts or provisions.[...]
(d) is a shareholder in or member of an undertaking, and:
(aa) a majority of the members of the administrative, management or supervisory bodies of that undertaking who have held office during the financial year, during the preceding financial year and up to the time when the consolidated accounts are drawn up, have been appointed solely as a result of the exercise of its voting rights; or
(bb) controls alone, pursuant to an agreement with other shareholders in or members of that undertaking (a subsidiary undertaking), a majority of shareholders'or members' voting rights in that undertaking. [...]
They (the Member States) make the application of (aa) above dependent upon the holding's representing 20% or more of the shareholders'or members'voting right.
2. Apart from the cases mentioned in paragraph 1 the Member States may require any undertaking governed by their national law to draw up consolidated accounts and a consolidated annual report if [...]:
(a) that undertaking (a parent undertaking) has the power to exercise, or actually exercises, dominant influence or control over another undertaking (the subsidiary undertaking) [...]."[425]

Art. 1 (1) (c) and Art. 1 (2) (a) provide also control instruments that are not based on shareholding, however the underlying requirement is still shareholding (parent and subsidiary). If there is a domination contract or a similar provision in the company statutes of the subsidiary then this can be considered as control for the purpose of Art. 1 of this directive, only if this possibility exists in the (company) law applicable to the subsidiary. However, if a Member State does not prescribe consolidation in the case of a mere

[425] Seventh Council Directive of 13 June 1983, based on the Art. 54 (3) (g) of the Treaty on consolidated accounts (83/349/EEC)

domination contract or similar provision in the statutes of the subsidiary, then this Member State will not recognise this case. Grundmann notes that the domination contract as an instrument known mainly in German law has been declared to be relevant only if both Member States concerned decide to opt for this.[426]

Arts. 32 et seq. deal with companies which are not under the control of one affiliated company but on which significant influence is exercised. Where an undertaking, included in a consolidation, exercises a significant influence over the operating and financial policy of an undertaking not included in the consolidation in which it holds a participating interests, that participating interest must be shown in the consolidated balance sheet as a separate item with an appropriate heading. An undertaking must be presumed to exercise a significant influence over another undertaking where it has 20% or more of the shareholders' or members' voting rights in that undertaking.
Art. 33 of the Seventh Directive provides the following:

"Where an undertaking included in a consolidation exercises a significant influence over the operating and financial policy of an undertaking not included in the consolidation (*an associated undertaking*) in which it holds a *participating interest*, as defined in Article 17 of Directive 78/660 EEC, that participating interest shall be shown in the consolidated balance sheet as a separate item with an appropriate heading. An undertaking shall be presumed to *exercise a significant influence* over another undertaking where it has *20% or more* of the shareholders' or members' voting rights in that undertaking."[427] (*Italics, RD*)

The Committee defines *associated undertaking* or associated enterprise as an undertaking exercising "significant influence over the operating and financial policy of another undertaking". It seems that this significant influence can only originate from a *participating interest*. According to Art. 17 of Directive 78/660 (the Fourth Directive), "participating interest" means rights in the capital of other undertakings, whether or not represented by certificates, which, by creating a durable link with those undertakings, are intended to contribute to the company's activities. According to Art. 17 of the Fourth Directive, "the holding of part of the capital of another company shall be presumed to

[426] Grundmann, S., *European Company Law*, IAS Communitatis I (Oxford: Intersentia, 2007), p. 343.
[427] Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts, Official Journal L 193, 18/7/1983, at 11.

constitute a participating interest where it exceeds a percentage fixed by the Member States which *may not exceed 20%*."

Apparently, 20% can be considered the minimum threshold for exercising significant influence:

"An undertaking shall be presumed to exercise a significant influence over another undertaking where it has 20% or more of the shareholders' or members' voting rights in that undertaking."[428]

It must be noted that the term "significant influence" also appears in IFRS. The IFRS concept of control will be discussed in the second part of this chapter.

The OECD Model does not provide a definition of the term "control". Art. 3 (2) OECD Model provides that any term that is not defined in the tax treaty must have the meaning of the domestic tax law of the Contracting States, unless the *context* requires otherwise. For instance, if that domestic meaning is in conflict with the purpose of the treaty a sensible meaning within the context and purpose of the treaty has to be found.[429]
Chapter 5 will discuss the historical development of Art. 9 OECD Model and its criteria. From this analysis conclusions may be drawn with respect to the question whether "participation in control" is an independent, separate criterion or an additional criterion in relation to the other two criteria (the participation in capital and management criteria).

The OECD Glossary on Tax Terms, which is not included in the OECD Model and is not considered to necessarily reflect an official position of the OECD in interpreting international tax terms in the context of a tax treaty, provides the following definition of "control":

"the capacity of one person to ensure that another person acts in accordance with the first person's wishes, or the exercise of that capacity. The exercise of control by one person over another could enable individuals and corporations to avoid or reduce their tax liability"[430]

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[428] Ibid., at 17, Art. 59.
[429] Cf.Art. 31 of the Vienna Convention on the Law of Treaties concluded in Vienna, 23 May 1969 (hereinafter: VCLT).
[430] OECD, Glossary of Tax Terms, www.oecd.org/document/29/0,2340,en_2649_34897_33933853_1_1_1_1,00.html

Looking at the word "or" in Art. 9 OECD Model ("participation in management, control *or* capital") it seems that "participation in control" is a separate, independent criterion for association. However, as shown in the previous sections, *only* a participation in capital (a shareholding) may not be sufficient to influence or dominate the transfer prices of the other company. "Control" is therefore required. From the wording of Art. 9 OECD Model it seems that there is no relationship between "control" and a participation in management and capital. In the next chapters I will analyse whether a relationship exists between those three elements of Art. 9 OECD Model. Conclusions will be drawn with regard to the control aspects of a participation in capital and management.

As already stated in Chapter 1, "Control" in the absence of a company law-based relationship or in the absence of any formal right to exercise control can be described as "de facto" control. Participation in capital and management can be characterised as "de jure" concepts: concepts covered by company law. If the participation-in-control criterion were considered an independent criterion, it would then be unclear whether this criterion covers relationships between legally independent entities. For instance, would "participation in control" cover open market dominating buyer-seller relationships for the purpose of Art. 9 OECD Model?
The answer to the above questions will be provided in Chapter 9. Besides the historical analysis, which will be made in Chapter 5, the analysis of the arm's length principle and Art. 9 (2) OECD Model provided in Chapter 2 may offer clues as to how to interpret the criterion "participation in control" and to identify its dependent or independent function in the context of the application of the arm's length principle. This analysis will also be provided in Chapter 9.

In case the participation-in-control criterion were considered to be an independent criterion for the existence of associated enterprises, and this might be argued on the basis of the presence of the word "or" in "participation in management, control *or* capital", legally independent enterprises can be considered associated enterprises. In practice, this may lead to additional taxation. This can be illustrated by the examples of China and Brazil. The Chinese rules specify various forms of de facto relationship such as transactions between parties concerning loans, guarantees, services or sales in the open market. In Brazil various relationships such as partners of a joint venture, exclusive agents, distributors and dealers between Brazilian and foreign entities fall within the scope of associated enterprises. Family relationships are also covered by the scope of related parties under the Brazilian transfer pricing rules. Because of the broad scope of the transfer pricing rules, in reality many import and export transactions between legally independent and unrelated companies could be subject to transfer pricing adjustments and compliance with the Brazilian transfer pricing rules. Countries such as India and Portugal also characterise legally independent companies that are dependent in a commercial way from an otherwise unrelated foreign trading partner as associated, for example in cases where the manufacture or processing of goods or articles carried out by one enterprise is wholly dependent on the use of business or commercial rights of which the other enterprise is the owner (India). In Chapter 9 I will discuss whether these broad interpretations of "associated enterprises" are in line with the arm's length principle, the underlying principle of Art. 9 OECD Model.

The Commentary on Art. 9 OECD Model states that no re-writing of accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms. It also does not usually mean that a taxpayer is trying to avoid or evade tax when the commercial conditions charged in a transaction are different from the conditions charged between other independent companies in the open market. Open market conditions between buyer and seller might result in situations of control. For example, if a buyer generates over 90% of the sales of the seller, then the buyer is generally able to influence the prices to his benefit. But can this situation be considered to be "participation in control" for the purpose of Art.9 OECD Model? And does this situation lead to transfer pricing documentation requirements and to adjustments of prices by tax authorities?

3.4.5 Minority shareholders: control and diversity of interests

The so-called "oppression" remedy of minority shareholders in company law is relevant for the control concept of Art. 9 OECD Model as it may restrict the "control" of a majority shareholder.
The rules of the Second Directive on the mandatory competence of the general meeting for capital measures, the pre-emption right of shareholders and equal treatment deal with shareholders' rights within the organisation. According to Grundmann, these rules make a characteristic of shareholder protection in European company law visible: shareholders' rights in current business operations or in the general meeting are not harmonised, but only what could be termed to be the "constitutional" rights of shareholders: capital measures, restructuring measures and the guarantee of keeping the same share.[431] The following rights can be considered as the most important minority rights:

- Rights influencing the shareholders' meeting;
- Veto rights; and
- Sell-out rights.

Grundmann states that minority shareholders' rights are highly developed in Germany, more so than in the United Kingdom.[432] However, the shareholders' meeting in Germany has fewer powers in very important matters than it has in the United Kingdom, France and Italy. This tends "to advance the board's interests or the interests of a dominant shareholder in Germany".

In their analysis of the shareholder-oriented model, Hansmann and Kraakman state the following:

"The shareholder-oriented model does more than assert the primacy of shareholder interests, however. It asserts the interests of all shareholders, including minority shareholders. More particularly, it is a central tenet in the standard model that minority or non-controlling shareholders should receive strong protection from exploitation at the hands of controlling shareholders. In

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[431] Grundmann, S., *European Company Law*, IAS Communitatis I (Oxford: Intersentia, 2007), p. 753.
[432] Grundmann states that the German minority shareholders' rights include more extended time limits for convening a meeting compared to the UK minority shareholders'rights, right to convene a meeting and add to the agenda starting at lower thresholds).

publicly-traded firms, this means that all shareholders should be assured an essentially equal claim on corporate earnings and assets."[433]

Large shareholders are usually well informed about the affairs of the company. However, the position of the controlling shareholder(s) creates potential conflicts of interests with minority shareholders. These minority shareholders, as in companies with fully dispersed ownership, lack sufficient information and resources to monitor management and the controlling shareholder(s).[434]
The question arises whether oppression remedies of minority shareholders could limit the control of the majority shareholders for the purpose of Art. 9 OECD Model.
An interesting case is in this respect the Canadian case of *Ford Motor Company of Canada, Limited v. Ontario Municipal Employees Retirement Board et al.* (the *Ford Canada* case).[435] [436] The *Ford Canada* case dealt with the impact of intercompany transfer pricing policies on the valuation of shares owned by minority shareholders. The issue was whether the transfer pricing system applied by Ford Canada and its parent, Ford US, oppressed the minority shareholders for purposes of the Canada Business Corporations Act (thereinafter: CBCA). According to the CBCA, a body corporate is affiliated with another body corporate if one of them is the subsidiary of the other or both are subsidiaries of the same body corporate or each of them is controlled by the same person.
If two bodies corporate are affiliated with the same body corporate at the same time, they are deemed to be affiliated with each other.[437] For the purposes of

[433] Hansmann, H, and Kraakman, R., "*The End of History for Corporate Law*" (Cambridge, Harvard University Press, 2000), p. 10. Hansmann and Kraakman state that there are two conspicuous reasons for this approach, both of which are rooted in efficiency concerns. One reason is that, absent credible protection for non-controlling shareholders, business corporations will have difficulty raising capital from the equity markets. The second reason is that the devices by which controlling shareholders divert to themselves a disproportionate share of corporate benefits commonly involve inefficient investment choices and management policies.
[434] Report of the High Level Group of Company Experts on a modern regulatory framework for company law in Europe (Brussels: 4 November 2002), p. 60.
[435] *Ford Motor Company of Canada, Limited v. Ontario Municipal Employees Retirement Board* et al., Ontario Superior Court of Justice (Commercial List), [No. 98-CL-3075], decision filed 22 January 2004.
[436] Turner, R., "The Ford Motor Company of Canada Case: An Analysis", 11 *International Transfer Pricing Journal* 4 (July/August 2004), pp. 172-178.
[437] Canada Business Corporations Act, Secs. 2 (a) and (b), definition list.

the CBCA, a body corporate is controlled by a person or by two or more bodies corporate if:

- (a) securities of the body corporate to which are attached more than 50% of the votes that may be cast to elect directors of the body corporate are held, other than by way of security only, by or for the benefit of that person or by or for the benefit of those bodies corporate; and
- (b) the votes attached to those securities are sufficient, if exercised, to elect a majority of the directors of the body corporate.

The CBCA also provides for the situation when a body corporate is a subsidiary of another body corporate. This is the case when it is controlled by that other body corporate, or when it is controlled by that other body corporate and one or more bodies corporate each of which is controlled by that other body corporate. A body corporate is also a subsidiary of another body corporate if it is a subsidiary of a body corporate that is a subsidiary of that other body corporate.[438]
The case was heard under commercial corporate statutes and not under the tax laws of Canada. Therefore, the outcome of the case is not binding upon the Canadian Tax Court or Canadian Federal Court for tax purposes.[439] In the light of the above, the Court did not explicitly answer the question whether Ford's transfer pricing system contravened Canada's tax laws or those of the United States.

The minority shareholder, Ontario Municipal Employees Retirement Board (hereinafter: OMERS) invoked the shareholder relief provisions of the CBCA. Under the CBCA, a shareholder has the right to dissent from a continuance in another jurisdiction and also to dissent from an amalgamation and to require the dissenter's shares to be purchased by the corporation for the "fair value" on the business day preceding that on which the corporate action was undertaken. Ford Canada applied to the Court to seek a determination of the fair value of the shares in respect of the dissenting shareholders. By counterclaim, OMERS et al. argued that they had been unfairly oppressed. According to the relevant corporate statutes, they would then be entitled to receive additional compensation per share not only in respect of the buy-out valuation, but also in

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[438] Ibid.

[439] Turner, R., "The Ford Motor Company of Canada Case: An Analysis", 11 *International Transfer Pricing Journal* 4 (July/August 2004), p. 172.

respect of the prior years. OMERS et al. asserted that the transfer pricing system used by Ford Canada and Ford US was oppressive. Therefore, OMERS et al. made a claim for historical oppression and a claim with a future element, to be taken into account in setting the value of the Ford Canada shares as from 11 September 1995. Hence, the question was raised whether OMERS et al., as minority shareholders, were oppressed in such a way that the statutory remedy for oppression was operative. The Court considered the relevance of Section 247 of the Canadian Income Tax Act. In the Court's observation, reference was also made to Section 241 of the CBCA. R.S.C. 1985, C.1. (5th supplement), as amended Section 247 of the Canadian Income Tax Act contained Canada's transfer pricing rules for years as from 1997. For the years at issue, Section 69 of the Act, as it then read, applied. Unlike Section 247 of the Canadian Income Tax Act (hereinafter: CITA), which requires that transfer pricing reflect arm's length terms and conditions, Section 69 of the CITA provided a standard of "reasonable in the circumstances".[440] Section 241 of the CBCA reads as follows:

"241. (1) A complaint may apply to a court for an order under this section.
Grounds
(2) if, on an application under subsection (1), the court is satisfied that in respect of a corporation or any of its affiliates
(a) any act or omission of the corporation or any of its affiliates effects a result
(b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner, or
(c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner
that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer, the court may make an order to rectify the matters complained of."[441]

The Court decided as follows:

"The Court views the fundamental issue of this case somewhat differently from the parties and expressed this view at different points in the course of the trial.

[440] Turner, R., "The Ford Motor Company of Canada Case: An Analysis", 11 *International Transfer Pricing Journal* 4 (July/August 2004), note 27. The full text of Section 247 of the Canadian Income Tax Act can be found on: http://www.canlii.org/en/ca/laws/stat/rsc-1985-c-1-5th-supp/latest/rsc-1985-c-1-5th-supp.html

[441] Canadian Income Tax Act, Section 241.

In the Court's view, the matter of the lawfulness of the transfer pricing system from a tax regime standpoint is properly a matter between the corporations and the tax authorities. Ford Canada should be able to follow a transfer pricing system that meets the approval of the tax authorities; provided however, *the transfer pricing system cannot be unfair to minority shareholders such as to constitute actionable oppression within the meaning of Section 241 of the CBCA.*
That is, it is not sufficient for a taxpayer to simply have a transfer pricing regime that does not find objection with the tax authorities. *The transfer pricing system must not result in unfairness to minority shareholders such as to constitute oppression within the ambit of the CBCA.*
A transfer pricing system must meet the requirements of the tax regulators and also be fair to minority shareholders. There is nothing contradictory about these *dual requirements* for a transfer pricing system."[442] *(Italics, RD)*

The Court held that at issue was not whether the transfer pricing system complied with the tax requirements, but whether the transfer pricing system was unfair to the minority shareholders. The Court held the view that Ford US treated Ford Canada as if it were a wholly-owned subsidiary, with the acquiescence of the management and directing mind of Ford Canada. In the opinion of the Court, Ford US maintained a transfer pricing system that was unfairly prejudicial to the interests of the minority shareholders. Ford US was the beneficiary of a transfer pricing system which yielded non-arm's length results. The Court held:

"Such conduct was detrimental to Ford Canada but more significantly, was prejudicial to the interests of only the minority shareholders. The majority shareholder, Ford US, gained 100% of the benefits at corresponding costs to it of only 94% of the unfair losses to Ford Canada."[443]

The Court did not consider the transfer pricing system to be at arm's length from a commercial perspective. Furthermore, the Court distinguished tax requirements and the fairness requirements towards minority shareholders as mentioned in the CBCA, and noted that the two were not irreconcilable. As also noted by Turner, neither Section 69 of the Canadian Tax Act, nor Section

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[442] *Ford Motor Company of Canada, Limited v. Ontario Municipal Employees Retirement Board* et al., Ontario Superior Court of Justice (Commercial List), [No. 98-CL-3075], decision filed 22 January 2004, paras. 128-129.
[443] Ibid., para. 349.

247 require that a transfer pricing system should be fair in order to meet the reasonableness or arm's length standard. Turner notes:

"Therefore, it would seem that the fairness standard applied by Court for purposes of the CBCA would not be followed by a Court in a tax case and that the tax analysis would be made on the basis of the facts and circumstances. In fact, for years prior to 1998, the pricing must be reasonable in the circumstances; one would expect the relevant circumstances to include the contractual relationship between the parties."[444]

This is also recognised by the Court. The Court held that income tax authorities do not restructure transfer pricing arrangements. Rather, they seek to ensure that the prices for the product and service transfers are within an acceptable arm's length price range. If they are not, then the prices are adjusted to bring them within the arm's length range.[445]

The Court distanced itself from evaluating Ford's transfer pricing system for tax purposes.[446] Turner states that this case provides a "heads-up" to the standards of corporate governance where there are minority share interests to be considered. In his view, looking at the circumstances, it would seem that board members and corporate managers must not only seek to determine whether the intercompany pricing policies are compliant with tax requirement, but also whether the pricing policies are fair to *all* shareholders.[447]

The above-mentioned *Ford Canada* case shows the relevance of company law for the application of Art. 9 OECD Model. Company law covers cases of interconnection through capital and management. By providing protection to minority shareholders, company law may restrict the control of majority shareholders (even) for transfer pricing purposes.

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[444] Turner, R., "The Ford Motor Company of Canada Case: An Analysis", 11 *International Transfer Pricing Journal* 4 (July/August 2004), p. 177.

[445] *Ford Motor Company of Canada, Limited v. Ontario Municipal Employees Retirement Board* et al., Ontario Superior Court of Justice (Commercial List), [No. 98-CL-3075], decision filed 22 January 2004, para. 120.

[446] Ibid., para. 129.

[447] Turner, R., "The Ford Motor Company of Canada Case: An Analysis", 11 *International Transfer Pricing Journal* 4 (July/August 2004), p. 178.

3.4.6 Joint ventures

Another case that illustrates the difficulties of the interpretation of the concept of "associated enterprises" is a joint venture. Multinational companies are often engaging in international activities through joint ventures with unrelated companies. Generally, foreign investors contribute a substantial amount of capital when establishing the joint venture with domestic partners. Both the foreign investor and the local partner(s) jointly manage and control the business activities.

Two issues can be identified. With regard to the relationship between the two joint venture partners, Company A and B, Nguyen notes that these parties themselves should "not be considered associated parties for transfer pricing adjustment purposes because there is no shareholding relationship between the parties and thus the parties generally have no common interest in each other".[448]

The second issue is whether Art. 9 OECD Model can be applied to transactions between one of the parties to the joint venture and the joint venture itself. It can be questioned whether Art. 9 OECD Model covers transactions between (joint venture partner) Company A or (joint venture partner) Company B and JV. According to Art. 9 OECD Model, there is a participation (of A or B) in the capital of the JV. Company A or B can contribute intangibles, cash, specific services to the joint venture. It must also be noted, that host countries require foreign investors to contribute a substantial amount of capital (equity) when establishing the joint venture with local partners. The JV partners agree to create a new entity and new assets by contributing equity. Foreign investors and local partners then jointly manage, control business activities and share profits or losses of this company.[449] By jointly contributing capital, managing and controlling business activities each party to the joint venture and the joint venture can be considered associated enterprises for the purpose of the application of the arm's length principle. However, an important question is whether the joint venture partner is able to *control* the joint venture with a participation in capital of 50% (or less).

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[448] Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61 (Jönköping: Jönköping University, 2009), p. 167.

[449] See also Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61 (Jönköping: Jönköping University, 2009), p. 167.

In the case of a 50/50 joint venture with an otherwise unrelated company, the possibility of controlling the joint venture for its own benefit may be absent. A JV partner may not agree to profit shifting to the benefit of the other party. Hence, where there is a 50/50 joint venture between Company A and B, and Company A is unable to control the profit shifting or to influence transactions of the joint venture to its own benefit, whether there is a *controlling* participation in capital as required by Art. 9 OECD Model is questionable. If the transactions are not at arm's length and imply an advantage or benefit for joint venture partner A, then partner B would not agree to these transactions.
The question arises whether associated enterprises exist under Art. 9 OECD Model when the partner to the joint venture cannot influence the transactions of the joint venture for its own benefit. A qualifying participation in capital under Art. 9 OECD Model can only be determined when one of the partners can influence pricing in a way which is only beneficial to itself, not to the other joint venture partner.

It may be possible that both partners to the joint venture agree with transactions made by the joint venture which are not at arm's length. These situations have occurred in the United States.
The question whether the IRS could apply Sec. 482 to challenge transfer prices between a foreign company and its 50%-owned US joint venture, or between a US company and its 50% foreign joint venture was already an issue in the 1945 case of *Lake Erie and Pittsburgh Ry. Co. v. Comr.*[450] Two unrelated railroad companies each held 50% of the shares of a railroad company Lake Erie. The two unrelated railroad companies amended their original agreement several years later so that they were no longer required to pay rent to Lake Erie.[451] The IRS attempted to allocate rental income from the competing companies to Lake Erie. The US Tax Court held that Sec. 45 (the predecessor of Sec. 482) was not applicable. The two companies were not controlled by the same interests and neither of them individually had control of Lake Erie.[452]

[450] T.C.558 (1945), acq.1945 C.B. 5 nonacq. 1965-2 C.B. 7.

[451] The companies were not related; they had no common stockholders, officers or directors.

[452] The Tax Court reasoned: "We do not think that it can be said that where two or more corporations owned by different sets of stockholders control another corporation such other corporation is controlled by the same interests." Many years later commentators criticised this decision by stating that if the *Lake Erie* decision is good law, it would seem that the effect of Section 482 could be avoided if two unrelated, and ostensibly competing, taxpayers should each acquire a 50% interest in an entity which they intend to utilize for tax avoidance purposes. See Krupsky, K.. "Chapter 10: Application of Section 482 to international Joint

Twenty years later, the IRS stated that in the *Lake Erie* case the court's interpretation of control by the same interests is inconsistent with the broad language of the section and with the Income Tax Regulations. According to the IRS, the interpretation of the court disregards the realities of the arrangement. The competing railroad companies were not unrelated companies, they acted together, joined by a *common interest* and explicit agreements.[453]

Another interesting case is the *B. Forman Co. v. Commissioner* case.[454] In the *B. Forman Co. v. Commissioner* case, two partners of a 50/50 joint venture were competitors and not related parties. Both partners provided an interest-free loan to the joint venture. The Commissioner adjusted and increased the interest income of the two joint venture partners, based on a 5% interest rate. The Tax Court held that the two partners did not control the joint venture because the 50% shareholding of each partner was not sufficient to manipulate and affect the joint venture. However, the Court of Appeals reversed the decision of the first tax court and decided that Section 482, the basic arm's length provision in US Income Tax Law, should be applied to the transaction of interest-free loans that were granted by the two 50% joint venture partners. The Court of Appeals was of the opinion that those interest-free loans to the joint venture were identical and therefore the two joint venture partners had together dictated every action for their common interest in the joint venture. The Court held that although unrelated, the two joint venture partners had acted *in concert* with their dealings in the joint venture for their collective interest.[455] Apparently, the focus of the lower tax court was in this case on ownership, whereas the focus of the Court of Appeals was on the reality of control and the ability to arbitrarily shift income between the taxpayers rather than on the formal ownership. The Court of Appeals focused on the substance of control between the taxpayers rather than the form of ownership in which control was exercised.[456]
Two American authors, Davis and Lainoff, argue that in case the IRS is unable to show that both co-venturers are engaging in non-arm's length dealings with

Ventures", 890 *BNA Tax Management* (2001), p. 13; Hewitt, "Section 482- Allocation of Income and Deductions Among Related Taxpayers", 20 *Inst. on Fed. Tax'n* 463, 474 (1962).
[453] Rev. Rul. 65-142, 1966-1 C.B. 223.
[454] 54 T.C. 912 (1970), revised, 453.F.2d.1144(2d Cir.), cert. Denied, 407 U.S.934 (1972).
[455] The *B. Forman Co. v. Commissioner* case, 453 F.2d 1144, 1155 (2d Cir. 1972, 407 U.S. 934 (1972).
[456] See also Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61 (Jönköping: Jönköping University, 2009), p.174.

the venture, the IRS should not be able to argue that the co-venturers have acted in concert for purposes of Sec. 482. The ability of the IRS to show the presence of common control will be impaired.[457]

The 1994 US Regulations strengthen the legal position of the IRS by adding language to the definition of "controlled":

"Controlled" includes any kind of control, direct or indirect [...] including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose."[458]

The question resulting from Sec. 482 is whether the joint activities of two unrelated 50/50 joint venture parties constitute the arbitrarily shifting of taxable income on a non-arm's length basis.
If there is a transaction that differs from a standard transaction between unrelated enterprises, which are not JV partners, then the IRS may state that there is an "acting in concert". In that case the taxpayers must prove that the pricing is at arm's length.

If the joint venture (JV) were established in the United States, the IRS could challenge any or all of the foregoing transactions/transfer prices in order to allocate more taxable income to JV. In that case this taxable income would be subject to US tax. On the other hand, the taxing authorities of the foreign JV partner A may seek to allocate income from JV to A. This could result in a situation of international double taxation. For instance, if JV partner A were established in an European country, such as the Netherlands, the United Kingdom or Denmark, this international double taxation would not be solved by a corresponding adjustment as those countries apply a different approach of association.

[457] Davis, B. and Lainoff, S., "U.S. Taxation of Foreign Joint Ventures,"46 *Tax Law Review* (1991), pp.165, 206 (citing Brittingham and French). Where the IRS is unable to show that both co-venturers are engaging in non-arm's length dealings with the venture, it should not be able to argue that the co-venturers have acted in concert for purposes of Sec. 482, and its ability to show common control should be impaired. Also, in case of *Forman*, the presence of a material unrelated co-venturer does not automatically preclude the IRS from making a Sec. 482 adjustment on a transfer of property to the venture, the presence of the co-venturer certainly raises the burden to a level that the government rarely will be able to meet.
[458] Regs. Sec. 1.482-1(i)(4).

3.5. Conclusions

The concept of associated enterprises delimits the application of the arm's length principle.
According to Art. 9 OECD Model, "associated enterprises" exist when one enterprise participates directly or indirectly in the management, control or capital of the other enterprises, or when the same persons participate directly or indirectly in the management, control or capital of both enterprises.
Art. 9 OECD Model suggests a two-step analysis: tax authorities should first determine the existence of "associated enterprises" and if associated enterprises exist, then it should be analysed whether the conditions that are made or imposed between the two enterprises are at arm's length.

The term "associated enterprises" was introduced by Carroll in his report of 1933, where he used the word "associated companies" for convenience purposes. At that time, the term "associated companies" covered only parent and subsidiary companies.

Art. 9 OECD Model only provides for two forms of association:

- One enterprise participates directly or indirectly in the management, control or capital of the other enterprise (Art. 9 (1) (a) OECD Model); or
- The same persons participate directly or indirectly in the management, control or capital of both enterprises (Art. 9 (1) (b) OECD Model).

A comprehensive definition of what participation in management, control or capital means is not given. The Commentary and the OECD TP Guidelines do not provide a clear definition of "associated enterprises" either. In the 1979 OECD Report it was expressed that it was not thought to be necessary to define such expression as "associated enterprises" and "under common control" as a *broad basis of common understanding* of what was meant was assumed to exist. This indicates that a common understanding (autonomous interpretation) of the notion of "associated enterprises" must exist.[459]

Also the "bracket definition" in the Commentary that explains "associated enterprises" as parent and subsidiary companies and companies under

[459] See Chapters 4 and 5.

common control, cannot be considered to be a proper definition of "associated enterprises". Concerning Art. 9 (1) (a) OECD Model it focuses on a (sole) shareholding situation only. Concerning Art. 9 (1) (b) OECD Model it does not elaborate on the term "under common control". However, if "*de facto*" control would be covered, the Commentary would probably have indicated this explicitly.

It may be concluded from the Commentary on Art. 11 and 12 OECD Model that Art. 9 OECD Model only covers corporate relationships and not personal relationships, such as relationships based on blood or marriage. Paragraph 34 of the Commentary on Art. 11 OECD Model provides examples of relationships that are covered by Art. 11 OECD Model but which are not covered by Art. 9 OECD Model. This is particularly interesting for countries having domestic transfer pricing regulations that consider a relationship by blood and marriage as an association for transfer pricing purposes.[460]

The OECD Model does not elaborate on the specific order of the terms "management, control or capital". Though a participation in capital through a sole or majority participation including voting rights in the capital of an enterprise is the most common form of association (for instance parent-subsidiary relationships), the OECD Model does not explain why capital is mentioned as the last instance.

The text of Art. 9 OECD Model suggests that "control" is an independent criterion of equal importance to management and capital. If control were considered to be an independent criterion, then the concept of associated enterprises would also cover *de facto* control, control that exists in the absence of any formal right to exercise control, for instance where a buyer has a dominating negotiating power over a seller. The difficulty of this criterion also appears in the context of joint ventures.

Vogel concludes from the "bracket definition" that the concept of "associated enterprises" only covers cases of interconnection under company law. The concept of "associated enterprises" covers *de jure* relationships, referring to relationships based on company law. As stated above, "participation in capital" is the most common form of association. The Commentary on Art. 10 (2) (a)

[460] As will be shown in Chapter 4, which deals with treaty interpretation, domestic concepts of association for transfer pricing purposes covering relationships by blood or marriage would be rejected by Art. 9 OECD Model.

OECD Model states that "capital" should be understood as it is understood in company law. Company law deals with shareholders' relationships and relationships between management, shareholders and the company. Company law is relevant for the application of Art. 9 OECD Model, as EU company law and domestic company laws deal with all kinds of aspects in relation to shareholders, management and the company itself. For instance, company law provides bases for control-enhancement mechanisms and company law may restrict the control of majority shareholders and/or provide minority shareholders control.

The term "participation in capital" in Art. 9 OECD Model refers to shareholding. It is possible for shareholders to influence the decisions of the company. Shareholders may control a proportion of the total voting rights much larger than their ownership rights. Control-enhancement mechanisms allocate control rights and may give minority shareholders control over the enterprise. Control-enhancement mechanisms available in company law may limit the control of an enterprise participating in the capital of another enterprise, for example through multiple-voting rights, voting-rights ceilings, ownership ceilings, non-voting shares etc. Specifically because of the so-called separation of ownership and control in company law, it can be concluded that a specific required percentage to fulfil the participation-in-capital criterion is not decisive to determine whether one enterprise can influence or control the transfer prices of the other enterprise. The concept of control and power are related to the structure of decision-making within the company. As shown in the *Ford Canada* case, company law may also restrict the control of majority shareholders with respect to the transfer pricing system if minority shareholders are oppressed (minority shareholders' protection).

The important question is whether a shareholder has enough (voting) power to determine strategic financial and operating decisions of an enterprise. For instance, share certificates holders and holders of options generally have no voting power to influence or control the company. Economic control/voting models, for instance dealing with voting power indices, may be useful to measure the formal shareholder's voting power and control.
Although the word "or" in Art. 9 OECD Model seems to indicate that "participation in control" is a separate, independent criterion for association, the presence of control is required for identifying whether one holds a "participation in capital" that has the possibility to influence the transfer prices. Thus, control in addition to the criteria "participation in capital" and

"participation in management" is required to determine associated enterprises for the purpose of Art. 9 (1) OECD Model. For instance, share certificate holders with no control (voting power) will not qualify as associated enterprises for the purpose of Art. 9 OECD Model.

On the basis of the above I conclude that –for the sake of clarity- the terms "participation in management" and "participation in capital" should be supplemented with the adjective "controlling". The matter whether "participation in control" is a criterion independent from the other designations of "associated enterprises" will be discussed in Chapter 5.

Art. 3 (2) OECD Model states that any term not defined in the convention shall have the meaning under the domestic tax laws of the countries applying the convention, unless the context requires otherwise. Before turning to the domestic legislation as eventually stated by Art. 3 (2) OECD Model, I will analyse the historical development of Art. 9 OECD Model in Chapter 5 in an effort to determine whether the history of Art. 9 OECD Model provides important clues for an autonomous interpretation of "associated enterprises". In Chapter 6 I will discuss the various domestic interpretations of the concept of "associated enterprises". My analytical findings and concluding remarks included in this chapter will be used for the final conclusions in Chapter 9. Before briefly discussing tax treaty interpretation in Chapter 4, I will analyse the concept of associated enterprises under IFRS.

Chapter 3: Part II – the concept of associated enterprises in IFRS

3.6. Introduction

Calculating the profits of a company following the rules of financial accounting may lead to a very different outcome compared to calculating the taxable profits. This is mainly caused by the different aims of financial and tax accounting. The main aim of tax accounting is to ascertain the taxes payable by a company. Financial accounting tries to provide an economic evaluation of profit, losses and possessions and liabilities. Therefore, there may be different outcomes when performing tax accounting or performing financial accounting on the same factual basis. The objective of financial reporting is to provide financial information about the reporting entity that is useful to potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers. The International Accounting Standards Board (IASB) notes that financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of the past events and do not necessarily provide non-financial information. There is a variety of users of financial statements. However, the IASB concentrates on investors because it assumes that once their information needs have been fulfilled, the needs of others will have been met as well. The IASB also stresses the fact that the information should be helpful to the user to predict expected future cash flows.

Financial accounting is undergoing a growing influence from International Accounting Standards/ International Financial Reporting Standards (IAS/IFRS). In many continental jurisdictions, financial accounting emphasises creditor protection and uses the principle of prudence as its main principle.[461]
In 2002 the European Union agreed that from 1 January 2005 International Accounting Standards / International Financial Reporting Standards would apply to the consolidated accounts of the EU listed companies.
As IAS/IFRS finds its origin in Anglo-American countries, such as the United States, Canada and the United Kingdom, these standards have been strongly influenced by the Anglo-American view on accounting.

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[461] Essers, P.H.J., et al., *The Influence of IAS/IFRS on the CCCTB, Tax Accounting, Disclosure and Corporate Law Accounting Concepts, A Clash of Cultures*, EUCOTAX Series on European Taxation, Vol. 23 (London: Kluwer Law International, 2009), General Introduction.

In the following sections I will analyse the concept of association and control in the international financial reporting standards. I will use the findings of this analysis to ascertain whether these concepts provide clues for the interpretation of "associated enterprises" in the context of the OECD Model.

3.6.1. History International Accounting Standards / IFRS

As early as in the nineteenth century, local law tended to have limited requirements for bookkeeping, accounting and financial reporting. This local law resulted in the issuance of accounting standards on national level. As a result, there were many differences between the accounting standards of each country. In the early twentieth century this raised the discussion between academics and practitioners about the harmonisation of these national standards. Research known as "international comparative accounting" surveyed these accounting systems, compared the findings from these surveys and classified these different national accounting systems.[462] These surveys revealed that countries could be clustered based upon national accounting standards and practices. The differences between these national systems could be explained by looking at circumstances such as the legal system, the role of capital markets and tax influences.[463]

As a consequence of the growth of multinational enterprises during the 1970s, the need for capital increased. However, investors and financiers noticed the lack of international comparability of financial information on which they had to base their investment decisions.[464] Harmonisation of accounting standards, more financial disclosures and more transparency were required by both the investors and the governments (for example, by securities regulators). Harmonised standards would lead to improved comparability and understanding among a wider public, leading to a lower required cost of capital. Harmonisation would also lead to lower costs for multinational enterprises, as there would be less need for compiling information on the basis of different accounting systems in different countries.

During the Tenth World Congress of Accountants in 1972, a proposal was discussed for the foundation of an International Accounting Standards Committee (IASC). The IASC was founded in 1973 by 16 national

[462] Ibid., p. 2.

[463] Ibid.

[464] Ibid.

professional accounting bodies.[465] The main goal of the IASC was to formulate and publish, in the public interest, accounting standards to be observed in the presentation of financial statements and to promote their acceptance and observance. Furthermore, the IASC generally worked for the improvement and harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements. The professional accounting bodies that had founded the IASC agreed to make every effort to promote the adoption of the IAS in their countries and to put the generally accepted national accounting principles (GAAP) on par with IAS. From the beginning, there was a major influence within the IASC of the Anglo-American view on accounting. In the United Kingdom and Ireland, Canada and the United States, professional accountants had started to develop accounting standard based upon best practice.[466] It should be noted that although the United Kingdom and the United States are both Anglo-American, the way of drafting their standards differs. Due to the importance of legal security, the United States set very detailed standards with no possibility to deviate from the details. On the other hand, Continental Europe and the United Kingdom followed the "true and fair view" approach, setting less detailed standards and offering possibilities for accountants to deviate from the standards. The Fourth EC Directive requires Member States to lay down this principle in their local law. The international financial reporting standards have always followed this approach, but in 2003 the option was inserted for jurisdictions not to allow the "true and fair view" principle to override. Although there was a strong influence of the Anglo-American countries within the IASC, a lot of options for different accounting methods were introduced in the standards.

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[465] The sixteen accounting bodies were from the following nine countries: Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the UK and Ireland and the US.

[466] The Anglo-American countries did not have law such as the "Code Napoleon". See Essers, P.H.J., et al., *The Influence of IAS/IFRS on the CCCTB, Tax Accounting, Disclosure and Corporate Law Accounting Concepts, A Clash of Cultures*, EUCOTAX Series on European Taxation, Vol. 23 (London: Kluwer Law International, 2009), p. 3. Van der Tas and Van der Zanden describe that the US approach used to be a more pragmatic approach based on business practice. In the 1960s and early 1970s, both the United States and the United Kingdom implemented a conceptual framework in their accounting standards to ensure that the standards are based upon some general principles. As Van der Tas and Van der Zanden describe, the accounting system in the United States is balance-sheet oriented. It focuses on the proper presentation of assets and liabilities and is less concerned about the matching of income and expenses in the income statement. With a view to comparability of financial statements in the case of investment decisions, there is a tendency to leave as few options as possible for companies when preparing their financial statements.

Important are the different views held in Continental Europe and the Anglo-American countries regarding a company structure. In the Anglo-American view, the company is an instrument in the hands of shareholders and the members of the board are the agents of the principals (the shareholders). The shareholders own the company and therefore hold the balance between assets and liabilities. From a Continental European point of view, the shareholder is not the owner of the company but the owner of shares in the company. The board of the company has to serve the interest of the company as an institution and has a duty towards *all* its stakeholders. Consequently, equity in principle belongs to the company and not to its shareholders.[467]

As from 1974 new exposure drafts were published and standards approved every year. During these times, the constitution and the procedures for publishing the exposure drafts and approving the standards were redrafted. In 1987 the first "IASC Bound Volume of IAS" was published, comprising over 30 standards. A comparability project was initiated, in which the differences between IAS and the most important standards, such as US GAAP, were identified.[468]
Because problems occurred between the application of principles in the different standards due to the topic-related standards structure, the IASC developed conceptual frameworks as used in the United States and the United Kingdom. The purpose was to solve internal inconsistencies within and between the standards.
In 1997 the Standing Interpretations Committee (SIC) was formed by the IASC. The SIC provides guidance on the interpretation of international accounting standards on issues brought to its attention by the IASB's constituents on relatively short notice.
In 2000 the IASC grew to more than 150 professional accountancy bodies from over 110 countries. In 2001 the IASB took over the responsibilities of the IASC. The IASB started by developing new standards called IFRS. The existing IAS were also improved by the IASB. In 2007 even the US SEC decided to accept IFRS for non-US companies listed in the US and started a discussion on the application of IFRS by US companies.

467 Ibid., p. 4.
468 Ibid., p. 5.

3.7. European Union

As early as the 1990s, discussions were held about convergence between accounting standards of the US and Europe. As the German government wanted to facilitate the possibility for German companies to attract foreign investment, the German government introduced the "Kapitalaufnahme Erleichterungsgesetz". This law allowed companies that are listed at a foreign stock exchange to use IAS, US GAAP or another international accounting system deemed to be equal to the EU Directive on consolidated annual accounts. As a consequence, the European Commission decided to opt for the use of IAS in the consolidated financial statements of listed companies under certain conditions. As mentioned by Van der Tas and Van der Zanden, "the standards of the IASC, to be used in the EU, should be in line with the principles used in the EU Directives on annual accounts and are to be subjected to an endorsement procedure in which the European institutions give the standards its democratic legitimacy".[469] In 2002 the EU Council and Parliament adopted Regulation 1606/2002, which requires listed companies to use IAS/IFRS as approved by the European Union in their consolidated accounts from 1 January 2005. Furthermore, listed and non-listed entities were also permitted to use approved IAS/IFRS in their statutory or single annual accounts and non-listed companies were permitted to use IAS/IFRS in their consolidated accounts.[470]

3.8. Structure

The IASB publishes its standards in a series of pronouncements called International Financial Reporting Standards (IFRSs). The term "International Financial Reporting Standards" includes IFRS, IAS and Interpretations which originated with the IFRIC or its predecessor, the former Standing Interpretations Committee (SIC).

The way in which an IFRS is drafted is similar to the way rules are drafted in the United Kingdom and the United States. Each standard contains a specific topic. Besides the rule itself, the standard also provides guidance for the implementation of this rule. These rules are stated in the body of the law, and

[469] Ibid., p. 6.

[470] The author does not elaborate on the difference between IFRS issued by the IASB and IFRS adopted by the EU (EU-IFRS).

the guidance on this rule is included in explanatory notes. However, the most recent standards contain general principles in the main body of the text, accompanied by significant additional guidance on the implementation of the standard in practice and the basis for the conclusion reached.[471]

The IASC/IASB developed a *Framework for the Preparation and Presentation of Financial Statements*, which defines the objectives of financial statements and states the underlying assumptions as well as the qualitative characteristics that financial statements should meet. This Framework also containes definitions of the constituting elements of financial statements and the criteria for recognition and derecognition. The standards should follow the principles as laid down in this framework. The Framework for the Preparation assists the IASB:

- in the development of future IFRSs and its review of existing IFRSs; and
- in promoting the harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRSs.

Furthermore, the Framework may assist:

- preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of a standard or an Interpretation;
- auditors in forming an opinion on whether financial statements are in conformity with IFRSs;
- users of financial statements in interpreting the information contained in financial statements prepared in conformity with IFRSs; and
- those who are interested in the work of the IASB, providing them with information about its approach to the formulation of accounting standards.

The Framework is not an IFRS. However, as stated by the IASC, when developing an accounting policy in the absence of a standard or an

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[471] See also Essers, P.H.J., et al., *The Influence of IAS/IFRS on the CCCTB, Tax Accounting, Disclosure and Corporate Law Accounting Concepts. A Clash of Cultures*, EUCOTAX Series on European Taxation, Vol. 23 (London: Kluwer Law International, 2009), p. 3.

Interpretation that specifically applies to an item, an entity's management is required to refer to, and consider the applicability of, the concepts in the Framework.[472]

The name of the organisation concerned is the International Accounting Standards Committee Foundation. The International Accounting Standards Board is now the standard-setting body of the IASC Foundation. The objectives of the IASC Foundation are:

- to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;
- to promote the use and rigorous application of those standards
- in fulfilling the objective associated with the above two objectives, to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies; and
- to bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high-quality solutions.[473]

3.8.1. Qualitative characteristics

The IASB uses four principal characteristics that make the information provided in the financial statements useful to users. These four characteristics are understandability, relevance, reliability and comparability. The principle of understandability means that the information provided in the financial statements is readily understandable to users. Users are assumed to have a reasonable knowledge of business and economic activities and accounting. They should further have a willingness to study the information with reasonable diligence.The relevance-characteristic refers to two interrelated aspects: the predictive and confirmatory role of the information. Information should be relevant to the decision- making needs of users. The information can

[472] IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.
[473] IASC Foundation Constitution, Part A, at 1.

be helpful in confirming the earlier predictions as well as to help to make a prediction for future periods. The other aspect concerns the materiality of the information. Information is material if its misstatement could influence the economic decisions of users. The reliability-characteristic means that the information in the financial statement is reliable for the users. The IASB refers to several aspects in this context, such as faithful representation, substance over form, neutrality, prudence and completeness. The IASB states the following about "substance over form" in its framework:

"If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an entity may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the entity continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if there was a transaction)."[474]

With respect to the comparability characteristic, the IASB states that users must be able to compare the financial statements of any entity through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities in order to evaluate their relative financial position, performance and changes in financial positions. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an entity and over time for that entity and in a consistent way for different entities.[475]

[474] Framework for the Preparation and Presentation of Financial Statements, IASB, paragraph 34.

[475] Paragraph 39 of Framework for the Preparation and Presentation of Financial Statements, IASB. Van der Tas and Van der Zanden note that "from the definitions and the explanatory paragraphs, it seems that the IASB had a more balance sheet oriented approach than a profit and loss oriented approach. In the definition of assets the verb 'control' is crucial. However, this verb is not defined in the Framework. In the glossary to the IASB bound volume, only control of an entity is described. In continental Europe control of an asset normally implies that one has the absolute power to dispose of a good in the economic

The above-mentioned four principal characteristics can be recognised in the "associated enterprises" and "control" concepts in IFRS/IAS, which will be discussed in the next sections.

3.9. IAS 27 Consolidated Financial Statements and Accounting for Investments in Subsidiaries

3.9.1. Main features of IAS 27 (2008 version)

One of the relevant accounting standards for this research is IAS 27. The objective of IAS 27 (2008 version) is to enhance the relevance, reliability and comparability of the information that a parent entity provides in its separate financial statements and in its consolidated financial statements for a group of entities under its control.[476] This Standard specifies:

a. the circumstances in which an entity must consolidate the financial statements of another entity (being a subsidiary);[477]

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environment. In respect of the definitions of assets and liabilities, the IASB refers to the substance over form discussion:
"In assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of finance leases, the substance and economic reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its useful life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the finance lease gives rise to items that satisfy the definition of an asset and a liability and are recognized as such in the lessee's balance sheet." See Essers, P.H.J., et al., *The Influence of IAS/IFRS on the CCCTB, Tax Accounting, Disclosure and Corporate Law Accounting Concepts, A Clash of Cultures*, EUCOTAX Series on European Taxation, Vol. 23 (London: Kluwer Law International, 2009), p. 16 and paragraph 51 of the IASB Framework for the Preparation and Presentation of Financial Statements.

[476] IAS 27 (2008) should be read in the context of the Basis for Conclusions, the *Preface to International Financing Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance. See IAS 27 (2008) Preface.

[477] According to IAS 27 paragraph 10, a parent need not present consolidated financial statements if and only if:

b. the accounting for changes in the level of ownership interest in a subsidiary;
c. the accounting for the loss of control of a subsidiary;[478] and
d. the information that an entity must disclose to enable users of the financial statements to evaluate the nature of the relationship between the entity and its subsidiaries.

It is written in the scope of IAS 27 (2008) that this standard must be applied "in the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent". IAS 27 (2008) must also be applied in accounting for investments in subsidiaries, jointly controlled entities and associates when an entity elects, or is required by local regulations, to present separate financial statements.[479] An entity must disclose information about the nature of the relationship between the parent entity and its subsidiaries.

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a. The parent is itself a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
b. the parent's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);
c. the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and
d. the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with International Financial Reporting Standards.

[478] In the introduction of IAS 27 (IN8) the IASB states that changes in a parent's ownership interest in a subsidiary that do not result in the loss of control are accounted for within equity. When an entity loses control of a subsidiary it derecognises the assets and liabilities and related equity components of the former subsidiary. Any gain or loss is recognised in profit or loss. Any investment retained in the former subsidiary is measured at its fair value at the date when control is lost. Further, the Board also states that non-controlling interests must be presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent. Total comprehensive income must be attributed to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.

[479] IAS 27 (2008), scope 1 and 3, p. 1422.

3.9.2. Definitions of IAS 27 (2008)

IAS 27 (2008) defines the following terms that are relevant for this study:[480]

Control
"*Control* is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities."

Consolidated financial statements
"Consolidated financial statements are the financial statements of a group presented as those of a single economic entity."

Group
"A group is a parent and all its subsidiaries."

Non-controlling interests
"Non-controlling interest is the equity in a subsidiary non-attributable, directly or indirectly, to a parent."

Parent
"A parent is an entity that has one or more subsidiaries."

Subsidiary
"A subsidiary is an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent)."

A parent must present consolidated financial statements in which it consolidates its investments in subsidiaries in accordance with this Standard. However, a parent need not present consolidated financial statements if, and only if:

(a) the parent itself is a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise

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[480] International Financial Reporting Standards 2008, including International Accounting Standards and Interpretations as approved at 1th January 2008, the consolidated text of International Financial Reporting Standards as approved on 1 January 2008, IASB (2008), IAS 27 at 4.

entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
(b) the parent's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);
(c) the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and
(d) the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with IFRSs.

Furthermore, paragraph 13 of IAS 27 (2008) reads as follow:[481]

"13. Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting powers of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent owns half or less of the voting power of an entity when there is: (see also SIC -12 *Consolidation- Special Purpose Entities)*

a. power over more than half of the voting rights by virtue of an agreement with other investors;
b. power to govern the financial and operating policies of the entity under a statute or an agreement;
c. power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or
d. power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body."

In preparing consolidated financial statements, an entity combines the financial statements of the parent *and its subsidiaries* line by line by adding together like items of assets, liabilities, equity, income and expenses.
Paragraph 14 of IAS 27 states that an entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity voting power or reduce another party's voting power over the

[481] IAS 27 (2008), para. 12, p. 1424.

financial and operating policies of another entity (potential voting rights). In paragraph 14 of IAS 27 it is stated that the existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by another entity, are considered when assessing whether an entity has the power to govern the financial and operating policies of another entity.[482] The expression "directly or indirectly through subsidiaries" used in paragraph 13 also indicates the *de jure* basis on which control is based.

The reference to *de facto* control is given as an additional criterion to the *de jure* basis of control. Paragraph 15 of IAS 27 states that in assessing whether potential voting rights contribute to control, the entity examines all facts and circumstances, including the terms of exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination, that affect potential voting rights, except the intention of management and the financial ability to exercise or convert such rights.[483]

The consolidated financial statements present financial information about the group as a single economic entity. The carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary are eliminated. Then non-controlling interests in the profit or loss of consolidated subsidiaries for the reporting period are identified. Finally non-controlling interests in the net assets of consolidated subsidiaries are identified separately from the parent's ownership interests in them.

Paragraph 41 of IAS 27 provides disclosure rules that focus on levels of association. They deal with:

(a) the nature of the relationship between the parent and a subsidiary when the parent does not own, directly or indirectly through subsidiaries, more than half of the voting power;
(b) the reason why the ownership, directly or indirectly through subsidiaries, of more than half of the voting or potential voting power of an investee does not constitute control.

[482] Ibid., para. 14, p. 1424.
[483] Ibid., para.15, p. 1424.

3.10. IAS 24 Related Party Disclosures

In November 2009 the IASB issued a revised version of IAS 24 Related Party Disclosures. The revised standard is effective for annual periods beginning on or after 1 January 2011, with earlier application permitted.
IAS 24 requires disclosures about the related parties and transactions with those related parties. The objective of this Standard is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit and loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties.
The IASB revised IAS 24 in 2009 by:

(a) simplifying the definition of a related party, clarifying its intended meaning and eliminating inconsistencies from the definition; and by
(b) providing a partial exemption from the disclosure requirements for government-related entities.

IAS 24 contains the following text in paragraphs 5 and 6:

"5. Related party relationships are normal features of commerce and business. For example, entities frequently carry on parts of their activities through subsidiaries, joint ventures and associates. In those circumstances, the entity has the ability to affect the financial and operating policies of the investee through the presence of control, joint control or significant influence.

6. A related party relationship could have an effect on the profit or loss and financial position of an entity. Related parties may enter into transactions that unrelated parties would not. For example, an entity that sells goods to its parent at cost might not sell on those terms to another customer. Also transactions between related parties may not be made at the same amounts as between unrelated parties."[484]

The IASB states that knowledge of an entity's transactions, outstanding balances, including commitments, and relationships with related parties may affect assessments of its operations by users of financial statements, including

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[484] IAS 24 (2011), paras. 5 and 6.

assessments of the risk and opportunities facing the entity.[485] Relationships between a parent and its subsidiaries must be disclosed irrespective of whether there have been transactions between them. An entity must disclose the name of its parent and, if different, the ultimate controlling party.

According to IAS 24, a related party is a person or entity that is related to the entity (called the "reporting entity") that is preparing its financial statements. A person or a close member of that person's family is related to a reporting entity if that person:

(1a) has control or joint control over the reporting entity;
(1b) has significant influence over the reporting entity; or
(1c) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.[486] Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director of that entity.

A close member of the family of a person should be interpreted as a family member who may be expected to influence, or be influenced by, that person in their dealings with the entity and include:

(a) that person's children and spouse or domestic partner;
(b) children of that person's spouse or domestic partner; and
(c) dependants of that person or that person's spouse or domestic partner.

IAS 24 also provides for the situation when an entity is related. An entity is related to a reporting entity if any of the following conditions apply:

(a) The entity and the reporting entity are members of the same group. This means that each parent, subsidiary and fellow subsidiary is related to the others.
(b) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
(c) Both entities are joint ventures of the same third party.
(d) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.

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[485] Ibid., para. 8.
[486] Ibid., para. 9.

(e) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.
(f) The entity is controlled or jointly controlled by a person identified under the above-mentioned 'persons criteria') 1a, 1b or 1c.
(g) A person identified in (1a) has significant influence over the entity or is a member of the key management personnel of the entity, or of a parent of the entity.[487]

It should be noted that there are special rules regarding government-related entities.[488]

IAS 24 provides definitions in detail. For instance, "related party transaction" is defined as a "transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged". More importantly, IAS 24 also defines "control":

"Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities."[489]

"Control" should not be confused with "significant influence". Significant influence is the "power to participate in the financial and operating policy decisions of an entity, but is not control over those policies. Significant influence may be gained by share ownership, statute or agreement."[490]
It should be identified as an influence on the financial and operating policy decisions, but not as a decisive influence. The OECD Model does not use the term "significant influence" for the application of Art. 9 OECD Model.

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[487] Ibid., para. 9.

[488] Ibid., para. 25. A reporting entity is exempt from the disclosure requirements of paragraph 18 of IAS 24 in relation to related party transactions and outstanding balances, including commitments, with:
(a) a government that has control, joint control or significant influence over the reporting entity; and
(b) another entity that is a related party because the same government has control, joint control or significant influence over both the reporting entity and the other entity.

[489] Ibid., para. 9.

[490] Ibid.

It appears from the text that significant influence is a *de jure* criterion: it is based on share ownership, statute or agreement; elements originating from company law.

IAS 24 also defines "joint control": joint control is the contractually agreed sharing of control over an economic activity.[491]

The IASB states that in considering each possible related party relationship, attention is directed to the substance of the relationship and not merely the legal form. With regard to this consideration, IAS 24 paragraph 11 does not identify the following situations as being "related":

"(a) two entities simply because they have a director or other member of key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.
(b) two venturers simply because they share joint control over a joint venture.
(c) providers of finance, trade unions, public utilities and departments and agencies of a government that does not control, jointly control or significantly influence the reporting entity, simply by virtue of their normal dealings with an entity, even though they may affect the freedom of action of an entity or participate in its decision making process.
(d) a customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of business, simply by virtue of the resulting economic dependence."[492]

For the application of IFRS, two partners in the joint venture are not related when they share joint control. A pure open market situation between (independent) buyer and seller should not lead to association or "related parties" for the purpose of IAS24, either. The text "a customer [...] with whom an entity transacts a significant volume of business, simply by virtue of the resulting economic dependence" refers to the acceptance of the results of the open market. Even though there is "economic dependence", for instance if a third party could influence the prices of the other by virtue of his mere economic dominance, this will not result in a related party transaction as the parties are independent from a company law perspective. IAS 24 recognises open market situations and does not interpret these open market situations as

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491 Ibid.

492 Ibid., para. 11.

situations between related parties. In that sense, IAS 24 rejects the view that even open market situations, such as mere economic dependence would qualify as situations of "related" or "associated".

3.11. IASB Project on Consolidation

3.11.1. Introduction

In June 2003, the IASB added a project on consolidation to its agenda.[493] The objective of the project was to publish a single International Financial Reporting Standard (IFRS) on consolidation to replace IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation- Special Purpose Entities.* The project addressed the following aspects:

- a revision of the control definition in order to apply the same control criteria to all legal entities. The new IFRS identifies the principles of *control*, and determines how to identify whether an investor controls an investee and therefore must consolidate the investee; and
- the new IFRS sets out principles for the preparation of consolidated financial statements.

The Board had been developing the project with the following principles in mind:

a. Consolidation should be driven by the principle of reporting a parent and its subsidiaries as if they were a single economic entity.
b. Identifying whether an entity is a subsidiary should be based on control, for instance an entity's control of another entity should be used as a proxy for identifying the assets controlled by the first entity.
c. Only one entity can control another entity. In other words, control must be unilateral or non-shared.
d. There should be no exemption from consolidation because a subsidiary's operations are dissimilar to that of its controller's or because an entity adopts measurement models different to those of the controller.

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[493] See the IASB Report on Consolidation, version June 2008.

e. Consistent control criteria and a single comprehensive IFRS (to replace IAS 27 and SIC-12) should apply to all entities.[494]

Although not every country applies IFRS for financial accounting, the international importance of the IFRS is significant. The notion of "control" is becoming more important in financial accounting. The IASB analyses the concept of "control" in detail. In these sections I will discuss the concept of "control".

The IASB revised International Accounting Standard 27 *Consolidated and Separate Financial Statements* (IAS 27) in 2003 as part of its project on Improvements to International Accounting Standards. The Board's main objective was to reduce alternatives in accounting for subsidiaries in consolidated financial statements and in accounting for investments in the separate financial statements of a parent, venture or investor. The Board did not reconsider the fundamental approach to consolidation of subsidiaries contained in IAS 27.

In response to the recent economic turmoil and the recommendations of the Financial Stability Forum in November 2007 and April 2008, the IASB Board decided to prioritise the consolidation project and go straight to the publication of an Exposure Draft (ED) rather than a Discussion Paper.[495] This exposure draft was issued in December 2008 for comments from the public. IFRS 10 was published on 12 May 2011.

IAS 27 was amended as part of the second phase of the business combinations project in 2008. That phase of the project was undertaken jointly with the US Financial Accounting Standards Board (FASB). The amendments related, primarily, to accounting for non-controlling interests and the loss of control of a subsidiary. The boards concluded the second phase of the project, by the IASB issuing the amended IAS 27 and the FASB issuing FASB Statement No. 160 *Non-controlling Interests in Consolidated Financial Statements,* along with, respectively, a revised IFRS 3 *Business Combinations* and FASB Statement No. 141 (revised 2007) *Business Combinations.*[496]

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[494] Ibid., p. 2.

[495] See also Exposure Draft IFRS X, Discussion points for roundtable meetings, 17 September 2008.

[496] IAS 27 (2008), see IN1 and IN2, p. 1420.

In July 2008 the staff presented a first staff draft of the exposure draft to the Board for discussion. This draft was written on the basis of the tentative decisions made over the period the Board has been debating the issues. This was designed to demonstrate to the Board how a more general model could be developed. The staff revised that draft to reflect feedback from individual Board members. A revised draft was then circulated to selected members of the IFRS Community. The project was also designed to enhance the disclosures required for both consolidated and non-consolidated entities. According to the staff, "the recent economic turmoil has highlighted a widely held perception that current accounting and disclosure requirements do not give sufficient information to users of the financial statements to allow them to understand the risks an entity has exposure to – particularly for off-balance sheet entities."[497]

3.11.2. IASB Project on Consolidation: June 2008

The June 2008 Project Update provides the following definition of "control" under the chapter "*The definition of Control*":[498]

"*The definition of Control*

9. The Board has tentatively decided that a parent entity has a controlling interest in another entity when it has exclusive rights over that entity's assets and liabilities which give it access to the benefits of those assets and liabilities and the ability to increase, maintain or protect the amount of those benefits. Therefore, to control an entity the potential controller must satisfy three tests:

a. it must have the ability to direct the strategic financing and operating policies of the entity (the "Power Criterion");
b. it must have the ability to access the benefits flowing from the entity (the "Benefits Criterion"); and

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[497] Ibid., at 4.

[498] IASB Project Update on the Consolidation Project, June 2008 Project that provides that "updates are provided for the information and convenience of constituents who wish to follow the IASB's deliberations. All conclusions reported are tentative and may be changed at future IASB meetings. Decisions become final only after completion of a formal ballot to issue an International Financial Reporting Standard, Interpretation, or Exposure Draft".

c. it must be able to use its Power so as to increase, maintain or protect the amount of those benefits."[499]

The IASB formulates two criteria and a relationship between those two criteria by which control could be determined. The IASB continues with the text:

"*Power with less than a majority of the voting rights*

10. IAS 27 clearly contemplates that there are circumstances in which one entity can control another entity without owning more than half of the voting power. During its deliberations, the Board has confirmed its view that an entity holding a minority interest can control another entity in the absence of any formal arrangements that would give it a majority of the voting rights. For example, control is achievable if the balance of holdings is dispersed and the other shareholders have not organised their interests in such a way that they exercise more votes than the minority holder. This is sometimes referred to as "*de facto* control"."

This *de facto* control should not be confused with *de facto* control that covers open market situations, such as mere economic dependence. It seems from the wording of the paragraph quoted above that there should be a (minority) interest in the other company, which results in voting power. This interest is based on company law. The title of this paragraph ("*Power with less than a majority of the voting rights*") refers to control originating from a participation in capital. When comparing this IASB criterion with the *participation-in-capital* criterion of Art. 9 OECD Model, it seems that the IASB is of the opinion that there can be control even when a party has less than a majority of the voting rights. For example, if one shareholder holds 10% of the shares of a listed company this may result in control if there are no other shareholders with the same or higher level of participation in the capital. The IASB recognises this by stating that when the other shareholders have not organised their interests in such a way that they exercise more votes than the minority holder, the minority holder may still control the company.

The text continues:

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[499] IASB Project Update on the Consolidation Project, June 2008.

"11. During those deliberations, the Board has made it clear that, in its view, the control concept in IAS 27 includes de facto control. The Board accepts that it would have been helpful if IAS 27 had included guidance to assist [...] in exercising the judgement to apply the control concept. Any proposals to replace IAS 27 would include guidance on de facto control."

With regard to options over an entity, the Board provided this paragraph:

"*Potential voting rights (options over an entity)*

12. The Board tentatively decided that when an option holder holds sufficient options that, if exercised, would place it in control of another entity, that is not sufficient, in itself, to establish that the option holder meets the Power Criterion. However, there might be situations in which the holding of options, taken in conjunction with other facts and circumstances, indicates that the option holder currently has power over the entity.

13. The Board had also tentatively concluded that whether or not exercise of potential voting rights is economically favourable to the holder of those rights is not relevant to the assessment of whether the Power Criterion is satisfied."

The "power criterion" refers to directing the strategic financing and operating policies of the entity. There are minimum requirements to be met before one company *controls* the other for financial accounting purposes. The "power criterion" does not generally qualify option holders as having control over an entity.

The Board also analyses veto rights in the June 2008 Consolidation Project Update:

"14. Parties such as holders of non-controlling interests or lenders may have the right to veto decisions or their consent may be a prerequisite to some decisions. The Board has tentatively concluded that veto rights, even if limited to the ability to block actions, might negate control if those rights relate to operating and financial policies. To negate control those veto rights must also relate to decisions in the ordinary course of business – rather than being limited to fundamental changes in the organisation (such as disposals or business units or acquisitions of significant assets).

15. The Board has also tentatively concluded that veto rights may in some circumstances be sufficient to enable holders to exercise control."

With regard to paragraph 15, the IASB is of the opinion that control may only be deemed to exist when "those veto rights also relate to decisions in the ordinary course of business, rather than being limited to fundamental changes in the organisation".

3.11.3. Control over the strategic operating and financing policies of a legal entity[500]

The Board elaborated further on the concept of control. During the Board Meeting in London on 23 July 2008, the Board emphasised in its Cover Paper that the consolidation project had become "increasingly important because of the current credit crisis."[501]
The Agenda paper consisted of three parts. Agenda paper 14A summarised the working draft; Agenda paper 14B contained five cases used to test the working draft and Agenda paper 14C was the working draft itself.

The goals of the Board were to:
a. improve the comparability of financial statements (by providing clearer (explicit) principles and adequate application guidance than is provided in IAS 27 and SIC-12); and
b. to improve the quality of information that is available to users about the legal entities that, correctly, are not consolidated but which generate some risk for the reporting entity (and are not within the scope of IFRS 7).[502]

[500] IASB Project on Consolidation 23 July 2008, Agenda Paper 14, Board Meeting 23 July 2008 in London.
[501] IASB, Cover Paper (Agenda paper 14), 23 July 2008, London, p. 1. In this cover paper the Board also wrote that regulators were questioning whether the current accounting for securitisation transactions and the type of vehicle sometimes used to facilitate these transactions was appropriate. Regulators had also asked the Board to assess whether the disclosure requirements related to securitisations, guarantees, special purpose entities and structured investment vehicles were adequate.
[502] IASB, Report on Consolidation, 23 July 2008, An Introduction to the staff working draft , Agenda paper 14A.

The purpose of this Agenda paper was to summarise the principles underpinning the staff working draft of a proposed revised consolidation standard. This Agenda paper:

a. stated the objective of that standard;
b. clarified its scope;
c. *defined control and its components;* and
d. summarised the Board's work on disclosures.[503]

In the working draft 14A the Board explained how a reporting entity might have control over a legal entity because it has control over the strategic operating and financing policies.
Control over the strategic operating and financing policies of a legal entity can give the reporting entity the ability to direct the day-to-day activities of that entity, regardless of whether that is achieved by making those decisions directly or by delegating that responsibility to management or others. Therefore, control over the strategic operating and financing policies of a legal entity gives the controlling party the power to use or manage the assets and liabilities of that entity so as to benefit from them, as if they are its own.
The Board stated that control over the strategic operating and financing policies of a legal entity is often achieved by having a majority of the voting rights of that entity. The working draft presumed that a reporting entity that controls more than half of the voting rights of a legal entity controls that entity. The Board clarified that a reporting entity can also have control over the strategic operating and financing policies of a legal entity with less than half the voting rights in circumstances in which there are no other dominant voting interests in the entity. This could include circumstances in which the other owners have not organised their interests in such a way that they actively cooperate when they exercise their votes so as to have more dominant voting power than the holder of the single largest ownership interest. The Board believed that this "clarification will end diversity in practice on how to apply the control definition without a majority of voting rights."[504]

IAS 27 (2008) states that the existence and effect of potential voting rights that are currently exercisable or convertible should be considered when assessing whether the reporting entity has the power to govern the (strategic) financing

[503] Ibid., p. 2.
[504] Ibid., p. 6.

and operating policies of a legal entity. IAS 27 (2008) further clarifies that the intention of management and the financial ability to exercise or convert those potential voting rights should not affect the assessment.

The Board was of the opinion that the requirement in IAS 27 could lead to a reporting entity being deemed to control a legal entity even though it holds potential voting rights that are deeply out of the money. The Board was concerned "that this consequence might create off-balance sheet structuring opportunities" and that its working draft "emphasises therefore that control must be current".[505]

According to the Board, the option to achieve control does not *constitute* control before the holder exercises that option. However, an option in combination with other factors might provide a reporting entity with control over a legal entity.[506]

3.11.4. Control of a legal entity wi*hout control over the strategic operating and financing policies

The Board believed that a reporting entity could have control over a legal entity even though it does not have control of what is generally thought of as the strategic operating and financing policies of that entity.[507]

According to the Board, the constituting documents of an entity, and the legal framework in which it operates, might limit the range of transactions and activities in which a legal entity can engage or define a range of transactions and activities in which it is not permitted to engage. The Board gave the following example: a legal entity which might be prohibited from investing into a new type of business without all of its owners agreeing to such a change. However, the working draft intended to develop one single control model for all legal

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[505] Ibid.

[506] Ibid. The Board illustrated this with the following example: "A reporting entity holds a currently exercisable option to acquire all outstanding shares of a legal entity at their fair value. Unless the option is exercised, the reporting entity does not have the power to use or manage the assets and liabilities of that entity so as to benefit from them, as if they are its own. In contrast, an option that is presently exercisable for little or no cash or other consideration is a strong indicator that the reporting entity has control over the legal entity. This is, because the reporting entity can choose at any given time to use or manage the assets and liabilities of the legal entity so as to benefit from them, as if they are its own."

[507] Ibid., p. 7.

entities regardless of their nature and, to thus eliminate the need for more or less arbitrary categorisations of legal entities.
According to the Board, control of the strategic operating and financing policies of a legal entity is meaningless when the *constituting documents* or other contractual arrangements of a legal entity restrict the powers available to the governing body of a legal entity to the extent that the strategic operating and financing policies will not affect the benefits generated by the legal entity.[508]

In cases where a reporting entity assesses whether it has control over a legal entity, the Board stated that this could be helpful to understand how else the reporting entity could have structured the transaction and why the reporting entity has chosen a particular legal form. The Board is of the opinion that if the reporting entity could have undertaken the business activities or transactions within its own legal structure (i.e. by the parent) with substantially the same economic effect that is achieved by undertaking the business activities or transactions in separate legal entities, this is an indication that the reporting entity controls the legal entity.

The Board also confirmed that the assessment of control is a continuous process. The reporting entity not only assesses whether it has control over a legal entity when it establishes a relationship with that entity, but it continuously monitors whether it has achieved control over a legal entity that it previously did not control or whether it lost control over a legal entity that it previously controlled.

3.11.5. Assessing control

In assessing control, according to the Board, the reporting entity controls a legal entity if it:
a. is exposed to benefits from that entity; and
b. has the power to make the decisions that affect the benefits generated by that entity.[509]

In the next sections I will analyse the above requirements.

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[508] Ibid.
[509] Board Meeting 23 July 2008, project on Consolidation, subject: An introduction to the staff working draft (Agenda paper 14A).

3.11.5.1. Assessing control: benefits from a legal entity

Benefits are the returns to which a reporting entity is entitled from its involvement with a legal entity, which vary with the performance of the legal entity.

The working draft of the IASB Board of 23 July 2008 identified the following characteristics of benefits:

a. Benefits must vary;
b. Benefits must have the potential to be favourable;
c. Benefits are not limited to returns of the legal entity.

With respect to the characteristic "*Benefits must vary*" the Board stated:
"The financial returns generated by a legal entity are shared among those who invest in the entity. Some investors will receive a contractually agreed return on investment [...]. Those returns are common to the relationship between a supplier or service provider and its customers and are normally not indicative of a control relationship. However, some investors prefer or accept returns that vary with the performance of the investment. We (the Board) believe that a reporting entity will only require or accept variable returns if it also has the ability to maximise those returns. Our working draft states therefore that the benefits a reporting entity receives from its control of a legal entity must vary with the financial performance of the legal entity".[510]

With respect to the characteristic "*Benefits must have the potential to be favourable*" the Board stated:

"To benefit from a legal entity, the reporting entity must be exposed to positive and negative variable returns. This requirement addresses a problem that the FASB has been made aware of when reviewing the requirements in FIN 46R Variable Interest Entities. The FASB observed that some off-balance sheet structures used loss insurance as means to circumvent the requirements in FIN46R. This means that a third party guarantees to make up for any lower than expected returns, without any other interest or involvement in the entity. Under FIN 46R that party would be required to consolidate the legal entity. Our working draft clarifies that to control a legal entity the reporting entity

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[510] Ibid., p. 9.

must be entitled to both higher and lower than expected returns. A reporting entity that guarantees to make up for lower than expected returns of a legal entity without controlling that entity would not consolidate the entity, but recognise a financial liability for this obligation."[511]

Regarding the requirement "*Benefits are not limited to returns of the legal entity*", the Board stated:

"Our working draft clarifies that to determine the variable returns it receives for a legal entity the investor considers all returns to which it is entitled from its involvement with that entity. Those returns include returns from the performance of the entity itself. However, a reporting entity might also have returns that are not available to other investors. This is the case when it uses the assets of the investee in combination with its other assets, such as combining functions to achieve economies of scale [...]"

3.11.5.2. Assessing control: power over a legal entity

Power is the ability of a reporting entity to participate in the management of the assets and liabilities of a legal entity.[512] When a reporting entity controls a legal entity, the reporting entity will have the ability to manage assets and liabilities if they are its own and to exclude others from using or managing those assets and liabilities.

The working draft of 23 July 2008 of the IASB identified the following characteristics of power:

a. Power does not need to be absolute;
b. Power affects the performance of the legal entity.

[511] Ibid., p. 9: the Board believed that "exposure to the legal entity can include support offered by a reporting entity to the legal entity to protect the reputation of the reporting entity. Offering support to a legal entity is not, in itself, sufficient to give the reporting entity control of the legal entity. If such support exists the reporting entity will need to assess whether it is also able to benefit from the legal entity and what powers it has to manage those benefits". The Board was also of the opinion that the reporting entity would need to assess whether the support is such that it meets the definition of a liability and it should be accounted for in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

[512] See Board Meeting 23 July 2008, project on Consolidation, subject: An introduction to the staff working draft (Agenda paper 14A), p. 10.

a. Power does not need to be absolute

The Board believed that a reporting entity can have power over a legal entity, even though other parties have protective rights in that entity. The Board acknowledged that some contracting parties might have rights in a legal entity that enable their holder to participate in the day-to-day activities of the legal entity, rather than being limited to fundamental changes in the activities of the entity. Those rights are sometimes referred to as participating rights. If other parties hold participating rights in the legal entity, the reporting entity does not have power over it.[513]

What is also important for this study is that the Board wrote:

"Similarly, a legal entity might be economically dependent from a single customer. That customer might have significant rights over the legal entity, i.e. it might have its own staff monitoring the production processes of the legal entity. Those rights are there to protect the quality of the product or service the customer is receiving.
They do not give the customer *control* over the legal entity." *(Italics, RD)*

For financial accounting purposes, the Board is of the opinion that the above-mentioned example should not lead to *control* over the other legal entity by a customer. This differs from the transfer pricing practices in various countries. Various States consider *de facto* forms of control, for instance mere economic dependence (large buyer/seller relationship), as control for transfer pricing purposes.

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[513] The Board gives the following example in its introduction to the staff working draft of 23 July 2008: "A legal entity is a manufacturing business. The reporting entity holds 75 per cent of the voting rights in the legal entity. This gives the reporting entity the ability to manage the legal entity's assets as if they are its own assets. The reporting entity might use the legal entity's assets independently of the other assets that it controls. Alternatively, the reporting entity might use the assets of the legal entity in combination with its other assets to create value outside of the legal entity. Therefore, the reporting entity has power over the legal entity. However, to protect the non-controlling interests, the legal entity has policies in place that restrict the reporting entity's power. These policies prohibit the reporting entity from using its power over the legal entity in a way that decreases the value of the non-controlling interests."

b. Power affects the performance of the legal entity

The working draft assumed that investors require power that is proportionate to their entitlement to the benefits from a legal entity. Accordingly, power must be sufficient to allow them to participate in an entity to ensure that they are compensated for, or benefit from, their investment.

3.11.5.3. Assessing control: relation between benefits and power

According to the Board, benefits and power must not be assessed in isolation.[514] The Board is of the opinion that when assessing control over a legal entity, the reporting entity always needs to investigate both components of control. That is, the reporting entity "needs to investigate the benefits that it receives from a legal entity as well as the power it has over that entity."[515] However, power should be proportionate to the reporting entity's entitlement to the benefits from a legal entity. The definition of control requires that a reporting entity benefits from a legal entity through the exercise of power over that entity. A reporting entity controls another entity when it has rights that are sufficient to give it the power to be able to use or manage the assets and liabilities of that entity as if they are its own. That power must enable the reporting entity to affect the benefits it receives from the entity. Therefore, benefits and power are related and must be considered together when determining whether a reporting entity controls a legal entity.

3.11.5.4. Accounting requirements and disclosures

The purpose of the consolidation project is to revise the definition of control and the disclosure requirements in IAS 27. In addition to a revision of the control definition, the Board was asked to investigate whether a proposed revised consolidation standard should include additional disclosure requirements. The Board believed that a reporting entity should disclose information that enables users of its financial statement to evaluate:

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[514] Board Meeting 23 July 2008, project on Consolidation, subject: An introduction to the staff working draft (Agenda paper 14A), p. 11.
[515] Ibid.

a. the judgement that management has made in the process of applying the reporting entity's accounting policies when reaching decisions to consolidate or not and the financial effects of those judgements;
b. the nature and financial effects of restrictions on assets and liabilities resulting from legal entity boundaries that exist within its group;
c. the financial effects of changes in a parent's ownership interest or the loss of control of a subsidiary;
d. the nature of, and risks associated with, its significant involvement with legal entities that it does not control.

3.11.5.5. Control versus significant involvement

The Board developed disclosure principles for legal entities that the reporting entity controls as well for entities in which the reporting entity has significant involvement. The reporting entity consolidates all legal entities that it controls and also provides disclosures for those entities. In contrast, the reporting entity provides disclosures for entities in which it has significant involvement, but does not consolidate those entities. Legal entities that the reporting entity neither controls nor has a significant involvement in are not disclosed.

The Board defined significant involvement as "the ability to participate in the decisions of how to use or manage the assets and liabilities of a legal entity so as to benefit from them that is not sufficient to control that entity."[516] Therefore, assessing whether a reporting entity has significant involvement in a legal entity involves the same decision-making process as is undertaken in assessing whether the reporting entity controls the legal entity. The difference is that the reporting entity will have concluded that the powers and related benefits are not sufficient to give it control over the legal entity.

Accordingly, a reporting entity can have significant involvement in a legal entity by:
a. participating in the governing body of the legal entity by having, for example, the ability to appoint, or by having sufficient voting rights to appoint, directors to the governing body;
b. having a contract to service or administer the assets or liabilities, or both, of the entity;

[516] Ibid., p. 13.

c. having the ability to appoint management personnel;
d. dominating the major contracts of the legal entity.

In the several working papers issued by the IASB, the IASB staff also wrote that control might be established on the basis of less than half of the voting rights. This could include circumstances when the other shareholders have not organised their interests in such a way that they actively cooperate when they exercise their votes so as to have more dominant voting power than the holder of the single largest ownership. "This type of dominant voting power is commonly referred to as *de facto* control. However we (the IASB staff) have deliberately chosen not to use this term in the exposure draft because its use implies that it is not the same as control."[517] The IASB staff's view is that "control is control and it can be achieved in different ways".[518]

The definition of significant involvement is intended to "capture all business structures that give an entity the ability to participate in decisions on how to manage or use assets and liabilities in those structures". Once an entity determines that it has significant involvement with another entity, it will need to make additional disclosures to allow users of the financial statements to understand the nature of their relationship with, and the risks associated with, those entities. Entities in which a party has significant involvement will not be consolidated.

3.11.5.6. Application Guide on Agenda Paper 3A, 20 October 2008[519]

Appendix B is the Application Guide on the Staff Draft of Consolidation Exposure Draft (the Agenda Paper 3A of 20 October 2008). It provides a guide to the following issues. Some important issues mentioned in the Application Guide will be summarised below.

Protective rights
A reporting entity must assess whether it controls an entity even though other parties have approval or veto rights. That assessment is on the basis of whether, and to what extent, those parties are able to direct the activities of the entity. A

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517 Ibid., p. 9.
518 Ibid.
519 Ibid., Appendix B- Application Guide p. 18.

reporting entity can control an entity even though other entities have protective rights in that entity. Protective rights are usually related to the contractual arrangements an entity has with other parties. Protective rights often relate to fundamental changes in the activities of an entity or might apply only in exceptional circumstances.

Agency relationships

A fiduciary relationship, such as one involving trustees and beneficiaries of trusts, is an example of when a trustee might appear to be the controlling party, but the trustee is acting as an agent of the beneficiaries. Although a trustee might have the ability to make decisions concerning the financing and operating activities of the trust, this ability is governed by the trustee's fiduciary responsibility to act in the best interests of the beneficiaries of the trust.

When assessing control, a reporting entity must also consider the rights of its agents. A reporting entity might control an entity because:

(a) the reporting entity has an agent exercising power over that entity on behalf of the reporting entity

(b) the reporting entity's rights, combined with the rights that its agents can exercise on its behalf, give the reporting entity power over that entity; or

(c) the reporting entity can take the power away from the other party by, for example, removing that other party from its role with that entity.[520]

Control without a majority of the voting rights

Any of the following factors indicates, in the absence of other factors, that a reporting entity with less than a majority voting interest in an entity controls that entity:

(a) the reporting entity can dominate the governing body, and therefore the strategic operating and financing policies. Examples of indicators are:

(i) dominating the process of nominating members of the entity's governing body and/or obtaining proxies from other holders of voting interests; and

(ii) appointing members to fill vacancies of the entity's governing body until the next election.

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[520] Ibid. The Application Guide also lists the parties that might act as agents of a reporting entity. See Appendix B p. 21.

(b) the reporting entity can participate in the management of the entity, such as:

(i) appointing, hiring, reassigning or dismissing the entity's key management personnel;
(ii) sharing of resources between the entity and the reporting entity;
(iii) causing the entity to enter into significant transactions that benefit the reporting entity.

(c) the reporting entity can access the residual assets of the entity, such as:

(i) dissolving the entity and redirecting the use of its assets; or
(ii) accessing, under a statute or agreement, the entity's resources.

3.11.5.7. Assessing control of a structured entity

In November 2008, the IASB staff prepared several discussion papers, including Agenda Paper 16C *Assessing control of a structured entity*.[521] The other agenda papers were:

Agenda paper 16A- Currently exercisable options and convertible instruments;
Agenda paper 16B- Dual role as agent and investor with voting rights;
Agenda paper 16D- Disclosure requirements;
Agenda paper 16E- Separate Financial Statements;
Agenda paper 16F- Comment period for the exposure draft; and
Agenda paper 16G-Transition.

3.11.5.8. Agenda paper 16A- Currently exercisable options and convertible instruments

In Agenda paper 16A the treatment of options was reconsidered in the light of the consolidation exposure draft. This agenda paper analysed:

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[521] The other discussion papers were: Agenda paper 16A – Currently exercisable options and convertible instruments; Agenda paper 16B – Dual role as agent and investor with voting rights; Agenda paper 16D- Disclosure requirements; Agenda paper 16E- Separate Financial Statements; Agenda paper 16F; Comment period for the exposure draft and Agenda paper 16G- Transition. See *Information for Observers*, IASB, November 2008 Board Meeting London.

a. whether and, if so, under which facts and circumstances potential voting rights are sufficient for a reporting entity to have control of another entity; and
b. whether a reporting entity should assess potential voting rights continuously when determining whether it controls another entity.

The staff analysed the requirements in IAS 27. IAS 27 states that a reporting entity may own options or other instruments that have the potential, if exercised, to give the reporting entity voting rights or reduce another party's voting rights in another entity. IAS 27 refers to those instruments as potential voting rights. According to that standard, the existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing control. IAS 27 clarifies that in assessing whether potential voting rights contribute to control, the entity examines all facts and circumstances that affect potential voting rights, except the intention of management and the financial ability to exercise or convert such rights.[522]

The IASB staff argued that if holding an option were to give the option holder control of the underlying asset, the reporting entity would treat the exercise of the option as inconsequential. However, the staff did not rule out the possibility that there might be situations in which the holding of options, taken in conjunction with other facts and circumstances, might lead to the conclusion that the option holder has present control over the other entity. According to the staff, the definition of control of an entity requires the parent to have the power to direct the activities of the entity to generate returns for the parent. When the activities of an entity are directed by means of strategic operating and financing policies, the body that determines those policies acts as an agent for the shareholder. The shareholders ultimately have the power to direct the activities by having the ability to appoint the members of the governing body. When considering potential voting rights, the question is whether the holder of the voting interests is itself an agent of the option holder. If this is the case, the option holder is the controlling party.[523] There were two conflicting views held by the IASB Staff:

"We agree that options must be assessed on the basis of power and returns. However, some of us think that having an option for which it is beneficial for

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[522] See *Information for Observers*, November 2008, London, IASB, Project on Consolidation, Agenda Paper 16A, Consolidation: Sweep Issues- Options, warrants and convertible instruments.
[523] Ibid., p. 4.

the holder to exercise is, of itself, power. We refer to this as the *economic power view*. The rest of us think that for an option to give the holder the power to direct the activities of the underlying entity the option holder will need to have related rights. We refer to this as the *related rights view*."

With respect to the *economic power view*, the IASB staff stated the following. According to some staff members, the holder of options over shares that would benefit from exercising those options is in a position of strength over the holder of the shares. This because the option holder can take those shares away from the current holder and has an economic incentive to do so. Therefore the holder of options is able to direct the holder of the shares to act in accordance with the option holder's explicit, or implicit, directions. However, an option does not need to be in the money. For example, exercising an option might give the holder access to returns that are not available to other parties.[524] It is argued that if an option holder does not have the means to exercise the options the option holder is not in a position of strength over the holder of the shares. The financial crisis in 2009 illustrated that an option holder might not be able to obtain the funding to exercise options. Therefore the financial ability of the holder of the options right should be one of the factors to be considered when assessing those rights. The IASB staff noted that this view is contrary to the current requirements in IAS 27.

3.11.5.8.1 Related rights

Proponents of the economic power view proposed that the exposure draft states that a reporting entity controls an entity over which it has options if:

a. the options are currently exercisable; and
b. the exercise of the options is beneficial for the option holder.

The supporters of the related rights view think that when a reporting entity writes or acquires potential voting rights, there is a purpose in doing so. The options might be designed for speculative or protective purposes or to give the holder the ability to direct the activities of the entity to which they relate. The terms and conditions attached to the options will reflect that intention.

[524] For example, returns through synergies.

Proponents of the related rights view think that the exposure draft should include guidance that states that the holding of an option can give the holder the ability to direct the activities of an entity. The reporting entity should consider the purpose of the potential voting rights at the time that the reporting entity writes or purchases those potential voting rights.[525] The IASB staff stated that pricing an option with a trivial exercise price is evidence that the option is designed to give the holder control.

3.11.5.8.2. Continuous assessment

A reporting entity holding potential voting rights would continually assess whether the holding of those potential voting rights gives it the ability to direct the activities of the entity to which the voting rights relate. Assessment of control is continuous. However, the IASB stated that those staff members supporting the economic power view would assess the value of the option to the holder. A change in the value of that option could cause a change in control. Therefore, a reporting entity might consolidate an entity for a part or parts of a reporting period because the change in market condition is a change in power over the activities of an entity. The staff supporters of the power view think that the assessment of options requires consideration of all facts and circumstances and suspect that mere changes in market conditions would rarely trigger consolidation or deconsolidation on a repeated basis.

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[525] See Information for Observers, November 2008, London, IASB, Project on Consolidation, Agenda Paper 16A, Consolidation: Sweep Issues- Options, warrants and convertible instruments, p. 6.

3.11.5.8.3. Consistency with a passive shareholding

In its draft the staff also presented an example of an investor that has 60% of the voting interests in an entity but has yet to exercise those votes.
The supporters of the economic power view argued that the option holder is like the passive investor. The fact that exercising the option would be beneficial gives the holder power over the option counterparty and it is not necessary to exercise the option to exercise that power. The supporters of the related rights view think that this is consistent with the passive investor scenario, but only because the options by themselves do not give the holder the right to vote. It is "the related rights" that give the option holder power and focusing on those rights differentiates an option holder from a passive investor.[526]

3.11.5.9. Agenda paper 16C- Consolidation: Sweep Issues- Assessing control of a structured entity[527]

In its October meeting, the staff draft of the consolidation exposure draft included a rebuttable presumption:

"This draft IFRS presumes that if the reporting entity obtains returns that are substantially more than those received by any other party from its interest in a structured entity, then the reporting entity has power sufficient to control that structured entity. This presumption is on the basis that power and returns are related.
A reporting entity that obtains substantially more returns than any other party from its interest in a structured entity, must demonstrate that it does not control the structured entity."[528]

The staff recommended removing the rebuttable presumption relating to the assessment of control of a structured entity and replacing it with wording that requires the assessment of both power and returns when assessing control of a structured entity.

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[526] Ibid., p. 8.
[527] *Information for Observers*, November 2008, London, IASB, Project on Consolidation, Agenda Paper 16C, Consolidation: Assessing control of a structured entity.
[528] See *Information for Observers*, November 2008, London, IASB, Project on Consolidation, Agenda Paper 16C, Consolidation: Assessing control of a structured entity, at 1.

In its analysis, the staff stated that the proposed definition of control of an entity requires the consideration of both power and returns when assessing control of an entity. The staff is of the opinion that power and returns are related and must be considered together.
Power can be more difficult to assess when the activities of an entity are not directed by strategic operating and financing policies. The staff describes entities whose activities are directed in such a manner as structured entities. The rebuttable presumption regarding control of a structured entity removes the requirement to assess power. Although it is rebuttable, an entity could easily engineer a situation in which it passes a substantial portion of the returns of a structured entity to another party and avoid consolidation, even if it controls the entity.
The rebuttable presumption was included in the previous drafts of the exposure draft to ensure that a reporting entity could not avoid consolidation by arguing that it does not have power to direct a structured entity's activities. The staff also wrote: "We are concerned that the rebuttable presumption fails to meet this objective. Further, we think that the rebuttable presumption undermines the principles underlying the consolidation exposure draft and could have the opposite of its intended effect by creating structuring opportunities."[529]

The principle underlying the notion of control of an entity is reflected in the definition. The staff modified the control definition based on discussions at the October 2008 Board meeting. The definition now refers to returns, rather than benefits. The definition reads:

"A reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity."[530]

This definition is built on the principle that a reporting entity requires both power and returns to have control of an entity; one without the other simply does not constitute control.
The rebuttable presumption relating to structured entities effectively disregards power. A reporting entity can ignore power when assessing control of a structured entity if the reporting entity obtains substantially more returns than any other party. Similarly, according to the staff, a reporting entity can ignore

[529] Ibid., p. 2.
[530] Ibid., p. 3.

the power that it has if another party obtains substantially more returns than any other party.[531]
So the staff recommended removing the rebuttable presumption relating to the assessment of control of structured entities because:

a. structured entities should not be treated differently from other entities when applying the definition of control of an entity;

b. the rebuttable presumption is not needed to assess control of such entities; and

c. a quantitative analysis would inevitably create structuring opportunities and problems in terms of calculating returns.

According to the staff, a reporting entity can exert power over the activities of a structured entity through its involvement in establishing the activities of the entity and through its involvement in the ongoing decision-making that affects the activities of the entity.

3.12. Exposure Draft 10: introduction and objectives

The IASB initiated this project on consolidated financial statements with the objective of publishing a single IFRS on consolidation to replace the consolidation requirements in IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation- Special Purpose Entities*.[532] The main objectives of the project are to improve the definition of control and related application guidance so that a control model can be applied to all entities, and to improve the disclosure requirements for consolidated and unconsolidated entities.
In the next sections of this chapter IFRS 10 and its exposure draft are analysed. The exposure draft is discussed in this section, IFRS 10 in the next section.

Exposure draft 10 (hereinafter: ED 10) proposes a single definition of control for all entities and provides guidance on how to apply that definition in particular situations that have been found difficult when applying IAS 27 and

[531] Ibid.
[532] IASB, Exposure Draft 10 Consolidated Financial Statements, London December 2008.

SIC-12. As a consequence, the Board expected that entities will be consolidated on a more consistent basis, making the financial statements of groups more comparable and understandable.[533] [534]

The first issue is whether the control definition proposed in this exposure draft and the accompanying guidance on how to apply that definition provide clearer guidance for determining when one entity controls another. The second issue is whether the enhanced disclosure requirements for consolidated and unconsolidated entities will give capital providers and other users of financial statements information that is useful to their decision-making.[535]

ED 10 *Consolidated Financial Statements* was published by the IASB for comment only. The proposals are to be modified in the light of the comments received before being issued as an International Financial Reporting Standard (IFRS). The contents of ED 10 consist of two main parts.
The first part includes an introduction and invitation to comment.[536] The second part of exposure draft 10 includes the Draft IFRS *Consolidated Financial Statements*.[537]

3.12.1. Draft International Financial Reporting Standard: *Consolidated Financial Statements- Core Principle*

The core principle of the draft IFRS is that a "reporting entity presents financial statements that consolidate its assets, liabilities, equity, income, expenses and cash flows with those of the entities that it controls".[538]
Appendix A, the defined terms list, is an integral part of the draft IFRS. The Appendix provides important descriptions for this study.

The definition of "*consolidated financial statement*" is as follows: "The financial statements of a parent and the entities that it controls presented as a single entity".

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[533] Ibid., p. 5, para 3.
[534] Ibid., para. 4.
[535] Ibid., para. 5.
[536] IASB, Exposure Draft 10 Consolidated Financial Statements, London December 2008, pp. 1 – 13.
[537] Ibid., pp. 14-55
[538] Draft IFRS ED 10, para. 1.

The definition of a "*parent*" is: "An entity that has one or more subsidiaries."

The definition of a "*subsidiary*" is: "An entity that is controlled by a parent. A legal structure such as a company or trust can comprise more than one entity."

The definition of the term "*control of an entity*" is: "The power of a reporting entity to direct the activities of another entity to generate returns for the reporting entity".

Paragraph 2 of ED 10 summarises exceptions to which this draft IFRS does not apply.[539]

3.12.2. Draft International Financial Reporting Standard: *Consolidated Financial Statements- Control of an entity*

IAS 27 currently defines control "as the power to govern financial and operating policies of an entity so as to obtain benefits from its activities".[540] Further guidance on when an entity should consolidate special purpose entities is provided in SIC-12. However, the consolidation models in IAS 27 and SIC-12 differ. For example, there can be difficulties determining whether particular entities are within the scope of IAS 27 or SIC-12, resulting in diversity in practice and reduced comparability of consolidated financial statements.
ED 10 proposes to address those inconsistencies by replacing the definition of control in IAS 27 and the indicators of control in SIC-12 with "a single definition of control that would apply to all entities".[541]

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[539] Draft IFRS ED 10, para. 2. A parent need not present consolidated financial statements if it meets all of the following conditions:
(i) the parent is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity ad its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
(ii) the parent's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);
(iii) the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; and
(iv) the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with IFRSs.
[540] Ibid., p. 6 para. 7.
[541] Ibid., para. 9.

In ED 10 the Board proposes the following definition of "control of an entity":[542]

"A reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity."

This is reconfirmed in paragraph 4 of ED 10. That paragraph describes when a reporting entity controls another entity:
"[...] when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity".

The Board noted that the consequences of this definition are that only one party can control an entity and that there could be circumstances in which an entity is not controlled by any party.
From paragraph 5 of ED 10 it may be concluded that the parent's power to direct the activities of a subsidiary precludes others from controlling the subsidiary. Thus, a parent does not share control of a subsidiary. Nevertheless, the power needs not be absolute.[543] Protective rights held by other parties do not preclude a parent from controlling a subsidiary but they might restrict its power. Protective rights are designed to protect the interests of the party holding those rights without giving that party control of the entity to which they relate.[544] Protective rights often apply to fundamental changes in the activities of an entity, or apply in exceptional cases.
Although a parent has the power to direct the activities of a subsidiary to generate returns for its own benefit, other parties such as non-controlling interests, can share those returns.

According to the Board, control of another entity requires the power to direct the activities of that other entity. The power to govern the financial and operating policies, as stated in IAS 27, is just one means of having power to direct the activities of another entity. Power can be achieved in many ways, including by having voting rights, by having options or convertible instruments, by means of contractual arrangements, or a combination of these, or by having

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[542] Ibid., para. 10.
[543] Ibid., para.6.
[544] Ibid., Appendix B, p. 28, at B1 – B2. An example of protective rights are approval or veto rights granted to other parties that do not affect the strategic operating and financing policies of the entity.

an agent with the ability to direct the activities for the benefit of the controlling entity.[545]

For example, a reporting entity can also have power even if it has not exercised its voting rights or options to acquire voting rights, or is not actively directing the activities of another entity.[546]

This can be concluded from paragraph 8 of ED 10. Paragraph 8 states that a reporting entity can possess the power to direct the activities of another entity by different means, including by having voting rights, by having options or convertible instruments to obtain voting rights, by means of contractual arrangements, or a combination of these.[547] However, it is not required that a reporting entity has to exercise its power to direct the activities of an entity to control that entity.

A reporting entity can also have power by having an agent act on its behalf. In contrast, a reporting entity does not have power when it is acting solely as an agent. According to Appendix B, the application guidance on ED 10, an agent "is a party engaged to act on behalf of another party or parties (the principals)". An agent might have the ability to direct the activities of an entity, for example by making decisions concerning the operating and financing activities of the entity. However, that ability is governed by agreement, law or fiduciary responsibility that requires the agent to act in the best interest of the principal. The agent must use any decision-making ability delegated to it to generate returns primarily for the principal.[548] Removal rights can indicate an agency relationship. For example, a principal often has the right to remove, without cause, an agent that is empowered to direct the activities of an entity for the principal. That unconditional right to remove the agent ensures that the principal has the power to direct the activities of the entity.[549]

If an agent is not remunerated on a level that is not commensurate with the services performed, then this might indicate involvement with an entity beyond that of an agent. Therefore, this might indicate control.[550]

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545 Ibid., p. 7, para. 12.

546 Ibid., p. 7, para. 13.

547 Ibid., para. 8 and 9.

548 Ibid., appendix B, p. 29, at B3.

549 Ibid., see B4: Rights to remove a party only in circumstances such as bankruptcy are protective rights.

550 Ibid., see B5: ED 10 gives the following examples which might indicate control:

a. the fees are more than would be received for similar services negotiated on an arm's length basis;

b. the fees are large relative to the total expected returns of the entity to which the services are provided;

With respect to returns, the proposed definition in ED 10 retains the concept in IAS 27 that control conveys the right to obtain benefits from another entity.[551] The exposure draft uses the term "returns" rather than "benefits" (as used in IAS 27), because "benefits" might imply only positive returns.
Paragraph 10 of ED 10 describes that returns from involvement with an entity vary with that entity's activities and can be positive or negative. A parent is exposed to the variability of returns and has the ability to affect the returns generated for it. Returns generated for a parent may include dividends, other forms of economic benefits distributed by a subsidiary, and changes in the value of the subsidiary attributable to the parent and any of the parent's other subsidiaries. Returns may also include returns that are not available to non-controlling interests.[552]

3.12.3. Draft International Financial Reporting Standard: *Consolidated Financial Statements- Assessing Control*

The exposure draft retains the presumption in IAS 27 that a reporting entity that can exercise more than half of the voting rights in another entity has the power to direct the activities in the absence of circumstances that indicate otherwise. The exposure draft provides guidance on how to assess power and returns when:[553]

(a) a reporting entity has less than a majority of the voting rights
(b) control of a structured entity is being assessed.

Paragraph 12 states that when assessing control, a reporting entity must consider power and returns together. A reporting entity must also consider how the reporting entity can use its power to affect the returns. [554] The reporting entity's power to direct the activities of another entity is generally correlated with its exposure to the variability of returns from that other entity.

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c. the expected variability in the fees is large relative to the total expected variability of the returns of the entity to which the services are provided.

[551] The term "returns" replaces the "benefits" used in the previous drafts and used in IAS 27.

[552] Draft IFRS ED 10, para. 11.

[553] Ibid., p. 8, para. 16

[554] Ibid., para. 12.

The draft IFRS in ED 10 also states that a reporting entity needs to consider all relevant facts and circumstances when assessing control.[555]

Assessment is continuous

A reporting entity must also assess control continuously. A reporting entity's power to direct the activities of another entity can change as a consequence of actions by the reporting entity or because of changes in facts and circumstances. Fluctuations in the reporting entity's returns, without a change in the reporting entity's power to direct the activities of another entity, does not cause that reporting entity to obtain or lose control of that other entity. However paragraph 16 of ED 10 states "if the reporting entity ceases to receive returns from its involvement with an entity, it does not control that entity".[556]

Related arrangements

The ED10 draft IFRS also requires that a reporting entity must consider the terms and conditions of all related arrangements when assessing control. Paragraph 18 describes the indicators that may lead to a related arrangement. The first indicator is that the arrangements are entered into at the same time or in contemplation of each other. The second indicator is that the arrangements form a single arrangement designed to achieve an overall commercial effect. Thirdly, one arrangement considered on its own is not justified economically, but it is justified economically when considered together with other arrangements.[557]

Assessing returns

The draft IFRS of ED 10 states that returns generated for a reporting entity are returns it receives from its involvement with another entity, including returns from related arrangements. Those returns can include fixed fees in conjunction with variable returns from related arrangements, and include returns already received as well as those to be received.[558]

Assessing power to direct activities

According to the draft IFRS of ED 10, a reporting entity must assess whether it has power to direct the activities of an entity by having voting rights or other arrangements. A reporting entity must also assess whether it has power to

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555 Ibid., para. 14.

556 Ibid., para. 16.

557 Ibid., para. 18.

558 Ibid., para. 20.

direct the activities of a structured entity. Paragraph 22 clarifies in which case a reporting entity has the power to direct the activities of another entity: "[...] if it can determine that other entity's strategic operating and financing policies"[559]

The draft IFRS of ED 10 describes three forms of power:

- power to direct activities with a majority of the voting rights;
- majority of the voting rights but no power to direct activities;
- power to direct activities without a majority of the voting rights.

As stated in paragraph 23 of the draft IFRS, a reporting entity can have the power to direct the activities of another entity by having the power to appoint or remove the members of that entity's governing body that have more than half of the voting rights with that body, if the determination of strategic operating and financing policies is by that body. If the appointment or removal of the members of an entity's governing body is determined by voting rights, a reporting entity with more than half of those voting rights controls that governing body and has the power to direct the activities of that entity unless paragraph 25 of the draft IFRS applies.

Paragraph 25 states that a reporting entity with more than half of the voting rights of another entity might not have the power to direct the activities of that other entity. This situation will exist if legal requirements, the founding documents of the other entity or other contractual arrangements restrict the power of the reporting entity to the extent that it does not have the power to direct the activities of the entity or if another party has the power to direct the activities of the entity.[560]

The draft IFRS also describes situations where a reporting entity may have the power to direct the activities of another entity even if it holds less than half of the voting rights of that entity. The draft IFRS presents the Board's view that an entity that holds less than half of the voting rights in another entity may control that other entity in some situations. The draft IFRS in ED 10 includes application guidance on how to apply the control principle when assessing whether a reporting entity has power to direct the activities of another entity with less than half of the voting rights. The application guidance also considers:[561] (a) options and convertible instruments to obtain voting rights of

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[559] Ibid., para. 22.

[560] Ibid., para. 25. The draft IFRS gives the example of an entity in which a reporting entity has more than half of the voting rights placed under legal supervision.

[561] Ibid., para. 17

an entity and (b) how to assess whether an entity has control if it holds voting rights both directly and on behalf of other parties as an agent.[562]
Power without a majority of the voting rights can be the case if the reporting entity has more voting rights than any other party and these voting rights are sufficient to give the reporting entity the ability to determine the entity's strategic operating and financing policies. In paragraph 28 of the draft IFRS an example is given of a reporting entity that is the dominant shareholder that holds voting rights and all the other shareholders with voting rights are widely dispersed and are not organised in such a way that they actively cooperate when they exercise their votes so as to have more voting power than the reporting entity.

When assessing control, a reporting entity considers all relevant facts and circumstances. Paragraphs B9 – B16 provide application guidance for circumstances in which a reporting entity has the power to direct the activities of another entity even though it holds less than half of the voting rights of the entity.
The application guide on ED10 provides the following indicators of power to direct the activities of an entity:[563]

- The reporting entity can dominate the governing body, and therefore determine the strategic operating and financing policies. Examples given by the application guide are dominating the process of electing members of the entity's governing body or obtaining proxies from other holders of voting rights and appointing members to fill vacancies on the entity's governing body until the next election.
- The reporting entity can appoint, hire, reassign or dismiss the entity's key management personnel.
- The reporting entity shares resources with the entity. For example, the entity and reporting entity might share key management personnel.
- The reporting entity has the ability to direct the entity to enter into significant transactions that benefit the reporting entity.
- The reporting entity has access to the residual assets of the entity.

[562] Paras. 26-29 and B9-B16 of the draft IFRS set out the Board's proposals regarding the assessment of power with less than half of the voting rights. The Board sets out its reasoning for those proposals in paragraphs BC63-BC97 of the Basis for Conclusions.
[563] Ibid., p. 30, para. B9.

The existence of agreements with other vote holders is also an example of circumstances in which a reporting entity might have the power to direct the activities of another entity even though it holds less than half of the voting rights. Such an agreement may give the reporting entity the right to exercise voting rights sufficient to give the reporting entity the power to direct the activities of another entity, even though the reporting entity itself holds voting rights that would not be sufficient to give it power.[564] If the reporting entity can exercise those voting rights to generate returns for itself, the reporting entity controls the other entity to which the voting rights relate.

When assessing control, a reporting entity must also consider what powers it has to direct activities of an entity that arise from arrangements other than those that give the reporting entity voting rights. The application guide describes that such arrangements could enable the reporting entity to direct activities that would normally be directed by the governing body of that other entity. Examples are agreements that give the reporting entity the power to direct the manufacturing process of an entity.[565] Economic dependence of an entity on the reporting entity, such as relations of a supplier to its main customer, does not, by itself, lead to the reporting entity having the power to direct the activities of that other entity. However, the reporting entity might have that power if its other arrangements are considered in conjunction with its voting rights. Sometimes having more voting rights than any other party enables a reporting entity to prevent other parties from changing the contractual arrangements the reporting entity uses to direct the activities of another entity.[566] This shows that open market situations do not result in consolidation. The influence a buyer has on the seller will not qualify as the power to direct the activities of that other entity. Control is based on relationships originating from company law, for instance voting rights.

The application guide also confirms that difficulties may arise on the question whether a reporting entity that holds voting rights, both directly and on behalf of other parties as an agent, uses the voting rights of the other parties for its own benefit or for the benefit of those other parties. The application guide states that in such circumstances, in assessing whether it has voting rights sufficient to control another entity, the reporting entity excludes the voting

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[564] Ibid., para. B10

[565] Ibid., p. 32, para. B14.

[566] Ibid., para. B16.

rights it holds as an agent only if the reporting entity can demonstrate that it is obliged to act in the best interests of those other parties or has implemented policies and procedures that ensure the independence of the decision-making in its role as an agent from that as a holder of voting rights directly.[567]

The following are examples of parties that often act for a reporting entity:[568]

- The reporting entity's related parties as defined in IAS 24 Related Party Disclosure.
- A party that received its interest in the entity as a contribution from the reporting entity.
- A party that has agreed not to sell, transfer or encumber its interests in the entity without the prior approval of the reporting entity.
- A party that cannot finance its operations without financial support from the reporting entity.
- An entity with the same board of directors as the reporting entity.

Paragraph B13 provides guidance on assessing control in situations of options and convertible instruments.
When assessing control, a reporting entity considers whether its power from holding options or convertible instruments to obtain voting rights, taken in conjunction with other relevant facts and circumstances, gives it the power to direct the activities of another entity. According to the guidance, a reporting entity that holds options or convertible instruments has the power to direct the activities of another entity if one of the following requirements is met:[569]

- The governing body of that entity determines strategic operating and financing policies in accordance with the wishes of the reporting entity. This might be the case if, for example, the reporting entity holds voting rights together with options or convertible instruments to obtain voting rights that, if exercised or converted, would give the reporting entity voting rights sufficient to determine the entity's strategic operating and financing policies.
- Any party with voting rights that is the counterparty to an option agreement acts as an agent for the reporting entity and those voting

[567] Ibid., p. 30, para. B11.
[568] Ibid., p. 30, para. B12.
[569] Ibid., p. 32, para. B13.

> rights are sufficient to give the reporting entity the ability to determine the entity's strategic operating and financing policies.

The option or conversion agreement gives the reporting entity particular rights relating to the strategic operating and financing policies that enable the reporting entity to have the power to direct the activities of the entity.

ED 10 also introduces the term "structured entity". Special purpose entities referred to in SIC-12 have characteristics similar to structured entities. As described in the exposure draft and according to the Board, unlike entities that are controlled through a governing body there is no single, simple test that the Board could identify for assessing control of a structured entity. Rather, the exposure draft proposes that a reporting entity should assess the particular circumstances of its relationship with a structured entity, and consider factors such as the purpose and design of the structured entity and how decisions are made about the activities that cause the returns of the entity to vary.[570]
The Board also states that power can be difficult to assess when considering who controls a structured entity. According to the Board, some think that power could be easily disguised and, therefore, that a reporting entity might more easily avoid consolidating a structured entity that it controls than would be the case in accordance with SIC-12.[571] One way of addressing this would be to propose a risks-and- rewards "fall back" test if power cannot be assessed. According to that approach, a reporting entity would consolidate another entity if it is exposed to a particular level of variability of returns of a structured entity, without any requirement to have the power to direct the activities of that structured entity. However, others think that consolidation on the basis of control creates fewer structuring opportunities than control with a "fall back" test. They are concerned that a "fall back" test creates an incentive to deliberately shift the basis of consolidation away from control.[572]
When assessing control of a structured entity, ED 10 states that it is necessary to identify how returns from the entity's activities are shared and how decisions, if any, are made about the activities that affect those returns.

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[570] IASB, Exposure Draft 10 Consolidated Financial Statements, London December 2008, p. 9 para. 20. The Board set out its reasoning for the proposals for structured entities in paras. BC98-BC121.
[571] Ibid., p. 9, para. 21.
[572] Ibid.

The draft IFRS in ED 10 lists the following relevant facts and circumstances which should be considered by the reporting entity:[573]

- The purpose and design of the structured entity;
- The reporting entity's return from its involvement with the structured entity;
- The activities of the structured entity, including the extent to which the strategic operating and financing policies that direct those activities have been predetermined;
- Related arrangements;
- The reporting entity's ability to change the restrictions or predetermined strategic operating and financing policies;
- Whether the reporting entity acts as an agent for other parties, or another party acts as its agent.

According to the draft IFRS, understanding the purpose and design of a structured entity helps to assess how the activities of that entity are directed and how returns are shared among its participants.[574]
The more a reporting entity is exposed to the variability of returns from its involvement with an entity, the more power the reporting entity is likely to have to direct the activities of that entity that cause the returns to vary. A reporting entity is likely to have power to direct the activities of a structured entity if it is exposed to the variability of returns that are potentially significant to the structured entity and the reporting entity's exposure is more than that of any other party.[575] Therefore, the analysis of a reporting entity's return from its involvement with the structured entity is important.
Another important factor when assessing control is analysing the activities of the structured entity. Control of an entity that has a limited range of activities is determined on the basis of how that limited range of activities is directed and how the returns it receives from its involvement with the entity are shared.

[573] Ibid., p. 20, para. 31.
[574] See para. 32 of ED10. This paragraph gives the following example. A reporting entity is likely to control a structured entity that has been created to undertake activities that are part of the reporting entity's ongoing activities (e.g. the entity might have been created to hold legal title to an asset that the reporting entity uses in its own activities, providing a source of financing for the reporting entity). The reporting entity is unlikely to surrender power to direct such a structured entity's activities because of the importance of those activities to the reporting entity's activities.
[575] Ibid., para. 33.

Paragraph 34 of the draft IFRS in ED 10 provides that a reporting entity should identify what activities cause the returns to vary and assess whether it has power to direct those activities. A reporting entity's ability to act when circumstances arise or events happen constitutes power if that ability relates to the activities that cause the reporting entity's returns to vary. A reporting entity does not have to exercise its power in order to have power to direct the activities of a structured entity.[576]

The draft IFRS in ED 10 also states that a reporting entity can control a structured entity by means of related arrangements. Paragraph 37 of the draft IFRS gives a clear example of a reporting that could establish a structured entity whose founding documents restrict its activities to purchasing fixed rate receivables of the reporting entity for cash, collecting payments from those receivables and passing those payments to the investors in the structured entity. In this example, in the absence of other facts, the reporting entity controls the structured entity. The reporting entity has the power to direct the activities of the structured entity by having the ability to direct how the assets of the structured entity are managed.[577]

A reporting entity can also have the power to direct the activities of a structured entity if the reporting entity has the ability to change the restrictions or predetermined strategic operating and financing policies according to which the structured entity operates.[578]

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[576] Ibid., para. 34. Para. 35 illustrates this by the following example. If the only assets of an entity are receivables, then managing any defaulting receivables is the only activity that causes the returns to vary and, thus, affects the returns of the structured entity's participants. In this example, the party with the power to direct how any defaulting receivables are managed, and in having that power can affect its returns from its involvement with the entity, controls that entity. A party has that power by managing any defaulting receivables itself or by delegating to its agent the management of defaulting receivables. That party has the power to direct the activities of the entity irrespective of whether any of the receivables actually defaults. See para. 35 of ED 10, p. 22.

[577] Ibid., at para. 37.

[578] Ibid., at para. 38. For example, a reporting entity can have the power to direct the activities of a structured entity by having the right to dissolve the entity or to change the entity's charter or bylaws. A reporting entity can have the right to dissolve an entity by holding liquidation rights, redemption rights or other rights.

3.13. IFRS 10

Continuing its work after the publication of ED 10, the IASB published IFRS 10 in May 2011, which replaced IAS 27.
In the Basis for Conclusions on IFRS 10, which is not a part of IFRS 10, an analysis is provided of the current concept of control. IAS 27 requires the consolidation of entities that are controlled by a reporting entity and it defines control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. SIC-12, which interprets the requirements of IAS 27 in the context of special purpose entities, places greater emphasis on risks and rewards. According to the IASB staff, this perceived conflict of emphasis has led to the inconsistent application of the concept of control. The IASB staff states that this is aggravated by a lack of clear guidance as to which investees are within the scope of IAS 27 and which are within the scope of SIC-12. As a result, assessing control sometimes falls back on a "quantitative assessment of whether the investor has a majority of the risks".[579] The IASB staff states that tests based on "sharp bright line" distinctions may create structuring opportunities.

The Board states that control is the *only* basis for consolidation.[580] An investor should consolidate an investee and should present in its consolidated financial statements the assets, liabilities, equity, income, expenses and cash flows of an investee if an investor has the power to direct the activities of the investee that significantly affect the investee's returns and can benefit by using its power. An investor that is exposed, or has rights, to variable returns from its involvement with the investee, but does not have the ability to direct the activities of the investee so as to affect the amount of the investor's return from its involvement with the investee, does not control the investee. The exposure to risks and rewards is an indicator of control. Without any exposure to risks and rewards, an investor is unable to benefit from any power that it might have and therefore cannot have control.[581]
The IASB Board does not regard control and risks and rewards as competing models. The exposure to risks and rewards, or returns as this is expressed in IFRS 10, is an essential element of control. In the great majority of cases, the approaches would lead to the same accounting conclusions. However, a

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[579] IASB staff draft IFRS X *Consolidated Financial Statements*, September 2010, Basis for Conclusions on IFRS 10.
[580] Ibid., p. 9.
[581] Ibid., p. 13.

control-based model forces an investor to consider all of its rights in relation to the investee rather than relying on arbitrary bright lines that are associated with risks and rewards approaches.[582]

The content of this new IFRS is as follows:

- Objective
  paras. 1-3
- Scope
  para. 4
- Control
  paras. 5-18
  - Power
  - Returns
  - Link between power and returns
- Accounting Requirements
  paras. 19-26
  - Non-controlling interests

  - Loss of control
- Appendix A: Defined Terms
  para. A
- Appendix B: Application guidance
  paras. B1-B99
- Appendix C: Effective date and transition
  paras. C1-C9
- Appendix D: Amendments to other IFRSs
  paras. D1-D30

This IFRS identifies the principles of control and determines how to identify whether an investor controls an investee and therefore must *consolidate* the investee. Furthermore, this IFRS sets out the principles for the preparation of consolidated financial statements.

IFRS 10 requires that an investor determine whether it is a parent by assessing whether it *controls* one or more investees. An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with

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[582] Ibid., p. 15.

the investee and has the ability to affect those returns through its power over the investee.
Thus, an investor controls an investee if, and only if, the investor has all of the following elements:

- power over the investee;
- exposure, or rights, to variable returns from its involvement with the investee; and
- the ability to use its power over the investee to affect the amount of the investor's returns.[583]

As may be concluded from IFRS 10, an investor must consider all relevant facts and circumstances when assessing whether it controls an investee. The investor must reassess whether it controls an investee if *facts and circumstances* indicate that there are changes to one or more of the three elements of control as listed above. IFRS 10 also indicates that two or more investors can *collectively* control an investee when they must act together to direct the activities that significantly affect the returns of the investee:

"In such cases, because no investor can direct the activities without the co-operation of the others, no investor individually controls the investee. Each investor would account for its interest in the investee in accordance with the relevant IFRSs."[584]

IFRS 10 explains how "power" should be interpreted. The IASB describes various characteristics of power: power need not be absolute; power need not have been exercised; power precludes others from controlling an investee. According to the IASB, an investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities, for instance the activities that significantly affect the investee's returns. This power arises from *rights*. In order to control an investee, an investor must have the power to direct the activities of the investee that significantly affect the investee's returns.

Initially, reference is made to voting rights:

[583] IFRS 10, paras. 5-8.
[584] Ibid., para. 9.

"Sometimes assessing power is straightforward, such as when power over an investee is obtained directly and solely from the voting rights granted by equity instruments such as shares, and can be assessed by considering the voting rights from those shareholdings."[585]

The IASB concept of "control" is explained in detail by the IASB. However, the basis of control is still to be found in company law (voting rights).

An investor with the ability to direct the relevant activities has power even if its rights to direct have yet to be exercised. If two or more unrelated investors each have existing rights that provide the unilateral ability to direct different relevant activities, the investor that has the current ability to direct the activities that most significantly affect the returns of the investee has power over the investee.[586]

With respect to the required returns, the IASB states that an investor must be exposed, or have rights, to variable returns from its involvement with an investee to control the investee. The returns can be positive, negative or both and can vary as a result of the investee's performance. The link between the power and returns is explained in paragraph 17 of IFRS 10. A parent must not only have power over an investee and exposure or rights to variable returns from its involvement with the investee, a parent must also have the ability to use its power over the investee to affect its returns from its involvement with the investee.[587]

The IASB has provided a definition list in Appendix A, which is an integral part of IFRS 10. Consolidated financial statements are defined as the financial statements of a group, which consolidate the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries and present them as those of a single economic entity.

For tax law purposes, a subsidiary exists when the requirements of company law are met. In most cases, there should be a shareholding by one company in the other. However, IFRS 10 defines "subsidiary" more abstract, without referring to shareholding only:

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[585] Ibid., para. 11.
[586] Ibid., para. 13
[587] Ibid., para. 17.

"Subsidiary: an entity that is controlled by another entity."[588]

The development of association for the purpose of consolidation is no longer identified with the terms "participation" or "shareholding" or "owning shares", but it is identified with the term "control".

For the purpose of IFRS 10, control is defined as follows:

"an investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee."[589]

Control is the main element for consolidation and is based on company law. If there is power over the investee and there are rights to variable returns from its involvement with the investee and the ability to use the power over the investee to affect the amount of the investor's returns, then control exists.
Control exists not only by means of equity instruments, such as ordinary shares in an investee. The assessment of control will focus on which party, if any, is able to exercise sufficient *voting rights* to direct the investee's operating and financial policies. By focusing on the voting rights, situations between buyer and seller, although one might strongly influence the other, do not fall under "control".
For more complex cases it may be necessary to consider many or all of the following factors to determine whether an investor controls an investee:

(a) what the relevant activities are and how decisions about these activities are made;
(b) whether the rights of the investor give it the current ability to direct those activities;
(c) whether the investor is exposed, or has rights, to variable returns from its involvement with the investee; and
(d) whether the investor has the ability to use its power over the investee to affect the amount of the investor's returns.

As shown above, the concept of control in IFRS 10 is based on company law and is discussed in-depth by the IASB.

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[588] Ibid., Appendix A.
[589] Ibid.

3.14. Conclusions

In 1976 the EC Commission submitted a first Proposal for a Directive on Consolidated Accounts, finally adopted in 2002.[590] Consolidated accounts are the part of accounting law which is primarily affected by the uniform international sets of IAS/IFRS accounting standards. These are the standards in accordance with which, under EC law, consolidated accounts have to be prepared as of 2005 if one member of the group raises capital on regulated capital markets.

The concepts of "control" and "related parties" are explained in detail by the IASB for the purpose of financial accounting standards (IAS and IFRS). Although IAS/IFRS deal with financial accounting, an analysis of the control and related parties concepts in this area provides interesting clues as to the interpretation of associated enterprises in tax law.

The objective of IAS 27 (2008) is to enhance the relevance, reliability and comparability of the information that a parent entity provides in its financial statements. It defines "control" as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. A "subsidiary" is defined as an entity that is controlled by another entity, known as the parent. According to IAS 27, control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting powers of an entity. Furthermore, IAS 27 also provides for situations when the parent owns half or less of the voting power of an entity but still controls the latter entity. Control is based on *company law* and can therefore be considered as a *de jure* criterion.

The objective of IAS 24 (2011) is to ensure that an entity's financial statements contain the disclosures necessary to drawn attention to the possibility that its financial position and profit and loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties. IAS 24 considers parties related when one enterprise has control or joint control over the reporting entity, or has significant influence over the reporting entity, or is a member of the key management of the reporting entity.

IAS 24 states that "control" should not be confused with "significant influence". Significant influence can be defined as "the ability to participate in the decisions

[590] Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts, Official Journal L 193, 18/7/1983, pp. 1-17.

of how to use or manage the assets and liabilities of a legal entity so as to benefit from them that is not sufficient to control that entity".

The concepts of control and significant influence are both based on *de jure* relationships, not *de facto* relationships. IAS 24 states that a customer, supplier, franchisor or general agent with whom an entity transacts a significant volume of business, cannot be considered "related" simply by virtue of the resulting economic dependence.[591] IAS 24 rejects the view that open market situations, such as a mere economic dominance, may qualify as transactions between related parties, as the basis for disclosure is company law.

The IASB has introduced the new IFRS 10 in May 2011. This IFRS supersedes IAS 27 and is effective after 1 January 2013. IFRS 10 addresses a revised definition of control that is based on a "power" and "returns" criterion. In this context power needs not to be absolute; power needs not have been exercised and power precludes others from controlling an investee. Power without a majority of voting rights may exist when the reporting entity has more voting rights than any other party and these voting rights are sufficient to give the reporting entity the ability to determine the entity's strategic operating and financing policies.

According to the IASB Board, control of the strategic operating and financing policies of a legal entity is meaningless "when the constituting documents or other contractual agreements of a legal entity restricts the powers available to the governing body of a legal entity".
The assessment of "control" focuses on which party, if any, is able to exercise sufficient voting rights to direct the investee's operating and financial policies. Control exists when an investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. It can be concluded that also the control concept in IFRS 10 is based on *de jure* forms of control, originating from company law, for example rights in the form of voting rights and rights to appoint, reassign or remove key management members.

From the above I conclude that the concept of associated enterprises or related parties in IAS/IFRS has a *de jure* basis; it originates from company law. A

[591] IAS 24 (2011), para. 9.

relationship based on shareholding or voting rights is essential in determining the existence of associated enterprises. The term "*de facto* control" is used in IAS/IFRS but this term should not be confused with control originating from *de facto* situations, such as mere economic dominance. Though the differences between tax accounting and financial accounting remain significant, the concept of control and association in financial accounting supports the view that control, for the application of the arm's length principle, does not cover mere economic dominance, outside relationships vested in company law.

Chapter 4: Tax treaty interpretation

4.1. Introduction

The purpose of this chapter is to provide a brief analysis of the interpretation of tax treaties. It must be emphasised that this chapter does not purport to give a comprehensive overview of the large amount of legal writings on the topic of the interpretation of tax treaties.[592] It would be outside the scope of this study to discuss the many aspects of the interpretation of tax treaties. However, a general overview of the interpretation of tax treaties is required for the purpose of this study. Besides providing a brief analysis of the general interpretation rules of the Vienna Convention on the Law of Treaties (Arts. 31 and 32), this chapter discusses the *lex specialis* Art. 3 (2) OECD Model. The findings of this chapter are used to conclude in the next chapters whether an autonomous interpretation of the term "associated enterprises" exists.

[592] Regarding the interpretation of tax treaties, see generally: Baker, P., *Double Taxation Conventions: A Manual on the OECD Model Tax Convention on Income and on Capital, Introductory Topics, E. The Interpretation of Double Taxation Conventions* (London: Sweet and Maxwell, 2001); Engelen, F., *Interpretation of Tax Treaties under International Law*, IBFD Doctoral Series, Vol. 7 (Amsterdam: IBFD, 2004), pp. 425-515; Lang, M. (ed.), *Tax Treaty Interpretation*, EUCOTAX Series on European Taxation, Vol. 3 (London: Kluwer Law International, 2002); Prokisch, R. and Vogel, K., *General Report- Interpretation of Double Taxation Conventions*, Cahier de droit fiscal international, Volume LXXVIIIa (London: Kluwer Law International, 1993), pp. 55-87; Vogel, K., "Double Tax Treaties and Their Interpretation", 4 *International Tax and Business Lawyer* 1 (1986), pp. 4-85; Van Raad, C., "Interpretatie van belastingverdragen", 47 MBB 2/3 (1978), pp. 49-56; Ward, D.A., "Introduction to the Law Relating to Treaties", in: *Ward's Tax Treaties 1996-1997* (Toronto: Carswell, 1996), pp. 3-67; Lehner, M., "Interpretation of Tax Treaties According To German Theory and Practice", in: Vogel, K. (ed.), *Interpretation of Tax Law and Treaties and Transfer Pricing in Japan and Germany*, (London: Kluwer Law International, 1998) pp. 103-110; Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997); See also Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Series on International Taxation, Vol. 35 (London: Kluwer Law International, 2010), pp. 123-130.

4.2. Tax treaties

Tax treaties recognise that each Contracting State applies its own law. The most widely-held view is that treaty obligations limit the Contracting States' application of that law.[593] Tax treaties do not create the "right to tax". Both constitutional laws and public international law recognise that States have jurisdiction to tax. As Vogel indicated, "the starting point of all considerations must be to realize that the domestic law on the one hand and the law of double taxation on the other are two mutually independent legal spheres that have their own boundaries and definitions".[594] Double tax conventions establish an "independent mechanism to avoid double taxation through restriction of tax claims in areas where overlapping tax claims are expected, or are at least theoretically possible".[595] According to Vogel, Art. 9 OECD Model restricts domestic law. I agree with his view. If Art. 9 OECD Model would not restrict domestic law, Art. 9 OECD Model and treaty rules corresponding to it would be superfluous. They would be neither a basis for profit adjustments nor would they have any impact on domestic law. According to Vogel, Art. 9 OECD Model and its corresponding treaty rules make sense only if they are taken to have the same significance as double tax convention rules generally, thus that they restrict domestic law.

Tax treaties not only deal with the elimination of double taxation, they also address issues such as the prevention of fiscal avoidance and evasion through the exchange of information and the assistance in the collection of taxes. Furthermore, they address the issue of the elimination of discriminatory taxation.[596] The Contracting States mutually bind themselves to tax only to a limited extend, or not to levy taxes in cases when the treaty reserves taxation for the other Contracting State.

In the early 1920s the tax experts of the League of Nations described this "boundary on domestic taxation" as a classification of items of income and their assignment to the Contracting States. The treaty rules with this particular

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[593] Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 26.

[594] Ibid., p. 55.

[595] Ibid., p. 26. Vogel rejects the view hold by Becker and Lehner that Art. 9 does not restrict domestic law. See also Fiscal Committee, Report to the OEEC, "*The elimination of double taxation*, (Paris: OECD, September 1958), p. 12.

[596] See also Arts. 24-27 OECD Model.

function may be called "classification and assignment rules" or "distributive rules".

4.3. The Vienna Convention on the Law of Treaties of 23 May 1969

The Vienna Convention on the Law of Treaties (hereinafter: VCLT) is generally regarded as customary international law on the interpretation of treaties.The VCLT provides a system for the interpretation of treaties. With regard to States that have not entered into the VCLT, it is important to note that the VCLT in many cases merely codifies existing norms of customary international law.[597] Therefore, those rules apply to all treaties independently of the VCLT.

Article 31 of the VCLT reads:

"Article 31. General rule of interpretation

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
a. any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
b. any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There shall be taken into account, together with the context:
a. subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
b. any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
c. any relevant rules of international law applicable in the relations between the parties.
4. A special meaning shall be given to the term if it is established that the parties so intended."

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[597] ICJ, Namibia Case, First Advisory Opinion, ICJ Reports (1971)

From Art. 31 VCLT it may be concluded that the text of a treaty must be interpreted in good faith in accordance with the ordinary meaning given to the terms of the treaty in their context and in the light of its object and purpose.[598] The Commentary to the VCLT states that the objections to giving too large a place to the intentions of the parties as an independent basis of interpretation find expression in the proceedings of the Institute of International Law.[599] On the other hand, the textual approach commends itself by the fact that *'le texte signé est, sauf de rares exceptions, la seule et la plus recente expression de la volonte commune des parties'*.[600] The International Court of Justice has stressed more than once that it is not the function of the interpretation to revise treaties or to read into them what they do not contain, expressly or by implication.

The first paragraph contains three separate principles. The Commentary to the VCLT explains these three principles. The first principle is the "interpretation in good faith" principle, which follows directly from the *pacta sunt servanda* rule. If a treaty is open to two interpretations, only one of which effectively ensures the fulfilment of the purpose of the treaty, Art. 31 (1) VCLT confirms that it is this interpretation that must be applied.
The second principle includes the essence of the textual approach. The parties are presumed to have that intention which appears from the ordinary meaning of the terms used by them. The third principle, as described by the Commentary to the VCLT, is one both of common sense and good faith; the ordinary meaning of a term is not to be determined in the abstract but in the context of the treaty and in the light of its object and purpose.[601]

The Permanent Court of International Justice also stressed in an early Advisory Opinion that the context is not merely the article or section of the treaty in which the term occurs, but the treaty as a whole:

[598] Art. 31 (1) VCLT.
[599] Commentary to Article 31 Vienna Convention on the Law of Treaties, concluded in Vienna, 23 May 1969, para, 11.
[600] Ibid.
[601] The Court states in its Advisory Opinion on the Competence of the General Assembly for the Admission of a State to the United Nations: "The Court considers it necessary to say that the first duty of a tribunal which is called upon to interpret and apply the provisions of a treaty, is to endeavour to give effect to them in their natural and ordinary meaning in the context to which they occur. If the relevant words in their natural and ordinary meaning make sense in their context, that is an end of the matter". See ICJ Reports 1950, at 8 and VCLT Commentary to Article 31, para. 12.

"In considering the question before the Court upon the language of the Treaty, it is obvious that the Treaty must be read as a whole, and that its meaning is not to be determined merely upon particular phrases which, if detached from the context, may be interpreted in more than one sense."[602]

The second paragraph of Art. 31 VCLT provides what "context" comprises. In the light of this paragraph, an important question is how far other documents connected with the treaty are to be regarded as forming part of the "context" for the purposes of interpretation. Two classes of documents should be regarded as such:

1. Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty; and
2. Any instrument which was made in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

According to the Commentary to the VCLT, this provision is based on the principle that a unilateral document cannot be regarded as forming part of the "context" within the meaning of Art. 31, unless it was not only made in connection with the conclusion of the treaty, but its relation to the treaty was accepted in the same manner by the other parties.[603] However, the Commentary to the VCLT states that the fact that these two classes of documents are recognised in paragraph 2 as forming part of the "context" does not mean that they are "necessarily to be considered as an integral part of the treaty".[604] It depends on the intention of the party in each case whether they are an actual part of the treaty. For the purpose of interpreting the treaty, these categories of documents should not be treated as mere evidence to which recourse may be had for the purpose of resolving an ambiguity or obscurity, but as part of the context for the purpose of arriving at the ordinary meaning of the terms of the treaty.[605]

With respect to paragraph 3A of Art. 31 VCLT, the question sometimes arises as to whether an understanding reached during the negotiations concerning the

[602] Competence of the ILO to Regulate Agricultural Labour, P.C.I.J.(1922), Series B, Nos. 2 and 3, p. 23.
[603] VCLT Commentary to Art. 31, para. 13.
[604] Ibid.
[605] Ibid.

meaning of a provision was or was not intended to constitute an agreed basis for its interpretation. It is well settled that when an agreement as to the interpretation of a provision is established as having been reached before or at the time of the conclusion of the treaty, "it is to be regarded as forming part of the treaty".[606]
The Commentary on paragraph 3B of Art. 31 VCLT explains the interpretation element as "any subsequent practice in the application of the treaty, which establishes the understanding of the parties regarding its interpretation". This element constitutes objective evidence of the understanding of the parties to the meaning of the treaty.

The value of subsequent practice varies accordingly as it shows the *common understanding* of the parties as to the meaning of the terms. The Commentary describes that the Commission considered that the subsequent practice establishing the understanding of the parties regarding the interpretation of a treaty should be included in paragraph 3 as an authentic means of interpretation alongside interpretative agreements.[607]

The third element that should be taken into account, together with the context, is the phrase "any relevant rules of international law applicable in the relations between the parties". This element states that, *inter alia,* the ordinary meaning to be given to the terms of a treaty is to be determined "in the light of the general rules of international law in force at the time of its conclusion".[608] This element is a reflection of the general principle that a juridical fact must be appreciated in the light of the law contemporary with it. The Committee transferred this element of interpretation to paragraph 3 as being an element that is extrinsic both to the text and to the "context" as defined in paragraph 2.[609]

Paragraph 4 provides for the situation in which, notwithstanding the apparent meaning of a term in its context, it is established that the parties intended it to have a special meaning.[610] Some members of the Committee argued that technical or special use of the term normally appears from the context and the

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[606] Ibid., para. 14.
[607] Ibid., para. 15.
[608] Ibid., para. 16.
[609] Ibid.
[610] Ibid., para. 17.

technical or special meaning becomes "*the ordinary meaning in the particular context*".

Article 32 of the Vienna Convention on the Law of Treaties reads:

"Article 32. Supplementary means of interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

a. leaves the meaning ambiguous or obscure; or
b. leads to a result which is manifestly absurd or unreasonable."

The Commission's approach to treaty interpretation was that the text of the treaty must be presumed to be the authentic expression of the intentions of the parties. The elucidation of the meaning of the text rather than an investigation *ab initio* of the supposed intentions of the parties constitutes the object of interpretation.[611]
It follows from Art. 31 VCLT that the ordinary meaning of terms, the context of the treaty, its object and purpose, and the general rules of international law, together with authentic interpretations by the parties, are the primary criteria for interpreting a treaty. The Commentary on Art. 32 VCLT states that it would be unrealistic and inappropriate to lay down in the draft articles that no recourse whatsoever may be had to extrinsic means of interpretation until after the application of the rules contained in Art. 31 VCLT has disclosed no clear or reasonable meaning. In practice, international tribunals, as well as States and international organisations, have recourse to subsidiary means of interpretation for the purpose of confirming the meaning that appears to result from an interpretation of the treaty in accordance with Art. 31 VCLT.[612] The Court itself has on numerous occasions referred to the *travaux préparatoires* for the purpose of confirming its conclusions as to the "ordinary" meaning of the text.
From Art. 32 VLCT it follows that recourse to further means of interpretation, including preparatory work, is permissible for the purpose of confirming the meaning resulting from the application of Art. 31 and for the purpose of

[611] Ibid., para. 17.
[612] Ibid., para. 18.

determining the meaning when the interpretation according to Art. 31 VCLT leaves the meaning ambiguous or obscure, or leads to an absurd or unreasonable result.

In the light of the above, the word "supplementary" emphasises that Art. 32 VLCT does not provide for alternative, autonomous means of interpretation. It only provides for means to aid an interpretation governed by the principles contained in Art. 31 VCLT.

A simple explanation of the terms "ordinary meaning" and "special meaning" as mentioned in Art. 31 VCLT cannot easily be provided. Some scholars state that the principal function of the distinction made between the ordinary meaning and special meaning is to emphasise that the burden of proof lies with the party asserting that term has not been used in its ordinary sense.The rules of interpretation laid down in the VCLT are applicable to tax treaties concluded by States after the entry into force of the VCLT with regard to such States, pursuant to Article 4 VCLT.[613]

4.4. Art. 3 OECD Model; autonomous interpretation of associated enterprises?

Art. 3 OECD Model "groups together a number of general provisions required for the interpretation of the terms used in the Convention".[614] However, the term "associated enterprises" is not included in the list of Art. 3 (1) OECD Model. Art. 3 (1) OECD Model defines certain terms, but states "*unless the context otherwise requires*".[615] *(Italics, RD)*

As will be shown in this section and in Chapter 5, the OECD points to an "autonomous interpretation" of the concept of "associated enterprises".

In Chapter 5 I will analyse the historical development of Art. 9 OECD Model. If the history of Art. 9 OECD Model supports an autonomous interpretation of "associated enterprises", then the autonomous qualification seems to be the most supportable solution.[616] As a consequence, this entails the development of

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[613] Engelen, F., *Interpretation of Tax Treaties under International Law*, IBFD Doctoral Series, Vol. 7 (Amsterdam: IBFD, 2004), pp. 539-542.

[614] OECD Commentary 2010, Commentary on Art. 3 (1).

[615] Art. 3 (1) OECD Model.

[616] Ibid., p. 58. See also Wassermeyer, F., "Art. 9 MA", in: *Doppelbesteurung* (München, Verlag H.C. Beck, 2008), Art. 9, marginal number 1; also Wittendorff, J., *Transfer Pricing and*

"the continued progress towards an international tax language superseding national linguistic usage".[617] In Chapter 6 I will discuss the various domestic interpretations of "associated enterprises".

When a legislature unilaterally enacts new domestic tax laws, which are contrary to an existing treaty without the treaty having been amended or terminated, such legislative action results in a violation of the treaty under international law. This type of treaty violation is called "treaty override". The OECD defines treaty override as "the enactment of domestic legislation intended by the legislature to have effects in clear contradiction to international treaty obligations".[618] Sometimes attempts are made at justifying legislation that is contradictory to a treaty by claiming that this legislation only combats treaty abuses. It therefore does not contravene the proper meaning of the treaty at all. In the early 1990s, the OECD already declared itself against treaty overriding legislation, even in cases of combating abuse.[619]
If legislation of this type is to be recognised at all under international law, it must clearly ensnare only those particular cases in which an individual application of the abuse concept would be justified.[620]

An autonomous interpretation of "associated enterprises" may be derived through Art. 3 (2) OECD Model.[621] Art. 3 (2) OECD Model can be considered

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the Arm's Length Principle in International Tax Law, Series on International Taxation, Vol. 35 (London: Kluwer Law International, 2010), p. 215.

[617] Prokisch, R. and Vogel, K., *General Report- Interpretation of Double Taxation Conventions*, Cahier de droit fiscal international, Vol. LXXVIIIa (London: Kluwer Law International, 1993), p. 161.

[618] OECD Committee on Fiscal Affairs, *Tax Treaty Override* (Paris: OECD, 1989).

[619] Ibid.

[620] See also Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 70.

[621] For literature on this topic, see for instance Baker, P., *Double Taxation Conventions: A Manual on the OECD Model Tax Convention on Income and on Capital, Introductory Topics, E. The Interpretation of Double Taxation Conventions* (London: Sweet and Maxwell, 2001); Engelen, F., *Interpretation of Tax Treaties under International Law*, IBFD Doctoral Series, Vol. 7 (Amsterdam: IBFD, 2004), p. 438; Lang, M. (ed.), *Tax Treaty Interpretation*, EUCOTAX Series on European Taxation, Vol. 3 (London: Kluwer Law International, 2002); Prokisch, R. and Vogel, K., *General Report- Interpretation of Double Taxation Conventions*, Cahier de droit fiscal international, Volume LXXVIIIa (London: Kluwer Law International, 1993), pp. 55-87; Vogel, K., "Double Tax Treaties and Their Interpretation", 4 *International Tax and Business*

to be a lex specialis in relation to Arts. 31 and 32 VCLT, which means that the interpretation of any term not defined in a tax treaty is, in principle, governed exclusively by Art. 3 (2) OECD Model. Because of the absence of a fully developed "international tax language", a tax treaty incorporates certain legal terms derived from the tax laws of the Contracting States, which must be interpreted in accordance with those laws.

If the parties to the treaty use certain terms that otherwise have a specific legal meaning for the purposes of the taxes to which the treaty applies, and have not agreed to a common interpretation, the meaning under their applicable tax laws is the ordinary meaning to be given to those in their context.

In the absence of a common interpretation agreed on by the parties to the treaty, either expressly or by necessary implication, the rule of interpretation embodied by Art. 3 (2) OECD Model requires that the terms of a tax treaty that have a specific legal meaning under the applicable tax laws of the Contracting States are given that meaning for purposes of the treaty, *unless it can be established by reference to the context that a different meaning was in fact intended*. In that case there is an *autonomous interpretation* according to the rules of international law, even though domestic laws use the same expression but with a different meaning.

None of the OECD Member countries have made observations on the interpretation of Art. 3 (2) OECD Model or Art. 9 (1) OECD Model as set out in the Commentary. Neither has any OECD Member country or non-Member country entered a reservation on Art. 3 (2) OECD Model or on Art. 9 (1) OECD Model.

Art. 3 (2) OECD Model reads as follows:

Lawyer 1 (1986), pp. 4-85; Van Raad, C., "Interpretatie van belastingverdragen", 47 MBB 2/3 (1978), pp. 49-56; Ward, D.A., "Introduction to the Law Relating to Treaties", in: *Ward's Tax Treaties 1996-1997* (1996), pp. 3-67; Lehner, M., "Interpretation of Tax Treaties According To German Theory and Practice", in: Vogel, K. (ed.), *Interpretation of Tax Law and Treaties and Transfer Pricing in Japan and Germany*, (London: Kluwer Law International, 1998) pp. 103-110; Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997). See also Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Series on International Taxation, Vol. 35 (London: Kluwer Law International, 2010), pp. 123-130.

"As regards the application of the Convention by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State."[622]

The term "context" as used in Art. 3 (2) OECD Model comprises the treaty as a whole, including its preamble and annexes, as well as its *object* and *purpose*. Art. 3 (2) OECD Model should be applied in good faith. Paragraph 13.1 of the Commentary on Art. 3 (2) OECD Model explicitly states that mutual agreements entered into that establish the meanings of terms not defined in the

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[622] The Commentary on Art. 3 (2) OECD Model reads as follows:

11. This paragraph provides a general rule of interpretation for terms used in the Convention but not defined therein. However, the question arises which legislation must be referred to in order to determine the meaning of terms not defined in the Convention, the choice being between the legislation in force when the Convention was signed or that in force when the Convention is being applied, i.e. when the tax is imposed. The Committee on Fiscal Affairs concluded that the latter interpretation should prevail, and in 1995 amended the Model to make this point explicitly.

12. However, paragraph 2 specifies that this applies only if the context does not require an alternative interpretation. The context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the article therefore allows the competent authorities some leeway.

13. Consequently, the wording of paragraph 2 provides a satisfactory balance between, on the one hand, the need to ensure permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided).

13.1 Paragraph 2 was amended in 1995 to conform its text more closely to the general and consistent understanding of Member countries. For purposes of paragraph 2, the meaning of any term not defined in the Convention may be ascertained by reference to the meaning it has for the purpose of any relevant provision of the domestic law of a Contracting State, whether or not a tax law. However, where a term is defined differently for the purposes of different laws of a Contracting State, the meaning given to that term for purposes of the laws imposing the taxes to which the Convention applies shall prevail over all others, including those given for the purposes of other tax laws. States that are able to enter into mutal agreements (under the provisions of Article 25 and, in particular, paragraph 3 thereof) that establish the meanings of terms not defined in the Convention should take those agreements into account in interpreting those terms.

Convention, shall be taken into account when interpreting those terms. It could therefore be argued that a common interpretation, agreed upon between two competent authorities under Art. 25 (3) OECD Model can be considered to be "context" within the meaning of Art. 3 (2) OECD Model.

Art. 3 (2) OECD Model governs only the interpretation of words ("terms") used in the treaty. As explicitly stated in the Commentary on Art. 3 (2) OECD Model, a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention.[623]

Vogel is of the opinion that it is impossible to infer from Art. 3 (2) a *systematic* preference for interpretation from the context over interpretation by reference to national law. Whether the context "otherwise requires", an approach other than recourse to domestic law, may, in accordance with the rule of logic, be determined only if the meaning of a term has previously been established under that law. From this, according to Vogel, it would seem that an interpretation according to domestic law should take preference.[624] Since, however, such an interpretation may also require further correction, both interpretation procedures must be viewed in mutual reciprocity.[625] Furthermore, Vogel argues that it is also inconsistent with the wording of Art. 3 (2) OECD Model to limit reference to domestic law to those cases where "the criterion for interpretation according to the context has been fully explored, but the meaning of the treaty continues to remain unclear". Vogel derives this from the phrase "unless the context otherwise *requires*". In his opinion, this phrase would then read "unless the context yields no other, or absolutely no other, interpretation".[626] He concludes that not every apparently convincing interpretation from the context should give rise to a divergence from the rule of Art. 3 (2) OECD Model, but only those based on relatively strong arguments.[627]

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[623] OECD Commentary on 3 (2), para. 13.

[624] Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 214.

[625] Ibid.

[626] Ibid.

[627] Endorsed by Avery Jones, J.F., et al. See Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 214. However, see also Lang, M. (ed.),

In this respect, these "relatively strong arguments" can be found in the concept of the arm's length principle. The "boundaries" of the concept of associated enterprises are provided by the purposes of the arm's length principle. As stated in Chapter 2, the arm's length principle is to be considered to be a general principle of international taxation. This principle serves the principles of equality and neutrality between associated enterprises and independent enterprises. The purpose of the arm's length principle indicates that an autonomous interpretation of the concept of associated enterprises is desirable.

In 1960 the OEEC seems to refer to an autonomous interpretation of the concept of associated enterprises:

"It should perhaps be said at this point that neither Article is strikingly novel or particularly detailed. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of European double taxation Conventions concluded since the war, and it is fair to say *that the solutions adopted have generally conformed to a standard pattern*. It is generally recognised *that the essential principles on which this standard pattern is based are well founded*, and it has been thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater clarity."[628]

In 1979 the OECD again points to an autonomous interpretation of the concept of associated enterprises:

"It was not thought to be necessary to define such expression as "associated enterprises" and "under common control" as a *broad basis of common understanding* of what was meant was assumed to exist."[629]

From the interpretation rules of the VCLT it follows that Art. 3 (2) OECD Model must also be interpreted in good faith in accordance with the ordinary meaning given to the terms of the treaty in their context and in the light of its

Tax Treaty Interpretation, EUCOTAX Series on European Taxation, Vol. 3 (London: Kluwer Law International, 2002).

[628] See also OEEC, FC(60), annex E, p. 22, para. 2, (Paris: 25 May 1960) FC(60) 157.

[629] OECD Committee on Fiscal Affairs, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979).

object and purpose.[630] From the perspective of the VCLT, this good faith implies that a Contracting State may not erode or evade it obligations under the treaty by subsequently amending in its domestic law the definitions or meanings of the terms not defined in the treaty. This requirement of good faith can also be found in the Commentary on Art. 3 (2) OECD Model, which says that a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention.[631]

As Lang states, the literature on international tax law has attempted to justify an interpretation of undefined terms used in a tax treaty in the context of the treaty in order to avoid the adverse legal consequences that may result from treaty interpretation according to domestic tax law of the Contracting States.[632] Contracting States should interpret tax treaty provisions in such a way as to reach an "autonomous characterization in the context of the treaty", as this seems to be the most desirable method to solve conflicts of qualification. Therefore, Contracting States should interpret the term "context" in Art. 3 (2) OECD Model as broadly as possible, so as to find the proper solution and avoid references to domestic laws.[633] Lang states:

"[...] the object and purpose of the OECD Model suggests putting considerable weight on the phrase "unless the context otherwise requires" and that the term "context" may have a very broad meaning. It covers not only the whole OECD Model but also the preparatory work of the OECD Model such as the Commentary. All historical, systematical and teleological aspects that are important for the interpretation of the OECD Model may be taken into account."[634]

Lang concludes that if one applies such a broad understanding of the term "context" it is hard to imagine a tax treaty provision whose meaning cannot be developed by "thoroughly examining its *context*". Recourse to domestic law is

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[630] See also Engelen, F., *Interpretation of Tax Treaties under International Law*, IBFD Doctoral Series, Vol. 7 (Amsterdam: IBFD, 2004), p. 429.
[631] OECD Commentary on 3 (2), paragraph 13.
[632] See also Lang, M., Burgstaller, E. and Haslinger, K. (eds.), *Conflicts of Qualification in Treaty Law* (Vienna: Linde Verlag Wien, 2007), p. 31.
[633] Ibid.
[634] Ibid., p. 32.

only rarely necessary.[635] This approach offers an appropriate way to solve problems of conflicts of qualification in most cases. Vogel states that it is of relevance to state that the Contracting States are sometimes reluctant to accept autonomous definitions in the text of the treaty since such a definition restricts their discretion in applying the tax treaty.[636]

As will also shown in Chapter 5, the OECD assumption that a broad basis of common understanding of what is meant by the terms "associated enterprise" and "under common control" indicates the existence of an autonomous interpretation of "associated enterprises".[637]
Therefore, I will investigate in Chapter 5 whether an autonomous interpretation of "associated enterprises" exists. In Chapter 6 I will analyse the different domestic concepts of associated enterprises. But before turning to Chapter 5, I will first discuss the OECD Model and the OECD Commentaries.

4.5. The OECD Model

The purpose of the OECD Model Tax Convention is the avoidance of double taxation and the prevention of tax avoidance.[638] The purpose of Art. 9 (2) OECD Model is to prevent economic double taxation. Paragraph 1 of the Introduction to the OECD Commentary provides the explanation of international juridical double taxation. International juridical double taxation can generally be defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods.[639] Economic double taxation can generally be defined as the imposition of taxes in two (or more) States on the same economic transaction, item or income or capital during the same period, but in the hands of different

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[635] Lang, M., *The Application of the OECD Model Tax Convention to Partnerships. A Critical Analysis of the Report Prepared by the OECD Committee on Fiscal Affairs* (Vienna: Linde Verlag Wien, 2000), pp. 23-24.

[636] Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), pp. 58-59.

[637] See also Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Series on International Taxation, Vol. 35 (London: Kluwer Law International, 2010), p. 215.

[638] OECD Model Tax Convention, *Introduction*, paragraph 1.

[639] OECD Model Tax Convention, Introduction OECD Commentary, paragraph 1.

taxpayers'.[640] The harmful effects of double taxation on the exchange of goods and services and movements of capital, technology and persons are so well known, that, according to the OECD, it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries. It has long been recognised among the OECD Member countries that it is desirable to "clarify, standardize, and confirm the fiscal situation of taxpayers" who are engaged in commercial, industrial, financial, or any other activities in other countries through the application by all countries of common solutions to identical cases of double taxation.[641] The OECD Model provides a means of settling on a uniform basis the most common problems that arise in the field of international juridical double taxation. The OECD states that when Member countries conclude or revise bilateral conventions, they should conform to the OECD Model Tax Convention as interpreted by the Commentaries thereon, taking into account the reservations contained therein. The OECD expresses that the tax authorities of the Member countries concerned should follow these Commentaries, as modified from time to time and subject to their observations thereon, when applying and interpreting the provisions of their bilateral conventions that are based on the Model Convention.[642]
The worldwide recognition of the provisions of the Model Convention and their incorporation into a majority of bilateral conventions have helped make the Commentaries on the provisions of the Model Convention a "widely-accepted guide to the interpretation and application of the provisions of existing bilateral conventions".[643] In the view of the OECD this has facilitated the interpretation and the enforcement of these bilateral conventions along common lines. The OECD states that the importance of the Commentary, being a generally accepted guide, becomes greater as the network of tax conventions continues to expand.[644] In the next section the legal status of the OECD Commentaries will be discussed.

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[640] See for example, Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997) and Kemmeren, E.C.C.M., *Principle of Origin in Tax Conventions- A Rethinking of Models* (Dongen: mr. Eric C.C.M. Kemmeren/Pijnenburg vormgevers en uitgevers, 2001), p. 14.
[641] OECD Model Tax Convention, Introduction OECD Commentary, para. 2.
[642] Ibid.
[643] Ibid., para. 15.
[644] Ibid.

4.6. The OECD Commentaries

The legal status of the OECD Commentaries has been a topic of discussion for many scholars.[645] As early as 1967 Van den Tempel described the importance of the OECD Commentaries:

"[...] it is to be expected that the interpretation by national administrations or by national judges of provisions in bilateral treaties which have been taken from the O.E.C.D. draft, will be influenced by the commentary, because it can be assumed that the parties to a treaty, which follow the O.E.C.D. text, have understood that text according to the meaning expressed in the commentary, which they have also adopted in the drafting of the O.E.C.D text. Such interpretation will contribute to the development of a body of international concepts and rules independent from national law."[646]

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[645] See for instance: Kemmeren, E.C., "De rol van het OESO-Commentaar bij de uitleg van belastingverdragen en het Europese recht: trias politica onder toenemende druk?" in: Gribnau, H. (ed.), *Principieel belastingrecht*, Liber Amicorum Richard Happe, Opstellen aangeboden aan prof. mr. R.H. Happe ter gelegenheid van zijn afscheid als hoogleraar aan de Universiteit van Tilburg (Nijmegen: Wolf Legal Publishers, 2011), pp. 95-108; Baker, P., *Double Taxation Conventions: A Manual on the OECD Model Tax Convention on Income and on Capital, Introductory Topics, E. The Interpretation of Double Taxation Conventions* (London: Sweet and Maxwell, 2001); Engelen, F., *Interpretation of Tax Treaties under International Law*, IBFD Doctoral Series, Vol. 7 (Amsterdam: IBFD, 2004), p. 438; Lang, M. (ed.), *Tax Treaty Interpretation*, EUCOTAX Series on European Taxation, Vol. 3 (London: Kluwer Law International, 2002); Prokisch, R. and Vogel, R., *General Report- Interpretation of Double Taxation Conventions*, Cahier de droit fiscal international, Volume LXXVIIIa (London: Kluwer Law International, 1993), pp. 55-87; Vogel, K., "Double Tax Treaties and Their Interpretation", 4 *International Tax and Business Lawyer* 1 (1986), pp. 4-85; Van Raad, C., "Interpretatie van belastingverdragen", 47 MBB 2/3 (1978), pp. 49-56; Ward, D.A., "Introduction to the Law Relating to Treaties", in: *Ward's Tax Treaties 1996-1997* (1996), pp. 3-67; Lehner, M., "Interpretation of Tax Treaties According To German Theory and Practice", in: Vogel, K. (ed.), *Interpretation of Tax Law and Treaties and Transfer Pricing in Japan and Germany*, (London: Kluwer Law International, 1998) pp. 103-110; Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997). See also Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Series on International Taxation, Vol. 35 (London: Kluwer Law International, 2010), pp. 123-130.

[646] Van den Tempel, A.J. , "Relief from Double Taxation, A comparison of the work of the League of Nations and of the Organisation for Economic Cooperation and Development", in: Van den Tempel, A.J., *Seventh Chapter of the Book Developments in taxation since World War I* (Amsterdam: IBFD, 1967), pp. 23-26.

The Commentaries are a widely-accepted guide to the interpretation and application of the tax treaties based on the OECD Model. As the Commentaries have been drafted and agreed upon by the experts appointed to the Committee on Fiscal Affairs by the Governments of OECD Member countries, they are of special importance in the development of international fiscal law.[647] The OECD emphasises the following in its Commentary:

"Although the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, which *unlike the Model* are legally binding international instruments, they can nevertheless be of great assistance in the application and *interpretation* of the conventions and, in particular, in the settlement of any disputes."[648]

The OECD Council states in a recommendation to the OECD Member countries that their tax authorities should follow the Commentaries when applying and interpreting treaties that are based on the OECD Model. However, Council recommendations are not binding on the Member countries. According to Art. 18 (b) of the OECD Rules of Procedures of the Organisation, the Member countries are only obliged to consider whether it is appropriate to implement a recommendation.[649] Paragraph 29 of the Introduction to the OECD Model provides that the OECD Commentaries are not legally binding international instruments.

Chinkin and Engelen state that the Commentaries on the OECD Model may be classified as a form of "elaborative soft law"; principles that provide guidance to the interpretation, elaboration, or application of hard law.[650] The Commentaries reflect the consensus of the Member countries as to "the proper

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[647] Introduction OECD Commentary, para. 29.1

[648] Ibid.

[649] Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 44; Engelen, F., *Interpretation of Tax Treaties under International Law*, IBFD Doctoral Series, Vol. 7 (Amsterdam: IBFD, 2004), p. 456; Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Series on International Taxation, Vol. 35 (London: Kluwer Law International, 2010), p. 123.

[650] Chinkin, C., "Normative Development in the International Legal System", in: Shelton, D. (ed.), *Commitment and Compliance* (Oxford: Oxford University Press, 2000), p. 30 and Engelen, F., *Interpretation of Tax Treaties under International Law*, IBFD Doctoral Series, Vol. 7 (Amsterdam: IBFD, 2004), p. 458.

interpretation and application of the provisions of existing tax treaties that are based on the OECD Model Tax Convention".[651] According to Chinkin, it can be said that the "hard and soft law are inter-dependent and that the latter derives authority, and extends the meaning of, the former".[652]
Several authors state that the OECD Commentaries are not in the nature of a treaty under international law, as the Member countries have not intended to make it a legally binding instrument. This view is supported by paragraph 29 of the Introduction to the OECD Model:

"The Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries which, unlike the Model are legally binding instruments."[653]

The OECD itself states the following with regard to the legal status of the OECD Commentaries:

"29.3 *[Use by judiciary]* Bilateral tax treaties are receiving more and more judicial attention as well. The courts are increasingly using the Commentaries in reaching their decisions. Information collected by the Committee on Fiscal Affairs shows that the Commentaries have been cited in the published decisions of the courts of the great majority of Member countries. In many decisions, the Commentaries have been extensively quoted and analyzed, and have frequently played a key role in the judge's deliberations. The Committee expects this trend to continue as the world-wide network of tax treaties continues to grow and as the Commentaries gain even more widespread acceptance as an important interpretative reference."[654]

Kemmeren analyses the status of the OECD Commentaries in the light of the *trias politica* principle. He points out that the OECD Commentaries are published by the Committee of Fiscal Affairs (CFA), whose members are senior officials from all OECD Member governments (the executive power in the *trias politica* principle). It may therefore be concluded that, according to Kemmeren, tax authorities may change the meaning of provisions of tax

[651] Ibid.
[652] Ibid.
[653] Introduction to the OECD Model, para. 29.
[654] Ibid., para. 29.3

treaties by amending the OECD Commentary.[655] Therefore, Kemmeren argues that courts should not rely blindly on the OECD Commentaries. The senior officials of the OECD Member governments may make changes to the OECD Commentary that are not supported by the text of the relevant provision or that are different from the previous versions of the Commentary. In that case, as also stated by Wittendorff, the Commentaries cannot be ascribed any importance as a source of law:

"The legal status as a means of interpretation implies that, when applying the terms of a treaty, an independent examination must be made of whether the interpretation in the OECD Commentaries is correct. If the interpretation in the Commentaries is not compatible with the wording of the OECD Model, then the Commentaries cannot be ascribed any importance as a source of law."[656]

Prokisch and Vogel conclude that the OECD Model and Commentaries have created an *international tax terminology* that establishes the ordinary meaning of the terms in tax treaties.[657] Accordingly, the meaning of a term must be interpreted according to its context. Vogel states that if a treaty follows the wording of the OECD Model, the Contracting States have intended that the terms of the treaty should be given the same meaning as in the Commentaries, particularly if the Commentary in question is long established.[658]

The OECD confirms that the Commentaries are useful both in deciding day-to-day questions of detail and in resolving larger issues, involving the policies and purposes behind various provisions. Tax officials give great weight to the guidance contained in the Commentaries. Taxpayers also make extensive use of the Commentaries in conducting their businesses and planning their business

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[655] Kemmeren, E.C.C.M., "De rol van het OESO-Commentaar bij de uitleg van belastingverdragen en het Europese recht: trias politica onder toenemende druk?", in: Gribnau, H. (ed.), *Principieel belastingrecht*, Liber Amicorum Richard Happe, Opstellen aangeboden aan prof. mr. R.H. Happe ter gelegenheid van zijn afscheid als hoogleraar aan de Universiteit van Tilburg (Nijmegen: Wolf Legal Publishers, 2011), pp. 95-108.

[656] Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Series on International Taxation, Vol. 35 (The Netherlands: Kluwer Law International, 2010), p. 124.

[657] Vogel, K. (ed.), *Interpretation of Tax Law and Treaties and Transfer Pricing in Japan and Germany*, (London: Kluwer Law International, 1998), p. 48.

[658] Due to the limited size of this study, I will not discuss in-depth the academic discussion on the legal status of the periodically revised OECD Commentaries.

transactions and investments.[659] The OECD expresses its view that the Commentaries are of particular importance in countries that do not have a procedure for obtaining an advance ruling on tax matters from the tax administration, as the Commentaries may be the only available source of interpretation in that case.

Courts are also increasingly using the Commentaries in reaching their decisions. Information collected by the Committee of Fiscal Affairs shows that the Commentaries have been cited in the published decisions of the courts of the great majority of Member countries. The Commentaries have been extensively quoted and analysed in many decisions, and have frequently played a "key role in the judge's deliberations".[660] The Committee of Fiscal Affairs expects this trend to continue as the worldwide network of tax treaties continues to grow. Furthermore, the Commentaries gain even more widespread acceptance as an important interpretative reference.[661]

In cases where Member countries are unable to concur in the interpretation given in the Commentary on the article concerned, an observation on the Commentaries has been inserted. The Committee states that these observations "thus do not express any disagreement with the text of the Convention, but usefully indicate the way in which those countries will apply the provisions of the Article in question".[662] Since the observations are related to the interpretations of the articles given in the Commentaries, no observation is needed to indicate a country's wish to modify the wording of an alternative or additional provision that the Commentaries allow countries to include in their bilateral conventions. All Member countries are in agreement with the aims and the main provisions of the OECD Model. However, nearly all Member countries have entered reservations on some provisions that are recorded in the Commentaries on the articles concerned. The Commentary states that there has been no need for countries to make reservations indicating their intent to use the alternative or additional provisions that the Commentaries allow countries to include in their bilateral conventions or to modify the wording of a provision of the OECD Model to confirm or to incorporate an interpretation

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[659] Introduction OECD Commentary, para. 29.2.

[660] Introduction OECD Commentary, para 29.3.

[661] Ibid. However, see also Kemmeren, E.C.C.M., "De rol van het OESO-Commentaar bij de uitleg van belastingverdragen en het Europese recht: trias politica onder toenemende druk?", in: Gribnau, H. (ed.), *Principieel belastingrecht*, Liber Amicorum Richard Happe, Opstellen aangeboden aan prof. mr. R.H. Happe ter gelegenheid van zijn afscheid als hoogleraar aan de Universiteit van Tilburg (Nijmegen: Wolf Legal Publishers, 2011), pp. 95-108.

[662] Ibid., para. 30.

of that provision put forward in the Commentary. Insofar as an OECD Member State has entered reservations, the other Member countries will retain their freedom of action in accordance with the principle of reciprocity when negotiating bilateral conventions with the former.[663]

With respect to Art. 9 OECD Model, the Czech Republic and Hungary reserve the right not to insert Art. 9 paragraph 2 OECD Model in their conventions. However, in the course of negotiations they are prepared to accept paragraph 2 and at the same time to add a third paragraph limiting the potential corresponding adjustment to bona fide cases. Australia reserves the right to propose a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, as far as the information available to the competent authority permits, in accordance with the principles of this article. Germany reserves the right not to insert paragraph 2 in its conventions but is prepared in the course of negotiations to accept this paragraph based on Germany's "long-standing and unaltered understanding that the other Contracting State is only obliged to make an adjustment to the amount of tax to the extent that it agrees, unilaterally or in a mutual agreement procedure, with the adjustment of profits by the first mentioned State".[664] Italy reserves the right to insert in its treaties a provision according to which it will make adjustments under paragraph 2 of Article 9 only in accordance with the procedure provided for by the mutual agreement article of the relevant treaty. Furthermore, Slovenia reserves the right to specify in paragraph 2 that a correlative adjustment will be made only if it considers that the primary adjustment is justified.

The non-Member countries Brazil, Russia, Thailand and Vietnam reserve the right not to insert paragraph 2 of Art. 9 OECD Model in their conventions.[665]

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[663] Ibid., para. 31.

[664] See OECD Commentary 2010, Commentary on Art. 9 (2), Reservations on the Article.

[665] Furthermore, Bulgaria, Lithuania, Russia and South Africa reserve the right to replace "shall" by "may" in the first sentence of paragraph 2 of Art. 9 OECD Model in its conventions. Malaysia and Serbia reserve the right to specify in paragraph 2 that a correlative adjustment will be made if the adjustment is considered to be justified. Ivory Coast, Morocco and Tunisia reserve the right not to insert paragraph 2 in their conventions unless the commitment to make an adjustment does not apply in the case of fraud, wilful default or neglect. In such a case Tunisia reserves the right to limit the adjustment to periods not covered by its internal statute of limitation. Israel reserves its right to insert a provision according to which any appropriate adjustment to the amount of the tax charged therein on

More importantly, there are no reservations made on Art. 9 (1) OECD Model.

As the Committee is of the opinion that changes to the Commentaries should be relevant in interpreting and applying conventions concluded before the adaption of these changes, it disagrees with any form of *a contrario* interpretation that would necessarily infer from a change to an article of the OECD Model or to the Commentaries that the previous wording resulted in consequences, different from those of the modified wording. It is explicitly stated by the Committee that amendments are intended to "simply clarify, not change, the meaning of the Articles or the Commentaries, and such *a contrario* interpretations would clearly be wrong in those cases".[666]

Today, it may be concluded that OECD Member countries and many non-Member countries have largely conformed to the OECD Model when concluding or revising bilateral conventions. The progress made towards eliminating double taxation between Member countries can be measured by the increasing number of conventions concluded or revised since 1957, in accordance with the Recommendations of the Council of the OECD. These conventions follow the pattern and, in most cases, the main provisions of the OECD Model. The impact of the OECD Model has extended far beyond the OECD territories. It has been used as a basic reference document in negotiations between Member and non-Member States and even between non-Member countries, as well as in the work of other worldwide or regional international organisations in the field of double taxation and related problems.[667] The OECD Model has also been used as the basis for the original drafting and the subsequent revision of the United Nations Model Double Taxation and the subsequent revision of the United Nations Model Double Taxation Convention between Developed and Developing Countries, which reproduces a significant part of the provisions and Commentaries of the OECD Model. Tax administrations and taxpayers of many OECD Member and non-Member countries consult the Commentaries for the purpose of the interpretation of tax treaties that are based on the OECD Model.

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those profits shall be implemented notwithstanding any time limits or other procedural limitations in the domestic law of the Contracting States, except such limitations as apply to claims made in pursuance of such an agreement.

[666] Introduction to OECD Model, para. 36.

[667] Ibid., para. 13.

4.7. Conclusions

Tax treaties recognise that each Contracting State applies its own law. The most widely-held view is that treaty obligations limit the Contracting States' application of that law. Tax treaties do not attribute the "right to tax". According to the VCLT, the ordinary meaning of a term is not to be determined in the abstract but in the context of the treaty and in the light of its object and purpose. According to the VCLT, it is not the function of interpretation to revise treaties or read into them what they do not contain, expressly or by implication. Contracting States are to be presumed to have that intention which appears from the ordinary meaning of the terms used by them. Also according to the Commentary on the VCLT, the ordinary meaning of a term is not to be determined in the abstract but in the context of the treaty and in the light of its object and purpose.

The purpose of the OECD Model is removing the obstacles that double taxation presents to the development of economic relations between countries and promoting the exchange of goods and services and movements of capital, technology and persons by avoiding double taxation and preventing tax avoidance. The OECD states that when Member countries conclude or revise bilateral conventions, they should conform to the OECD Model Tax Convention as interpreted by the Commentaries thereon, taking into account the reservations contained therein. The OECD emphasises that "although the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, which *unlike the Model* are legally binding international instruments, they can nevertheless be of great assistance in the application and *interpretation* of the conventions and, in particular, in the settlement of any disputes."[668]
It is important to note that the OECD Commentaries are published by the Committee of Fiscal Affairs, whose members are senior officials from all OECD Member governments. As stated by Kemmeren, there is a possibility that tax authorities may "change" the meaning of tax treaties by amending the OECD Commentary. The Committee explicitly states that amendments to the Commentary are intended to "simply clarify, not change, the meaning of the Articles or the Commentaries, and such *a contrario* interpretations would clearly be wrong in those cases".[669] Therefore, it can be argued that the

[668] Introduction OECD Commentary, para. 29.1.
[669] Introduction to the OECD Model, para. 36.

Commentaries cannot be ascribed any importance as a source of law if the interpretation in the Commentaries is not compatible with the wording of the OECD Model.
Despite the aforesaid, the worldwide recognition of the provisions of the Model Convention and their incorporation into a vast majority of bilateral conventions have helped make the Commentaries on the provisions of the Model Convention a "widely-accepted guide to the interpretation and application of the provisions of existing bilateral conventions".[670]

Art. 3 (2) of the OECD Model states that any term not defined in the convention shall have the meaning that it has at that time under the law of that State, *unless the context otherwise requires.*
The phrase "unless the context otherwise requires" refers to situations where a reference to an interpretation according to domestic law fails to provide a clear solution to the particular tax issue.
With regard to "context" Lang states:

"[...] the object and purpose of the OECD Model suggests putting considerable weight on the phrase "unless the context otherwise requires" and that the term "context" may have a very broad meaning. It covers not only the whole OECD Model but also the preparatory work of the OECD Model such as the Commentary. All historical, systematical and teleological aspects that are important for the interpretation of the OECD Model may be taken into account."[671]

The examples provided in Chapter 1 show that reference to domestic law for the interpretation of "associated enterprises" may lead to double taxation. This indicates that reference to domestic law fails to provide a solution to the problems caused by the interpretation of "associated enterprises".
As shown in this section and as will be shown in Chapter 5, indications exist that refer to an "autonomous interpretation" of "associated enterprises"; the OECD referred to this autonomous interpretation by stating that there is a "broad basis of common understanding of what is meant by the terms

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670 Ibid., para. 15.
671 Ibid., p. 32.

"associated enterprise" and "under common control", and that the "solutions have generally conformed to a standard pattern".[672]

For the above reasons I will first investigate in Chapter 5 whether an autonomous interpretation exists. In Chapter 5 I will analyse the historical development of Art. 9 OECD Model. If the history of Art. 9 OECD Model, in addition to its purpose, supports an autonomous interpretation of "associated enterprises", then the autonomous qualification seems to be the most supportable solution.[673]As a consequence, this will entail the development of "the continued progress towards an international tax language superseding national linguistic usage".[674] In Chapter 6 I will discuss the various domestic interpretations of "associated enterprises" and analyse whether these domestic concepts could provide a solution to this tax issue.

[672] OECD Committee on Fiscal Affairs, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979) and OEEC, FC(60), annex E, p. 22, para. 2, (Paris: 25 May 1960) FC(60) 157.

[673] Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 58. See also Wassermeyer, F., "Art. 9 MA", in: *Doppelbesteurung* (München, Verlag H.C. Beck, 2008), Art. 9, marginal number 1 and Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Series on International Taxation, Vol. 35 (London: Kluwer Law International, 2010), p. 215.

[674] Prokisch, R. and Vogel, K., *General Report- Interpretation of Double Taxation Conventions*, Cahier de droit fiscal international, Vol. LXXVIIIa (London: Kluwer Law International, 1993), p. 161.

Chapter 5: Historical background of Art. 9 OECD Model: League of Nations - OECD

5.1. Introduction

In this chapter I will analyse the historical development of Art. 9 OECD Model. The purpose of this analysis is to find an answer to the question whether the history of Art. 9 OECD Model supports an autonomous interpretation and, if the answer is affirmative, what this autonomous interpretation is of the concept of associated enterprises.

5.1.1. The 1923 Report of the Committee of Economic Experts

Art. 9 OECD Model finds its origin in the early reports of the League of Nations in the 1920s. At that time the International Chamber of Commerce (ICC) appointed an International Committee on Double Taxation to address the question of double income taxation in an international setting.[675] Officials from six countries represented this Committee.[676] In a 1920 resolution the ICC called for governments to give relief from double income taxation.[677] The ICC recognised that during and after World War I, the combatant States both imposed new income taxes and raised the rates of existing taxes to the point where double taxation could have a negative effect on any international commerce.[678] The International Financial Conference held at Brussels in 1920

[675] League of Nations, *Double Taxation and Tax Evasion, Report and Resolutions submitted by the Technical Experts to the Financial Committee of the League of Nations*, (Geneva: 7 February 1925), Document F212, p. 7. With resolution no. 11 of the Constituent Congress in 1920 the ICC had placed the problem of double taxation on its agenda.

[676] The participating countries were Belgium, France, Italy, the Netherlands, the United Kingdom and the United States.

[677] See Herndon, J. G., *Relief From International Income Taxation: The Development of International Reciprocity for the Prevention of Double Income Taxation* (Chicago: Callaghan, 1932), p. 30. See also Seligman, Edwin R.A., *Double Taxation and International Fiscal Cooperation* (New York: The Macmillan Co., 1928), p. 114.

[678] See also International Chamber of Commerce, *Report on the Work of the International Chamber of Commerce Regarding International Double Taxation*, (1939) p. 11.

also recommended that the League of Nations should take up the question of double taxation.[679]

The League of Nations understood the concerns associated with double taxation. Therefore, it established several consecutive committees to deal with the question of double income taxation. In 1921 the League of Nations instructed the Financial Committee to study the question of double taxation. The Financial Committee decided to first of all examine this vast field of investigation from a theoretical and scientific point of view.[680]

The Financial Committee asked certain economists to prepare a report on double taxation. The terms of reference given to these four experts were fixed in March 1922 by a Subcommittee of the Financial Committee.[681] These

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[679] Resolution No.12 proposed by the Commission on International Credits on the Brussels Conference in 1920 read:

"Apart from the above-mentioned proposals [...] the Conference believes that the activities of the League of Nations might usefully be directed towards promoting certain reforms and collecting the relevant information required to facilitate credit operations. In this connection the Conference considers it well to draw attention to the advantages of making progress under each of the following heads. [...] An international understanding which, while ensuring the due payment by everyone of his full share of taxation, would avoid the imposition of double taxation which is at present an obstacle to the placing investments abroad." See also Ke Chin Wang, "International Double Taxation of Income: Relief Through International Agreement 1921-1945", 59 *Harvard Law Review* 73, 81 (1945).

[680] League of Nations, *Double Taxation and Tax Evasion, Report and Resolutions submitted by the Technical Experts to the Financial Committee of the League of Nations*, (Geneva: 7 February 1925) Document F212, p. 9.

[681] League of Nations Economic and Financial Commission, *Report on Double Taxation, submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*, Document E.F.S. 73.F.19. (Geneva: 5 April 1923).

The following economists prepared this report: Prof. Bruins from the Netherlands, Prof. Senator Einaudi of Italy, Prof. Seligman of the United States and Sir Josiah Stamp KBE of Great Britain. The terms of reference given to these four experts were as follows:

1. What are the economic consequences of double taxation from the point of view:
   a) of the equitable distribution of burdens
   b) of interference with economic intercourse and with the free flow of capital? To what extent are these consequences
   similar in the different types of cases commonly described as double taxation?
2. Can any general principles be formulated as the basis for an international convention to remove the evil consequences of
   double taxation, or should conventions be made between particular countries, limited to their own immediate requirements? In the latter alternative, can such particular conventions be so framed as to be capable ultimately of being embodied in a general convention?

experts, the Committee of Economic Experts, published their report on double taxation in 1923.[682] This report not only dealt with allocating business profits, it generally addressed the question of allocating taxing rights with respect to all types of income. In this report the experts discussed the doctrine of economic allegiance and the ways in which this economic allegiance could be subdivided.[683] They assumed that economic allegiance was the basis upon which the total tax paid by the individual should reach the competing authorities. According to the authors of the 1923 Report, the four principles of economic allegiance are the acquisition of wealth, the location of wealth, the enforceability of the rights to wealth and the consumption of wealth.

The first part of the 1923 Report explains the economic consequences of double taxation as regards both the equitable distribution of fiscal burdens and the influence of double taxation on economic intercourse and the free flow of capital. It approves, defines and develops the conclusions contained in a note by Coates communicated to the Financial Committee by its British Member, Sir Basil Blackett, in 1921. The second part deals with the general principles which govern international competence in the matter of taxation. The authors recapitulate the older fiscal theories (the costs theory and the benefit theory) and the theory of nationality, and they develop the modern doctrine of "economic allegiance", to the effect that "a part of the total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority". They then analyse economic allegiance. The third part of the report is devoted to the application of these principles and develops four general methods by which double taxation may be avoided. The authors finally point out the advantages and disadvantages of each of these four systems and conclude that on the subject of income taxation in its

3. Are the principles of existing arrangements for avoiding double taxation, either between independent nations (e.g. Rome Convention) or between the component portions of a federal State, capable of application to a new international convention?
4. Can a remedy be found, or to what extend can a remedy be found, in an amendment of the taxation system of each individual country, independently of any international agreement?
5. To what extent should the conventions on the subject of double taxation establish an international control to prevent fraudulent claims?

[682] Ibid. In this report the authors recapitulated the older fiscal theories (the cost theory and the benefit theory) and the theory of nationality, and they developed the modern doctrine of "economic allegiance", to the effect that "a part of the total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority".

[683] Ibid., pp. 22-31.

developed form, the reciprocal exemption of the non-resident under method 2 (see note) is the most desirable practical method of avoiding "the evils of double taxation" and should be adopted wherever countries feel in a position to do so.[684] Surprisingly, the term "economic allegiance" did not return in the later Reports of the League of Nations.

Important for this study, while presenting the four considerations of weight in economic allegiance, the authors of the 1923 Report stated:

"It is not pretended that every function falls easily into one of these four classes. For example, a manager of an estate in Java may be said to be the directing brain living in Java, and some of the legal rights relating to that estate may be enforceable in Java; on the other hand, the final *control* and direction may be in the hands of directors in Amsterdam."[685] (*Italics, RD*)

"Finally, the actual recipient of a part of the profits may be a shareholder in London. It is not easy in the last analysis to decide whether the production or origin stage can be said to end in Java or whether the brains in Amsterdam are not an essential part of all the operations concerned in production. Moreover, before the London shareholder can get hold of the wealth, two sets of legal rights may have to be exercised: first, those relating to incorporation of the company in Amsterdam; and, secondly, those relating to the ownership by the company of the property in Java. The analysis is therefore not in any sense final."

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[684] See League of Nations, *Double Taxation and Tax Evasion, Report and Resolutions submitted by the Technical Experts to the Financial Committee of the League of Nations*, Document F.212 (Geneva: 7 February 1925), p. 9.
There experts described the following four methods: the method of total deduction; the country of origin exemption method (the country of origin exempts all non-residents from taxes imposed on income drawn from sources within its borders); a method consisting in dividing the tax and allocating the relief given between the two States; and the method of the assignment of income.
[685] League of Nations, Economic and Financial Commission, *Report on Double Taxation, Report submitted to the Financial Commission by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*, (Geneva: 3 April 1923) Document FE.F.S. 73. See League of Nations, *Double Taxation and Tax Evasion, Report and Resolutions submitted by the Technical Experts to the Financial Committee of the League of Nations*, Document F.212 (Geneva: 7 February 1925), p. 23.

In the example quoted above the experts made a distinction between a managerial control of the enterprise, the manager in Java, and a "final control", the directors in Amsterdam. The Committee of Economic Experts neither dealt with the subject of associated enterprises nor with the term "control". This example may be taken as evidence that the members of the Financial Committee were aware of the use of the term "control" in tax law.
It is, however, not apparent from the 1923 Report which forms of control were known during that time. At least two forms of control could be inferred from the above example: the shareholder and the managerial control. These forms of control are forms that are derived from company law. Unfortunately, the authors only used this example to show possible difficulties of the application of the four considerations of weight in economic allegiance. The 1923 Report did not provide any more examples that included the term "control" or terms related to concern relations.

5.1.2. The 1925 Report of the first Committee of Technical Experts

In the Report and Resolutions on Double Taxation and Tax Evasion of 1925 the experts discussed various ways to divide profits.[686] Also, in this Report the authors were apparently aware of problems arising from the taxation of related companies. They stated that when an industrial concern carries on its activities

[686] League of Nations, *Double Taxation and Tax Evasion – Report and Resolutions submitted by the Technical Experts to the Financial Committee of the League of Nations*, Document F212 (Geneva: 7 February 1925), p. 16. This report described different principles of the division of profits: "*In cases in which an enterprise carries on its activities in several States, we have been led to lay down the principle of the division of income between these States. The four economists, in their Report, and particularly in its Appendix, have indicated the principles in accordance with which this division might be effected. In the various conventions concluded in Central Europe, we find that there are already provisions on this subject; we would mention particularly the Treaty, and the regulations for its applications, of 1921 and 1922 between Austria and Czechoslovakia, and the Treaty of March 1924 between Danzig and Poland, which prove a sufficiently accurate basis for computing the division of profits. For instance, the latter agreement contains provisional rules which take the kilometric length as the basis or index of division in the case of transport enterprises, and gross receipts and profits in the case of other business enterprises. The regulation for the application of the treaty between Austria and Czechoslovakia also provides methods for the flat-rate computation of the profits of firms, according as the establishments sell, purchase, or purchase and sell simultaneously. A Royal Decree of August 28th, 1922, in Belgium contains similar provisions.*
Such apportionment of profits constitutes then, an operation which, though delicate, is feasible, and which is already carried out in several countries. It should even be noted that these operations in treaties concluded in Central Europe apply both to personal taxes and impots reels."

throughout the world, "very serious technical difficulties may be encountered in determining an apportionment of the profits".[687] It seems from the text of the 1925 Resolutions that the experts did not focus specifically on the taxation of concerns or related enterprises, but that they mainly paid attention to the taxation of permanent establishments, which at that time included associated enterprises. The following quote illustrates this:

"If the enterprise has its head office in one of the States and in another has a branch, an agency, an establishment, a stable commercial or industrial organization, or a permanent representative, each one of the Contracting States shall tax that portion of the net income produced in its own territory. Therefore, the financial authorities of the interested States shall be able to request the taxpayer to hand in general balance-sheets, special balance-sheets and all other relevant documents."[688]

According to Vogel, these first League of Nations drafts consider subsidiaries to be permanent establishments of their parent company. Vogel noted that consequently those drafts did not need any provisions along the lines of Art. 9 OECD Model.[689] Article 5 of the later 1927 Report considered affiliated companies as permanent establishments.[690] For that reason, the texts relating to the taxation of permanent establishments are useful to the interpretation of the current OECD concept of associated enterprise.[691]

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[687] Ibid. The authors paid attention to the maritime transport industry. "*When an industrial concern carries on its activities throughout the whole world, the importance of the actual headquarters, or the "brain" of the enterprise, becomes paramount; and, above all,* "very serious technical difficulties may be encountered in determining an apportionment of the profits."

[688] Ibid., see *Text of the Resolutions,* article I, paragraph C sub 2.

[689] See Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice,* 3rd ed. (London: Kluwer Law International, 1997), p. 518.

[690] See also Section 2.4.

[691] Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law,* Series on International Taxation, Vol. 35 (London: Kluwer Law International, 2010), p. 87. Wittendorff holds the view that above provision must be assumed to have been drafted under the influence of German tax law (*Filialtheorie*). According to the German Income Tax Act of 1925 a subsidiary could be treated as a permanent establishment of its parent company.

A specific article concerning the taxation of associated enterprises was only introduced in the League of Nation Draft Convention after 1933.[692] As mentioned in Chapter 2, the main principles of allocation, the separate accounts principle and the arm's length principle, were introduced and developed in the context of permanent establishments, covering both branches and subsidiaries.

Although in the 1925 Resolutions no study was made with respect to the taxation of associated enterprises, the text of article IV paragraph 2 of the 1925 Resolutions included the important terms "management" and "control", which are currently also used in Art. 9 of the OECD Model.[693] This article did not deal with transactions between associated enterprises. However, when studying this article, I noticed that the way the terms "management" and "control" were used is similar to the way these terms are used in the current Art. 9 OECD Model. I quote this part of Art. IV of the 1925 Resolutions:

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[692] See also Section 2.4.

[693] See Art. 9 of the OECD Model Tax Convention on Income and Capital 2010, which is quoted below:

"Article 9 - Associated Enterprises

Paragraph 1: "Where

a. An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b. the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

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

Paragraph 2:

"Where a Contracting State includes in the profits of an enterprise of that State and taxes accordingly-profits on which an enterprise of the other Contracting State has been charged to tax in that other Contracting State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount for the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provision of this Convention and the competent authorities of the Contracting States shall if necessary consult each other."

"The State which has the right to levy the tax is the State in which the head office is situated, or, if that office is not the real centre of *management and control* of the undertaking, the State in which this centre is situated."[694] (*Italics, RD*)

Although the above-mentioned phrase did not deal with transactions between associated enterprises (transfer pricing), there is a remarkable similarity with the current grammatical use of the words "management" and "control" in Art. 9 OECD Model. Art. 9 OECD Model uses the expression "participation in *management, control* or capital".

It was the 1927 Report which elaborated on the reason for the use of the specific combination "*management*" and "*control*". As I will show in the following sections, the purpose of this combination was to prevent undesirable taxable situations.

Unfortunately, the experts did not perform any analysis in their 1925 Report on differences between management and control. I could not determine from the text of the 1925 Report and Resolutions what the distinction exactly was between those terms, and more importantly, what the meaning was of the term "control" in the light of this study. Apparently, the term "control" during that time was a commonly used term in tax law, at least in the countries where the tax experts performed their studies. In the absence of a specific explanation given in these early reports of the League of Nations, it may be argued that the interpretation of this term was a purely domestic interpretation, based on domestic law.

5.1.3. The 1927 Report of the second Committee of Technical Experts

The experts continued their research. In 1927 the Committee of Technical Experts prepared draft conventions for the prevention of double taxation.[695]

[694] League of Nations, supra note 9, see *Text of the Resolutions*, article IV, paragraph 1, titled *Fiscal Domicile of Companies and Corporate Bodies*. Article I, paragraph C sub 2a also stated: 'Nevertheless, in the case of maritime navigation undertakings, in view of the very particular nature of their activities and of the difficulty of apportioning their profits, particularly in the case of companies operating in a number of countries, the experts admit an exception to this principle – to the effect that the tax should, subject to reciprocity, be imposed only by the country in which *the real centre of management and control of the undertaking is situated*.'

[695] League of Nations, *Report on Double Taxation and Tax Evasion*, presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, Document C.216.M.85 (Geneva/London: 12 April 1927).

Article 4 of the Draft of a Bilateral Convention for the Prevention of Double Taxation provides:

Article 4:
"Income from shares or similar interests shall be taxable in the State in which the real centre of management of the undertaking is situated."[696]

The Commentary on Art. 4 of the 1927 Report states the following:

"Income from shares or similar interests is the subject of Article 4 of the draft; under the provisions of this article, it is taxable in the State in which the real centre of management of the undertaking, that is to say the management and control of the business, is situated, so that the case of a purely nominal centre of management is excluded".[697]

Although this part of Art. 4 deals with residence, whereas Art. 9 OECD Model deals with associated enterprises, Art. 4 may provide a clue whether "control" in Art. 9 OECD Model should be considered to be a separate, independent criterion or not. The word combination "management and control" has a special function in Art. 4. It can be questioned whether the specific word combination as present in Art.9 OECD Model (management, control or capital) has a similar function.

Apparently, in this Report "the real centre of management of the undertaking" should be read as the place of "management and control of the business".[698] The two elements "management" and "control" are mentioned in combination with each other. From the wordings of the Commentary on Art. 4, it seems that both terms "control" and "management" are essential in this case. Use of only the term "management of the business" in order to explain what was meant by the term "real centre of management" was apparently not sufficient to prevent undesirable taxable situations.
If the term "control" was not mentioned in the Commentary and the real control of the company was situated in another country than where the

[696] Ibid., at 10.
[697] Ibid., at 14.
[698] Following the words "this is to say.." in the Commentary on article 4 of the 1927 Report, see League of Nations, *Report on Double Taxation and Tax Evasion presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, Document C.216.M.85, (Geneva/London: 12 April 1927), p. 14.

nominal centre of management would be situated, the nominal centre would still qualify as the real centre of management.[699] Looking at the text of the draft convention, this would be in conflict with the object and scope of the article and draft convention concerned.[700] After all, the Committee was instructed to prepare the draft conventions with "a view to the avoidance of double taxation and the prevention of tax evasion".[701] Characterising nominal centres of management as the real centres of management could lead, without the term "control" in the Commentary, to tax evasion. This could also be concluded from the words "*so that the case of a purely nominal centre of management is excluded*". The above text indicates that a combination of the words "control" and "management" was required in order to prevent tax evasion and tax manipulation.
My analysis of Art. 9 OECD Model raises the question whether the expression "*participation in management, control or capital*" and more specifically, whether this combination of the words "management, control" also has a similar special function as set by the words "management and control" in Art. 4, even though the two articles have different purposes.[702] Art. 9 OECD Model provides the text "participation in management, control *or* capital" and therefore, at first sight, it seems to indicate that there is no relationship between those three elements. I will discuss the introduction of the phrase "participation in management, control or capital" in the following sections.

Although Art. 4 deals with the taxation of income from shares, it shows that specific combinations of words may have a special meaning and purpose. I have identified this specific purpose of the combination "management and control"

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[699] And therefore the State where the nominal centres of management were settled should have the right to tax. This could result in tax evasion. See also the example used in the 1923 Report; League of Nations, Economic and Financial Commission, *Report on Double Taxation, Report submitted to the Financial Commission by Professors Bruins, Einaudi, Seligman and Stamp*, Document FE.F.S. 73.F.19, 212 (Geneva: 3 April 1923), p. 23.
[700] Ibid., p. 4.
[701] Ibid., pp. 4-8.
[702] Art. 9 of the 2010 OECD Model Tax Convention starts with:
"*Where an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise...*"
In Art. 9 OECD Model (2010) the words "management, control or capital" are not a required combination, as the term "management and control" is in the above-mentioned Art. 4 and the Commentary of the 1927 Draft. The presence of an associated enterprise can be concluded whether there is a direct or indirect participation in management, control or capital of an enterprise.

in the case of Art.4; the use of this specific combination aims to prevent tax evasion and tax avoidance.

Art. 5 of the 1927 Draft of a Bilateral Convention for the Prevention of Double Taxation deals with the taxation of permanent establishments. This article includes two very important principles for transfer pricing today. Those two principles are now implemented in Art. 9 OECD Model.

Art. 5 provides:[703]

"Article 5:
"Income from any industrial, commercial or agricultural undertaking and from any other trades or professions shall be taxable in the State in which the persons controlling the undertaking or engaged in the trade or professions possess permanent establishments.

The real centres of management, affiliated companies, branches, factories, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a bona fide agent of independent status (broker, commission agent, etc.) shall not be held to mean that the undertaking has a permanent establishment in that country.

Should the undertaking possess permanent establishments in both Contracting States, each of the two States shall tax the portion of the income produced in its territory.

In the absence of accounts showing the income separately and in proper form, the competent administration of the two Contracting States shall come to an arrangement as to the rules for apportionment.
Nevertheless, income from maritime shipping concerns shall be taxable only in the State in which the real centre of management is situated."

The sentence

"In the absence of accounts showing the income separately and in proper form, the competent administration of the two Contracting States shall come to an arrangement as to the rules for apportionment."

[703] League of Nations, *Report on Double Taxation and Tax Evasion*, presented by the Committee of Technical Experts on Double Taxation and Tax Evasion (Geneva/London, 12 April 1927), Document C.216.M.85, pp. 10-11.

refers to accounts showing the income *separately*. This is a reference to the separate accounts principle.[704] Furthermore, this sentence states that in situations where accounts were not "showing the income *in proper form, the competent administration of the two Contracting States shall come to an arrangement as to the rules for apportionment*". This last phrase can be considered as an early basis of mutual agreement procedures today.[705] [706]

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[704] The Commentary of the 1927 Report on Art. 5 of its Draft of a Bilateral Convention for the Prevention of Double Taxation states:

"Paragraphs 2 and 3 of this clause govern the case in which the undertaking possesses permanent establishments in both contracting States; in that event, "each of the two States shall tax the portion of the income produced in its territory". This is an application of the so-called system of apportioning the income according to its source. "In the absence of accounts showing this income separately and in proper form, the competent administrations of the two contracting States shall come to an arrangement as to the rules for apportionment."

These rules will vary essentially according to the undertakings concerned; in certain States account is taken, according to the nature of the undertakings, of the amount of capital involved, of the number of workers, the wages paid, receipts, etc. Similarly, in cases where the products of factories are sold abroad, a distinction is often made between 'manufacturing' and 'merchanting' profits, the latter being the difference between the price in the home market and the sale price abroad, less cost of transportation."

[705] This could be compared with Art. 9 OECD Model: "either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent 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."

[706] The Commentary on Art. 5 of the 1927 Report reads as follows:

"This clause has reference to income from any industrial, commercial or agricultural undertakings, and from any other trades or professions; it is to be taxable in the countries in which the persons controlling the undertakings or engaged in the trade or profession, possess *permanent establishments*.

The word "undertakings" must be understood in its widest sense, so as to cover all undertakings, including mines and oilfields, without making any distinction between natural and legal persons.

The second paragraph gives a list of the establishments which are considered as permanent; they are: real centres of management, affiliated companies, branches, factories, agencies, warehouses, offices, depots, no matter whether such establishments are used by the traders themselves, by their partners, attorneys, or their other permanent representatives.

Nevertheless, the fact that an undertaking has business dealings with a foreign country through a bona-fide agent of independent status (broker, commission agent, etc.) shall not be held to mean that the undertaking in question has a permanent establishment in that country. The words "bona-fide agent of independent status" are intended to imply absolute independence, both from the legal and economic point of view. The agent's remuneration must not be below what would be regarded as a normal remuneration. The Committee has

The authors of the above-mentioned Report wrote "*persons controlling the undertaking*". At what level one can speak of "persons controlling the undertaking" is mentioned neither in this article nor its Commentary, nor in other parts of the 1927 Report and previous Reports.[707] That the words "control" and "controlling" have a meaning can be argued with reference to section 5.1.1 of this chapter. The 1923 Report written by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp mentioned even then a managerial control and a final control. I was unable to find any explanation on the expression "control" in the 1923 and 1927 Reports.

5.1.4. The 1928 Report of the General Meeting of Government Experts

The League of Nations continued their efforts to prevent double taxation. In 1928 the General Meeting of Government Experts presented a Report on

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not expressed an opinion on the point whether purchasing offices or sales offices are to be considered as places of business, this being a question of fact.

Paragraphs 2 and 3 of this clause govern the case in which the undertaking possesses permanent establishments in both Contracting States; in that event, "each of the two States shall tax the portion of the income produced in its territory" This is an application of the so-called system of apportioning the income according to its source.

"In the absence of accounts showing the income separately and in proper form, the competent administrations of the two Contracting States shall come to an arrangement as to the rules for apportionment."

These rules will vary essentially according to the undertakings concerned; in certain States account is taken, according to the nature of the undertakings, of the amount of capital involved, of the number of workers, the wages paid, receipts, etc. Similarly, in cases where the products of factories are sold abroad, a distinction is often made between "manufacturing" and "merchanting" profits, the latter being the difference between the price in the home market and the sale price abroad, less cost of transport. These criteria are, of course, merely given as indications.

The last paragraph of Article 5 contains an express exception to the principle laid down in the first paragraph: it provides that income from maritime shipping or air-navigation concerns shall be taxable only in the State in which the real centre of management is situated.

This paragraph may, according to circumstances, be deleted or its provisions limited. They may also be extended to cover river, lake or air navigation. Would the last paragraph of Article 5 be omitted, the rules for apportionment laid down in that article would remain applicable."

[707] League of Nations, *Report on Double Taxation and Tax Evasion*, presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, Document C.216.M.85 (Geneva/London 12 April 1927), pp. 10-11 and 15.

double taxation and tax evasion.[708] This meeting was attended by representatives from 27 countries,[709] a large number in comparison to the four countries represented in the 1920 Committee of Economic Experts, seven countries in the 1925 Committee of Technical Experts and 13 countries in the 1927 Committee. The Meeting unanimously adopted the resolution that the object of the model draft Convention should be to prevent double taxation and tax evasion.[710]

The technical experts stated that their draft bilateral Convention for the Prevention of Double Taxation was particularly applicable to countries that levy impersonal taxes and also a personal general tax. The text model could also be used to serve as model in the event of the simultaneous existence of a general tax in the country of domicile, and schedular taxes in the country of origin. They added that the text of the Convention could be abridged whenever two Contracting States possessed sufficiently similar fiscal systems.[711]

From the very outset it became clear to the General Meeting of Government Experts that it would be highly desirable to draw up such simplified texts in addition to the first text. The Meeting therefore added two new texts of model bilateral Conventions to the draft Convention for the Prevention of Double Taxation. These new text models draw no distinction between impersonal and personal taxes. The first text model applied to relations between countries in which taxation by reference to domicile predominates. The second text model applied to relations between countries having different fiscal systems.[712]

When comparing Arts. 4 and 5 of the 1928 Report with the same articles of the 1927 Report, some differences appear. Art. 4 of the 1928 Report reads:

[708] League of Nations, *Double Taxation and Tax Evasion, Report presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, Document C.562.M. 178 (Geneva: 31 October 1928), distributed to the Council and the Members of the League.

[709] Ibid., p. 5 and pp. 37-38. These countries were Austria, Belgium, Bulgaria, China, Czechoslovakia, Danzig, Denmark, Estonia, France, Germany, Great Britain, Greece, Hungary, the Irish Free State, Italy, Japan, Latvia, the Netherlands, Norway, Poland, Romania, South Africa, Spain, Sweden, Switzerland, the USSR and the United States.

[710] Ibid., p. 5: "The Meeting, which is attended by the representatives of twenty-seven countries, notes that, as regards their main principles, the model draft Conventions prepared by the technical experts constitute a useful basis for discussion for the preparation of model texts, whose object shall be to prevent double taxation and tax evasion".

[711] Ibid., p. 7.

[712] Ibid., p. 7.

"Income from shares or similar interests shall be taxable in the State in which the real centre of management of the undertaking is situated."[713]

Analysis of the text of Art. 4 of the 1928 Report indicates that this is an exact copy of the text of the 1927 Report. The 1928 Commentary on Art. 4 of the Draft Convention 1A uses a similar expression as is used by the 1927 Commentary.[714] The Commentary on Art. 4 of the 1928 Report states:

"Income from shares or similar interests is the subject of Article 4 of the draft; under the provisions of this article, it is taxable in the State in which the real centre of management of the undertaking, that is to say the management and control of the business, is situated, so that the case of a purely nominal centre of management is excluded."[715]

The above-mentioned text of the 1928 Commentary on Art. 4 is identical to the 1927 Commentary on Art. 4. The 1928 Report does not give a definition of the phrase "management and control of the business" either. However, Art. 5 of draft convention 1A of the 1928 Report contains some important differences compared to Art. 5 of the 1927 Report. Art. 5 of the 1928 Report reads:

"Income, not referred to in Article 7, from any industrial, commercial or agricultural undertaking and from any other trades or professions shall be taxable in the State in which the permanent establishments are situated.

The real centres of management, branches, mining and oilfields, factories, workshops, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a bona-fide agent of independent status (broker, commission agent, etc.) shall not be held to mean that the undertaking in question has a permanent establishment in that country.

Should the undertaking possess permanent establishments in both Contracting States, each of the two States shall tax the portion of the income produced in its territory. The competent administrations of the two Contracting States shall come to an arrangement as to the basis for apportionment.

713 Ibid., p. 8.
714 Ibid., pp. 8 and 12.
715 Ibid., p. 12.

Nevertheless, income from maritime shipping and air navigation concerns shall be taxable only in the State in which the real centre of management is situated."[716]

Some phrases of Art. 5 of the 1928 Report were different from the ones published in the 1927 Report.
The phrase "referred to in Article 7" was added in the first sentence. Art. 7 concerns the taxation of salaries.[717] More importantly for this study, the words of the 1927 Report "in which the persons controlling the undertaking or engaged in the trade or profession possess permanent establishments" of Art. 5 of the 1927 Report were replaced by the words "in which the permanent establishments are situated" in the 1928 Report.[718]

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[716] Ibid., p. 8.

[717] I will not discuss this additional sentence as it falls outside the scope of this study.

[718] The Commentary on Art. 5 of the 1928 Report reads as follows:

"This clause has reference to income from any industrial, commercial or agricultural undertakings, and from any other trades or professions, not referred to in Article 7; it is to be taxable in the countries in which the persons controlling the undertakings or engaged in the trade or profession, possess *permanent establishments.*

The word 'undertakings' must be understood in its widest sense, without making any distinction between natural and legal persons.
The second paragraph gives a list of the establishments which are considered as permanent; they are: real centres of management, branches, mine and oilfields factories, workshops, agencies, warehouses, offices and depots, not matter whether such establishments are used by the traders themselves, by their partners, attorneys, or their other permanent representatives.

Nevertheless, the fact that an undertaking has business dealings with a foreign country through a bona-fide agent of independent status (broker, commission agent, etc.) shall not be held to mean that the undertaking in question has a permanent establishment in that country. The words 'bona-fide agent of independent status' are intended to imply absolute independence, both from the legal and economic points of view. The agent's remuneration must not be below what would be regarded as a normal remuneration. The Committee has not expressed an opinion on the point whether purchasing offices or sales offices and plants are to be considered as places of business, this being a question of fact.

Paragraphs 2 and 3 of this clause govern the case in which the undertaking possesses permanent establishments in both Contracting States; in that event, "each of the two States shall tax the portion of the income produced in its territory" This is an application of the so-called system of apportioning the income according to its source.

"The competent administrations of the two Contracting States shall come to an arrangement as to the bases for apportionment."

These bases will vary essentially according to the undertakings concerned; in certain States account is taken, according to the nature of the undertakings, of the amount of capital involved, of the number of workers, the wages paid, receipts, etc. Similarly, in cases where the products of factories are sold abroad, a distinction is often made between "manufacturing"

Art. 5 no longer used the words "persons controlling the undertaking". These words were moved from the Model to the Commentary of the 1928 Report. Art. 5 of the 1928 Report now referred directly to the required presence of the permanent establishment by using the words "the permanent establishments". The Committee provided no reasons why it replaced the text "persons controlling the undertaking" by the words "permanent establishments" and why it moved the first text to the Commentary. The Committee did not elaborate on why it had made these changes to Art. 5 and its Commentary. It may be argued that the Committee wanted to use more general principles and general terms, such as the term "permanent establishment".[719] The reference that can support this view is a phrase from the 1933 Report. The Committee wrote that it was "advisable in the view of diversity of national laws and the extreme complexity and variety of individual cases" to prescribe only general principles".[720] This may indicate that the Committee used terms that were generally known and accepted as standards. It may also be possible that the Committee used terms that should be used as standards in the future. The term "permanent establishment" could be regarded as such a term which the League of Nations preferred to use in its current and future Reports. When we look to the OECD Model, we see that today the term "permanent establishment" is a widely used common expression.

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and "merchanting" profits, the latter being the difference between the price in the home market and the sale price abroad, less cost of transport. These criteria are, of course, merely given as indications.

The last paragraph of Article 5 contains an express exception to the principle laid down in the first paragraph: it provides hat income from maritime shipping or air-navigation concerns shall be taxable only in the State in which the real centre of management is situated.

"If maritime shipping or air-navigation concerns carry on other activities independent of shipping (for example, the business of sale of goods, banking or of a warehouse-keeper), such activities will respectively be dealt with in accordance with the other provisions of this Convention."

Furthermore, the scope of the last paragraph of Article 5 may be extended so as to apply also to river and lake shipping."

[719] See also Altman, Z.D., *Dispute Resolution under Tax Treaties*, IBFD Doctoral Series, Vol. 11 (Amsterdam: IBFD, 2005), pp. 43-52.

[720] Fiscal Committee of the League of Nations, *Report to the Council on the fourth session of the Committee- held in Geneva from June 15th to 26th, 1933*, Document number C.399. M. 204 (Geneva: 1933), p. 2. I quote the relevant text published by the Committee:
"In view of the diversity of national laws and the extreme complexity and variety of the individual cases that arise, the Committee thought it advisable to prescribe only general principles." See also Altman, Z.D., *Dispute Resolution under Tax Treaties*, IBFD Doctoral Series, Vol. 11 (Amsterdam: IBFD, 2005), p. 50.

The phrase "persons controlling the undertakings" had moved from the article itself to the Commentary on Art. 5 of the 1928 Report:

"This clause has reference to income from any industrial, commercial or agricultural undertakings, and from any other trades or professions, not referred to in Article 7; it is to be taxable in the countries in which the persons controlling the undertakings or engaged in the trade or profession, possess permanent establishments."

Surprisingly, on the first page of the 1928 Report, the *Corrigenda* describes that the Commentary on Art 5, phrase

"it is to be taxable in the countries in which the persons *controlling* the undertakings or engaged in the trade or profession, possess permanent establishments." *(Italics, RD)*

should be read as:

"it is to be taxable in the countries in which the permanent establishments are situated."[721]

Thus, the specific expression "persons controlling the undertakings" in Art. 5 was replaced by the term "the permanent establishments". The term "persons controlling the undertakings" was moved to the Commentary. However, the Corrigenda stated that in the Commentary this term should be replaced by the term "permanent establishment". Looking at the development of Art. 5 OECD Model and in particular at the use of the expression "persons controlling the undertakings", I must conclude that in the 1928 Report the expression "persons controlling the undertakings" was systematically replaced by the term "permanent establishment".[722]

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[721] League of Nations, *Double Taxation and Tax Evasion, Report presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, Document number C.562.M. 178 (Geneva: 31 October 1928), distributed to the Council and the Members of the League, p. 1 of the English text model and p. 2 of the French text model.

[722] There were also some other differences in the text of Art. 5 in the 1927 Report and 1928 Report. Art. 5 of the 1927 Report used the following words:

"In the absence of accounts showing this income separately and in proper form, the competent authorities of the two Contracting States shall come to an arrangement as to the rules of apportionment."

In the 1928 Report the Committee of Technical Experts also suggested that a Committee should be set up as part of the League of Nations to study taxation questions. The General Meeting of Government Experts on Double Taxation and Fiscal Evasion examined this suggestion and adopted a resolution. The General Meeting of Government Experts recommended that this new Fiscal Committee should examine the possibility of establishing "rules for the apportionment of the profits or capital of undertakings operating in several countries".[723] The General Meeting itself had not entered into the details of this question.

5.1.5. The 1929 Report of the Fiscal Committee

The Fiscal Committee of the League of Nations was established in 1929. Some of the main issues of this Committee were the examination of the possibility of establishing rules for the apportionment of the profits or capital of undertakings operating in several countries and measures for the avoidance of the double taxation of trusts and companies possessing a large number of transferable securities. At its first session in 1929, the Fiscal Committee held a

In the 1928 Report this sentence read: *"The competent administrations of the two Contracting States shall come to an arrangement as to the basis for apportionment."*
The Commentary of the 1928 Report also gave an explanation of the sentence "each of the two States shall tax the portion of the income produced in its territory". It stated that this sentence is "an application of the so-called system of apportioning the income according to its source". League of Nations, *Double Taxation and Tax Evasion, Report presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, Document number C.562.M. 178 (Geneva: 31 October 1928), distributed to the Council and the Members of the League, p. 12.

[723] Ibid., p. 34 of chapter *Proposals Regarding Future Organisation* reads:
"The Meeting holds, that in addition to the work suggested by the Committee of Technical Experts, the latter might deal with all questions connected with the study of fiscal problems - in particular, methods for the prevention of double taxation in the matter of income derived from patents and authors' rights; rules for the apportionment of the profits or capital of undertakings operating in several countries; measures for the avoidance of the double taxation of trust and companies possessing a large number of transferable securities." See also Fiscal Committee of the League of Nations, *Report to the Council on the work of the first session of the Committee - held in Geneva 26th October 1929*, Document number C.516.M.175 (Geneva: October 1929), p. 4.

preliminary discussion on the whole question.[724] It soon came to the conclusion that, in order to do useful work, it would be essential to have a detailed knowledge of the present practice in the various countries. The Fiscal Committee requested detailed information on the subject from all its Members. The Committee also asked the representative of the International Chamber of Commerce whether that body would co-operate in this enquiry and, if so, to inform it what, in their opinion, would be the best methods of apportionment.[725]
The Fiscal Committee decided to add to the study of this question the examination of a resolution voted by the International Chamber of Commerce at its Congress held at Amsterdam in July 1929. This resolution provided that:

"the fact that an undertaking has business relations with a foreign country through a local company the stock of which it owns in whole or in part, should not be held to mean that the undertaking in question has a permanent establishment in that country".[726]

It is here that for the first time the Fiscal Committee referred to a distinction between an associated enterprise and a permanent establishment in its Reports. Although this resolution was voted by the ICC, the resolution was mentioned in the 1929 Report by the Committee. In the ICC resolution, presence of an associated enterprise did not imply that the undertaking had a permanent establishment. This would mean that separate rules, or at least a statement that specific rules were applicable to associated enterprises, were required for the taxation of associated enterprises if the Committee was to take up this resolution.

This question was examined in detail by the Committee. After discussion, the Committee stated that:

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[724] See also Fiscal Committee of the League of Nations, *Report to the Council on the work of the first session of the Committee - held in Geneva 26th October 1929*, Document number C.516.M.175 (Geneva: October 1929), p. 4.
[725] Ibid., pp. 2-5.
[726] Id, p. 5. The correct resolution was given in the 1930 Report, Fiscal Committee of the League of Nations, *Report to the Council on the work of the second session of the Committee - held in Geneva 31th May 1930*, Document number C.340. M.140 (Geneva: 1930), p. 5, ad 1. I quote here the correct text of the Resolution voted by the ICC at the Amsterdam Congress in July 1929: "The fact that an undertaking has business dealings with a foreign country through a local company the stock of which it owns in whole or in part, should not be held to mean that the undertaking in question has a permanent establishment in that country."

"it became clear that the principle at issue, though of great importance, only *affected a small number of cases.* The Committee also found that this question formed but a part of the general question of the distribution of the profits of industrial or commercial undertakings. It was therefore decided to postpone considerations of this point and to take no decision until the replies to the questionnaire relating to the principal question had been received and analysed."[727] *(Italics, RD)*

The above-mentioned statement may indicate why the Committees did not focus on associated enterprises till 1929. In the post-World War I period in which governments tried to collect revenue for restoring their war-torn economies, the general question of the international distribution of profits had not yet been answered. There were only a few other issues regarding the taxation of concerns, so there was no priority to immediately study the taxation of associated enterprises.

5.1.6. The 1930 Report of the Fiscal Committee

In the 1930 Report the Fiscal Committee appointed a Subcommittee with instructions to submit a draft multilateral convention. This draft convention should be based upon some general proposals and should embody "such other measures to reduce international double taxation as are likely to secure the acquiescence of a considerable number of countries".[728] Among these proposals the Subcommittee had to consider if it were to be desirable to also add the following proposal:

"The fact that an undertaking has business dealings with a foreign country through a local company, the stock of which it owns in whole or in part, should not be held to mean that the undertaking in question has a permanent establishment in that country."[729]

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[727] Fiscal Committee of the League of Nations, *Report to the Council on the work of the first session of the Committee, held in Geneva 26th October 1929*, Document number C.516.M.175 (Geneva: 1929), p. 5.

[728] Fiscal Committee of the League of Nations, *Report to the Council on the work of the second session of the Committee, held in Geneva 31th May 1930*, Document number C.340. M.140 (Geneva: 1930), p. 8.

[729] Ibid., p. 9.

In the 1929 Report the Fiscal Committee had framed a detailed questionnaire on rules for the apportionment of profits from undertakings operating in several countries. The questionnaire was titled "Apportionment Of Profits Or Capital From Enterprises Operating In Several Countries".
This questionnaire was analysed in a report prepared by Professor Adams and added as Appendix II to the 1930 Report.[730] According to Adams, the replies to the questionnaire revealed a great diversity of law and practice regarding most of the subjects to which the questions were addressed.[731] Adams also stated in Appendix II that:

"In assessing the profits of a branch of a foreign company (and more particular in assessing the profits of a subsidiary or filial of a foreign holding company), a large majority of States avowedly seek to determine the profits of the branch separately and for that purpose pay regard only to the accounts of the branch itself, without reference to the accounts of the foreign company."

According to Adams, the separate accounting principle "reveals a close approach to uniformity of law and practice." [732] [733] In Appendix II of the 1930 Report Adams also reported that some countries rewrite the accounts of a company in order to prevent tax evasion or show true income.[734]

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[730] Ibid., Appendix II, pp.10-17.

[731] Ibid., Appendix II, p. 10.

[732] Ibid., Appendix II, pp. 10 and 12, where it is also stated: "Practically all the replies state categorically that the local company, which is a subsidiary of a foreign corporation, is a separate legal entity and enjoys the same treatment as other national companies. It is therefore taxed on the basis of its own accounts." Also on p. 16 of the Report the term "separate accounting" is used explicitly: "Other countries, such as the United States of America, consider the method of "separate accounting" as decidedly preferable to any hard-and-fast formula for allocation".

[733] Nevertheless, Adams also concluded that in cases where separate accounting proves to be unsatisfactory, "various methods of approximation are widely used. But only in a small minority of States is preference given to the "method of apportionment" by which the income of the branch or subsidiary is computed as a fraction of the entire income of the foreign corporation or holding company".

[734] Fiscal Committee of the League of Nations, *Report to the Council on the work of the second session of the Committee, held in Geneva 31th May 1930*, Document number C.340. M.140 (Geneva: 1930), p. 12: " (d) In order to prevent evasion or show true income, the fiscal authorities may allocate income as between the foreign parent company and the local subsidiary (United States of America). (e) Where the profits of a subsidiary are artificially

The term "control" was used in Appendix II. With respect to the question how a country taxes third-country sales profits, Great Britain answered that this "depends upon whether the trade in the third State is *controlled* by the branch".[735] Earlier, in Appendix II South Africa had stated that "if an intermediary stage in a series of business transactions which resulted, as a whole, in the production of income carried out in the Union, no attempt would be made to assess for Union taxation a portion of the profit derived from *transactions* which, as a whole, *were controlled* from outside the Union".[736]
Although Appendix II mentions the term "control" in some places, this term was not explained or clarified. The Appendix describes situations where some countries used the term "control" as a trigger for taxation.
The questionnaire shows that countries already interpreted the term "control" in their own domestic legislation. For example, question A bis A of the questionnaire of Adams reads:

"By what general methods does the Administration of your country arrive at the ascertainment of the profits of trust and holding companies operating in several countries - Where a Holding Company domiciled in one State *controls* one or more Foreign Subsidiary Companies." *(Italics, RD)*

Adams used the term "control" in his questionnaire without any explanation of this term in his communication with the Member countries. There is no explanation of this term to be found in the earlier Reports and Draft Conventions of the League of Nations.

From this, it may be argued that the conceptual meaning of the term "control" was already generally known by the Member countries or that these States applied a common interpretation of the term "control", as their answers to the questionnaire did not contain any indistinctness regarding or comments on the term "control". Obviously, the Member countries accepted the term "control", though the term was not explained in the earlier Reports. As the Member countries would apply their domestic interpretation of a term which was not

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concealed, a charge may be made upon the parent company based upon the true profits of the subsidiary (Great Britain and Spain)."

[735] Ibid., Appendix II, p. 14. Question J reads as follow: *If a company, with its head office in one State, has a branch in your State which makes sales in a third State without having there a permanent establishment, are the profits derived from the sales in the third State ascribed to the branch or to the head office or partly to each?*

[736] Ibid.

explained in the Reports, the question arises why the term "control" was not explained in the earlier Reports. One of the reasons may be that during the 1920s and the early 1930s there were only a few cases in which the taxation of associated enterprises and possible different interpretations of the term "control" might have led to double taxation. My view could be supported by the statement of the Committee that *"it became clear that the principle at issue, though of great importance, only affected a small number of cases"*.[737]
It is also possible that there were different interpretations of "control" in domestic tax law but that the tax authorities paid no attention to these differences, as more important general issues had to be solved first (the allocation problem). Apparently, it was not urgent to hold a discussion on a specific interpretation of the term when the general issues had not yet been solved. From the texts of the Reports it may be concluded that a discussion on the interpretation of the word "control" never took place at the League of Nations' level.

The Committee had difficulties with the taxation of multinational enterprises, as can be illustrated by the following quote:

"The Committee held an exhaustive discussion, which revealed the complexity of the question and the numerous obstacles which face any attempted solution. Nevertheless, while fully realising the difficulty of the task, the Fiscal Committee is of the opinion that the moment has come to deal with the real substance of the question, since, until this is settled, one of the principal causes of double taxation will continue to exist."[738]

Apparently, the Committee was aware that the fact that there was no article dealing with the taxation of associated enterprises caused problems in the field of double taxation. The Fiscal Committee decided that a further study of the apportionment of profits had to be made. A former assistant of Adams, Dr Mitchell B. Carroll, was entrusted with this enquiry.[739]

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[737] Ibid.

[738] Ibid., p. 5.

[739] Fiscal Committee of the League of Nations, *Report to the Council on the work of the third session of the Committee, held in Geneva 06th June 1931*, Document number C.415. M.171 (Geneva: 1931), p. 5.

5.1.7. The 1931 Report of the Fiscal Committee

In the 1931 Report the Fiscal Committee asked the Subcommittee to consider whether it would be desirable to add to Art. 4 concerning company profits the following sentence:

"The fact that an undertaking has business dealings with a foreign country through a local company the stock of which it owns in whole or in part should not be held to mean that the undertaking in question has a permanent establishment in that country."[740]

After some discussion, the Subcommittee considered that this addition would lead to considerable difficulties and decided to reject it. It was only in 1933 that the Committee again took up this proposal.

5.1.8. The 1933 Report of the Fiscal Committee

In 1933 Carroll reported to the Fiscal Committee on the enquiry into the apportionment of profits which he had conducted in a large number of countries.[741] [742] The Fiscal Committee stated:

"Mr. Carroll's very detailed report can be usefully consulted as a guide for the application of those principles to the complex cases that are encountered in practice. The fundamental principle laid down is that, for tax purposes, permanent establishments must be treated in the same manner as independent enterprises operating under the same or similar conditions, with the corollary that the taxable income of such establishments is to be assessed on the basis of their separate accounts."[743]

In this statement the Committee stressed two major principles which form an important basis for the current Art. 9 OECD Model. The first principle is the

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740 Ibid., Appendix I, p. 9.

741 League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV, Document No. C.425(b).M.217 (b).1933.II.A. (Geneva: 1933).

742 Fiscal Committee of the League of Nations, *Report to the Council on the fourth session of the Committee, held in Geneva from June 15th to 26th, 1933*, Document number C.399. M.204 (Geneva, 1933), p. 1.

743 Ibid., p. 2.

arm's length principle and the second principle is the separate accounting principle. I refer to Chapter 2 for a an analysis of these principles.

The Subcommittee submitted to the Committee recommendations covering the field of the allocation of profits in the form of a draft Convention. The Subcommittee indicated that those recommendations could either be embodied in international conventions or be introduced directly into the legislation of the different countries. After a thorough discussion of the text submitted, the Committee agreed to this draft. It is this draft which introduced Art. 5, the predecessor of Art. 9 OECD Model:

Article 5 of the 1933 Draft Convention reads:[744]

"When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and as the result of such situation there exists, in their commercial or financial relations, conditions different from those which would have been made between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the law of the State of such enterprise".

Finally there was a separate article dealing with the transactions between associated enterprises. The predecessor of the current Art. 9 OECD Model is very important for this research. Looking at the text of the current Art. 9 OECD Model, I note that the text of Art. 5 of the 1933 Draft Convention has not been changed significantly. By analysing Art. 5, I hope to find more information on the use of the terms "associated enterprises" and "participation in management, control or capital" that are used in Art. 9 OECD Model.

When analysing Art. 5 and comparing it with Art. 9 OECD Model, I have discovered some interesting differences. First of all, the current Art. 9 (1) (b) OECD Model reads:

[744] Ibid., Annex, p. 4.

"[...] the same *persons* participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State [...]"[745]

This means that if only *one person* controls two or more enterprises, then Art. 9 OECD Model would not be applicable. This is strange as Art. 9 (1) (a) OECD Model deals with *one* enterprise participating directly or indirectly in the management, control or capital of an enterprise of the other Contracting State. The question arises why the OECD chose to use *persons* instead of *person*. The OECD Model does not provide any explanation of the term "persons" in Art. 9 OECD Model. The text of Art. 5 of the 1933 Report uses the word "interests". This means that Art. 5 would also have been applicable when only *one person* controls both enterprises. That is in line with the first part of Art. 5.
The OECD probably replaced the term "interests" by the term "persons" without realising that the term "persons" would make Art. 9 OECD Model inapplicable to situations when *one person* controls both enterprises. A parent-subsidiary situation is covered, but a parent participating in two subsidiaries would not be covered by Art. 9 OECD Model? This is definitely not in line with the other parts of Art. 9 OECD Model. It is therefore remarkable that today Art.9 OECD Model still includes the word "persons", even though the use of this word excludes certain situations of association.

One of the other important findings is that Art. 5 of the 1933 Draft Convention refers to a *"dominant participation in the management or capital of an enterprise"*. Art. 9 OECD Model reads: "an enterprise [...] participates directly or indirectly in the management, *control* or capital of an enterprise".

Art. 5 of the 1933 Draft Convention does not use the expression *"participation in control"* as the current Art. 9 OECD Model does. Despite the fact that the term "control" was already used in the earlier Reports of 1927, 1928 and 1930 the Committee decided to limit Art. 5 only to "dominant participation in management or capital". The authors of the 1933 Report did not elaborate on why they did not use the term "control" as in "participation in control". However, this may be explained by looking at section 4.1.3. The purpose of the combination of the words "management and control" in Art. 4 (taxation of interest) was to prevent tax evasion and tax manipulation. By *not* using the term "control" and therefore only using the term "management" tax evasion might

[745] Art. 9 (1) (b) OECD Model.

result. In the above-mentioned Art. 5 of the 1933 Draft Convention, the term "control" was not used as a separate participation criterion. Instead, the term "dominant" was used to *support* the other two participation criteria. A *controlling influence* through management or capital would generally cover all cases. What is the difference between "dominant participation" and "participation"? If we look at the term "dominant participation in the capital of an enterprise", it may be argued that only specific levels of participation qualify for the application of Art. 5 of the 1933 Draft Convention. Looking at the question whether indirect investments, such as portfolio investments, would qualify as associated enterprises for the application of Art. 9 OECD Model, it can be argued that the term "dominant" indicates that *only* those participations in management and capital qualify as associated enterprises, if those participations lead to a dominating influence in the company. This is in line with sections 3.4.3 and 3.4.4 of this book. The expression "are owned or controlled" does not refer to *de facto* control. At that time, Carroll interpreted "control" as "control through ownership of stock in a local company" and rejected *de facto* control as a form of association covered by Art. 5.

The Fiscal Committee was of the opinion that not every level of participation could result in association for the purposes of transfer pricing regulations. The level of participation should be at least "dominant, controlling". In other words, the enterprise holding the participation in the other enterprise should have the ability to dominate or to control the other enterprise's policy for the purpose of profit shifting. From that point of view, it can be concluded that at the time of the introduction of the predecessor of Art. 9 OECD Model, there was no independent and separate participation-in-control criterion. The term "control" or "dominating" had a supporting function: it could be considered to be an additional qualification to the participation-in-management and participation-in-capital criteria.

It is important to realise that the Committee was of the opinion that only those participations in management and capital qualify that are dominant. This can be the case when the participant holds a majority of shares, or at least an amount of shares sufficient to dominate the company.

In the Commentary on Art. 5 of the 1933 Draft Convention the experts stated:

"Article 5 deals with subsidiaries which will be taxed as independent enterprises provided no profits or losses are transferred as a result of the relations between the affiliated companies. If such transfers are effected, the administration will make the necessary adjustments in the balance- sheets."

There were separate rules regarding the taxation of associated enterprises (Art. 5) and permanent establishments (Art.3). Art. 3 of the 1933 proposed Draft Convention reads as follows:[746]

"If an enterprise with its fiscal domicile in one contracting State has permanent establishments in other contracting States, there shall be attributed to each permanent establishment the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Such net income will, in principle, be determined on the basis of the separate accounts pertaining to such establishments. Subject to the provisions of this Convention, such income shall be taxed in accordance with the legislation and international agreements of the State in which such establishment is situated.

The fiscal authorities of the contracting States shall, when necessary, in execution of the preceding paragraph, rectify the accounts produced, notably to correct errors or omissions, or to re-establish the prices or remunerations entered in the books at the value which would prevail between independent persons dealing at arm's length.

If an establishment does not produce an accounting showing its own operations, or if the accounting produced does not correspond to the normal usages of the trade in the country where the establishment is situated, or if the rectifications provided for in the preceding paragraph cannot be effected, or if the taxpayer agrees, the fiscal authorities may determine empirically the business income by applying a percentage to the turnover of that establishment. This percentage is fixed in accordance with the nature of the transactions in which the establishment is engaged and by comparison with the results obtained by similar enterprises operating in the country.

If the methods of determination described in the preceding paragraphs are found to be inapplicable, the net business income of the permanent establishment may be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment has participated. This determination is made by applying to the total income coefficients based on a comparison of gross receipts, assets, number of hours worked or other appropriate factors, provided such factors be so selected as to ensure results approaching as closely as possible to those which would be reflected by a separate accounting."

[746] Fiscal Committee of the League of Nations, *Report to the Council on the fourth session of the Committee, held in Geneva from June 15th to 26th, 1933*, Document number C.399. M.204 (Geneva, 1933).

In above-mentioned Art. 3 of the Draft Convention important principles are mentioned which are also included in Art. 9 OECD Model. First, the Commentary on the above Draft Convention states that a permanent establishment should be treated as an independent enterprise.[747] This is the separate entity approach. The Commentary on Art. 3 also states that when the relationship between the establishments has led to the granting of especially favourable terms to either one of them, which are not at arm's length, the administrations will make the necessary adjustments to the accounts. Here we see the arm's length principle, which is one of the general principles laid down in Art. 9 of the OECD Model[748] and the main principle of current transfer pricing regulations of many countries. In the last phrase the Commentary mentions the formulary apportionment method as an appropriate method of profit allocation. It states that taxation of profits could be done on the basis of the turnover or by some other appropriate method.[749]

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747 Ibid., p. 6.

748 Art. 9 OECD Model (2010) reads: "and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent 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."

749 The Commentary on Art. 3 of the Draft Convention, adopted for the Allocation of Business Income between States for the purpose of taxation, Fiscal Committee of the League of Nations, *Report to the Council on the fourth session of the Committee, held in Geneva from June 15th to 26th, 1933*, Document number C.399. M.204, Annex (Geneva: 1933), p. 6 reads as follows:

"Under Article 3, the fiscal authorities must, in principle, treat a permanent establishment situated in their territory as an independent enterprise.

If the taxpayer produces, in respect of that establishment, separate accounts in proper form which show its relations with the international enterprise to be normal and adequately reflect them, the fiscal authorities will take those accounts as a basis for the assessment.

If, on the other hand, the relationship between the establishments has led to the granting of specially favourable terms to one or other of them, or has caused the accounts to give an inaccurate idea of the situation, the administration will make the necessary corrections.

If the nature or importance of those corrections render[s] such adjustment impossible in practice, the fiscal authorities will resort to another method of assessment and will tax the profits either on the basis of the turnover or by some other appropriate method. These methods will also be applied when the taxpayer does not furnish appropriate accounts or when he agrees to the use of one of these methods.

Article 3 does not expressly regulate the allocation of interest on debts, but it follows from the principles laid down in Article 3 that such interest will not be attributed to an establishment unless it refers to debts contracted by the permanent establishment itself

Carroll also analysed the question of fiscal jurisdiction in his report on the taxation of foreign and national enterprises:[750]

"The question of fiscal jurisdiction has already been settled to a large degree by the tax laws and jurisprudence of a number of countries, by bilateral conventions for the prevention of double taxation, and proposals for its solution are found in the model Conventions for the prevention of double taxation adopted at the General Meeting of Governmental Experts in Geneva, 1928. In substance, this question of jurisdiction is settled by employing only two principles of liability: those of source and fiscal domicile. The principles of taxation at the place of receipt or the place of payment are therefore eliminated. Moreover, the sources mentioned are the immediate sources of income and are not subject to extra-territorial extensions because of a business connection, economic relations *or control through ownership of stock in a local company*." [751] *(Italics, RD)*

Carroll concludes in his report on the taxation of foreign and national enterprises that it is evident from the tenor of Art. 5 and its Commentary that the term "undertaking" or "enterprise" includes, when referring to a corporation, merely the corporate entity and its own branches, forming a part of the single corporate entity. It does not include subsidiary corporations organised in the same or other countries which are themselves separate legal entities, or affiliated corporations which are not *controlled* by the first-mentioned corporation. Carroll notes that the code of principles for eliminating double taxation adopted by the International Chamber of Commerce specifically excludes a subsidiary company from the definition of the term "permanent establishment".[752]

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commensurately with its own needs as an independent enterprise. In the case of debts contracted by the international enterprise, a portion of the interest may be deducted from the income of the dependent permanent establishment, provided that the money borrowed has been used for the particular requirements of that establishment, that the amount corresponds to what would have reasonably been required by an independent enterprise and that the interest charges have not been included in the prices and remunerations entered in the accounts."

[750] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV, League of Nations Document No. C.425(b).M.217 (b).1933.II.A (Geneva: 1933), p. 170.

[751] Ibid.

[752] Ibid., p. 169, footnote.

According to Carroll, the fundamental legal difference between a subsidiary and a branch is the following:

"The fundamental legal difference, however, is that each transaction between the parent company and a subsidiary company, or between two subsidiaries, should be carried out as a legal transaction between independent enterprises, whereas if the corporation carries out its activities through its own branch or branches, it does not generally in practice, nor in law, make contracts with or between such component parts of its own organization."[753]

Carroll illustrates the difference with the following example. If a corporation produces goods at its own factory in one country and sells the goods at its branch in a second country, the corporation does not realise any profit until the goods have been sold to outsiders. This is true even though the goods were billed from the factory to the branch at the independent factory price used in billing goods to outside dealers.[754]
However, the very fact that a subsidiary company is formed to operate an establishment of any kind within a country gives rise to the necessity of carrying on business subject to the same legal requirements as any other corporate entity within the country. The subsidiary must have an adequate capital, and the nature of its activities and its contractual relations with outsiders and other corporate units of the enterprise will determine its income. If its income is diverted to other units of the enterprise in any way, the tax authorities have only to examine the intercompany transactions, appraise their terms and results in the light of sound legal and business principles, or by comparing them to independent companies engaged in similar activities under similar circumstances, and recapture any profit that may be shown to have been diverted.[755]

Before the introduction of Art. 5 in the 1933 Model, Carroll advocated for a separate article concerning the taxation of associated enterprises. He argued in favour of separating the associated enterprise from the permanent establishment concept:

"As the conduct of business between a corporation and its subsidiaries on the basis of dealings with an independent enterprise obviates all problems of

753 Ibid., p. 176.
754 Ibid.
755 *Ibid., p. 177.*

allocation, it is recommended that, in principle, subsidiaries be not regarded as permanent establishments of an enterprise but treated as independent legal entities; and if it is shown that inter-company transactions have been carried on in such a manner as to divert profits from a subsidiary, the diverted income should be allocated to the subsidiary on the basis of what it would have earned had it been dealing with an independent enterprise."[756]

Carroll explains in the above text *when* an adjustment of transactions should take place: when inter-company transactions have been carried out in such a manner as to *divert profits.*

Only when the arm's length principle has been violated are adjustments authorised. Furthermore, Carroll considers the concept of associated enterprises to be a concept based on company law: subsidiary companies that are "*control(led) through ownership of stock in a local company*".

5.1.9. The 1935 Report of the Fiscal Committee

During the fifth session of the Fiscal Committee in 1935 Art. 5, which was introduced in 1933, was renumbered as Art. 6 in the 1935 Report. The text of this article remained unchanged until the Second World War.[757] The text of Art. 3 essentially did not change.[758]

During my research, I was unable to find an answer to the question whether empirical or fractional apportionment methods were allowed to be used as a "back up" method. Indeed, Art. 3 concerning the taxation of permanent establishments did sanction these two methods and preferred the arm's length method. But this was not clearly stated in Art. 5 of the 1935 Report. In 1937 the International Chamber of Commerce commented on the 1935 Report. During its Congress in Berlin, the International Chamber of Commerce wanted it clarified that the empirical method and fractional apportionment method were

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[756] Ibid.

[757] Ibid., p. 6 and Fiscal Committee of the League of Nations, *Report to the Council on the ninth session of the Committee, held at Geneva from June 12th to 21th, 1939*. Document number C.181. M.110 (Geneva: 1939).

[758] Fiscal Committee of the League of Nations, *Report to the Council on the fifth session of the Committee, held in Geneva from June 12th to 17th, 1935*. Document number C.252. M.124 (Geneva: 1935), annex, pp. 5-6.

not available in the associated enterprise context.[759] The International Chamber of Commerce recommended an elimination of these two alternative methods. Because this discussion falls outside the scope of this chapter, I refer to Chapter 2 for an analysis of the arm's length principle.

5.1.10. The 1946 Report of the Fiscal Committee

During the last session the Committee held before the Second World War, it was suggested that a revision should be undertaken of the model bilateral conventions on tax matters which had been prepared in 1928 by the General Meeting of Government Experts on Double Taxation and Fiscal Evasion.[760] Just after the Second World War the Fiscal Committee of the League of Nations held its tenth session in London in 1946. As a result of the meetings in Mexico and in London the experts prepared two Model Conventions. The Fiscal Committee was of the opinion that "the Model Conventions prepared by those experts represent a definite improvement on the 1928 Model Conventions".[761] However, since the membership of the Mexico City and London meetings differed considerably, the Committee thought it was natural that the participants in the London meeting held, on various points, different views from those which inspired the Model Conventions prepared in Mexico.[762] Virtually, the only clauses where there was an effective divergence between the views of the 1943 Mexico meeting and those of the 1946 London meeting were those relating to the taxation of interest, dividend, royalties, annuities and pensions.

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[759] International Chamber of Commerce, *Report on the Work of the International Chamber of Commerce Regarding International Double Taxation* (1939), p. 38.

[760] Fiscal Committee of the League of Nations, *Report on the work of the tenth session of the Committee, held at London from March 20th to 26th, 1946*, Document number C.37. M.37. 1946 II A, (Geneva/London: 1946) communicated to the Council and the Members of the League, p. 6.

[761] Ibid., see also Fiscal Committee of the League of Nations, *Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion. Second Regional Tax Conference, Mexico, D.F. July 1943*, Document number C.2.M.2.1945 II.A. (Geneva: 1945).

[762] Ibid., p. 8: "The general structure of the Model Conventions drafted at the present session is similar to that of the Mexico models. A certain number of changes have been made in the wording, and some articles have been suppressed because they contained provisions already implied in other clauses. On other points, new articles have been inserted to make use of certain innovations contained in conventions, such as those between the United Kingdom and the United States, concluded since the 1943 meeting."

During this tenth session the Committee pointed out that it was desirable to arrive at a comprehensive set of rules regarding the determination and allocation of taxable income in the case of business enterprises carrying on their activities in more than one country. The provisions the Fiscal Committee suggested for that purpose embodied principles that "might require some elaborations as regards the manner in which they should be applied to the various types of enterprises".[763]
It is remarkable that Art. 6 concerning the taxation of associated enterprises of the 1935 Report was not mentioned in the draft of the Model Bilateral Convention for the prevention of the double taxation of income of 1946. Instead, this article was implemented in the Protocol of the London and Mexico Draft Model Tax Convention as Art. VII. This Protocol had to be considered to be an integral part of the Convention.[764]

Art. VII of the Protocol of the Mexico Draft reads:
"When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and, as the result of such situation, there exist in their commercial or financial relations conditions different from those which would have existed between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the laws of the State of such enterprise."[765]

Art. VII of the Protocol of the London Draft reads:
" When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and, as the result of such situation, there exist in their commercial or financial relations conditions different from those which would have existed between

[763] Ibid., p. 10.
[764] As the Introduction of the Protocol stated: "[...] *the undersigned Plenipotentiaries have agreed the following provisions, which shall form an integral part of the said Convention.*" See Fiscal Committee of the League of Nations, *London and Mexico Model Draft Tax Conventions, Commentary and Text- Introduction of the Protocol of the Mexico and London Model Tax Convention*, Document number: C.88.M. 88.1946 II.A (Geneva: November 1946), p. 72.
[765] Ibid., p. 82, Art. VII of the Protocol of the Mexico and London Model Tax Convention.

independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise."[766]

The main differences between the associated enterprises article of 1935 and the above Art. VII of the Protocol were the words *"conditions different from those which would have existed between independent enterprises"* of the 1946 Protocol and the words *"conditions different from those which would have been made between independent enterprises"*.

The requirement of the existence of a *dominant* participation in the management or capital of an enterprise remained unchanged in the 1946 Protocol.

In the Commentary on the London and Mexico Draft Convention no attention was paid to the terms "dominant *participation in the management or capital of an enterprise*". The Commentary described the arm's length principle and the separate accounting method.[767]

During my research on the 1946 Models and Protocols, I found certain articles which also used the same expressions as the article concerning the taxation of associated enterprises. Art. VIII of the London Draft Model Tax Convention, concerning the taxation of dividends, used the following expression:

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[766] Ibid., p. 83, Art. VII of the Protocol of the Mexico and London Draft Model Tax Convention 1946.

[767] Paragraph 8 of Art. V of the London and Mexico Protocol refers to subsidiary companies with the following sentence:
" *8. The fact that a parent company, the fiscal domicile of which is one of the contracting States, has a subsidiary in the other State does not mean that the parent company has a permanent establishment in that State, regardless of the fiscal obligations of the subsidiary toward the State in which it is situated.*" See Fiscal Committee of the League of Nations, *London and Mexico Model Draft Tax Conventions, Commentary and Text*, Document number: C.88.M. 88.1946 II.A. (Geneva: November 1946), pp. 76 and 77. The Commentary on this paragraph 8 of Art. V of the Protocol stated that
" *in taxing the parent company, the authorities of the country in which such (parent) company is situated may not take into account the actual profits made by the subsidiary company in the other country. These rules follow the principle that a subsidiary constitutes a distinct legal entity and should therefore be taxed separately.*" See Fiscal Committee of the League of Nations, *London and Mexico Draft Model Tax Conventions, Commentary and Text*, Document number: C.88.M. 88.1946 II.A. (Geneva: November 1946), Commentary, p. 17.

"dividends paid by a company which has its fiscal domicile in one contracting State to a company which has its fiscal domicile in the other contracting State and has a *dominant participation in the management or capital* of the company [...]" (*Italics, RD*)[768]

Art. X of the London Draft Model Tax Convention, concerning the taxation of royalties, contained also an expression that is used in the predecessor of Art. 9 OECD Model:

"royalties are paid by an enterprise of one contracting State to another enterprise of the other contracting State which has a *dominant participation in its management or capital*, or vice versa, or when both enterprises are *owned or controlled by the same interests* [...]" *(Italics, RD)*[769]

It seems from the above-mentioned articles that the expression "dominant participation in management or capital" and the expression "are owned or controlled by the same interests" were identical to Art. VII of the Protocol and were apparently adopted from Art. VII of the Protocol.

According to the Commentary, Art. VIII of the London Draft was intended to avoid the special cases of double or multiple taxation that *"may occur when the income distributed by a company is derived from dividends received from subsidiaries or related companies, etc. It was thought that an equitable and convenient manner of avoiding such double taxation was to exempt inter-company dividend distributions when the recipient company had a dominant participation in the management or capital of the paying company* [...]"[770]

768 Ibid., p. 65, Art. VIII paragraph 2 of the London Draft Model Tax Convention.
769 Ibid.
770 Ibid., Commentary, p. 25.

5.1.11. Conclusions

Art. 9 OECD Model finds its origin in the early reports of the League of Nations in the 1920s. The term "control" was used as early as 1923 during the first meetings of the Committee of Economic Experts. This Committee referred to two forms of control: a managerial control and a final control. In Art. 4 of the 1927 Report concerning taxation of income from shares "control" was used as an additional criterion to management, so that a purely nominal centre of management was excluded and tax evasion was prevented.

In the 1927 Draft of a Bilateral Convention for the Prevention of Double Taxation Art. 5 dealt with the taxation of permanent establishments, which also included associated enterprises. In the 1928 Commentary on this article, the Committee used the expression "persons controlling the undertaking". This expression was systematically deleted from the Reports.
In 1929 the ICC requested to the League of Nations inclusion of a separate article concerning the taxation of associated enterprises in the Model: "The fact that an undertaking has business dealings with a foreign country through a local company the stock of which it owns in whole or in part should not be held to mean that the undertaking in question has a permanent establishment in that country". In order to discuss this issue, a Subcommittee drafted a detailed questionnaire on the rules for apportionment of profits from undertakings operating in several countries. The term "control" was used in this questionnaire without any explanation. It may therefore be argued that the term "control" was already generally known by the Member countries, or at least how those States interpreted the term "control", as their answers to the questionnaire did not include any comments on the term "control". Apparently, the Member countries accepted the term "control", even though the term was not explained in the earlier Reports.

The Committee stated that the issue of taxation of associated enterprises, though of great importance, affected only a small number of cases. This may be one of the reasons why the League of Nations did not focus earlier on the taxation of associated enterprises. In 1933 Carroll recommended in his report to include a separate article dealing with the taxation of associated enterprises in the Model Convention. In the draft Convention of the 1933 Report the predecessor of Art. 9 OECD Model was included as Art. 5. This Art. 5 reads as follows:

"When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and as the result of such situation there exists, in their commercial or financial relations, conditions different from those which would have been made between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the law of the State of such enterprise".

The main textual difference with the current Art. 9 OECD Model is the absence of the term "participation in control". Art. 5 also includes the term "dominant" in the phrase "*dominant* participation in the management or capital of an enterprise of another Contracting State". These differences are very important for this study as they give a clue as to how to interpret the current participation-criteria of Art. 9 OECD Model. Not every level of participation could result in association for the purpose of this transfer pricing article. Association only exists if there is a participation in capital or management that can dominate or control the other company. The second part of Art. 5 considered a situation where both enterprises are owned or controlled by the same interests. In Art. 9 OECD Model the term "interests" is replaced by the term "persons". As a consequence, Art. 9 OECD Model would not cover situations where one person controls both enterprises. It seems that this would not be in line with the other parts of Art. 9 OECD Model and apparently the OECD did not take into account that replacing "interests" with "persons" would exclude some situations of association.

It may be concluded that the first predecessors of Art. 9 OECD Model did not consider "control" to be a separate independent criterion. There was no independent "control" criterion. Carroll also referred to interconnection envisaged under company law for the application of Art. 5. The expression "owned or controlled by the same interests" did not refer to *de facto* control. Carroll considered the concept of associated enterprises to be a concept based on company law: subsidiary companies that are "*control(led) through ownership of stock in a local company*".

The "associated enterprises" article did not change in the 1946 Model. In this Model the articles concerning the taxation of dividend and royalties also used the same expression to indicate association: "dominant participation in management or capital".

5.2. The period after 1946: the development of Art. 9 OECD Model

5.2.1. The 1958 Report of the Fiscal Committee of the O.E.E.C.

As a result in particular of the work begun in 1920 by the League of Nations, which led to the drafting in 1928 of Model Bilateral Conventions for the avoidance of double taxation, during the inter-war period a network of agreements was created principally between European countries. The work of the League of Nations finally resulted in the Draft Model Conventions of Mexico (1943) and London (1946) which served as a pattern for most of the bilateral Conventions signed or revised just after the Second World War.
In 1956 the Fiscal Committee of the Organization for European Economic Co-operation (OEEC) was set up to study fiscal questions relating to double taxation and other fiscal questions of a similar technical nature.[771] [772]
This Fiscal Committee had to submit a draft convention in 1961 for the avoidance of double taxation with respect to taxes on income and on capital to the Council of the OEEC.
In Chapter II (Article on permanent establishment) of its first Report on the elimination of double taxation in 1958, the Fiscal Committee wrote the following:

"6. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."[773]

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[771] Resolution of the Council C(56) 49 (Final), 16th March 1956. See also Report of the Fiscal Committee of the O.E.E.C., *The elimination of double taxation* (Paris: OEEC, 1958).
[772] The Organisation for European Economic Co-operation came into being with the signing of the Convention for European Economic Co-operation on 16th April 1948, when Member Governments pledged themselves "to combine their economic strength, to join together to make the fullest collective use of their individual capacities and potentialities, to increase their production, develop and modernize their industrial and agricultural equipment, expand their commerce, reduce progressively barriers to trade among themselves, promote full employment and restore or maintain the stability of their economies and general confidence in their national currencies". The United States and Canada participated in all the work of the Organisation as Associate Members.
[773] Report of the Fiscal Committee of the O.E.E.C., *The elimination of double taxation* (Paris: OEEC, 1958), annex p. 34. There was also a note in the Report stating: "*The expression*

If one compares paragraph 6, as quoted above, with Art. VII of the Protocol of the Mexico and London Drafts of 1946, it is remarkable that this paragraph does not use the words "(dominant) participation in the management or capital of an enterprise of another Contracting State" (*brackets, RD*). Instead, it only contains the words "controls or is controlled by". The above-mentioned paragraph 6 was renumbered as Art. 5 paragraph 7 in the OECD Model Tax Convention. Paragraph 7 of Art. 5 OECD Model reads:

"7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other".

The 2010 Commentary on this paragraph reads:

"It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company."[774]

When analysing *Chapter II, Article on permanent establishment* of the 1958 Report and taking into account that this article has not been changed in the 2010 OECD Model, it is surprising that the words "participation in the management or capital" of the above-mentioned 1943 Mexico and 1946 London Drafts are not used. Instead, the 1958 article only uses the words "controls or is controlled". I could not find any reasons given by the authors of the 1958 Report for the use of the words "controls or is controlled" only, so it seems that the authors of the 1958 Report assumed that the words "controls or is controlled" would be clear for the Contracting States and that they indicated a subsidiary company. This would also support an autonomous interpretation of "associated enterprises".

'enterprise of a Contracting State' means an enterprise carried on by a resident of the Contracting State concerned."

[774] OECD Commentary on Art. 5 (7).

Although one might conclude that from the words of Chapter II that the term "control" includes the participation in capital, there is a discrepancy with another chapter of the 1958 Report. Under Chapter IV of the 1958 Report concerning the article on tax discrimination on grounds of nationality or other similar grounds, the Fiscal Committee states:

"5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or *controlled*, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of that first-mentioned State are or may be subjected."[775]

From above paragraph it seems that there was a difference between *owning wholly or partly the capital* and *controlling the capital.* However, the authors of the 1958 Report did not elaborate on the exact differences between those two terms: owning capital and controlling capital. And if the term "control" does include the participation in capital, the authors still do not explain why they use two separate terms. It is also possible that this expression was just an unfortunate formulation at that time.

5.2.2. The 1960 Report of the Fiscal Committee of the OEEC

In the third report of the Fiscal Committee the Committee had agreed on two new articles concerning the allocation of profits to permanent establishments and associated enterprises (Arts. XV and XVI).[776] These two articles followed shortly after the article regarding the concept of the permanent establishment which the Committee presented in its first report. The Committee states that "rules are also needed for calculating the profits of an enterprise of a Contracting State dealing with an enterprise of the other Contracting State, where *one enterprise controls the other or both enterprises are under common control*".[777] *(Italics, RD)*

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[775] Id, p. 37.

[776] Third Report of the Fiscal Committee of the O.E.E.C., *The elimination of double taxation* (Paris: OEEC, 1960), p. 15.

[777] Ibid., p. 17.

I would have expected the Committee to use the phrase "where one enterprise has a dominant participation in management or capital". But instead the Committee wrote "where one enterprise controls the other". Thus, the word "control" is used as a general term which includes the participation in management and capital. Apparently the Committee considers the term "control" to be understood in the same way by all Member countries. Did the Committee assume a *common understanding* of the term "control" in the context of transfer pricing? The Reports remain unclear about this.

The Committee introduced another new term: *under common control*. The Committee does not provide an explanation of the term "under common control". Despite this, the Committee also uses this term in its next reports. Interestingly, there is a phrase in the Report in which the Committee may have stated why it does not clarify the term "under common control". The Committee writes in its third report that it had readopted the underlying principles of the Mexico and London Draft Model Conventions of the League of Nations. The Committee formulates these principles as clearly as possible and defines their practical application on a basis which is acceptable to all Member countries.[778]

The Committee states:

"The Fiscal Committee has not entered in detail into all the problems which can arise when a enterprise in one country makes profits in another, or attempted to draw up precise rules for each individual case. Indeed, this would not have been possible in the relatively restricted scope of an Article in a Convention, in view of the very many forms that international business assumes nowadays."[779]

In the 1960 Report the Committee continued with the words "Article XVI deals with the case of enterprises of a Contracting State which are under the *control of enterprises* of the other Contracting State, and of *enterprises under common control.*"

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[778] Ibid.

[779] Ibid.

Article XVI reads:[780]

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

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

This is the first time that the expression "participates [...] in the management, *control* or capital" appears. The expression "dominant participation in management or capital" as used by the League of Nations was replaced by the expression "participation in management, control or capital". Did the above mentioned Art. XVI provide a fundamental change in the article concerning the taxation of associated enterprises? From the wording of Art. XVI it seems that participation in control is a separate, fully independent criterion for association. However, the OECD did not mention in the Commentary or in the Model that they intend to change "control" from an additional criterion (a *controlling influence on the management or capital*) to an independent, separate criterion for association. At the beginning of this section I quoted this text of the Committee:

"rules are also needed for calculating the profits of an enterprise of a Contracting State dealing with an enterprise of the other Contracting State, where *one enterprise controls the other or both enterprises are under common control*".[781] *(Italics, RD)*

The term "controls the other" replaced the expression "dominant participation in management or capital". It may be argued that the Committee did not intent

[780] Id, Annex A p. 24.
[781] Ibid., p. 17.

to consider "control" a separate, independent criterion for association. It was only used as a reference to the current criteria for association: the dominant participation in management or capital.

As I just mentioned, there are some important differences between the 1946 London and Mexico Drafts and the 1960 Report. In contrast to the 1946 London and Mexico Drafts, which required a "dominant participation", the 1960 Report only requires "participation". Hence, the term "dominant" was removed from the 1960 Report and the term "control" was introduced. One might argue that Art. XVI of the 1960 Report applied a broader concept of association and could therefore be applied to more situations than Art. VII of the Protocol of the Mexico and London Drafts. I do not agree with this view. The term "dominant" was replaced by "control" and there was no explanation provided by the Committee. The Committee did not state anything about the scope of associated enterprises being broadened.

Secondly, the phrase of the 1946 London and Mexico Drafts "an enterprise of one contracting State has a dominant participation in the management or capital of [...]" is replaced in the 1960 Report by *"an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of [...]"*.

What the interpretation should be of the term "control" was not mentioned by the authors of the 1960 Report. Chapter IV of the 1958 Report did use "control" ("the capital of which is wholly or partly owned or *controlled*") and Chapter II of the 1958 Report also used the term "control" ("the fact that a company [...] controls or is controlled by"), but neither of these chapters elaborated on the expression "control". Even after analysing the Commentaries and the Working Party reports, I was unable to find an explanation as to why the term "participation in control" was introduced in Art. XVI of the 1960 Report and why it replaced the expression "*dominant* participation". If the OECD intended to broaden the scope of associated enterprises with a separate independent criterion (control), then the Committee would have mentioned this in its Working Party meetings or other Reports. I was unable to find an explanation or a statement by the OECD that they intended to broaden the scope of associated enterprises. Apparently, the associated enterprises concept was still based on a *dominating or controlling participation* in management or capital. It seems that "control" is not an independent criterion, but that it refers to a "controlling influence in management or capital". My view is also supported by the bracket-definition provided in the OECD Commentary. This bracket-definition explains associated enterprises from a company law perspective ("parent and subsidiary companies and companies under common control").

The Commentary on Art. XVI states in its general introduction that it might be necessary to have rules for ascertaining profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises *"are member of the same group of enterprises* or *are under the same effective control."*[782] *(Italics, RD)*

To be qualified as a member of the same group generally follows from company law. This refers to the participation-in-capital criterion. Interestingly, on page 17 of the 1960 Report the term "under common control" is used.[783] On page 33 of Annex E of the 1960 Report the term "under the same effective control" is used.[784]
The authors of the Report did not explain or indicate why they use two different terms, "under common control" and "under the same effective control". Did the authors mean the same but did they use different words? I could not find an answer to this question. The Commentary on Art.XVI nevertheless mentioned the following regarding the application of this article:

"[...] when both enterprises are member of the same group of enterprises".[785]
This may be interpreted as a formal criterion based on company law.

The Committee confirms that neither article (XV and XVI) is strikingly novel or particularly detailed.

"The question [...]how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of European double taxation Conventions concluded since the war, and it is fair to say that the solutions adopted have generally conformed a standard pattern."

This "standard pattern" is only based on the Reports and Models of the League of Nations until 1946. At that time, the concept of associated enterprises had been based on a *dominant* participation in the management or capital. If the

782 Ibid., Annex E, p. 33.
783 Ibid., p. 105.
784 Ibid., p. 109.
785 Ibid., Annex E, p. 33.

Committee refers to this standard pattern, it refers to the concept of associated enterprises which was known until 1946. Control was not an independent criterion, but only an additional requirement to the other two criteria (participation in management and capital).
Looking at the current OECD Model Tax Convention, I have to conclude that this *standard pattern* is also to be found in Art. 9 OECD Model. The wording of Art. 9 OECD Model is almost identical to the wording of Art. XVI of the 1960 Report.
My view is supported by the introduction of the "bracket definition". The Committee wrote in its Commentary on Article XVI:

"This Article deals with associated enterprises (parent and subsidiary companies and companies under common control) [...]"[786]

The term "bracket definition" was introduced by Hamaekers in the 1980s to refer to the explanation "parent and subsidiary companies and companies under common control".[787] The bracket definition takes company law as the *only* basis for association. Participation in management and capital find their origin in company law.
It is important to mention that this phrase in the Commentary on Art. XVI is today still present in the 2010 Commentary on Art. 9 OECD Model:

"This Article deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies and companies under common control) on other than arm's length terms."[788]

There was an international consensus on above articles. The articles established by the Fiscal Committee were welcomed by certain international organisations concerned with questions of double taxation and by Governments.[789] [790]

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[786] Ibid., Annex E, p. 42.
[787] See Chapter 3.
[788] OECD Model Tax Convention 2010, Commentary on Art. 9, para. 1.
[789] Report of the Fiscal Committee of the O.E.E.C., *The elimination of double taxation* (Paris: OEEC, 1961) p. 10.
[790] In a Resolution adopted at its XIVth Congress at Basle in September 1960, the International Fiscal Assocation "[...] notes with satisfaction the three reports published in 1958, 1959 and 1960 by the Fiscal Committee of the Organisation for European Economic Co-operation which recommend the inclusion of model clauses in future Conventions between the Member States of that Organisation; invites the Fiscal Committee of OEEC – or

5.2.3. The 1961 Report of the Fiscal Committee of the OEEC

In its reports to the Council in July 1959 and July 1960, the Fiscal Committee submitted a number of articles which, in addition to those it had already submitted in its first report, were intended to form the basis of the next Convention. In the Committee's view "the most important and most difficult question, that of the taxation of dividends, interests and royalties, still remained to be settled.[791]

In the fourth Report, the Committee investigates the taxation of dividends, interests and royalties. The articles dealing with the taxation of dividends, interests and royalties provide information on how to interpret the concept of "associated enterprise". For instance, the purpose of Art. 11(6) OECD Model is to restrict the operation of the provisions concerning the taxation of interest in cases where, *by reason of a special relationship between* the payer and the beneficial owner or between both of them and some other person, the amount of the interest paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they *stipulated at arm's length*."[792] Apparently, this so-called "special relationship" should be the cause of the deviation from the arm's length conditions.

In Annex F of this fourth Report the Fiscal Committee states:[793]

"The Mexico and London drafts give the right to tax dividends to the State in which the capital is invested or in which the company has its fiscal domicile. It is only where a company has a <<dominant participation>> in the management or capital of the company paying the dividends that the London draft allows an exemption in the country where that company has its fiscal domicile. The London and Mexico Conventions have not been adopted by the European States."

Organisation for Economic Co-operation and Development which is likely to succeed it- to continue its work and expresses the conviction that States will be influenced by the work of OECD when concluding new Conventions or revising existing ones; [...]". See the Fourth Report of the Fiscal Committee of the OEEC, *The elimination of double taxation* (Paris: OEEC, 1961), p. 12.

[791] Ibid., p. 7.

[792] OECD Commentary 11(6), para. 32.

[793] The Fourth Report of the Fiscal Committee of the O.E.E.C., *The elimination of double taxation* (Paris: OEEC, 1961), p. Annex F, p. 42.

As mentioned in the previous sections of this chapter, the term "dominant participation in the management or capital" was replaced by "participation in management, control or capital" in Art. XVI.
Hence, it is remarkable that the old expression "dominant participation in the management or capital" as used by the League of Nations was still used in Annex F of the fourth Report of 1961. I would have expected that the Committee would have systematically used the expression "participation in management, control or capital" in all the articles or had at least deleted the expression "dominant participation" in its texts. However, this is not the case in the text related to the taxation of dividends. It is also remarkable that the term "dominant participation" is written between special characters in this fourth Report:

"It is only where a company has a <<dominant participation>> in the management or capital of the company paying the dividends [...]"

At its 7th session in February 1958, the Fiscal Committee of the OEEC appointed Working Party 11, composed of the Delegates for France and Belgium, to study the problems connected with the taxation of interest and to submit proposals with a view to preparing a draft article for the Convention. In a restricted document of this Working Party (FC/WP11(61)2) - the revised fourth report on the taxation of interest- the delegates provided the following comments on the term "special relationship" on 10 April 1961:[794]

"It does not seem possible to give a precise definition of what is meant by "special relationship" referred to above. However, the terms of paragraph 6 of the Article elucidate the general significance which must be attached to this expression. A special relationship between recipient and payer or between either of them and some other person is essentially an economic relationship of dependence and control. In this connection, reference may be made to the cases envisaged in Art. XVI in relation to the taxation of industrial and commercial profits."

This proposed paragraph 6 of the Draft Article on the taxation of interest reads as follows:

[794] Working Party No. 11 of the Fiscal Committee (France – Belgium), *Revised Fourth Report on the Taxation of Interest* (received on 17 April 1961) (Paris, 10 April, 1961), FC/WP11 (61)2.

"Where a special relationship exists between the payer and the recipient which places either of them in a position of dependence upon and under the control of the other, or places both of them in a position of dependence upon and under the control of some other person, and by reason of conditions made or imposed, the amount of interest paid, having regards to the indebtedness in respect of which it exceeds the amount which would but for such relationship have been agreed upon [...]"

However, the Fiscal Committee rejected the above proposal and decided to change the text of this "safeguard clause". According to the Fiscal Committee, this new text was based on the text of the safeguard clause concerning royalties and the new comments thereon submitted by Working Party N° 8 (TFD/FC/123). The new text reads as follows:

"Where, owing to a special relationship between the payer and the recipient or between either of them and some other person, the amount of the interest paid, having regard to the indebtedness for which it is paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the interest shall remain taxable according to the Contracting States' own laws, due regard being had to the other provisions of this Convention."

On as early as 27 February 1961 Working Party 8, which dealt with the article concerning the taxation of royalties, stated:[795]

"The expression "special relationship" in the text must not be understood in a too restricted sense. It is not only between a company and its shareholders or between taxpayers with particularly close economic relations that excessive payments can occur. A personal relationship exists, in general, when there is a community of interests between parties, apart from the legal relationship giving rise to the payment of the royalties."

At the request of the Delegate for Switzerland that the wording of the fourth paragraph of Section b (7) (the safeguard clause for taxation of royalties) was modified so as to make it clear that the meaning of "special relationship" must

[795] Working Party No. 8 of the Fiscal Committee (Germany and Luxembourg), *Revised Third Report on the Taxation of Royalties* (received 24 February, 1961), FC/WP8/61 (1).

be taken to include, in particular, participation in management, control, or capital, and personal relationship by blood or marriage.[796]

The Minutes of the 23th Meeting state the following:[797]

"The Committee then turned to the Belgian reservation on the safeguard clause in paragraph 7 of the Article. The Delegate for Belgium thought that the existence of a special relationship ought not to be made in condition precedent for taxation by the country of source, because in the absence of arrangements for administrative assistance, it was often difficult to prove the existence of such a relationship. The Delegate for the United Kingdom thought that the paragraph could be drafted more precisely, without however going into too many details. The Delegate for Switzerland thought that the Commentary could refer to the special relationship criteria provided in Article 16. [...] considered that a State must not automatically assert its right to tax by reason that such a relationship existed and throw the burden of proof on to the taxpayer. The Delegate for Belgium thought that the Commentary might allow the States a certain latitude in the drafting of the safeguard clause and that they could in particular, agree upon the part of the royalties to be taken as the excess."

It seems that Member countries held different views on the concept of "special relationship", particularly with respect to the associated enterprise concept of Art. XVI.

Finally, paragraph 6 of the Commentary on Art. XXI, concerning the taxation of interest stated:[798]

"33. It is clear from the text that for this clause to apply, the interest held excessive must be due to a *special relationship* between the payer and the recipient or between either of them and some other person. There may be cited as examples cases where interest is paid to an individual or legal person who *directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having common interests with him. These examples,*

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[796] Fiscal Committee, *Minutes of the 23rd Session, held at the Château de la Muette, Paris, on Tuesday 7th, Wednesday 8th, Thursday 9th and Friday 10th March 1961*, FC/M(61) 2 (Paris: 31st March, 1961)

[797] Ibid.

[798] Ibid., Annex G, p. 58.

moreover, are similar or analogous to the cases contemplated by Article XVI regarding industrial and commercial profits." (*Italics, RD*)

A connection between Art. XXI (taxation of interest) and Art. XVI (taxation of associated enterprises) is confirmed in above-mentioned Commentary in the sentence "*These examples, moreover, are similar or analogous to the cases contemplated by Article XVI regarding industrial and commercial profits*".[799]

This special relationship is also mentioned in the fourth Report of 1961. An example can be found in the Commentary on Art. XXI paragraph 6 quoted earlier, concerning the taxation of interest. The Committee gives two examples of a special relationship situation in this paragraph 6:

1. "where interest is paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him"
2. "or is subordinate to a group having common interests with him"

The Commentary also uses the word "moreover" in the sentence:

"These examples, *moreover*, are similar or analogous to the cases contemplated by Article XVI regarding industrial and commercial profits."

Apparently the Committee considered Art. XXI to include the special relationship situations which were covered by Art.XVI (the current Art. 9 OECD Model). However, Art. XXI used the expression "dominant participation in management or capital", whereas Art. XVI used the expression "participation in management, control or capital". Does Art. XVI apply a broader concept of association? It seems that Art. XVI does not apply a broader

[799] The text of Art. XVI of the 1960 Report (current Art. 9 OECD Model) reads:
"Where
a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent 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."

concept of association. This can be concluded from the words "on the other hand".

The Committee continued in Art. XXI with an example of a special relationship which was not covered by Art. XVI:

"34. On the other hand, the concept of special relationship *also* covers relationships by blood or marriage and, in general, *any community of interests* as distinct from the *legal* relationship giving rise to the payment of the interests."[800]

Apparently, "control" covering relationships by blood or marriage and any community of interests distinct from the legal relationship is not a criterion for associated enterprises.

In the Commentary on Art. XXII concerning taxation of royalties the Committee also uses the same phrase as in the Commentary on Art. XXI: [801]

"22. It is clear from the text that for this clause to apply the payment held excessive must be due to a special relationship between the payer and the recipient or between both of them and some other person. There may be cited as examples cases where royalties are paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having common interests with him. These examples, moreover, are similar or analogous to the cases contemplated by Article XVI regarding industrial and commercial profits."

The Committee continues:
"23. On the other hand, the concept of special relationship also covers relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the royalty."

The words "on the other hand" indicate that this type of special relationship is not covered by Art. XVI. Apparently "control" in the context of the concept of associated enterprises should not be interpreted as "all forms of control" situations.

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[800] The Fourth Report of the Fiscal Committee of the O.E.E.C., *The elimination of double taxation* (Paris: OEEC, 1961), Annex F.
[801] Ibid., Annex H, p. 65

Vogel is also of the opinion that the latter types of relationship mentioned in subparagraph 34 of the OECD Model (the above Commentary on Arts. XXI and XXII) are apparently not covered by Art. 9 of the OECD Model Tax Convention (the former Art. XVI of the 1960 Report).[802] Vogel states:

"Article 11 (6) and article 12 (4) restricts application of the distributive rules governing interest (Article 11) and royalties (Article 12) to so much of the amount thereof as has not been fixed excessively by reason of a *special relationship* between the payer and the beneficial owner of between both of them and some other person (Article 11 (6) and Article 12 (4)). Both those provisions are *special rules* which take precedence over Article 9. The term "special relationship" is wider than the criteria which, under Article 9 (1) generate an association of enterprises. Both those provisions, however, apply only to *excessive* interest or royalties. An adjustment of interest or royalty payments which are too low is, therefore, permissible only where the conditions of Article 9 have been met. [...]
In contrast, application of the distributive rules on *interest* (Article 11) and *royalties* (Article 12) presupposes that, between the payer and the beneficial owner or between both of them and some other person, there was *no special relationship* which caused the payment of interest or royalties to be excessive. Such special relationships cover situations of dependency similar to those dealt with in Article 9, and "also ...relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the interest or royalties". Regarding Article 9, this leads to a converse argument, viz. that a relationship by blood or marriage, or any other "community of interests", *can* by itself *not constitute* an "association" within the meaning of Article 9."[803]

The texts of the Commentary of Arts. XXI and XXII provide that any community of interest *distinct* from the *legal* relationship is not an association as covered by Art. 9 OECD Model or its predecessor Art. XVI of the 1960 Report.

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[802] See also Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), pp. 524-525. See also Hamaekers, H., "Introduction to Transfer Pricing", *Tax Treatment of Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), Chapter 5: Associated Enterprises.
[803] Ibid., pp. 524-531.

5.2.4. The 1963 OECD Draft Convention

In 1963 the Fiscal Committee presented a report with the Draft Convention to the Council of the Organisation for Economic Co-operation and Development (OECD). The Fiscal Committee wrote in its General Remark:

"The Fiscal Committee has sought primarily to construct a Draft Convention which can be used in bilateral negotiations between Member countries. Since the work of the League of Nations, the value of a Model Convention has been universally recognized not only by the national authorities but also by the taxpayers themselves. The particular advantage of the Draft Convention established by the Fiscal Committee is that it has been especially designed to meet the present-day needs of Member countries, by experts belonging to the Member countries' tax administrations and responsible for the negotiation and day-to-day administration of double taxation Conventions."

This Model Convention was given the name "the 1963 Draft Double Taxation Convention on Income and Capital of the OECD". Art. XVI of the 1961 Report concerning associated enterprises was numbered as Article 9 in the 1963 Draft Double Taxation Convention on Income and Capital of the OECD.[804]
In the brief analysis of the articles of the draft convention the Fiscal Committee wrote:

"16. Article 9 deals with the case of an enterprise of one Contracting State which is under the control of an enterprise of the other Contracting State and that of enterprises under common control. It provides that in calculating the profits the taxation authorities may rewrite the accounts of such enterprises where and to the extent that, by reason of the special relations between such enterprises, the accounts do not disclose the profit which may properly be taxed in the State concerned on the separate enterprise principle. More detailed rules and procedures for re-allocating income between related enterprises will be considered by the Fiscal Committee in its future work."[805]

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[804] Fiscal Committee of the OECD, *Draft Double Taxation Convention on Income and Capital*, (Paris: OECD, 1963) p. 12.
[805] Ibid.

In this Draft Convention the Fiscal Committee presented an overview of the articles embodied in conventions signed between Member countries from July 1958 to July 1963.[806]
It is particularly interesting to note that Art. 9 concerning taxation of associated enterprises was already embodied in its entirety in ten conventions signed between OECD Member countries in the period between July 1958 and July 1963.[807]

Art. 9 of the 1963 OECD Draft Model Convention reads:

"Associated Enterprises
Where
a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would bê 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 profits of that enterprise and taxed accordingly".[808]

The Commentary on Art. 9 of the 1963 OECD Model provides the following explanation on the question how the concept of "associated enterprises" should be interpreted: "(parent and subsidiary companies and companies under common control)". Below follows the text of the 1963 Commentary on Art. 9:

[806] Ibid., p. 22.
[807] Ibid. The following conventions were signed between Member countries from July 1958 to July 1963, which embodied Art. 9 in its entirety (Art. XVI according to the third Report of the Fiscal Committee of the OEEC): United Kingdom – Sweden, Italy-Norway, Greece-Sweden, Austria- Denmark, Germany- Ireland, Austria-Luxembourg, United States-Luxembourg, Spain-France, Spain- Norway and Spain-Sweden. In the convention Germany-Ireland Art. 9 was not completely embodied in the proposed form, but the text adopted kept the essential provisions of the article.
[808] Ibid., p. 47.

"This Article deals with associated enterprises (parent and subsidiary companies and companies under common control) and provides that in such cases the taxation authorities of a Contracting State may for the purpose of calculating tax liabilities re-write the accounts of the enterprise if as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that country. It is evidently appropriate that rectification should be sanctioned in such circumstances, and the Article seems to call for very little comment. It should perhaps be mentioned that the provisions of the Article apply only if special conditions have been made or imposed between two enterprises. No rewriting of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms."

Remarkably, the term "common control" is used in the same Commentary on Art. 7. The Commentary on Art. 7 reads as follows:

"The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under *common control*, has had to be dealt with in a large number of European double taxation Conventions concluded since the war, and it is fair to say that the solutions adopted have generally conformed to a standard pattern. It is generally recognized that the essential principles on which this standard pattern is based are well founded, and it has been thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater clarity. The two Articles incorporate a number of directives. They do not, nor in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another [...] and it would be quite impossible within the fairly narrow limits of an Article in a double taxation Convention to specify an exhaustive set of rules for dealing with every kind of problem that may arise. This, however, is a matter of relatively minor importance. If there is agreement on general lines. Special cases may require special considerations, but it should not be difficult to find an appropriate solution if the problem is approached within the framework of satisfactory rules based on agreed principles." (*Italics, RD*)

Apparently the above-mentioned text shows that the Committee was convinced that there was a common understanding among Member countries on how the concept of "associated enterprises" should be interpreted. Or at least it shows that the Committee did not find it necessary to lay down precise rules on how to interpret the concept of "associated enterprises". This evidences the existence of an autonomous interpretation of the notion of "associated enterprises".

As already mentioned, the Commentary on Art. 11 paragraph 6 of the 1963 OECD Draft concerning the taxation of interest is also important for this research, and it states:

"34. It is clear from the text that for this clause to apply the interest held excessive must be due to a special relationship between the payer and the recipient or between either of them and some other person. There may be cited as examples cases where interest is paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having common interests with him. These examples, moreover, are similar or analogous to the cases contemplated by Article 9 on the taxation of associated enterprises."[809]

Apparently, the cases contemplated by Art. 9 include one controlling the other, being controlled by one, and one being subordinate to a group having common interests. Unfortunately Art. 9 OECD Model does not provide any clarification of these types of *control*.

5.2.5. The 1963 OECD Draft Convention: Revised text of certain articles of the 1963 OECD Draft Convention, issued in April 1972

The OECD issued a document which contains the revised texts of Arts. 1, 2, 3, 6, 8, 9, 11, 12, 13, 22 and 25 of the Draft Double Taxation Convention on Income and Capital of 1963 and of the Commentaries on these articles.[810]
When this document was published, these texts were not the subject of a Recommendation by the Council of the OECD. Therefore, these texts did not commit the Governments of Member countries.[811] The revised articles and Commentaries would be incorporated in the complete revised Draft Double

[809] Ibid., p. 115.
[810] OECD, *Revised text of certain articles of the 1963 OECD Draft Double Taxation Convention on Income and Capital and of the Commentaries Thereon* (Paris: OECD, April 1972).
[811] Ibid., p. 1.

Taxation Convention on Income and Capital, which the Committee intended to submit to the OECD Council at a later date.
The document includes a revision on Art. 9 Associated Enterprise of the 1963 OECD Draft Convention. The document mentioned that the text of Art. 9 was still subject to possible amendments as a result of work done by Working Group 7 of the Committee on Fiscal Affairs.[812] The most important change for the purpose of this study was the introduction of paragraph 2 in Art. 9 OECD Model.

The first paragraph of Art. 9 of this document is identical to Art. 9 of the 1963 OECD Model Tax Convention:

"Article 9 Associated Enterprises

1. Where

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

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

The second paragraph is a new paragraph:

"2. Where profits on which an enterprise of a Contracting State has been charged to tax in that State are also included in the profits of an enterprise of the other Contracting State and taxed accordingly, and the profits so included are profits which would have accrued to that enterprise of the other State if the conditions made between the enterprises had been those which would have

[812] Ibid., p. 6.

been made between independent enterprises, then the first-mentioned State shall make an appropriate adjustment to the amount of tax charged on those profits in the first-mentioned State. In determining such an adjustment due regard shall be had to the other provisions of this Convention in relation to the nature of the income, and for this purpose the competent authorities of the Contracting States shall if necessary consult each other."

This newly introduced paragraph refers to the corresponding adjustment and to mutual agreement procedures. I refer to section 2.4.3.1 for an analysis of Art. 9 (2) OECD Model.

5.2.6. The 1976 OECD Declaration on International Investment and Multinational Enterprises

In 1976 the governments of OECD Member countries issued the OECD Declaration on International investments and multinational enterprises.[813] In this declaration, the OECD Member countries state that international investment has assumed increased importance in the world economy and has contributed considerably to the development of their countries. Multinational enterprises play an important role in this investment process. According to the OECD Member countries, it seems appropriate to intensify their co-operation and consultation on issues relating to international investment and multinational enterprises through inter-related instruments each of which deal with a different aspect of the matter and together constitute a framework within which the OECD will consider specific issues. The common aim of the Member countries is to encourage the positive contributions which multinational enterprises can make to economic and social progress and to minimise and resolve the difficulties to which their various operations may give rise. In view of the transnational structure of such enterprises, the 1976 OECD Declaration states that this aim will be furthered by co-operation among the OECD countries where the headquarters of most of the multinational enterprises are established and where a substantial part of their operations is located. The Guidelines for Multinational Enterprises, which are annexed to the Declaration of 21th June 1976 by Governments of OECD Member Countries on International Investment and Multinational Enterprises[814], are

[813] OECD, *Declaration on International Investment and Multinational Enterprises* (Paris: OECD, 21 June 1976).
[814] Amended in 1979 and 1984.

designed to assist in the achievement of this common aim and to contribute to the improvement of the foreign investment climate.
The Guidelines for Multinational Enterprises, which take into account the problems which can arise because of the international structure of these enterprises, provides standards for the activities of these enterprises in the different Member countries.[815]

The 1976 OECD Declaration on International Investment and Multinational Enterprises also uses the term "control" without providing any explanation:

"[...] that Member countries should, consistent with their needs to maintain public order, to protect their essential security interests and to fulfil commitments relating to international peace and security, accord to enterprises operating in their territories and *owned or controlled directly or indirectly* by nationals of another Member country (hereinafter referred to as "Foreign-Controlled Enterprises") treatment under their laws, regulations and administrative practices, consistent with international law and no less favourable than that accorded in like situation to domestic enterprises." (*Italics, RD)*

More importantly, in paragraph 8 of the 1976 Declaration the OECD explains the term "multinational enterprise" as follows:

"8. A precise legal definition of multinational enterprises is not required for the purposes of the Guidelines. These usually comprise companies or other entities whose ownership is private, State or mixed, established in different countries and so linked that one or more of them may be able to exercise a significant influence over the activities of others and, in particular, to share knowledge and resources with the others. The degree of autonomy of each entity in relation to the others varies widely from one multinational enterprise to another, depending on the nature of the links between such entities and the fields of activity concerned.
For these reasons, the Guidelines are addressed to the various entities within the multinational enterprise (parent companies and/or local entities) according to the actual distribution of responsibilities among them on the understanding that they will co-operate and provide assistance to one another as necessary to

[815] OECD, *Declaration on International Investment and Multinational Enterprises*, (Paris, OECD, 21 June 1976), para. 6.

facilitate observance of the Guidelines. The word "enterprise" as used in these Guidelines refers to these various entities in accordance with their responsibilities."[816]

The Declaration uses the words "be able to exercise a significant influence over the activities of others" as a reference to "control", but it also defines multinational enterprises as "parent companies and/or local entities". This indicates that "control" may be explained as an additional criterion to a company law-based concept of association.

5.2.7. The 1979 Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises[817]

One of the most important documents on transfer pricing is the 1979 Report on Transfer Pricing and Multinational Enterprises. In the Preface of the 1979 Report, the Committee on Fiscal Affairs describes the term "multinational enterprises". According to the Committee, the term "multinational enterprise" usually means a group of associated enterprises operating across national frontiers.[818] These multinational enterprises have become powerful economic entities, each having –to a large degree- common strategies. The increasingly common phenomenon of related companies operating in a group with some degree of centralised management, yet with the individual members of the group operating under different national laws, has given rise to important problems regarding the taxation of corporate profits.
The 1979 Report states that it was not thought to be necessary to define such expressions as "associated enterprises" or "under common control".[819] The Report states that there was a *broad basis of common understanding* of what was meant.[820]

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[816] Ibid.

[817] OECD, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises*, adopted by the Committee on Fiscal Affairs in January 1979, approved by the Council of the OECD for publication. The Council of the OECD adopted the Recommendation annexed to it on 16 May 1979.

[818] Ibid., para. 1.

[819] OECD, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises*, adopted by the Committee on Fiscal Affairs in January 1979, approved by the Council of the OECD for publication.

[820] Ibid.

The Committee explains the interest of the tax authorities in the 1979 Report. Multinational enterprises may adopt transfer prices which are not arm's length prices in order to minimise tax (for example, by selling goods to a subsidiary in a tax haven country at less than arm's length prices) or they may adopt them for other reasons but, whatever the reason, "whenever intra-group transfers are not carried out at arm's length prices, the result is likely to be that profits are shifted from one company to another company in the group and the tax liability of the relevant companies distorted in consequence". Since national tax authorities need to determine the proper level of taxable profits of the affiliated enterprises operating within their jurisdictions, the transfer pricing policies of multinational enterprises are of great importance to them. Where there are grounds for believing that the taxable profits reported by a member of such a group are unduly low, the relevant national tax authority may have to examine the possibility that this is due to the transfer pricing policy applied by the group.[821]
The Committee states that in the organisation of their intra-group relations multinational enterprises are necessarily confronted with transfer pricing problems –essentially, a price has to be charged for every transaction. Even in seeking to fix its transfer prices on the arm's length basis itself, a multinational enterprise will face problems and the process will be all the more difficult if, as may happen, it is confronted with differing, perhaps conflicting requirements by different administrations. One of these problems could be the danger of double taxation if national tax authorities differ in their approach for tax purposes. Therefore, it is also important to multinational enterprises that common approaches to the resolution of transfer pricing problems should be developed.[822]

Under the aegis of the Committee of Fiscal Affairs of the OECD, a special working group of experts has studied this problem for a number of years. In addition, the group has held technical discussions with representatives of multinational enterprises under the aegis of the Business and Industrial Advisory Committee to the OECD and also with representatives of the Trade Union Advisory Committee to the OECD. Consultations have also taken place with the Secretariat of the Customs Co-operation Council. This report was unanimously adopted by the Committee of Fiscal Affairs in January 1979 and was the subject of a Recommendation of the Council on 16 May 1979.[823]

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[821] Ibid., para. 3.

[822] Ibid., para. 4.

[823] Ibid. See also the Annex of this Report on p. 67.

The main objectives of the 1979 Report are to set out as far as possible the considerations to be taken into account and to describe, where possible, generally agreed practices in determining transfer prices for tax purposes. In fact, this report can be seen as an attempt to set out the considerations to be taken into account, and the means available, for determining an arm's length price in the widely varying circumstances which arise in practice in connection with transactions between associated enterprises. Another purpose of this report is to establish as much as possible an approach with the objective of not only enabling the interests of the national tax authorities involved to be protected, but also of enabling the double taxation of the enterprises involved to be prevented.[824]

Some authors state that the 1979 OECD Transfer Pricing Guidelines were influenced by a proactive policy developed by the US Department of the Treasury. The US authorities showed the OECD Member countries that the problems of transfer pricing had to be solved at an international level and through a uniform principle.[825]

5.3. Conclusions

In the early 1960s the Fiscal Committee of the OEEC had to submit a draft convention for the avoidance of double taxation with respect to taxes on income and on capital to the Council. The Fiscal Committee introduced Art. XVI, the precursor of Art. 9 OECD Model. This Art. XVI was based on Art. VII of the Protocols of the 1943 Mexico Draft and of the 1946 London Draft. Art. VII of the London Draft reads as follows:

"When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and, as the result of such situation, there exist in their commercial or financial relations conditions different from those which would have existed between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner,

[824] Ibid.

[825] Eden, L., *Transfer Pricing and Corporate Income Taxation in North America* (Toronto: University of Toronto Press, 1998).

diverted to the other enterprise, shall be entered in the accounts of such former enterprise."[826]

The Fiscal Committee of the OEEC reformulated Art. XVI as follows:

"*Where*
a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State [...]"

The expression "dominant participation in management or capital" as used by the League of Nations was replaced by the expression "participation in management, control or capital".

From the above analysis of the various Reports written by the Fiscal Committee, it appears that the Fiscal Committee used the word "control" as a generally accepted term. The Fiscal Committee did not provide any explanation of the term "control". However, it used the term in specific phrases such as "where one enterprise *controls* the other or both enterprises are under common *control*". Especially because the Fiscal Committee emphasised that it readopted the underlying principles of the Mexico and London Model Conventions it can be concluded that the Fiscal Committee did not intend to give a different meaning to the term "control" with respect to associated enterprises; otherwise it would have mentioned this in its reports or drafts. The term "participation in control" should be considered to have the same function as the term "dominant" has had in the London and Mexico Models: an additional criterion to the two other criteria of *participation in capital and management*.
Also the Commentaries on the articles concerning the taxation of dividends, royalties and interest indicate that the concept of association in Art. 9 OECD Model is narrower than the "special relationship" concept of those articles:

[826] Fiscal Committee of the League of Nations, *London and Mexico Draft Model Tax Conventions, Commentary and Text,* Document number: C.88.M. 88.1946 II.A. (Geneva/London: 1946), p. 83, article VII of the Protocol of the Mexico and London Draft Model Tax Convention 1946.

"On the other hand, the concept of special relationship also covers relationships by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise [...]".

The Fiscal Committee did not state that it intended to broaden the scope of the associated enterprises concept, neither in the minutes of the Working Parties or in the reports of the Fiscal Committee. In 1961 the Fiscal Committee stated that the solutions adopted have generally "conformed a standard pattern" with respect to the allocation of profits of enterprises under common control. This so-called "standard pattern" has developed since the 1920s, during the publications of the first League of Nations reports.
In 1963 the Fiscal Committee presented Art. XVI as Art. 9 in the 1963 Draft Double Taxation Convention on Income and Capital of the OECD. The text of the Commentary on this Art. 9 stated that this "Article seems to call for very little comment". The conclusion may therefore be drawn, that the underlying concept of "associated enterprises" of 1946 remained unchanged in the new Art. 9 OECD Model. This conclusion is also supported by the 1979 Report, stating that it was not thought to be necessary to define such expressions as "associated enterprises" or "under common control", as there was a *broad basis of common understanding* of what was meant.[827]
I conclude –for the reasons mentioned in this chapter- that the change of wording in 1960 has no material purpose, but is only meant to be a mere drafting improvement.
The history of Art. 9 OECD Model gives evidence for the conclusion that there is an autonomous interpretation of the concept of "associated enterprises": controlling (dominating) participation in capital or management, either by one enterprise in another (Art. 9 (1) (a) OECD Model) or by one or more persons in two different enterprises.

In the next chapter various domestic concepts of "associated enterprises" will be analysed.

[827] OECD Committee on Fiscal Affairs, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979).

Chapter 6: Domestic interpretations of associated enterprises

6.1. Introduction

The purpose of this chapter is to examine the domestic interpretations of the concept of "associated enterprises" in the United Kingdom, the United States, Germany, Sweden, India, the Netherlands, China and Brazil in an effort to determine whether they provide important clues for the interpretation of "associated enterprises" under the OECD Model. It is not my intention to provide a full historical overview of the development of transfer pricing legislation of these countries. However, historical developments in particular in the United Kingdom and in the United States are relevant.
Almost all tax treaties and the domestic tax laws of many countries allow the tax authorities to adjust the profits of enterprises if the allocation of cross-border profits between two associated enterprises is not in accordance with the arm's length principle. Transfer pricing rules generally apply only to controlled transactions (transactions between associated enterprises) and not to all businesses that are subject to income tax laws.[828]
As a consequence of the transfer pricing laws and regulations, controlled transactions are also subject to transfer pricing documentation obligations and other compliance requirements.

Under the OECD Model and virtually all tax treaties, the concept of associated enterprises covers a direct or indirect participation in management, control or capital of an enterprise in another enterprise or direct or indirect participation in management, control or capital of the same person(s) in other enterprises. Under domestic tax laws, the definition of associated enterprises is in many cases even broader and more explicit, covering a wide range of *de jure* relationships between enterprises as well as a number of *de facto* forms of control between enterprises or between enterprises and individuals.
Different domestic interpretations of the concept of associated enterprises may result in double taxation. If the profit of an enterprise in one country is adjusted, but in the other country the enterprise is not recognised as an associated enterprise, double taxation may arise. On the other hand, as also stated by

[828] See also Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61 (Jönköping: Jönköping University, 2009), p. 161.

Hamaekers, undue additional tax may be levied if the scope of "associated enterprises" is too broad.[829]

[829] Ibid. See also Hamaekers, H., "Introduction to Transfer Pricing", *Tax Treatment of Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), Chapter 5: Associated Enterprises.

6.2. United Kingdom

6.2.1. Historical overview – the period before 1946

The development of UK transfer pricing regulations has started in as early as the early 1900s. By the start of the 20th century, many UK companies had overseas activities. Rates of tax tended to be slightly higher in the United Kingdom and additional levies had to be imposed. Before the First World War, manipulation of transfer prices caused taxation problems. In 1908 the Inland Revenue had been obliged to accept that not all of the profits made by a UK-based group could be taxed in the United Kingdom.[830]
With the knowledge that the profits of certain group companies were outside the scope of the UK's tax jurisdiction, the existence of cross-border tax opportunities began to emerge. It seems unlikely that much scope existed for the manipulation of import prices in cases where there were overseas activities, as many companies with overseas operations tended to be managed and controlled from the United Kingdom and therefore were UK resident. However, the Inland Revenue was also worried about non-resident companies which, instead of selling through branches in the United Kingdom, set up subsidiaries to do the selling and charged inflated prices.[831] As a result, Section 31(3) of Finance Act 1915 was introduced. If it appeared that the conduct of the business had been arranged to leave the resident company with less than the ordinary profit, which might have been expected to arise from that business, then the non-resident would be chargeable to tax in name of the resident as if the resident had been its agent.

The text of this Section reads as follows:

"(3) Where a non-resident person not being a British subject or a British, Indian, Dominion, or Colonial Firm or Company, or branch thereof, carries on business with a resident person, and it appears to the Commissioners by whom the assessment is made that, owing to the close connection between the resident and the non-resident person, and to the *substantial control* exercised by the non-resident over the resident, the course of business between those

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830 *Gramophone and Typewriter Ltd. v. Stanley* (1908) 2 KB 89.
831 See also League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV, League of Nations Document No. C.425(b).M.217 (b).1933.II.A (Geneva: 1933), p. 111.

persons can be so arranged, and is so arranged, that the business done by the resident in pursuance of his connection with the non-resident produces to the resident either no profits or less than the ordinary profits which might be expected to arise from that business, the non-resident person shall be chargeable to income tax in the name of the resident person as if the resident person were an agent of the non-resident person."[832] *(Italics, RD)*

Section 31(3) however had little value, since later court decisions casted doubt on the suitability of what was seen as a machinery provision for the purpose of imposing a charge.[833] Is seems that in as early as 1915 there was a focus on a "close connection" between the resident and the non-resident, and a focus on the "substantial control" exercised by the non-resident over the resident. This so-called "substantial control" would imply that the non-resident would be able to dictate the conditions of the transactions between the non-resident and the resident, so that profits may be shifted.

Section 31(3) of Finance Act 1915 also shows that several years before the first meetings of the Fiscal Committee of the League of Nations were held, the term "control" was used in domestic legislation.

The United Kingdom had a significant influence on the early development of the Draft Models of the League of Nations. One of the four economic experts who were entrusted with the enquiry to prepare the first report on double taxation was Sir Josiah Stamp, an economic expert from the United Kingdom.[834] Before the League of Nations dealt with the principal question of income and profit allocation, the UK Finance Act 1915 already provided methods to assess (non-) resident persons. For example, Section 31 (4) of Finance Act 1915 reads:

"Where it appears to the Commissioners by whom the assessment is made or, on any objection or appeal, to the general or special Commissioners that the true amount of the profits or gains of any non-resident person chargeable in the name of a resident person with income tax cannot in any case be readily ascertained the Commissioners may, if they think fit, assess the non-resident person on a percentage of the turnover of the business done by the non-resident person through or with the resident person in whose name he is

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[832] Section 31(3), Finance Act 1915

[833] UK International Manual (hereinafter: INTM) 431070

[834] League of Nations Economic and Financial Commission, *Report on Double Taxation, submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*, Document E.F.S. 73.F.19. (Geneva, 5 April 1923). See also Section 2.4.

chargeable, and in such case section fifty-three of the Income Tax Act, 1842, shall extend so as to require returns to be given of the business so done by the non-resident through or with the resident in the same manner as returns are to be given under that section of the profits or gains to be charged."[835]

In his report *Taxation of Foreign and National Enterprises* of 1933, Carroll described that in the law of the United Kingdom, the local company was taxed as a legal entity on the basis of its separate accounts. But if, owing to the *substantial control* exercised by the parent and the close connection between the two companies, the course of business was so arranged that the subsidiary showed profits less than ought to be expected to arise from its business, the parent may be charged through the subsidiary as agent upon its true profits. Generally, when this rule was invoked, the percentage-of- turnover method was employed to determine the profits as in the case of an ordinary agency or branch. According to Carroll, the principle in the United Kingdom Act was clearly intended to enable the Commissioners to recover tax on profits diverted from the local subsidiary to the foreign parent. In British India, where also a local subsidiary company was regarded as an independent legal entity, the same principle of taxing the subsidiary in the name of the parent as agent had been invoked, but without predicating recourse to this measure upon diversion of profits.[836]

The early UK transfer pricing rules focused on a concept of control, originating from a close connection between two companies. This concept of control was based on the existence of a *substantial control,* meaning that one party is able to arrange the course of business between two parties to the effect that the first party would either have no profits or less than the so-called "ordinary profits which might be expected to arise from that business". However, the Finance Act 1915 did not elaborate further on the term "*substantial control*".

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[835] Section 31(4) Finance Act 1915.

[836] See also League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV, League of Nations Document No. C.425(b).M.217 (b).1933.II.A (Geneva: 1933), p. 111.

6.2.2. Overview: the period from 1946

After the Second World War, the United Kingdom began to negotiate (new) double taxation agreements. The arm's length principle was introduced in Section 469 of the Income Tax Act (ICTA) of 1952, after the Inland Revenue, now Her Majesty's Revenue and Customs (HMRC), attempted unsuccessfully to apply tax treaty provisions to impose the arm's length principle. Before 1952 tax treaties did include an "associated enterprises" article, but there were doubts whether, in the absence of any specific transfer pricing legislation, the Inland Revenue could invoke the arm's length principle.

However, Section 469 was subject to limitations. The broad power which was granted to the Inland Revenue to challenge or change the prices of transactions as reflected in a company's account was regarded as highly contentious by taxpayers. The new regulation only applied to "a body of persons", for example companies and societies, but not to individuals.[837]

ICTA52/S469 provided that where any property was sold and

- the buyer was a body of persons over whom the seller had control or the seller was a body of persons over whom the buyer had control or both the seller and the buyer were bodies of persons and some other person had control over both of them; and
- the property was sold at a price less than 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,

then, in computing the income, profits or losses of the seller for income tax purposes, "the like consequences shall ensue as would have ensued if the property had been sold for the price which it would have fetched if the transaction had been a transaction between independent persons dealing as aforesaid".[838]

In this context, "control" has the meaning given to it by Section 333 (1) of ICTA 1952, which was almost identical to Section 468 of ICTA 1952:

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[837] ICTA88/S770 (1) (a) and ICTA88/S770 (2) (d).

[838] Section 469 *Income Tax Act 1952*.

"Control (except in the expression "central management and control") means, in relation to a body corporate, the power of a person to secure, by means of the holding of shares or the possession of voting power in or in relation to that or any other body corporate, or by virtue of any powers conferred by the articles of association or other document regulating that or any other body corporate, that the affairs of the first-mentioned body corporate are conducted in accordance with the wishes of that person, and, in relation to a partnership, means the right to a share of more than one-half of the assets, or of more than one-half of the income, of the partnership."[839]

It must be noted that already in 1908 the Court elaborated on the term "control". In the *Gramophone and Typewriter Ltd v. Stanley case* (1908) it was stated that:

"[...] even a resolution of a numerical majority at a general meeting of the company cannot impose its will upon the directors when the articles have confided to them the control of the company's affairs. The directors are not servants to obey directions given by the shareholders as individuals: they are agents appointed by and bound to serve the shareholders as their principals. They are persons who may by the regulations be entrusted with the *control* of the business, and if so entrusted they can be dispossessed from that control only by the statutory majority which can alter the articles."[840]

The above legislation (Section 333 (1) ICTA 1952), which contained the arm's length principle, was later included later in the general consolidation of tax law that created the Income & Corporation Taxes Act 1970 to become Section 485 of the ICTA 1970.
It was again consolidated and extended to become Sections 770-773 of the ICTA 1988. The scope of Section 485 was extended several times to cover a range of issues, its application and its operation. For instance, the range of transactions to which it could apply was changed and information-powers criteria were amended. However, none of these extensions changed the basic mechanism of applying the arm's length principle.

There were also developments in case law. The first important court case was the *Watson Brothers v. Hornby* case of 1942.[841] The brothers were poultry

[839] Section 468 (10), ICTA 1952.
[840] *Gramophone And Typewriter Ltd. v. Stanley* (1908) 2 KB 89, pp. 105-106.
[841] *Watson Brothers v. Hornby*, 24TC506 (1942).

farmers and were taxed on their profits under the at that time applicable Schedule B of UK tax law, which only charged a portion of the annual value of the land. They also ran a hatchery, which was a trade under the then applicable Case I Schedule D, because the activities were outside the definition of "husbandry". The brothers used the hatchery as their source of hens for the poultry business, so that it became necessary to consider at what value the chickens should be transferred from the Schedule D trade to the Schedule B farming business. The Inland Revenue relied on the mutuality principle, stating that a man cannot make a profit by trading with himself and therefore that the chickens should be transferred at the cost of rearing them. Market conditions, however, dictated that the chickens could have been sold only for something less than costs: some of the chickens sold had fetched four pence each, whereas the cost of rearing had been seven pence each. The Watson Brothers wrote off the difference between cost and market price and claimed it as a Schedule D loss. The Court upheld the claim that the arm's length principle should apply and allowed the market value (which was lower than cost) as the transfer price.[842]

The *Sharkey v. Wernher* case concerned the value at which horses should be transferred from a commercial stud farm and taken into personal use as racehorses. The House of Lords decided that the market value of the horses should be credited in the stud farm profits and not simply the cost of rearing.[843] Where trading stock is disposed of otherwise than by way of trade, market value should be credited for tax purposes. In *Petrotim Securities Ltd. v. Ayres,* a share-dealing company sold part of its trading stock to an associated enterprise at a gross under-value. The tax authorities held the view, that with regard to the investments which the share-dealing company had held as stock, the disposal at a gross undervalue could not be by way of trade and that consequently market value should be substituted for the agreed sale price.[844]

As a result of the negotiation of double tax agreements, both the arm's length principle and its relevance to the computation of trading profits developed in the United Kingdom. As described above, the impetus for the enactment of what became Section 770 of the ICTA 1988 (ICTA88/S770) came from a

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[842] See also INTM435010.

[843] 36 TC 275 (1955). See also Clark, R., Rose, J. and Wheeler, G., "The Application of Transfer Pricing Rules and the Definition of Associated Enterprises", 6 *International Transfer Pricing Journal* 4 (1999), pp. 144-152.

[844] *41 TC 389 (1963).*

problem which arose in 1950 concerning sales at undervalue by an overseas company to its UK subsidiary. Double taxation agreements included an "associated enterprises" article, but doubts were expressed whether, in the absence of any specific transfer pricing legislation, the Inland Revenue could invoke the arm's length principle to substitute the open market value of the property sold for the price included in the company's books. It was argued that treaties are incorporated into UK law by virtue of what is now ICTA88/S788. As a result, tax treaties could be used as if they were part of the UK domestic code.

Section 770 was introduced in 1988, providing information on the term "control" and criteria of associated enterprises. Section 770 was succeeded by Schedule 28AA in 1998.

6.2.3. Section 770 ICTA 1988

Paragraph 1 of ICTA88/S770 reads as follows:

"1) Subject to the provisions of this section and section 771, where any property is sold and
(a) the buyer is a body of persons over whom the seller has control or the seller is a body of persons over whom the buyer has control or both the buyer and the seller are bodies of persons over whom the same person or persons has or have control; and
(b) the property is sold at a price ('the actual price') which is either-
(i) less than 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 ('the arm's length price'), or
(ii) greater than the arm's length price,
then, in computing for tax purposes the income, profits or losses of the seller where the actual price was less than the arm's length price, and of the buyer where the actual price was greater than the arm's length price, the like consequences shall ensue as would have ensued if the property had been sold for the arm's length price. [...]"[845]

[845] The full text of ICTA88/S770 reads as follow:
(1) Subject to the provisions of this section and section 771, where any property is sold and

ICTA88/S770 does not apply unless the Board of HMRC so directs.[846] This is the "Board's Direction" feature; it provides that the legislation applies only if the Board *so directed*.[847] The reason behind this feature is to provide an element

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(a) the buyer is a body of persons over whom the seller has control or the seller is a body of persons over whom the buyer has control or both the buyer and the seller are bodies of persons over whom the same person or persons has or have control; and
(b) the property is sold at a price ('the actual price') which is either-
(i) less than 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 ('the arm's length price'), or
(ii) greater than the arm's length price,
then, in computing for tax purposes the income, profits or losses of the seller where the actual price was less than the arm's length price, and of the buyer where the actual price was greater than the arm's length price, the like consequences shall ensue as would have ensued if the property had been sold for the arm's length price.
(2) Subsection (1) above shall not apply-
(a) in any case where-
(i) the actual price is less than the arm's length price, and
(ii) the buyer is resident in the United Kingdom and is carrying on a trade there, and
(iii) the price of the property falls to be taken into account as a deduction in computing the profits or losses of that trade for tax purposes; or
(b) in any case where-
(i) the actual price is greater than the arm's length price, and
(ii) the seller is resident in the United Kingdom and is carrying on a trade there, and
(iii) the price of the property falls to be taken into account as a trading receipt in computing the profits or losses of that trade for tax purposes; or
(c) in relation to any transaction in relation to which section 493(1) or (3) applies; or
(d) in relation to any other sale, unless the Board so direct.
(3) Where a direction is given under subsection (2)(d) above all such adjustments shall be made, whether by assessment, repayment of tax or otherwise, as are necessary to give effect to the direction.

[846] ICTA88/S770(2).

[847] See also ICTA88/S772, which reads:
772 Information for purposes of section 770, and appeals
(1) The Board may, by notice given to any body corporate, require it to give to the Board, within such time (not being less than 30 days) as may be specified in the notice, such particulars (which may include details of relevant documents) as may be so specified of any related transaction which appears to the Board—
(a) to be, or to be connected with, a transaction with respect to which the Board might give a direction under section 770; or (b) to be relevant for determining whether such a direction could or should be given in any case; or (c) to be relevant for determining for the purposes of that section what price any property sold would have fetched had the sale been one between independent persons dealing at arm's length.
(2) For the purposes of a notice under subsection (1) above, a transaction is a related transaction if, but only if, it is one to which the body corporate to which the notice is given, or

of taxpayer protection by means of Head Office oversight. The application of

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a body corporate associated with that body, was a party; and for the purposes of this subsection two bodies corporate are associated with one another if one is under the control of the other or both are under the control of the same person or persons.
(3) Where, in the case of a transaction with respect to which it appears to the Board that a direction under section 770 might be given—
(a) one of the parties is a body corporate resident outside the United Kingdom and a 51 per cent. subsidiary of a body corporate ("the parent body") resident in the United Kingdom; and
(b) the other party is, or is a 51 per cent. subsidiary of, the parent body,
the Board may, by notice given to the parent body, require it to make available for inspection any books, accounts or other documents or records whatsoever of the parent body or, subject to subsection (4) below, of any body of persons over which it has control which relate to that transaction, to any other transaction (of whatever nature) in the same assets, or to transactions (of whatever nature) in assets similar to those to which the first-mentioned transaction related.
(4) If, in a case in which under subsection (3) above the parent body is by notice required to make available for inspection any books, accounts, documents or records of a body of persons resident outside the United Kingdom over which the parent body has control, it appears to the Board, on the application of the parent body, that the circumstances are such that the requirement ought not to have effect, the Board shall direct that the parent body need not comply with the requirement.
(5) If, on an application under subsection (4) above, the Board refuse to give a direction under that subsection, the parent body may, by notice given to the Board within 30 days after the refusal, appeal to the Special Commissioners who, if satisfied that the requirement in question ought in the circumstances not to have effect, may determine accordingly.
(6) Where it appears to the Board that a body of persons may be a party to a transaction or transactions with respect to which a direction under section 770 might be given, then, for the purpose of assisting the Board to determine whether such a direction should be given, an inspector specifically authorised in that behalf by the Board may, at any reasonable time, on production if so required of his authority—
(a) enter any premises used in connection with the relevant trade carried on by that body of persons (that is to say, the trade in the course of which the transaction or transactions were effected),
(b) inspect there any books, accounts or other documents or records whatsoever relating to that trade which he considers it necessary for him to inspect for that purpose, and
(c) require any such books, accounts or other documents or records to be produced to him there for inspection.
(7) An inspector's authority for entering any premises under subsection (6) above shall state the name of the inspector and the name of the body of persons carrying on the trade in connection with which the premises are used.
(8) If and so far as the question in dispute on an appeal to the General Commissioners or, in Northern Ireland, to a county court against an assessment to tax arises from a direction of the Board under section 770 the question shall be referred to and determined by the Special Commissioners.

these rules was at the discretion of HMRC. As a consequence, the usual penalties of making an incorrect return did not apply to transfer pricing.[848] This means that local tax officer was obliged to obtain a "direction" before adjusting a taxpayers profit in order to bring it into line with the arm's length principle.[849] ICTA88/S770 applies until 1999. The Corporation Tax Self Assessment Act (CTSA) and the new transfer pricing rules of Schedule 28AA came into effect in 1999.[850] It is useful to give a detailed overview of Section 770 because it provides an analysis of the associated enterprises concept and an explanation of the term "control" for transfer pricing purposes.[851]

ICTA88/S770 applies to transactions between associated persons where the actual price at which property is sold differs from the arm's length price. The legislation is directed primarily against sales at undervalue by UK resident persons to non-residents, and purchases at overvalue by UK resident persons from non-residents. ICTA88/S770 (1) (b) (i) defines the arm's length price as follows:

"The price which it might have been expected to fetch if the parties to the transactions had been independent persons dealing at arm's length."

The above phrase explicitly confirmed the arm's length principle as the standard for transactions between associated enterprises. ICTA88/S770 mandates to adjust the actual sales price to the arm's length price, unless the conditions in ICTA88/S770 (2) (a) (ii) are met:

- the buyer is resident in the United Kingdom and carries on a trade in the United Kingdom; and
- the actual price falls to be deducted in computing the profits of that trade for tax purposes (in case of profits of the seller) or the actual price falls to be regarded as a trading receipt in computing the profits of that trade for tax purposes (in case of profits of the buyer).[852]

Section 770(1) provides when ICTA88/S770 should be applied:

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[848] See Section 770 (2) (d): "unless the Board so direct".

[849] See INTM436050 for detailed information on directions.

[850] See also INTM436010.

[851] The application of S770 has been discussed in TC1 DSG Retail Ltd. And others v. HMRC Commissioners (23 April 2009).

[852] See INTM436020 for a full overview of the application of ICTA88/S770.

- the buyer is a body of persons over whom the seller has control; or
- the seller is a body of persons over whom the buyer has control; or
- both the buyer and the seller are bodies of persons over whom the same person or persons has or have control.

The definition of "body of persons" is included in ICTA88/S132 (1):

"any body politic, corporate or collegiate, and any company, fraternity, fellowship and society of persons whether corporate or not corporate."[853]

ICTA88/S773 (1) explicitly confirms that "body of persons" includes a partnership, but not an individual or a trust. For ICTA88/S770 to apply the controlling party does not have to be a body of persons. It may be an individual or a trust, but the controlled party (or parties) must be a body of persons. Individuals may therefore be party to transactions within the scope of ICTA88/S770, provided that they are the controlling party.

The requirements of association are provided in the same paragraph of ICTA88/S770. Sections 770-773 provide a meaning of control. Section 770 applies to transactions:

-between "bodies of persons" over whom the seller or buyer has control, which include companies, societies, etc. (Sec. 832 ICTA 1988 and partnerships Sec. 773 (2) ICTA 1988), but it excludes individuals.
-where a control relationship existed between those "bodies of persons", which amounted to more than 50% of the voting rights in a company (or the equivalent power obtained through some document other than shares) or a right to more than 50% of the income or assets of a partnership (Section 840 ICTA 1988); and
-where a sale was made at an undervalue or a purchase was made at an overvalue (Section 770 (2) ICTA 1988), so that transfer pricing adjustments could only increase taxable profits.

The term "control" refers to the association between the buyer and the seller. ICTA88/S770 applies to a transaction between a buyer and a seller where:

- The buyer *controls* the seller, or

[853] ICTA88/S132 (1).

- The seller *controls* the buyer, or
- Both are under *common control*.

This raises the question what is meant by the term "control". In contrast to the OECD Model Convention and its Commentary, ICTA88/S773 *Interpretation of Sections 770 and 771* describes where "control" must be concluded:

"(1) Nothing in ICTA88/S770 and 771 shall be construed as affecting the operation of any of the provisions of the 1990 Act.
(2) In sections 770 and 772-
'body of persons' includes a partnership, and
'control' has the meaning given by section 840;
and, for the purposes of ICTA88/S770, a sale shall be deemed to take place at the time of completion or when possession is given, whichever is the earlier.
(3) In determining for the purposes of sections 770 and 771 whether any person (alone or with others) has control over a body of persons-
(a) there shall be attributed to him any rights or powers of a nominee for him, that is to say, any rights or powers which another possesses on his behalf or may be required to exercise on his direction or behalf;
(b) there may also be attributed to him any rights or powers of a person with whom he is connected (within the meaning of section 839 but omitting subsections (5) to (7) and the exception in subsection (4)), including any rights or powers of a nominee for such a person, that is to say, any rights or powers which another possesses on behalf of such a person or may be required to exercise on his direction or behalf.
(4) Sections 770, 771, except subsection (5)(b), and 772 and this section shall, with the necessary adaptations, have effect in relation to lettings and hirings of property, grants and transfers of rights, interests or licences and the giving of business facilities of whatever kind as they have effect in relation to sales, and the references in those sections to sales, sellers, buyers and prices shall be deemed to be extended accordingly."

Paragraph 2 of ICTA88/S773 *Interpretation of Section 770 and 771* and ICTA88/S774 refer to Section 840 for the meaning of control.[854] Section

[854] The text of ICTA88/S774 reads as follows:
774 Transactions between dealing company and associated company
(1) Subject to the provisions of this section, where—

(a) a dealing company becomes entitled to a deduction, in computing the profits or gains of the company for tax purposes for any period, in respect of the depreciation in the value of any right subsisting against an associated company, being a non-dealing company; or
(b) a dealing company makes any payment to such an associated company, being a payment in respect of which the dealing company is entitled to a deduction in computing its profits or gains for tax purposes for any period;
and the depreciation or payment is not brought into account in computing the profits or gains of the non-dealing company, that company shall be deemed to have received on the last day of the period income of an amount equal to the amount of the deduction and shall be chargeable in respect thereof under Case VI of Schedule D.
(2) Where the non-dealing company is carrying on a trade, the income referred to in subsection (1) above shall, if the company so elects, not be so chargeable but shall be deemed to have been a receipt of the trade, or, if the company is carrying on more than one trade, to have been a receipt of such one of the trades as the company may choose.
(3) Where the non-dealing company is carrying on, or was formed to carry on a trade, then if—
(a) either—
(i) the right subsisting against it was a right to the repayment of moneys lent for meeting expenditure which has proved (in whole or in part) abortive, or
(ii) the payment to the company was made for meeting such expenditure, and
(b) that expenditure is such that the company is not entitled in respect of it to any allowance or deduction in computing losses or gains,
subsection (1) above shall not apply in so far as the expenditure proved abortive.
(4) For the purposes of this section—
(a) "company" includes any body corporate;
(b) "dealing company" means a company dealing in securities, land or buildings and includes any company whose profits on the sale of securities, land or buildings are part of its trading profits;
(c) "non-dealing company" means any company which is not a dealing company;
(d) two or more companies shall be treated as associated companies if one has control of the other or others, or any person has control of both or all of them;
(e) references to a company ("the first company") having control of another company ("the second company") shall be construed as references to the first company having control of the second company either by itself or in conjunction with any person having control over the first company, and "control" has the meaning given by section 840;
(f) "securities" includes shares and stock.
(5) Where it appears to the Board that by reason of any transaction or transactions a person may by virtue of this section have incurred any liability to tax, the Board may by notice served on him require him, within such time not less than 28 days as may be specified in the notice, to furnish information in his possession with respect to the transaction or any of the transactions, being information as to matters, specified in the notice, which are relevant to the question whether he has incurred any such liability to tax.

773(3) then goes on to extend ICTA88/S840 by referring to certain rights in determining whether a person has control over a body of persons.
Section 840 reads as follows:

"*840 Meaning of "control" in certain contexts*
For the purposes of, and subject to, the provisions of the Tax Acts which apply this section, "control", in relation to a body corporate, means the power of a person to secure—
(a) by means of the *holding of shares or the possession of voting power in* or in relation to that or any other body corporate; or
(b) by virtue of any powers conferred by the *articles of association or other document regulating* that or any other body corporate,
that the affairs of the first-mentioned body corporate are conducted in accordance with the wishes of that person, and, in relation to a partnership, means the right to a share of more than one-half of the assets, or of more than one-half of the income, of the partnership." *(Italics, RD)*

The concept of control is almost identical to the concept used in ICTA52/S333(1) and ICTA52/S468.
Control is explained as "the power of a person to secure [...] that the affairs of the [...] body corporate are conducted in accordance with [his] wishes." That power must be held by specific means, i.e. by means of

- The holding of shares;
- The possession of voting power;
- Powers conferred by the Articles of Association;
- Powers conferred by another document which regulates the body corporate.

In relation to a partnership, control means the right to a share of more than one-half of the assets, or of more than one-half of the income, of the partnership.

In case there is a "potential participant", who may, for example, have the rights and powers to acquire the ability to control or participate in the management in the future, then special rules apply. These provisions deal with indirect control. Additionally, a person can also be considered to be indirectly a participant in the management or capital of another person if those two persons are joint venture partners and each venture partner has 40% of the holdings, rights and powers of the joint venture company.

The above definition of control provided by Section 840 contains the following elements.
First there must be *power*. A person should have *power* to ensure that the affairs of a body corporate are conducted in accordance with the wishes of that person. The existence of power can be determined by the holding of shares or the possession of voting power. This is in line with the *participation-in-capital* criterion of Art. 9 OECD Model and the *participation-in-management* criterion. A person should have a specific minimum amount of participation in the capital (holding of shares or the possession of voting power) of an enterprise. This threshold should be at least sufficient to ensure that the affairs of this enterprise are conducted in accordance with the wishes of the controlling person.
It follows from Section 840 (b) that the element *participation in capital* is not the only "source of power". The expression "by virtue of any powers conferred by the articles of association or other document regulating that body corporate" apparently refers to specific *company law*-based means, such as the articles of association.

The powers need not be held directly in the body corporate in question, but may be held in any other body, for instance the parent company, provided that the holding confers the appropriate powers in the relevant entity. In relation to a partnership, control means the right to a share of more than one half of the assets, or more than one-half of the income of the partnership.[855]

These control rules make it difficult to apply ICTA88/S770 to joint ventures with a 50/50 participation. However, this has changed with the introduction of Schedule 28AA, see hereafter.[856]

Section 773 not only refers to Section 840, but also to Section 839 for the interpretation of control. ICTA88/839 deals with connected persons. For instance, UK VAT law adopts the definition of "connected persons", which is much broader than Section 840:

"839 *Connected persons*
(1) For the purposes of, and subject to, the provisions of the Tax Acts which apply this section, any question whether a person is connected with another shall be determined in accordance with the following provisions of this section

[855] ICTA/S840 and INTM436040.
[856] See also INTM432070.

(any provision that one person is connected with another being taken to mean that they are connected with one another).

(2) A person is connected with an individual if that person is the individual's wife or husband, or is a relative, or the wife or husband of a relative, of the individual or of the individual's wife or husband.

(3) A person, in his capacity as trustee of a settlement, is connected with any individual who in relation to the settlement is a settlor, with any person who is connected with such an individual and with a body corporate which, under section 681 is deemed to be connected with that settlement ("settlement" and "settlor" having for the purposes of this subsection the meanings given by subsection (4) of that section).

(4) Except in relation to acquisitions or disposals of partnership assets pursuant to bona fide commercial arrangements, a person is connected with any person with whom he is in partnership, and with the wife or husband or relative of any individual with whom he is in partnership.

(5) A company is connected with another company—

(a) if the same person has control of both, or a person has control of one and persons connected with him, or he and persons connected with him, have control of the other; or

(b) if a group of two or more persons has control of each company, and the groups either consist of the same persons or could be regarded as consisting of the same persons by treating (in one or more cases) a member of either group as replaced by a person with whom he is connected.

(6) A company is connected with another person if that person has control of it or if that person and persons connected with him together have control of it.

(7) Any two or more persons acting together to secure or exercise control of a company shall be treated in relation to that company as connected with one another and with any person acting on the directions of any of them to secure or exercise control of the company.

(8) In this section—

"company" includes any body corporate or unincorporated association, but does not include a partnership, and this section shall apply in relation to any unit trust scheme as if the scheme were a company and as if the rights of the unit holders were shares in the company;

"control" shall be construed in accordance with section 416; and

"relative" means brother, sister, ancestor or lineal descendant."

Paragraph 5 of ICTA88/S839 states that there is a connection between two companies when the same person has control of both, or a person has control of one and persons connected with him, or he and persons connected with him, have control of the other. For the term "control", ICTA88/S839 refers to ICTA88/S416, which applies a broader concept of control than ICTA88/S840.

ICTA88/S416 titled *Meaning of associated enterprise and control* reads as follows:

"(1) For the purposes of this Part, except paragraphs 2 and 9 (1) (a), (2) (a) and (3) (a) of Schedule 19, a company is to be treated as another's "associated company" at a given time if, at that time or at any other time within one year previously, one of the two has control of the other, or both are under the control of the same person or persons.

(2) For the purposes of this Part, a person shall be taken to have control of a company if he exercises, or is able to exercise or is entitled to acquire, direct or indirect control over the company's affairs, and in particular, but without prejudice to the generality of the preceding words, if he possesses or is entitled to acquire—

(a) the greater part of the share capital or issued share capital of the company or of the voting power in the company; or

(b) such part of the issued share capital of the company as would, if the whole of the income of the company were in fact distributed among the participators (without regard to any rights which he or any other person has as a loan creditor), entitle him to receive the greater part of the amount so distributed; or

(c) such rights as would, in the event of the winding-up of the company or in any other circumstances, entitle him to receive the greater part of the assets of the company which would then be available for distribution among the participators.

(3) Where two or more persons together satisfy any of the conditions of subsection (2) above, they shall be taken to have control of the company.

(4) For the purposes of subsection (2) above a person shall be treated as entitled to acquire anything which he is entitled to acquire at a future date, or will at a future date be entitled to acquire.

(5) For the purposes of subsections (2) and (3) above, there shall be attributed to any person any rights or powers of a nominee for him, that is to say, any rights or powers which another person possesses on his behalf or may be required to exercise on his direction or behalf.

(6) For the purposes of subsections (2) and (3) above, there may also be attributed to any person all the rights and powers of any company of which he has, or he and associates of his have, control or any two or more such companies, or of any associate of his or of any two or more associates of his, including those attributed to a company or associate under subsection (5) above, but not those attributed to an associate under this subsection; and such attributions shall be made under this subsection as will result in the company being treated as under the control of five or fewer participators if it can be so treated."[857]

Companies are connected if one of the two companies exercises or is able to exercise, or is entitled to acquire, direct or indirect control over the other company's affairs. Furthermore, without prejudice to the previous sentence, association should be determined when one of the two companies possesses or is entitled to acquire the greater part of the share capital or issued share capital of the other company or of the voting power in that other company. Compared to Section 840 which is applicable to transfer pricing, ICTA88/416 (2) includes a loose-end expression:

Control is deemed to exist if "he exercises, or is able to exercise or is entitled to acquire, direct or indirect control over the company's affairs, *and in particular*, but *without prejudice to the generality of the preceding words*, if he possesses or is entitled to acquire [...]". (*Italics, RD)*

Do the words "*but without prejudice to the generality of the preceding words*" indicate that not *only* the holding of shares or voting power results in control? If another form of control were to cover forms of *de facto control*, then this would imply a very strong broadening of the control definition. However, as indicated, the concept of control for transfer pricing purposes is laid down in Section 840. According to Section 773, in Section 770 "control" has the meaning given in Section 840. Section 840 provides that "control" can only exist by means of holding shares, possessing voting power, power conferred by the articles of association or by another document which regulates the body corporate. Although for the interpretation of Section 770 Section 773 *also* refers to Section 839, it excludes Section 839 paragraphs 5 to 7:

"there may also be attributed to him any rights or powers of a person with whom he is connected (within the meaning of section 839 *but omitting subsections (5) to (7) and the exception in subsection (4)*), including any rights or

[857] ICTA88/S416.

powers of a nominee for such a person, that is to say, any rights or powers which another possesses on behalf of such a person or may be required to exercise on his direction or behalf [...]" *(Italics, RD)*.

Paragraphs 5 to 7 of Section 839 provide for those situations where a company is connected with another company. Therefore, the broad control concept of Section 416 is not applicable to the application of Section 770. Instead, *only* the control concept of Section 840 is relevant for Section 770, which precludes other forms of control than "de jure".

There has been very little discussion in the courts of the meaning of control within Section 840.[858] The *CIR v. Lithgows Ltd* case concerned the sale of two ships by L Ltd to N Ltd at less than market value.[859] The Inland Revenue made a direction under the transfer pricing rules on the basis that both companies were under the same control within the meaning of what is now Section 840. The majority of the ordinary shares of L Ltd were held by four trustees of a deed of provision and nearly all those of N Ltd by three trustees of another deed of provision. The first-named trustee of each deed, entitled to exercise the voting rights attached to the shares, was the same person. The Court held that the two companies were not under the same control. According to the Court, control had to be established in accordance with the particular definition in the Section. By providing a definition of "control", Parliament had intended that the test of control for these purposes would be different from the ordinary meaning of control used elsewhere in the legislation. It was therefore not enough that the common trustee held a majority of the votes in each company, as that did not enable him (as one of several trustees) to secure that the affairs of the two companies were conducted in accordance with his wishes alone.[860]

Apparently under Section 840, control is the result of the holding of shares or the possession of voting power or any powers conferred by the articles of association. Control is based on a *de jure* relationship, a relationship based on company law. If there is no *de jure* relationship and control exists only because

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[858] Clark, R., Rose, J. and Wheeler, G., "The Application of Transfer Pricing Rules and the Definition of Associated Enterprises", 6 *International Transfer Pricing Journal* 4 (1999), pp. 144-152.

[859] 39 TC 270 (1960).

[860] Clark, R., Rose, J. and Wheeler, G., "The Application of Transfer Pricing Rules and the Definition of Associated Enterprises", 6 *International Transfer Pricing Journal* 4 (1999), pp. 144-152.

of a *de facto* situation, then it seems that control will not lead to the existence of associated enterprises for transfer pricing purposes. For instance, if one enterprise can control the pricing of another enterprise due to the fact that this first enterprise is the largest or perhaps the only customer of the second enterprise, and both enterprises are not associated through shareholding or management, then this *de facto* control will probably not lead to the existence of association for the purpose of ICTA88/S770.

6.2.4. Schedule 28AA

In 1999 a self-assessment system was introduced for companies. In preparation for this, the Finance Act 1998 significantly revised the transfer pricing rules and inserted these in Schedule 28AA. Schedule 28AA applied to periods ending on or after 1 July 1999. ICTA88/SCH28AA puts the onus on taxpayers to include in their Self Assessment any upward adjustment to their commercial profits that arise from the application of the arm's length principle. The purpose of ICTA88/SCH28AA is to counter tax loss generated by non-arm's length pricing, but it takes no account of whether or not the setting of the original transfer prices has been tax motivated.[861] ICTA88/SCH28AA was amended by the Finance Act of 2004. UK-UK transactions were exempt from transfer pricing rules for the purposes of calculating profits arising prior to 1 April 2004. However, to address uncertainty that arose concerning this exemption following a legal judgment by the European Court of Justice[862], the Finance Act 2004 ended this exemption.

The Explanatory Notes to Schedule 28AA states that this new legislation represents a "modernisation of the UK's transfer pricing regime".[863] According to the Explanatory Notes, ICTA88/SCH28AA brings the UK's transfer pricing regime more closely into line with the internationally recognised statement of the arm's length principle contained in Art.9 OECD Model. Furthermore, it confirms the UK's commitment to international best practice as set out in the OECD TP Guidelines.

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[861] INTM431050.

[862] Case C-324/00 (*Lankhorst-Hohorst*).

[863] Explanatory Notes to ICTA88/SCH28AA, paragraph 23.

The Board's Direction requirement was no longer included in ICTA88/SCH28AA. As taxpayers feared that this new code could weaken the taxpayers' protection during consultations, ICTA88/SCH28AA includes the "Board's Approval", which ensures a level of Head Office oversight in enquiry cases.

Schedule 28AA paragraph 1 reads as follows:

"*Schedule 28AA*
Provision not at arm's length
Basic rule on transfer pricing etc.

1. (1) this Schedule applies where –
   (a) Provision ('the actual provision') has been made or imposed as between any two persons ('the affected persons') by means of a transaction or series of transactions, and
   (b) At the time of making or imposition of the actual provision-
      (i) One of the affected persons was directly or indirectly participating in the management, control or capital of the other; or
      (ii) The same person or persons was or were directly or indirectly participating in the management, control or capital of each of the affected persons.

   (2) Subject to paragraphs 8, 10 and 13 below, if the actual provision-
   (a) differs from the provision ('the arm's length provision') which would have been made as between independent enterprises, and
   (b) confers a potential advantage in relation to United Kingdom taxation on one of the affected persons, or (whether or not the same advantage) on each of them,

the profits and losses of the potentially advantaged person or, as the case may be, of each of the potentially advantaged persons shall be computed for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision.

(3) For the purpose of this Schedule the cases in which provision made or imposed as between any two persons is to be taken to differ from the provision that would have been made as between independent enterprises shall include the case in which provision is made or imposed as between any two persons but no provision would have been made as between independent

enterprises; and references in this Schedule to the arm's length provision shall be construed accordingly."[864]

Paragraph 1 contains the basic transfer pricing rule, which is based upon the arm's length principle. It is widely drawn and is subject to the rules of construction in paragraph 2 of ICTA88/SCH28AA. It says that Schedule 28AA applies where a "provision" is made between two persons "by means of a transaction or series of transactions" *and* one of the affected persons was directly or indirectly participating in the management, control or capital of the other, or the same person or persons was or were directly or indirectly participating in the management, control or capital of each of the affected persons. ICTA88/SCH28AA applies to any situation where there is a provision between two connected persons and one person controls the other, or both are controlled by a third party. The controlled person must be a body corporate or a partnership. The controlling party, however, could be an individual.[865]

A transfer pricing adjustment is only allowed where the result of the actual provision compared with the arm's length provision results in a UK tax advantage for the person(s) concerned.[866] According to paragraph 5(1) of Schedule 28AA, a UK tax advantage exists when the effect of the actual provision is to reduce taxable profits or increase tax loses for any chargeable period.

Paragraph 1 uses an almost identical expression to that used in Art. 9 OECD Model. It uses the words "directly or indirectly participating in the management, control or capital of the other". Schedule 28AA applies to "persons" rather than to enterprises. However, the requirement of consistency between the legislation and the OECD Guidelines had led HMRC to issue guidance on the circumstances in which the legislation will not apply to a person acting in a capacity other than that of an enterprise. The guidance specifically refers to individuals and charities in this context.

Paragraph 1(2) (b) of Schedule 28AA requires that one of the persons involved in the transactions should have a tax advantage.

Paragraph 2 of Schedule 28AA reads as follows:

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[864] ICTA88/SCH28AA (1).
[865] INTM431060.
[866] ICTA88/ SCH28AA (1) (2).

"*Schedule 28AA*

Principles for construing rules in accordance with OECD principles

2. (1) This Schedule shall be construed (subject to paragraphs 8 to 11 below) in such manner as best secures consistency between-

(a) The effect given to paragraph 1 above; and

(b) The effect which, in accordance with the transfer pricing guidelines, is to be given, in cases where double taxation arrangements incorporate the whole or any part of the OECD Model, to so much of the arrangements as does so.

(2) In this paragraph 'the OECD Model' means-

(a) the rules which, at the passing of this Act, were contained in Article 9 of the Model Tax Convention on Income and on Capital published by the Organisation for Economic Co- operation and Development; or

(c) any rules in the same or equivalent terms.

(3) In this paragraph 'the transfer pricing guidelines' means-

(a) all the documents published by the Organisation for Economic Co-operation and Development, at any time before 1st May 1998, as part of their Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations; and

(b) such documents published by that Organisation on or after that date as may for the purpose of this Schedule be designated, by an order made by the Treasury, as comprised in the transfer pricing guidelines.[867]

Paragraph 2 sets out rules on construing the basic pricing rule contained in paragraph 1. The Schedule is to be construed in a manner consistent with the effect given to the arm's length principle as expressed in the OECD Model and elaborated in the OECD TP Guidelines.[868]

In paragraph 2 it is stated that Schedule 28AA should be interpreted consistently with the OECD Model and the OECD TP Guidelines. The OECD TP Guidelines are imported directly into UK legislation under paragraph 2 of Schedule 28AA. According to the Explanatory Notes to ICTA88/SCH28AA, paragraph 2 requires that Schedule 28AA should be "construed so as to achieve consistency between the *effect* given to paragraph 1 and the effect given to the

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[867] ICTA88/SCH28AA (2).

[868] See also INTM432030.

OECD Model wording where that or similar wording is incorporated in a double taxation agreement."[869]

In construing Schedule 28AA, regard must also be had to the OECD TP Guidelines. According to the Explanatory Notes, the United Kingdom has played a leading role in the development of these guidelines, and the new legislation underlines the UK's endorsement of them.[870]

As a consequence, the concept of "associated enterprises" which follows from the OECD Model, would be highly relevant for the application of this section. This is also confirmed by HMRC, when it stated:

"Where interpretations of the basic rule conflict, the OECD material takes precedence. The reference to the OECD Transfer Pricing Guidelines means documents published by the OECD before 1 May 1998 with any documents published in the future being included only if they are designated by an order made by the Treasury. The legislation requires interpretation in accordance with Article 9 and the OECD Transfer Pricing Guidelines regardless both of whether there actually is a double taxation agreement between the UK and the other country in question, and of the specific wording of any individual agreement."[871]

The legal basis for the application of the arm's length principle can be found in paragraph 2 of Schedule 28AA ICTA 1988. The rule does not apply to connected party cases where the only effect of non-arm's length pricing is to overstate taxpayers' profits for UK tax purposes. The rule applies where the effect of connected party pricing is the understatement of a taxpayer's profits or overstatement of losses for UK tax purposes.

Paragraph 2 of ICTA88/SCH28AA uses the term "persons" whereas Art. 9 OECD Model uses the term "enterprises". This indicates that ICTA88/SCH28AA has a broader scope; it includes bodies corporate, partnerships *and* individuals.
However, sub-paragraphs (1)2 and (1)3 of this Schedule require the actual provision to be compared with the arm's length provision that would have been

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[869] Explanatory Notes to ICTA88/SCH28AA, para. 50.
[870] Ibid., para. 51.
[871] INTM432030.

made between independent *enterprises*. Also paragraph 2 of ICTA88/SCH28AA states that this Schedule shall be construed in accordance with Art. 9 OECD Model and the OECD TP Guidelines, which focus on enterprises. This raises the question how the term "person" in Schedule 28AA should be interpreted: only as a 'body corporate' or partnership? INTM432090 indicates that the term "persons" should be interpreted broadly. According to INTM432090, this term encompasses more than trading activity: "a natural interpretation implies an intention to make profit or gain, or to undertake activity in a businesslike or commercial way".[872] HMRC confirms that there is likely to be little doubt that both parties to a provision are enterprises. But it also confirms that there are situations which may be less clear whether Schedule 28AA should be applied. This includes situations regarding individuals and charities. According to HMRC, it might be clear in some situations that both individuals and charities can act in a way that would cause them to be regarded as enterprises. This conclusion will follow whenever a trade is being carried on or in other cases where activities are carried on in an organised way with a view to profit or gain. It is therefore possible, that different conclusions will follow from different provisions made by the same person; some transactions may be made carried out in a capacity unrelated to an enterprise that is being carried on while others may be made in the context of the enterprise.[873]

INTM432090 provides examples of where ICTA88/SCH28AA could be applied or not applied to individuals:

- Participation in the management or control of a company does not in itself constitute the carrying on of an enterprise.
- If a company provides residential accommodation rent free to a participant who just makes personal use of it as their home, transfer pricing rules would not generally apply.
- Holding investments in a close investment holding company would not constitute an enterprise for the purpose of considering provisions made between the company and the individual.
- Lending to connected companies may or may not constitute an enterprise. If the activity is undertaken in a businesslike way with a view to generating gains on shares in the company, this is likely to represent a form of enterprise. On the other hand, isolated loans where

[872] INTM432090.

[873] Ibid.

> the intention is to provide long-term funding for a family business may well not be made in the context of an enterprise.[874]

Furthermore, INTM432090 explains that companies which are established on a non-profit basis will nonetheless carry on an enterprise if they undertake a commercial activity in a businesslike way.

Paragraph 4 of Schedule 28AA reads as follows:

"Schedule 28AA
Participation in the management, control or capital of a person

3. (1) For the purpose of this Schedule a person is directly participating in the management, control or capital of another person at a particular time if, and only if, that other person is at that time-
   (a) A body corporate or a partnership; and
   (b) Controlled by the first person.
   (2) For the purposes of this Schedule a person ('the potential participant') is indirectly participating in the management, control or capital of another person at a particular time if, and only if-
   (a) he would be taken to be directly so participating at that time if the rights and powers attributed to him included all the rights and powers mentioned in sub-paragraph (3) below that are not already attributed to him for the purposes of sub-paragraph (1) above; or
   (b) he is, at that time, one of a number of major participants in that other person's enterprise.
   (3) the rights and powers referred to in sub-paragraph (2)(a) above are-
   (a) rights and powers which the potential participant is entitled to acquire at a future date or which he will, at a future date, become entitled to acquire;
   (b) rights and powers of persons other than the potential participant to the extent that they are rights or powers falling within sub-paragraph (4) below;
   (c) rights and powers of any person with whom the potential participant is connected; and
   (d) rights and powers which for the purposes of sub-paragraph (2)(a) above would be attributed to a person with whom the potential

[874] Ibid.

participant is connected if that connected person were himself the potential participant.

(4) Rights and powers fall within this sub-paragraph to the extent that they-

(a) are required, or may be required, to be exercised in any one or more of the following ways, that is to say-

(i) on behalf of the potential participant;

(ii) under the direction of the potential participant; or

(iii) for the benefit of the potential participant; and

(b) are not confined, in a case where a loan has been made by one person to another, to rights and powers conferred in relation to property of the borrower by the terms of any security relating to the loan.

(5) in sub-paragraphs (3)(b) to (d) and (4) above, the reference to a person's rights and powers include references to any rights or powers which he either-

(a) is entitled to acquire at a future date, or

(b) will, at a future date, become entitled to acquire.

(6) In paragraph (d) of sub-paragraph (3) above, the reference to rights and powers which would be attributed to a connected person if he were the potential participant includes a reference to rights and powers which, by applying that paragraph wherever one person is connected with another, would be so attributed to him through a number of persons each of whom is connected with at least one of the others.

(7) For the purpose of this paragraph a person ('the potential major participant') is a major participant in another person's enterprise at a particular time if at that time-

(a) that other person ('the subordinate') is a body corporate or a partnership; and

(b) the 40 percent- test is satisfied in the case of each of two persons who, taken together, control the subordinate and whom one is the potential major participant.

(8) For the purpose of this paragraph the 40 percent- test is satisfied in the case of each of two persons wherever each of them has interests, rights and powers representing at least 40 percent of the holdings, rights and powers in respect of which the pair of them fall to be taken as controlling the subordinate.

(9) For the purpose of this paragraph-

(a) the question whether a person is controlled by any two or more persons taken together, and
(b) any question whether the 40 percent- test is satisfied in the case of a person who is one of two persons, shall be determined after attributing to each of the persons all the rights and powers attributed to a potential participant for the purposes of sub-paragraph (2)(a) above.
(10) References in this paragraph-
(a) to rights and powers of a person, or
(b) to rights and powers which a person is or will become entitled to acquire, include references to rights or powers which are exercisable by that person, or (when acquired by that person), will be exercisable, only jointly with one or more other persons.
(11) For the purposes of this paragraph two persons are connected with each other if-
(a) one of them is an individual and the other is his spouse, a relative of his or of his spouse, or the spouse of such a relative; or
(b) one of them is a trustee of a settlement and the other is-
(i) a person who is in relation to that settlement is a settler; or
(ii) a person who is connected with a person falling within sub-paragraph (i) above.
(12) In sub-paragraph (11) above-
'relative' means brother, sister, ancestor or lineal descendant; and
'settlement' and 'settlor' have the same meanings as in Chapter IA of Part XV."[875]

Paragraph 4 is the most relevant paragraph of Schedule 28AA for the purpose of this research. It defines "control" for the purpose of this Schedule and sets out rules for attributing rights and powers to a person when considering whether that person controls a company or partnership. It also introduces measures which deem a person to control a company or partnership where that person or another person each have at least 40% interest, as is often seen in joint ventures.[876] Paragraph 28AA (4) (12) refers to "relatives"; brothers, sisters, ancestor or lineal descendants. These are parties not covered by company law but may be considered to be another example of "de jure" relationships.

[875] ICTA88/SCH28AA (4).
[876] See also INTM432020 and INTM432060.

The expression *"participating in the management, control or capital"* of paragraph 1 of ICTA88/SCH28AA is summarised in INTM432020 by the word "control". Control is the key element in the interpretation of this article, following paragraph 4(1)(b) of this Schedule, where it is stated that "a person is participating directly in the management, control or capital of another person if that other person is a body corporate or a partnership; and *controlled* by the first person."

Apparently, the requirement of a participation in management, control or capital is *only* satisfied if one has control. ICTA88/SCH28AA(4) defines "control" for the purposes of this legislation and sets out rules that attribute rights and powers to a person when considering whether that person controls a company or partnership.[877]
In this context, the term "person" includes a body of persons. This means that a partnership can control a company even if, individually, none of the partners control the partnership or company.

In the first instance, "control" is defined by reference to ICTA88/S840 which considers matters such as voting power, power given by the articles of association and the actual ability of a person to direct the affairs of the company in the absence of the visible signs of such rights.
However, as also described in INTM432060, for the purposes of this legislation, the rights and powers which should be attributed to a person are those which:

- he is entitled to acquire at a future date or which he will at a future date become entitled to acquire;
- belong to another person but which are required or may be required to be exercised on behalf of, under the direction of or for the benefit of the first mentioned person;
- are exercisable by a person connected to the potential participant (broadly spouses and relatives or trustees and settlers.)

It may be necessary to go through more than one level of attribution so that in attributing rights to an individual, for example, from a spouse it will also be necessary to apply the attribution rules to the spouse and then attribute the total rights and powers to the individual. These attribution rules need to be considered in a relatively few cases. While the legislation prevents abuse where

[877] See also INTM432060.

trusts are interposed in a control chain, it does not reproduce ICTA88/839(4), with the result that persons are not connected simply by virtue of being members of the same partnership. The control rules in ICTA88/SCH28AA(4) also include a provision deeming a 40% participant in a joint venture to control that joint venture.

For the purpose of paragraph 4 (2) (b) of Schedule 28AA, a person can be regarded as a major participant in another person's enterprise if that other person ("the subordinate") is a body corporate or partnership, and the 40% test is satisfied in the case of each of two persons who, taken together, control the subordinate and of whom one is the potential major participant. The 40% test is satisfied wherever each of them has interests, rights and powers representing at least 40% of the holdings, rights and powers in respect of which the pair of them is taken as controlling the subordinate. This provision deems a 40% participant in a joint venture to control that joint venture. A joint venture, for these purposes, is a company or partnership which is controlled by two persons, each of whom has at least 40% interest in the venture. This measure is intended to address arrangements where participants in a joint venture are able to use non-arm's length prices to shift profit overseas for their mutual benefit.[878] The rules only apply to transactions between at least one of the joint venture parties and the joint venture itself, not between the two joint venture parties themselves, unless they are under common control according to paragraph 4 of Schedule 28AA. Before the introduction of Schedule 28AA, in a typical 50-50 joint venture, transactions between the joint venture company and its shareholders were previously unaffected. In the case of a 60-40 joint venture, under Section 770, transactions between the joint venture company and the 60% shareholder were covered. The 40% minority shareholder was not covered. Schedule 28AA applies to transactions between the joint venture company and both shareholders.

The Explanatory Notes to Schedule 28AA state:

"Paragraph 4 introduces a number of attribution rules which are not to be found in the control provisions in the existing legislation. On the whole these are marginal changes and will not affect the majority of taxpayers. The most important change is intended to prevent abuse where trusts are interspersed in

[878] INTM432070.

a control chain. At the same time the existing rule which attributes the rights and powers of partners has not been replicated."[879]

Paragraph 4A of Schedule 28AA provides that a person will be treated as having indirect control if the provision relates to financing arrangements for a body corporate or partnership and that person acted together with other persons in relation to those financing arrangements and would have control if the rights and powers of all those persons were taken into account.[880] In making that attribution of rights and powers, the rules on indirect participation of paragraph 4 of Schedule 28AA should be applied. According to paragraph 4A(4) of Schedule 28AA, this rule applies for financing arrangements put in place when the relevant persons were acting together or within six months of the date on which they ceased to do so.[881] In this context, financing arrangements should be interpreted as "arrangements made for providing or guaranteeing, or otherwise in connection with, any debt, capital or other form of finance". Paragraph 4A (7) of Schedule 28AA states that in that case application of Schedule 28AA is limited to the extent to which the provision relates to the financing arrangement.[882]

Paragraph 14 of Schedule 28AA reads as follows:

"Schedule 28AA
General interpretation etc.
14. (1) In this Schedule-
'the actual provision' and 'the affected persons' shall be construed in accordance with paragraph 1(1) above;
'the arm's length provision' shall be construed in accordance with paragraph 1(2) and (3) above;
'double taxation arrangements' means arrangements having effect by virtue of section 788l;
[...]
'the relevant activities', in relation to a person who is one of the persons as between whom any provision is made or imposed, means such of his activities as-

[879] Explanatory Notes to ICTA88/SCH28AA, para. 57.
[880] ICTA88/28AA(4a), introduced in 2005.
[881] Ibid.
[882] Ibid., subpara. 7.

(i) comprise the activities in the course of which, or with respect to which, that provision is made or imposed; and

(ii) are not activities carried on either separately from those activities or for the purpose of a different part of that person's business;

'transaction' and 'series of transactions' shall be construed in accordance with paragraph 3 above.

(2) Without prejudice to paragraphs 9(2) and 11(3) above, references in this Schedule to a person controlling a body corporate or a partnership shall be construed in accordance with section 840."

Paragraph 14(2) makes a reference to ICTA88/S840 for the definition of "control". Section 840 uses the expression "by virtue of any powers conferred by the *articles of association or other document regulating* that or any other body corporate".

The question arises whether the term "other document" should be interpreted restrictedly. Looking at the text of Section 840, the term "other documents" should be read in combination with the term "articles of association". This means that an explicit transfer of control to another enterprise would result in the other enterprise having control, but for instance a consignment agreement, which leads to the transfer of *de facto* control to the buyer, would not mean that the buyer has control.

Control of a partnership means the right to share in more than half of the partnership assets or income.

Control of a company means the ability of a person to "secure [...] that the affairs are conducted in accordance with the wishes of that person" by means of:

- The holding of shares (for example, more than 50% of the shares)
- The possession of voting power (for example, more than 50% of the votes)
- Powers conferred by a document regulating the company.

In the case of a partnership, control may be established when one party has a right to more than one half of the assets or income of that partnership.

Paragraph 4(1) of Schedule 28AA confirms that direct participation in the management, control or capital exists where one person controls a body corporate or partnership. However, there are different types of rules which may apply in the case of indirect participation. Those rules cover the following situations:

- Situations where the direct participation test would be met if additional rights and powers were attributed;
- Situations where a person is a "major participant";
- Situations where a person has "acted together" with others in relation to the financing arrangements of a body corporate or partnership.

If a person does not have direct control but would do so if certain additional rights are taken into account, then indirect control may exist. These additional rights include those a person will have in the future, those exercised on behalf of that person and those of "connected" persons.[883] Paragraph 4(12) of Schedule 28AA provides that persons are connected if there is either a family relationship or if one is the trustee of a trust and the other the settler or a person with a family relationship with the settler. This includes indirect family relationships as well.[884]

6.2.5. "Linked enterprises"

For the calculation of profits arising on or after 1 April 2004, there is an exemption from transfer pricing rules for the vast majority of transactions carried out by a business that is a small or medium-sized enterprise. The term "small or medium-sized enterprise" is defined using the European Recommendation 2003/361/EC. The exemption does not apply where a business has transactions with or provisions which include a related business in a territory with which the UK does not have a double tax treaty with an appropriate non-discrimination article. Such transactions remain subject to transfer pricing rules.[885] The European Commission published a revised recommendation on 6 May 2003 concerning the definition of micro-sized, small-sized and medium-sized enterprises.[886] The definition applies to any entity engaged in an economic activity, irrespective of its legal form. The Commission recommendation recognises that in two situations the staff and financial data of connected and associated enterprises must be included with

[883] ICTA88/28AA (4) (3).
[884] Ibid., subparas. 4 (6) and 4 (12).
[885] INTM432112.
[886] Recommendation 2003/361/EC concerning the definition of micro-, small- en medium-sized enterprises, C (2003) 1422, (OJL 124, 20 May 2003).

that of the enterprise seeking exemption. It refers to these as linked enterprises and partnership enterprises. A linked enterprise is an enterprise which has the right to control the affairs of the enterprise seeking exemption. This control may be either direct or indirect and take many forms including shareholding, voting rights and contractual rights.
For the purpose of calculating the data for an enterprise, all data for any second enterprise that is linked to an enterprise must be aggregated as well as all the data for any linked enterprises or partnership enterprises of that second enterprise. All the staff, turnover and balance sheet entries must be taken into account of that second enterprise.[887]

Linked enterprises are enterprises which have any of the following relationships with each other:

1. An enterprise has a majority of the shareholders' or member's voting rights in another enterprise;
2. An enterprise has the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another enterprise;
3. An enterprise has the right to exercise a dominant influence over another enterprise pursuant to a contract entered into with that enterprise or to a provision in its memorandum or articles of association;
4. An enterprise, which is a shareholder in or member of another enterprise, controls alone, pursuant to an agreement with other shareholders in or members of that enterprise, a majority of shareholders' or members' voting rights in that enterprise.

6.2.6. Corporation Tax Act 2010

The Corporation Tax Act 2010 (CTA 2010) and the Taxation (International and Other Provisions) Act 2010 (Taxation Act 2010), produced by the Tax Law Rewrite project, came into force for corporation tax purposes for accounting periods ending on or after 1 April 2010 and for income tax and capital gains tax purposes for the tax year 2010-11 and subsequent tax years.

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[887] See also INTM432112.

CTA 2010 largely consists of provisions covering much the same ground as those rewritten in the Income Tax Act for income tax, but includes provisions that are confined to corporation tax such as group relief. The Taxation Act 2010 consists of provisions with an international aspect. Parts of this Act, such as double taxation relief and transfer pricing, apply also to other taxes than corporation tax. For the most part, neither Act changes the effect of the law but they do correct some minor anomalies.

Both Acts provide definitions of the concept of associated enterprises. Although it is not the purpose of this study to analyse all concepts of control in UK tax law, Section 840 applies a rather restricted interpretation of control.

In paragraph 25, which deals with the taxation of companies with small profits, the term "associated companies" is defined as follows. A company is an associated company of another at any time when one of the two has control of the other, or both are under the control of the same person or persons.[888]
Also Section 408 of part 9 of the CTA 2010 defines the term "associated company" as follows:
A company is an "associated company" of another company on any day if, at the start of that day-
(a) one of the two has control of the other, or
(b) both are under common control of the same person or persons.[889]

For the interpretation of "control" reference is made to Sections 450 and 451 of Part 10 of the CTA 2010. A detailed description of "control" can be found in Section 450:[890]

"(2) A person ("P") is treated as having control of a company ("C") if P-
> (a) exercises,
> (b) is able to exercise, or
> (c) is entitled to acquire,
> direct or indirect control over C's affairs.

(3) In particular, P is treated as having control of C if P possesses or is entitled to acquire –
> (a) the greater part of the share capital or issued share capital of C,

888 Corporation Tax Act 2010, part 3- Companies with small profits, Section 25.
889 Corporation Tax Act 2010, part 9- Leasing plant or machinery, Sections 408 and 430.
890 Corporation Tax Act 2010, part 10- Close Companies, Section 450.

(b) the greater part of the voting power in C,
(c) so much of the issued share capital in C as would, on the assumption that the whole of the income of C were distributed among the participators, entitle P to receive the greater part of the amount so distributed, or
(d) such rights as would entitle P, in the event of the winding up of C or in any other circumstances, to receive the greater part of the assets of C which would then be available for distribution among the participators."

Apparently, controlling a company is based on a *de jure* relationship, a relationship covered by company law. Owning a greater part of the share capital or having voting power reflects the *de jure* relationships from which this "control" can be concluded.
Section 450 continues with the following paragraphs:

"(4) Any rights that P or any person has as a loan creditor are to be disregarded for the purposes of the assumption in above quoted subsection (3)(c).

(5) If two or more persons together satisfy any of the conditions in subsections (2) and (3), they are treated as having control of C."

Section 451 of part 10 of the CTA 2010 describes the rights and powers to be attributed. There may be attributed to a person all the rights and powers
(a) of any company of which the person has, or the person and associates of the person have, control,
(b) of any two or more companies within paragraph (a),
(c) of any associate of the person, or
(d) of any two or more associates of the person.[891]

Section 1011 of Part 23 *Company distributions* of the CTA 2010 provides the meaning of "associated enterprise". A company is an associated enterprise of another when one has control of the other, or both are under the control of the same person or persons.[892] For the purposes of Section 1011, a person controls a company if the person has *power to secure* that the affairs of the company are conducted in accordance with the person's wishes, and has that power by

[891] Corporation Tax Act 2010, part 10- Close companies, Section 451.
[892] Corporation Tax Act 2010, part 23- Company distributions, Section 1011.

holding shares in the company or any other company, or by possessing voting power in relation to the company or any other company, or by virtue of any powers conferred by the articles of association of the company or any other company, or any other document regulating the company or any other company.

The main difference between the concept of control in Section 840 (for the purposes of ICTA88/SCH28AA) and the other concepts of control in UK tax law is generally the reference to "other documents". In Section 840, these "other documents" should be interpreted as documents regulating a body corporate (for example, articles of association). These documents find their origin generally in company law, whereas some other concepts of control in UK tax law refer to other documents without the requirement that those documents should "regulate" that body corporate.

6.2.7. Conclusions

From the historical analysis of the Finance Act in this chapter, it appears that the concepts of "associated enterprises" and "control" were already applied at the beginning of the 20th century. The Finance Act of 1915 used the term "substantial control" in one of the early (transfer pricing) laws dealing with transactions between associated enterprises. This may indicate that there was a domestic understanding of the interpretation of "control" with respect to associated enterprises. However, for the interpretation of the concept of associated enterprises, the United Kingdom developed a detailed concept of control in ICTA 1952.

The ICTA52/S840 concept of control covers only *de jure forms* of control. This concept of control has not changed since its incorporation in ICTA 1952, which took place before the introduction of the 1963 OECD Model.

From the above analysis of Sections 770-773 and 840 of ICTA88 it may be concluded that the scope of "associated enterprises" in the United Kingdom focuses on "control". The concept of control for transfer pricing purposes is limited to *de jure* control: a controlling influence through shareholding, voting rights, management and participation in a partnership. The reference to "other documents" in Section 840 is not a loose end: the context in which the term "other documents" should be interpreted is "documents that regulate the body corporate". This could also be interpreted as a *de jure* form of control, as these documents find their origin in company law.

The successor of Section 770, Schedule 28AA, provides (new) transfer pricing legislation. The legislation was completely changed into a code aligned with Art. 9 OECD Model. Schedule 28AA requires that either one of the affected persons is directly or indirectly participating in the management, control or capital of the other, or the same person or persons is or are directly or indirectly participating in the management, control or capital of each of the affected persons. Schedule 28AA provides that a person is indirectly participating in the management, control or capital of another person at a particular time if the potential participant would be taken to control that other person directly by reason of having certain rights and powers attributed to him or, because he or she is at that time a major participant in that other person's enterprise. A person is a major participant in another person's enterprise at a particular time if at that time the other person is a body corporate or a partnership and the 40% test is satisfied. This 40% test is designed to bring joint ventures within transfer pricing rules. Before the introduction of Schedule 28AA, in a typical 60-40 joint venture, transactions between the joint venture company and the 40% minority shareholder were not covered.

Paragraph 2 states that Schedule 28AA should be interpreted consistently with the OECD Model and the OECD TP Guidelines. Therefore, an autonomous OECD concept of "associated enterprises" may be relevant for the UK interpretation of the concept of associated enterprises.

I conclude that the UK concept of control for transfer pricing purposes, based on *de jure forms of control* included in Schedule 28AA – 2(1)(b), 28AA (4) and Section 840, gives an important clue for the interpretation of "associated enterprises" under the OECD Model. The relevance of this conclusion becomes even greater because of the prominent role the UK has played in the development of the first Models and Draft Conventions of the League of Nations and the OECD.

6.3. United States

6.3.1. Historical overview

This part discusses the interpretation of the notion of "associated enterprises" for US transfer pricing purposes. The US transfer pricing legislation is included in Section 482 of the US Internal Revenue Code. Section 482 contains the authority for the US tax authorities to reallocate income or expenses of controlled taxpayers.

Four years after adoption of the modern US income tax in 1913, the IRS was given in 1917 authority to consolidate the accounts of related trades or businesses when it suspected that internal transactions were not made at market prices.[893] With the various exemptions or credits available to corporations beginning with the 1918 Act, the owners of closely held corporations soon became aware of the tax advantages available by creating two or more corporations to carry on the business formerly conducted by only one corporation, or to shift income or deductions between two or more such corporations to move high-income corporations into lower tax brackets, or to transfer income from a profit corporation to a loss corporation.[894]
Those tax reduction structures did not go unnoticed or unchallenged by the Commissioner of Internal Revenue. As a consequence, Congress proposed remedial legislation. One of the first authorizations for attacking associated enterprises was granted to the Commissioner by Congress in the 1921 Act, when the forerunner of Section 482 was enacted. This was Section 240 (d). In enacting the 1921 authorization, Congress was motivated by its realization that there was a good deal of "arbitrary shifting of profits between related businesses in its various forms".[895] The Commissioner's right to consolidate the accounts of associated enterprises has appeared in various forms in every Revenue Act since 1921.

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[893] Regulation 41, Arts. 77 and 78, promulgated under the War Revenue Act of 1917.

[894] See also Groh, R., "Multiple Entities", 40 *Taxes- the Tax Magazine* 487 (June 1962), p. 486.

[895] The House of Representative Report stated that "subsidiary corporations, particularly foreign subsidiaries, are sometimes employed to 'milk' the parent corporation, or otherwise improperly manipulate the financial accounts of the parent company." The House of Representative Report No. 350, 67th Cong., 1st Session, 14 (1921)

As the precursor of Section 482 it is appropriate to discuss subsection (d) of Section 240 of the 1921 Act. This subparagraph came into the law as an amendment to the existing provisions relating to the filing of consolidated returns. The amendment (subsection d) gave the Commissioner authority to act as follows:

"(d) For the purpose of this section a corporation entitled to the benefits of Section 262 shall be treated as foreign corporation, provided that in any case two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses."[896]

In the Revenue Act of 1924, Congress again dealt with this subject by an amendment which made adjustment of related-party transactions available to taxpayers as well as to the Commissioner:

"In any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may and at the request of the taxpayer shall, if necessary , in order to make an accurate distribution or apportionment of gains, profits income, deductions or capital between or among such related trades or businesses, consolidate the accounts of such related trades or businesses."

Apparently Congress had a specific situation in mind in enacting Section 240 (d) of the 1921 Act and in amending it in 1924. This follows from a quote of the discussion in the House: [897]

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[896] The Statutes at Large of the United States of America, from April 1921 to March 1923, Concurrent Resolutions of the two houses of Congress and Recent treaties, conventions, and executive proclamations, edited, printed, and published by authority of Congress under the direction of the Secretary of State, Vol. XLII, Washington 1923, Sixty-Seventh Congress, Sess. I, Ch. 136, 1921, Title 1. – General Definitions, Section 240 (d)

[897] 61 Congressional Record 5203

"*Mr. Hawley: [...]* In an attempt to evade taxation they (a related group of taxpayers) would make separate returns and divide up the income and keep out of the high brackets or transfer the greater proportion to foreign subsidiaries; but now by consolidating the return, giving authority to do that when the circumstances warrant, we can prevent evasion of the tax."

Although the statement of a particular legislator cannot be attributed to Congress without assuming that every Congressman agreed with the statement, the later regulations supported this view.
Apparently, the objective which Congress sought to obtain by this legislation was to prevent evasion.[898] In US tax literature, some authors have stated:

"Evasion is quite a different story from avoidance. One is illegal, perhaps a criminal offence, while the other is perfectly legal and proper as the courts have held up many occasions."[899]

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[898] The IBFD Glossary provides the following definition of tax avoidance:
"For tax purposes, avoidance is a term used to describe taxpayer behaviour aimed at reducing tax liability which falls short of tax evasion. While the expression may be used to refer to "acceptable" forms of behaviour, such as tax planning, or even abstention from consumption, it is more often used in a pejorative sense to refer to something considered "unacceptable", or "illegitimate" (but not in general "illegal"). In other words, tax avoidance is often within the letter of the law but against the spirit of the law. It generally contains elements of artificiality, e.g. as to the legal form adopted, and may often be considered to be contrary to the spirit of the law. However, its scope may vary from country to country, depending on attitudes of government, courts and public opinion. Some jurisdictions appear not to recognize the concept on the grounds either that the behaviour is legitimate or, if illegitimate, that it constitutes evasion. Examples of tax avoidance include locating assets in offshore jurisdictions, conversion of income to non- or lower-taxed gains, spreading of income to other taxpayers with a lower marginal tax rate, splitting of business activities to avoid VAT registration and lease and lease-back arrangements to take advantage of early input tax deduction."
The IBFD Glossary provides the following definition of tax evasion:
"Tax evasion, in contrast to tax avoidance, may be characterized as intentional illegal behaviour, or as behaviour involving a direct violation of tax law, in order to escape payment of tax. Tax evasion is generally accompanied by penalties which may be, but are not always, criminal in nature. Deliberate underreporting of taxable income would generally be considered an example of tax evasion. The term "evasion" tends to be used in French-speaking countries to refer to the concept of tax avoidance, while "tax fraud" is used to refer to the concept of tax evasion."
[899] Baker, R. and Baker, D. "The Pricing of goods in International Transactions between Controlled Taxpayers", 10 *Tax Executive* 235 (1957-1958), p. 243.

These authors were of the opinion that Section 482 was enacted to prevent evasion and was never intended to prevent a reduction in, or avoidance of, tax by the use of means which Congress itself had provided. Nor would there be any doubt that immediately after its passage, the Treasury, the Commissioner and the courts well understood that Section 482 applied only to "evasion". Those authors supported their view by the fact that several years thereafter, the Treasury advocated an amendment to Section 482 so that "avoidance" would be within its scope.[900]

In the Revenue Act of 1926 the general provisions for consolidated returns were repealed. Section 240 (d) of the 1921 and 1924 Acts was retained as Section 240 (f).

Already in the early 1920s the tax laws of the United States elaborated on the concept of associated enterprises. The tax laws included definitions and explanations of the term "control". These definitions and explanations were, however, not specifically applicable to transfer pricing issues. For example, Section 202 of the Revenue Act of 1921 of the United States provided the basis for determining gain or loss sustained from a sale or other disposition of property.[901] Section 202 (c) (3) established that *control* exists when a person owns or two or more persons own at least 80 percent of the voting stock and at least 80% of the total number of shares of all other classes of stock of the corporation:

"[...] (3) When (A) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For the purpose of this paragraph, a person is, or two or more persons are, "in control" of a corporation when owning at least 80

[900] Ibid., p. 244.
[901] The Statutes at Large of the United States of America, from April 1921 to March 1923, Concurrent Resolutions of the two houses of Congress and Recent treaties, conventions, and executive proclamations, edited, printed, and published by authority of Congress under the direction of the Secretary of State, Vol. XLII, Washington 1923, Sixty-Seventh Congress, Sess. I, Ch. 136, 1921, Sec. 202.

per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation."[902]

For the purpose of this article, which did not deal with international transfer pricing adjustments, the term "person" included partnerships and corporations, as well as individuals.[903] From this paragraph it may be concluded that "control" was purely based on a participation in capital. This can be argued by looking to the words "a person [...] is in control, when owning at least 80 per centum of the voting stock". Control was a result of a participation in capital with a threshold of at least 80%. Apparently, a *de jure* form of control, based on the holding of shares or voting rights, formed the basis for association in the context of the above article.

In these early Acts different concepts of "control" were applied with different purposes. In some cases, the concept of control was based on a shareholding and voting rights. The threshold of the various concepts of control could vary. With respect, however, to transfer pricing adjustments, it seems that the concept of association was much broader. Apparently, this broader concept was a result of the main purpose of the transfer pricing sections, which is prevention of tax evasion and avoidance. After 1934 it could be concluded from the Regulations that "control", as included in the current Section 482 (and former Section 45), was meant to be interpreted differently from the term "control", which was described in detail in the other tax law sections.

Section 240 of the Revenue Act of 1921 concerning the consolidated returns of corporations stated that for the purpose of section 240 two or more corporations are deemed to be affiliated:

"(c) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests."[904]

[902] Ibid., Sec. 202 (c) (3).

[903] The Statutes at Large of the United States of America, from April 1921 to March 1923, Concurrent Resolutions of the two houses of Congress and Recent treaties, conventions, and executive proclamations, edited, printed, and published by authority of Congress under the direction of the Secretary of State, Vol. XLII, Washington 1923, Sixty-Seventh Congress, Sess. I, Ch. 136, 1921, Title 1. – General Definitions, Section 2.

[904] Section 240(c), Revenue Act 1921.

Section 240 (d) continued:

"(d) For the purposes of this section a corporation entitled to the benefits of section 262 shall be treated as a foreign corporation: *provided*, that in any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses."[905]

Two forms of association were mentioned by Section 240 (d):

- two corporations were *owned* directly or indirectly by the same interests; or
- two corporations were *controlled* directly or indirectly by the same interests.

The relationship between Section 240 (c) and 240 (d) is interesting. Section 240 (c) refers to a form of control that relates to the capital of the other corporation, whereas Section 240 (d) speaks only of "owned or controlled" corporations and does not mention explicitly the term "stock". According to Section 240 (c), the stock should be owned or controlled by the same interests or one should own or control the stock or shares of the company. Control could exist only where one directly holds the stock of the other. Apparently the word "controls" in the phrase "controls through closely affiliated interests [...] all the stock" refers to the indirect holding of shares. I was unable to find a reason why the association requirement of Section 240 (c) included a reference to shareholding and why Section 240 (d) did not refer to the exercise of control through shareholding, but to a reality of control, which seems to include every form of *de facto* control.

Section 240, which dealt with domestic enterprises, made a distinction between owning capital (*owns directly all the stock)* and controlling all the stock of a company through closely affiliated interests. I could not find any explanation in these Sections of the differences between "owning capital" and "controlling capital/stock through closely affiliated interests". But looking at the context of this Section, it seems apparent that "controlling through [...] all the stock" refers

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[905] Ibid.

to indirect participation of capital, as in both cases the holding of stock is required.
The text of the Revenue Act of 1921 does not elaborate on what is meant by the expression "*by the same interests*". In the next paragraph of Section 240, the Revenue Act also applied the term "*controlled by the same interests*" in situations where a corporation is treated as foreign corporation:

"(d) For the purpose of this section a corporation [...] shall be treated as foreign corporation, provided that in any case two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests [...]"[906]

The same phrases were also used in Section 1331 regarding the consolidated returns in the early 1920s. This Section refers to transfer prices which are not at arm's length:

"For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others, or (2) when substantially all the stock of two or more corporations or the business of two or more partnerships was owned by the same interest, provided that such corporations or partnerships were engaged in the same or a closely related business, or one corporation or partnership bought from or sold to another corporation or partnership products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or one corporation or partnership as to assign to it a disproportionate share of net income or invested capital [...]".[907]

The Reports of the League of Nations, discussed in Chapters 2 and 5, remain unclear why the specific term "affiliated companies" was introduced and where this term found its origin. Art. 5 of the 1927 Draft of a Bilateral Convention for

[906] The Statutes at Large of the United States of America, from April 1921 to March 1923, Concurrent Resolutions of the two houses of Congress and Recent treaties, conventions, and executive proclamations, edited, printed, and published by authority of Congress under the direction of the Secretary of State, Vol. XLII, Washington 1923, Sixty-Seventh Congress, Sess. I, Ch. 136, 1921, Title 1. – General Definitions, Section 240 (d).
[907] Ibid., Title 1, Section 1331.

the Prevention of Double Taxation concerned the taxation of permanent establishments and considered "affiliated companies" as permanent establishments. If the term "affiliated companies" was taken over from the Revenue Acts of the United States, the question arises whether this term had the same meaning as the term had in the United States. It may be argued that this term was taken over from the Revenue Act of the United States, as the word "affiliated" was used in Section 240 of the 1921 Act and the United States had a significant influence on the works of the Fiscal Committee of the League of Nations. However, in the League of Nations documents no evidence is found to support this view.

In the Revenue Act of 1926, Section 203 took over the above quoted phrase of Section 202 of the Revenue Act of 1921. Section 203 defined the term "control" in a separate sub-paragraph:

"(i) As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation."[908]

Apparently, the general interpretation of "control" in the Revenue Act was one based on a *de jure* form of control whereas the later Section 45 contained a form of "control" which was based on a *de facto* form of control.
Section 240 of the Revenue Act of 1926 used three almost identical phrases as the current Section 482.This Section reads as follows:

"(f) In any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may and at the request of the taxpayer shall, if necessary in order to make an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses, consolidate the accounts of such related trades or businesses."[909]

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[908] The Statutes at Large of the United States of America, from December 1925 to March 1927, Concurrent Resolutions of the two houses of Congress and Recent treaties, conventions, and executive proclamations, edited, printed, and published by authority of Congress under the direction of the Secretary of State, Vol. XLIV, Washington 1927, Sixty-Ninth Congress, Sess. I, Chs, 26-27, Section 203.

[909] The first phrase of Section 482 reads: "In any case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and

Section 45 of the Revenue Act of 1928 dealt with the allocation of income and deductions. Section 45 can be considered as one of the earliest ancestors of Section 482 and bears an easily recognisable resemblance to it. The Ways and Means Committee Report on the bill destined to become the Revenue Act of 1928 explained that the section constituted a broadened version of Section 240 (f) of the Revenue Act of 1926 and was necessitated by the elimination of the consolidated return provisions of the 1926 Act.[910]

It used the words of Section 240 of the Revenue Acts of 1921 and of 1926. Section 45 of the Revenue Act of 1928 authorised the Commissioner to distribute, apportion or allocate gross income or deductions between related parties when allocation is necessary in order to prevent evasion of taxes or to reflect clearly the income.

Section 45 of the Revenue Act of 1928 reads as follows:

"In any case of two or more trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorised to distribute, apportion, or allocate gross income or deductions between or among
such trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such trades or businesses."[911]

The House Committee Report on Section 45 of the 1928 Act mentioned the following abuses at which the section was aimed:

"the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'."[912]

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whether or not affiliated) owned or controlled directly or indirectly by the same interests [...]".

[910] H.R. Rep. No. 2, 70th Congress, first Session 1928.

[911] The Statutes at Large of the United States of America, from December 1927 to March 1929, Concurrent Resolutions of the two houses of Congress and Recent treaties, conventions, and executive proclamations, edited, printed, and published by authority of Congress under the direction of the Secretary of State, Vol. XLV, Washington 1929, Seventieth Congress, Sess. I, Ch. 852 Section 45.

The early US Treasury Regulations of 1938 provide an explanation of Section 45. The Code of Federal Regulations states:

"3.45-1 *Determination of the taxable net income of a controlled taxpayer- (a) Definitions.*
When used in this section –
[...]
(3) the term "controlled" includes any kind of control, direct or indirect, whether legally enforceable and however exercisable or exercised. It is the reality of the control which is decisive, not its form nor the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted."[913]

Apparently, the United States applied a very broad concept of associated enterprises, based on a *de facto* form of control. The expression "it is the reality of the control which is decisive" indicates that all forms of control, *de jure* and *de facto*, can lead to "association" for the purpose of Section 45.

Then the Code of Federal Regulations continued with an explanation of the term "controlled taxpayer" and explained the term "true net income":

"(4) The term "controlled taxpayer" means any one of two or more organizations, trades or businesses owned or controlled directly or indirectly by the same interests."
(5) "Group" or "group of controlled taxpayers" means the organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.
(6) The term "true net income" means, in the case of a controlled taxpayer, the net income (or, as the case may be, any item or element affecting net income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deduction, or the item or element of either, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the

[912] H.R. Rep. No. 2, 70th Congress, first Session 1928.
[913] Code of Federal Regulations of the United States of America, the CFR 1938 ed., U.S. Treas. Reg. Section 3.45-1 (a) (3).

interests controlling it, choose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto)."[914]

The scope and purpose of Section 45 of the Act was to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, as may be concluded from the following text of the 1938 Regulations:[915]

"(b) Scope and purpose.
The purpose of section 45 of the Act is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting record truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this had not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income or deductions, or of any item or element affecting net income, between or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. "

The 1938 Code of Federal Regulations described the application of Section 45 of the Revenue Act:

"(c) Application
Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the *common control* is being used to reduce, avoid, or escape taxes. In determining the true net income of a controlled taxpayer, the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colourable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income or deductions. The authority to determine true net income extends to

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[914] Ibid., U.S. Treas. Reg. Section 3.45-1 (a) (4-6), p. 201.
[915] Ibid.

any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."[916] *(Italics added, RD)*

Interestingly, the term "common control" was used. In the 1960s and onwards, a similar expression was used by the OECD in the so-called "bracket definition". The term "bracket definition", introduced by Hamaekers, refers to the OECD Commentary on Art. 9 OECD Model. The Commentary defined "associated enterprises" as parent and subsidiary companies and companies under common control.[917]
The text of Section 45 "owned or controlled directly or indirectly by the same interests" seems to be applicable only in those situations covered by Art. 9 (1) (b) OECD Model. The parent-subsidiary situation (an Art. 9 (1) (a) OECD Model situation) is a situation where only *one* party has an interest in the other. The current US Transfer Pricing Regulations confirm that the latter situation is covered by Section 482:

"Controlled taxpayer means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and *includes the taxpayer that owns or controls the other taxpayers.* "Uncontrolled taxpayers" means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests." [918]

The history of Section 45/482 is instructive as to the purpose of the provision. Sections 45 of the Revenue Acts of 1928, 1932, 1934 and 1936 are identical and are statutory developments of Section 240 (f) of the Revenue Act of 1926 and Section 240 (d) of the Revenue Acts of 1924 and 1921. The report of the Joint Committee on Internal Revenue Taxation, in discussing Section 240 of the Revenue Act 1926, stated that "Congress enacted Section 240 for a dual purpose – to prevent tax evasion and to provide a sound, equitable and convenient method of taxation."[919]

[916] Ibid.
[917] See also Chapters 3 and 5.
[918] 26 CFR Ch.1 (4-1-2009 Edition), Sec. 482-1, para. 5 at 62.1
[919] H.R. Rep. No. 2, 70th Cong. 1st Session, 16-17.

The 1938 Code of Regulations states that the term "control" and therefore the concept of "association" for transfer pricing purposes as laid down in Section 45 and later Section 482 should be interpreted as a *de facto* control:

"Control includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted."[920]

One of the first regulations interpreting Section 45 was issued in 1938, as Article 45-1 of Regulations 86. These regulations remained virtually unchanged through repeated re-enactments of the revenue laws, including the Internal Revenue Codes of 1939 and 1954.[921] The regulations were framed in very general terms, without attempting to define methods of allocation or their application to specific transactions.

The different purposes of the various Acts, which contained "control" or "association", resulted in different conceptual interpretations applied by Treasury of the term "control" and "association". Most sections (excluding Section 45) applied a control criterion based on shareholding and voting rights. For example, Section 112 of the Revenue Act of 1928 dealt with the recognition of gain or loss. Paragraph (b) (5) of Section 112 stated that no gain or loss may be recognised if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation. For this purpose paragraph (j) defined "control" as the ownership of at least 80% of the voting stock and at least 80% of the total number of shares of all other classes of stock of the corporation.[922] [923]

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[920] Code of Federal Regulations of the United States of America, the CFR 1938 ed, U.S. Treas. Reg. Section 3.45-1 (a) (4-6), p. 201.
[921] See, e.g., Treas. Reg. 118 para. 39.45-1 (1953), the last published regulations under the Internal Revenue Code of 1939, and Treas. Reg. Para. 1.482-1 (a), (b) and (c), adopted by T.D. 6595, 1962-1 Cum. Bull. 49. See also Jenks, T., "Treasury Regulations under 482", 23 *Tax Law* 279 (1969-1970), p. 279.
[922] The Statutes at Large of the United States of America, from December 1927 to March 1929, Concurrent Resolutions of the two houses of Congress and Recent treaties, conventions, and executive proclamations, edited, printed, and published by authority of Congress under the direction of the Secretary of State, Vol. XLV, Washington 1929, Seventieth Congress, Sess. I, Ch. 852 Section 113.

As I pointed out earlier in this section, the question arises whether the League of Nations derived the term "affiliated companies" from US law. If this were the case, it may be argued that affiliation for the purpose of transfer pricing was based on *de facto* control in the early League of Nations Report. Support for this view may be found in Carroll's Report of 1933. Carroll wrote in his report that the method of reapportioning the profit in accordance with what would have been earned by independent persons is *"typified by the United States Revenue Act of 1932, Section 45"*.[924] He observes that under this provision, the Commissioner of Internal Revenue may request of the local subsidiary company all accounts and information necessary to allocate or apportion the income or deductions between the two companies in such a manner as to prevent evasion. He adds the following words in brackets: "(by shifting profits, the making of fictitious sales and other methods frequently adopted for the purpose of 'milking' the on or other), in order to arrive at the true tax liability of the local company".[925]
The Treasury Regulations after 1935 show that control should be interpreted as a *de facto* control, which leads to association for the purpose of transfer pricing. However, the level of influence of the United States on the League of Nations Reports and its Model Conventions cannot be ascertained. These Reports do not elaborate on the level of influence the United States had on the early Reports of the League of Nations. My findings in Chapters 2-5 show that control was not a separate criterion for establishing the existence of associated enterprises, but it was a supplementary criterion to the two other independent criteria, the participation in management and capital. If at all, it is unclear whether the League of Nations took over the term "affiliated companies" from

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[923] Another example is Section 112 of the Revenue Act 1939.Section 112 of the IRC 1939 defined "control" in the same way as in the earlier Revenue Acts:
"(h) control means the ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation." See The Statutes at Large of the United States of America, containing the Laws and Concurrent Resolutions enacted during the first session of the seventy-sixth congress of the United States of America 1939 and Treaties, International Agreements other than treaties, and proclamations, *compiled, edited, indexed, and published by authority of law under the direction of the Secretary of State*, Volume 53, Part 53, Part 1, Internal Revenue Code, approved February 10, 1939, Washington 1939, Sec. 113.
[924] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV, League of Nations Document No. C.425(b).M.217 (b).1933.II.A (Geneva: 1933); p. 110.
[925] Ibid.

the US transfer pricing sections or from other US sections, such as for instance Section 141.
Section 141 of the Revenue Act of 1928 provided a definition of the term "affiliated group". An affiliated group means one or more chains of corporations connected through stock ownership with a common parent corporation if:

"(1) at least 95 per centum of the stock of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations; and
(2) the common parent corporation owns directly at least 95 per centum of the stock of at least one of the other corporations."[926]

Under this Section affiliation was based only a participation in capital. The definition of affiliation was as follows:

"two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns at least 95 per centum of the stock of the other or others, or (2) if at least 95 per centum of the stock of two or more corporations is owned by the same interests. As used in this subsection the term "stock" does not include non-voting stock which is limited and preferred as to dividends."[927]

Section 45 remained almost unchanged in the Internal Revenue Code of 1939:

"In any case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorised to distribute, apportion, or allocate gross income or deductions between or among such organizations, trades or businesses, if he determines that such distribution, apportionment, or

[926] The Statutes at Large of the United States of America, from December 1927 to March 1929, Concurrent Resolutions of the two houses of Congress and Recent treaties, conventions, and executive proclamations, edited, printed, and published by authority of Congress under the direction of the Secretary of State, Vol. XLV, Washington 1929, Seventieth Congress, Sess, I, Ch. 852 Section 141.
[927] Ibid., Section 142.

allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses."[928]

One of the changes in the statutory language of Section 45 occurred in 1943, when Section 45 of the 1939 Code was amended to expand the list of items subject to reallocation.[929] Before this amendment, only gross income and deductions had been mentioned.

6.3.2. Section 482

Section 45 of the 1939 Code as last amended in 1943 remained virtually intact as Section 482 of the 1954 Code. Section 482 of the 1954 Code read as follows:

"In any case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses."[930]

The statutory language of 1954 Section 482 "owned or controlled directly or indirectly by the same interests" is extremely vague. The "common control"-element of Section 482 is neither tied by cross- reference to the stock attribution rules of Section 318, nor to the related taxpayers provisions of Section 267, nor to the definition of controlled groups found in Section

[928] The Statutes at Large of the United States of America, containing the Laws and Concurrent Resolutions enacted during the First Session of the Seventy-Sixth Congress of the United States of America 1939 and Treaties, International Agreements other than treaties, and proclamations, *compiled, edited, indexed, and published by authority of law under the direction of the Secretary of State,* Volume 53, Part 53, Part 1, Internal Revenue Code, approved February 10, 1939, Washington 1939.
[929] Revenue Act of 1943, paragraph 128 (b), 58 Stat.47.
[930] *Section 482 (1954 Code).*

1563.[931] Apparently, Section 482 requires an independent interpretation of the "common control" – element. In this regard, the Treasury Regulations of 1962 stated:

"Control includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted."[932]

Looking at the statutory language of the above regulations, one could conclude that the Internal Revenue Service was authorised to use Section 482 to prevent the arbitrary shifting of income and deductions. The determination by the Internal Revenue Service that there has been such an arbitrary shifting was presumably correct.[933] [934]
The regulations assumed that the interests controlling a group of controlled taxpayers have complete authority and power to conduct the affairs and accounting of the various entities in the controlled group so that each of the entities will reflect its true and accurate income.
As correctly stated by Murdoch in 1965, in most situations in which the Internal Revenue Service proposed reallocations under Section 482, the existence of the essential element of common control was obvious.[935] Murdoch stated that parent and wholly-owned subsidiary corporations, brother and sister corporations with identical stockholders owning exactly proportionate shares, and partnerships with identical partnership interests were clear examples of commonly controlled entities. However, relying on the "plasticity of the Code and on the breadth of the Regulations", the courts have found common control in instances far removed from the clear situations just mentioned.[936] For example, in *South Tex. Rice Warehouse Co.*, the Tax Court found common control as between a family partnership and a family

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[931] In the 1954 Code there were three sections designed to present tax evasion or avoidance in the form of creating, obtaining or utilising tax benefits not otherwise available, except though the creation of multiple tax entities.These sections were 482. 269 and 1551 (Section 45, 129 and 15(c) of the 1939 Code).
[932] Treas. Reg. Paragraph 1.482-1 (a) (3) 1962.
[933] Mertens, J., *Law of Federal Income Taxation* (Chicago: Callaghan, 1942), paragraph 50.61.
[934] See also *Hall v. Commissioner*, 294 F.2d 82, 87 (5th Cir. 1961).
[935] Murdoch, C. "The Scope of the Power of the Internal Revenue Service to Reallocate Under Section 482", 6 *Boston College Industrial and Commercial Law Review* 717 (1965), p. 720.
[936] Ibid.

corporation even though 35% of the stock of the corporation was owned by individuals who did not hold interests in the partnership.
In this case, the Tax Court relied in part on the proposition that the business operations of the partnership (drying and warehousing rice) were tied to the operations of the corporation (owning and leasing facilities for drying and storing of rice). There was no explicit authority in the statute for concluding that businesses are commonly controlled merely because their operations were interdependent.[937] According to Murdoch, the Tax Court's statement of interdependence of business operations to show common control was nothing more "than a make-weight argument to support a conclusion already reached on other grounds". If mere integration of business operations were in itself sufficient to show common control, Section 482 would suddenly become significant in a host of situations where it has never been considered significant. With respect to the above, Murdoch provided the example of an automobile manufacturer and a franchised dealer who would be considered under common control on the ground that without the products of the manufacturer, the dealer would have no inventory and that concomitantly the manufacturer would have no outlet for his product in the dealer's area.

It is important to note that in General Counsel's Memorandum 2856 it was stated in considering the early ancestors of Section 482, that the Board of Tax Appeals had aptly described the terms "owned or controlled directly or indirectly by the same interests" as " 'doubtful' and impossible of a strict definition".[938]

The *Matter of John S. Barnes, Inc.* case dealt with a decision involving a tax claim against a bankrupt corporation. The Court held that there was not the common control requisite for Section 45 of the 1939 Code where the suspect relationship was between a partnership and the debtor corporation. There, only the holders of 41.9%of the debtor's stock were interested in the partnership, and the debtor's stockholders held only a 35% interest in the partnership. The Court found that the dealings between the two corporations were not sufficient to justify allocation under Section 45 of the 1939 Code. Nonetheless, the Court stated as its conclusion that the comparative degrees of common ownership meant that the "community in control"- element of the statute was lacking.[939]

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[937] Ibid.
[938] VII-1 Cum. Bull. 128, 130 (1928).
[939] 53-2 U.S. Tax Cases, paragraph 9470 (S.D. Fla. 1953).

Also, in *Cedar Valley Distillery, Inc.*, the Tax Court expressed doubt that there was sufficient common control for purposes of Section 45 of the 1939 Code as between a partnership and a corporation. Fifty-two stockholders owned 46% of the corporate stock and owned no interests in the partnership; the individual who owned 54% of the corporation's stock had a 30% interest in the partnership. Another 30% partner had no interest of any kind in the corporation. The Court held that even if there were common control of the partnership and the corporation, the circumstances did not warrant allocation of the partnership income to the corporation.[940]

The Tax Court refused to attribute stock in lessor and lessee corporations held by husbands to their wives and vice versa for the purposes of Section 45 of the 1939 Code in the case *A.G. Nelson Paper Co.* case.[941] It appeared that the wives had purchased their interests in the lessor corporation with funds secured independently.

It seems that the courts determined that the required community of control did not exist without at the same time finding that there was no re-allocation justified.[942]

6.3.3. Current Section 482

The basic US transfer pricing provision is still included in Section 482 of the US Internal Revenue Code.
Section 482 forms the legal basis for the US tax authorities to adjust the taxable profits of controlled taxpayers if the US tax authorities consider that an adjustment is required to prevent tax evasion or clearly to reflect the income of

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[940] 16 T.C. 870 (1951); See also Murdoch, C. "The Scope of the Power of the Internal Revenue Service to Reallocate Under Section 482", 6 *Boston College Industrial and Commercial Law Review* 717 (1965), p. 721.
[941] 3 CCH Tax Ct. Mem. 913 (1944).
[942] See also Mertens, J., *Federal Income Taxation* (Chicago: Callaghan, 1942), paragraph 38.62 (1956 version), p. 122. A presumption of common control arises if income or deductions are arbitrarily shifted; see Jesse E. Hall Sr., 32 T.C. 390 (1959). Common control may be traced through common interests. See *Grenada Indus., Inc.*, 17 T.C. 231 (1951). The common control need not be complete; conversely, common control does not of itself justify reallocation.

any of such organizations, trades or businesses.[943] Section 482 is not just about evasion, it is about clear reflection of income, regardless of "evasion" issues. The current Section 482 is titled *Allocation of income and deductions among taxpayers* and reads as follows:

"In any case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of Section 936 (h) (3) (B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible". [944] [945]

Section 482 reflects the arm's length principle. In a recent case, the *Xilinx, Inc. v. Commissioner* case, the arm's length principle as underlying Section 482 was discussed by the courts.
The *Xilinx* case focused on whether the IRS could require that stock-based compensation expenses be included in the computation of the shared costs and the buy-in payment. In the Tax Court, the IRS argued that the commensurate-with-income standard required that "all" costs be shared, even if that required related parties to share costs that unrelated parties would not share. According to Xilinx, unrelated third parties do not share employee stock option expenses. Requiring that these costs be shared violates the arm's length standard. In its August 2005 decision, the Tax Court held that the commensurate-with-income standard does not replace the arm's length standard. The arm's length standard applies to all intercompany transactions. On appeal, the Court of Appeals for the Ninth Circuit reversed. Two judges, representing the majority of the three-judge panel, determined that employee stock options are to be included in costs to be shared under costs sharing arrangements. The decision was based on a legal canon that requires the specific to prevail over the general. After the

[943] The 1994 US Transfer Pricing Regulations, 1.482-1(b)(c).

[944] 26 USC Section 482. See also Study of Application and Administration of this Section: Pub.L. 101-508, title XI Sec. 11316, Nov 5, 1990, 104 Stat. 1388-458.

[945] The last sentence was introduced in 1986.See also the Congress Committee Report on Tax Reform Act of 1986.

rehearing, the Court of Appeals reissued its decision, affirming the Tax Court decision by a 2-1 majority.

In the *Xilinx* case, the majority of the Court of Appeals in its original opinion emphasised the purpose of Section 482:

"[...] Significantly, achieving an arm's length result is not itself the regulatory regime's goal: rather, its purpose is to prevent tax evasion by ensuring taxpayers accurately reflect taxable income attributable to controlled transactions."[946]

However, Judge Noonan emphasised in the revised opinion the following:

"(5) Purpose. Purpose is paramount. The purpose of the regulations is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions. The regulations are not to be construed to stultify that purpose. If the standard of the arm's length is trumped by 7 (d) (1), the purpose of the statute is frustrated. If Xilinx cannot deduct all its stock option costs, Xilinx does not have tax parity with an independent taxpayer."

According to Judge Noonan, the scope and purpose of Section 45 (the precursor of Section 482) of the Act was to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, as may be concluded from the following text of the 1938 Regulations:

"(b) Scope and purpose.
The purpose of section 45 of the Act is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting record truly reflect the net income from the property and business of each of the controlled taxpayers. [...] The standard to be applied in every case is that of

[946] *Xilinx, Inc. v. Commissioner*, 567 F. 3d 482 (9th Cir. 2009). On 12 August 2009 the taxpayer filed a petition with the Court of Appeals for a rehearing. *Xilinx, Inc. v. Commissioner*, Nos. 06-74246 and 06-74269. On 13 January 2010 the Court of Appeals for the Ninth Circuit withdrew its opinion. On 22 March 2010 the Court issued a revised opinion.

an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."[947]

Judge Fischer concurred with Judge Noonan in the most recent decision, stating that the regulations are contradictory in that the more general requirement contained in Reg. Section 1.482-1 states that all intercompany transactions must be priced at arm's length, while the specific rules applying to cost sharing and contained in Reg. Section 1.482-7 require the sharing of all costs:

"It is an open question whether these flaws have been addressed in the new regulations Treasury issued after the tax years at issue in this case."[948]

In his opinion, the Section 482 Regulations are hopelessly ambiguous and the ambiguity should be resolved in favour of what appears to have been the commonly held understanding of the meaning and purpose of the arm's length standard prior to this litigation. Whether the Section 482 Regulations are "hopelessly ambiguous" or not, the *Xilinx* case reaffirmed the position of the arm's length principle in US tax law.

Section 482 places a controlled taxpayer on a *tax parity* with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. Section 482 sets forth general principles and guidelines to be followed. Section 1.482-2 of the Regulations provides rules for the determination of the true taxable income of controlled taxpayers in specific situations, including controlled transactions involving loans or advances or the use of tangible property. Sections 1.482-3 through 1.482-6 provide rules for the determination of the true taxable income of controlled taxpayers in cases involving the transfer of property. Section 1.482-7T through Section 1.482-7 set forth the cost sharing provisions. Section 1.482-8 provides examples illustrating the application of the best method rule and Section 1.482-9T provides rules for the determination of the true taxable income of controlled taxpayers in cases involving the performance of services.[949]

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[947] Code of Federal Regulations of the United States of America, the CFR 1938 ed, U.S. Treas. Reg. Section 3.45-1 (b), at 201.

[948] Court of Appeals for the Ninth Circuit; *Xilinx Inc. v. Commissioner* (22 March 2010), footnote 4.

[949] See 26 CFR Ch.1 (4-1-2009 Edition), Sec. 482-1, at para. 2.

The phrase "commensurate with income" has remained an important factor in US transfer pricing policy development. In 1986 Congress concluded that US taxpayers were transferring valuable intangibles to related entities located in low-tax foreign jurisdictions for which comparable transactions were not available.[950]
Section 482 was amended to add the "commensurate with income" provision that required that payments made by a related foreign entity in exchange for the transfer of intangibles must be commensurate with the income attributable to that intangible.[951] Outright transfers of intangibles and licences or other similar arrangements involving cross-border movement of intangibles between associated enterprises were covered by this "super-royalty provision". The "commensurate with income" provision not only dealt with the income generation potential of the intangible at the time of initial transfer, it also required that royalties or other forms of payment for the intangible be adjusted over time to reflect significant changes in the income generation potential of such intangibles.[952]

The US tax authority determines the true taxable income of a controlled taxpayer by applying the arm's length principle. A controlled transaction meets the arm's length standard if the results of the transactions are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.
The Treasury Regulations Section 1.482-1 (b) (1) provides:

"In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same

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[950] See also Staff of Joint Committee on Tax, General Explanation of the Tax Reform Act of 1986, pp. 1013-1014.
[951] There were also other amendments made. See Section 367(d), amendment that provided a toll charge for outbound transfers of intangibles, and Section 936(h), amendment that provide the amount of the cost-sharing payment for possessions corporations electing the cost-sharing option. See also Levey, M. and Ruchelman, S., "Section 482- The Super Royalty Provisions Adopt the Commensurate Standard", 41 *Tax Lawyer* 3 (1988), p. 611; Levey, M.,"Inbound Transfer Pricing" 15, *International Tax Journal* 107 (Spring 1989).
[952] See also recently Levey, M. and Eisen, R., "Chapter 21: United States", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), p. 547.

transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances."

The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. There is no strict priority of methods. An arm's length result may be determined under any method without establishing the inapplicability of another method. However, if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. This is referred to as the best method rule.[953]

The Regulations on Section 482 paragraph 2 provide that the tax inspector may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such case, the tax inspector may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income. This appropriate allocation may take the form of an increase or decrease in any relevant amount. [954] A taxpayer may report on a timely filed US income tax return the results of its controlled transactions based upon prices different from those actually charged in order to reflect an arm's length result. Except for those situations provided in Section 482, Section 482 grants no other right to a controlled taxpayer to apply the provisions of Section 482 at will or to compel the tax inspector to apply such provisions. No amended returns will be permitted to decrease taxable income based on allocations or other adjustments with respect to controlled transactions.[955]

The above paragraph confirms that the existence of a "controlled" situation leads to application of transfer pricing regulations. Especially from the phrase "between or among the members of a *controlled* group if a *controlled* taxpayer", it may be concluded that transactions between entities without a shareholding relationship could be potentially adjusted under Section 482 if "control" exists. It should be noticed that the term "taxpayer" means any person, organization, trade or business, whether or not subject to any internal revenue tax.

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[953] 26 CFR Ch.1 (4-1-2009 Edition), Sec. 482-1, at para. 1.

[954] Ibid., para. 2.

[955] See also Sec. 1.6662 – 6T (a) (2).

The 1994 US Transfer Pricing Regulations provide specific definitions of the relevant terms for the application of Section 482. According to these regulations:

"Organization includes an organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation (as each is defined or understood in the Internal Revenue Code or the regulations thereunder), irrespective of the place of organization, operation, or conduct of the trade or business, and regardless of whether it is an exempt organization, or whether it is a member of an affiliated group that files a consolidated U.S. income tax return, or a member of an affiliated group that does not file a consolidated U.S. income tax return."[956]

In this context, the above term "trade or business" includes "a trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place of operation."[957] Employment for compensation will constitute a separate trade or business from the employing trade or business.

These regulations provide the following definition of "controlled taxpayer":

"Controlled taxpayer means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers. *Uncontrolled taxpayers* means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests." [958]

Important for this study, the US Treasury also provides the following definition of the term 'controlled':

"*Controlled* includes any kind of control, direct or indirect, whether legally enforceable or not, and, however exercisable or exercised, *including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose.* It is the reality of the control that is decisive, not its

[956] 26 CFR Ch.1 (4-1-2009 Edition), Sec. 482-1, para. 1 at 620.
[957] Ibid., para. 2 at 621.
[958] Ibid., para. 5 at 621.

form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted." [959]

The US concept of control for transfer pricing purposes includes control resulting from the actions of two taxpayers "acting in concert" or with "a common goal or purpose".

This explanation of "control" is completely different from that provided by other Sections included in the Revenue Acts before 1954, but is similar to the explanation provided by the Regulations of the 1930s. These other Sections interpreted control on a shareholding-basis or voting rights-basis only.

As may be argued from the above-mentioned wording, the current "control" expression of Section 482 is not limited to *de jure control* but covers *de facto* control. The determination of whether *control* exists requires a thorough evaluation of the "reality" of all the particular facts and circumstances of the case at issue. Not only can a participation in capital or management be considered "control" for the purpose of US transfer pricing, but also relationships between companies not based on company law result in the existence of associated enterprises.

A minority shareholding can be sufficient to fulfil the conditions for control if it gives the possibility of controlling the company.[960] If the IRS can show that there has been an income shifting, then there will be a presumption of control.[961] This approach differs from the approach of the OECD and United Kingdom, where *de jure* control must be determined before applying the arm's length principle.

The interpretation of "control" for transfer pricing purposes is significantly broader than that applied by other sections.[962] It seems that this transfer pricing

[959] Ibid., para. 4 at 621. See also Gustafson, C. et al., *Taxation of International Transactions, Materials, Text and Problems*, American Casebook Series (St. Paul, Minnesota USA: West Publishing Co., 1997), p. 503.
[960] See also *Bransford v. Commissioner*, TCM 1977-314 (1977).
[961] See *Dallas Ceramic Co. v. United States*, 598 F.2d 1382 (5th Cir. 1979) and *Hall v. Commissioner*, 294 F.2d 82 (5th Cir.1961).
[962] The concept of "control" in Section 482 is different than the concept of control in the other sections. For example, Section 368C provides definitions relating to corporate reorganizations. See 26 CFR Ch. 1 Sec.368-1. Section 368(c) defines the term "control" to mean the ownership of stock possessing at least 80 percent of the total combined voting

concept of "control" is wider because of the anti-abuse function of this transfer pricing section. These two different purposes, that is on the one hand putting associated and non-associated enterprise on the same footing for tax purposes (the pure application of the arm's length principle), and on the other hand the anti-abuse function, seems to be integrated in one Section, or rather "expression".

The following definitions or explanations are provided in 26 CFR Ch.1 (4-1-2009 Edition), Sec. 482-1:

"*Group, controlled group,* and group of controlled taxpayers mean the taxpayers owned or controlled directly or indirectly by the same interests."[963]

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power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Compare 26 CFR Ch. 6 Sec. 1504. Also Section 1504 provides a similar definition of control based on ownership or voting power. This concept of control is not so broad as the one applied in Section 482. Section 1504(a)(1) provides that an affiliated group means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if:[962]

(a) the common parent owns directly stock meeting the requirements of § 1504(a)(2) in at least one of the includible corporations, and

(b) (1) the common parent owns directly stock meeting the requirements of paragraph (2) in at least one of the other includible corporations, and

(2) stock meeting the requirements of paragraph (2) in each of the includible corporations (except the common parent) is owned directly by one or more of the other includible corporations.

Paragraph 2 of Section 1504 *80-percent voting and value test* provides more details about the requirements:

The ownership of stock of any corporation meets the requirements of this paragraph if it—

(a) possesses at least 80 percent of the total voting power of the stock of such corporation, and

(b) has a value equal to at least 80 percent of the total value of the stock of such corporation.

Section 1504(d) relates control also to shareholding:

Section 1504(d) *Subsidiary formed to comply with foreign law* states that in the case of a domestic corporation owning or controlling, directly or indirectly, 100 percent of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for the purpose of this subtitle as a domestic corporation.

[963] 26 CFR Ch.1 (4-1-2009 Edition), Sec. 482-1, para. 6 at 621.

"*Controlled transaction* or *controlled transfer* means any transaction or transfer between two or more members of the same group of controlled taxpayers. The term *uncontrolled transaction* means any transaction between two or more taxpayers that are not members of the same group of controlled taxpayers." [964]

"True taxable income means, in the case of a controlled taxpayer, the taxable income that would have resulted had it dealt with the other member or members of the group at arm's length. It does not mean the taxable income resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement the controlled taxpayer chose to make (even though such contract, transaction, or arrangement is legally binding upon the parties thereto)."

The existence of "control" may also be related to other elements, such as benefits, for the purposes of Section 1.482-7T. This Section deals with *cost sharing arrangements*:
"*Controlled participant* means a controlled taxpayer, as defined under Section 1.482-1(i)(5), that is a party to the contractual agreement that underlies the CSA, and that reasonably anticipates that it will derive benefits, as defined in paragraph (e)(1)(i) of this section, from exploiting one or more cost shared intangibles."[965] Benefits in this context are the sum of additional revenue generated, plus cost savings, minus any cost increases from exploiting cost shared intangibles.[966]
The following example illustrates this definition in paragraph (j)(1)(i) of Section 1.482-7T.
FP is a foreign corporation engaged in the extraction of a natural resource. FP has a US subsidiary (USS) to which FP sells supplies of this resource for sale in the United States. FP enters into a CSA with USS to develop a new machine to extract the natural resource. The machine uses a new extraction process that will be patented in the United States and in other countries. The CSA provides that USS will receive the rights to exploit the machine in the extraction of the natural resource in the United States, and FP will receive the rights in the rest of the world. This resource does not, however, exist in the United States. Despite the fact that the USS has received the right to exploit this process in the United

[964] Ibid., para. 7 at 621.
[965] 26 CFR Ch.1 (4-1-2009 Edition), Sec. 482-7T, paragraph (j) at 726.
[966] Ibid.

States, USS is not a controlled participant because it will not derive a benefit from exploiting the intangible developed under the CSA.[967]

The concept of control includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. According to the US Transfer Pricing Regulations, the reality of control is decisive, not its form or the mode of its exercise. A presumption of control also arises if income or deductions have been arbitrarily shifted between taxpayers.[968] One or more taxpayers who are owned or controlled directly or indirectly by the same interests are characterised as controlled taxpayer under the US transfer pricing law.
The US Transfer Pricing Regulation also defines the term "group, controlled group and group of controlled taxpayers"; the taxpayers who are owned or controlled directly or indirectly by the same interests. This includes taxpayers who own or control other taxpayers.[969]
Remarkably there is no specific minimum or substantial shareholding required by the US transfer pricing law that one taxpayer must have in another entity in order for the existence of controlled taxpayers to be determined. Transactions between two or more controlled taxpayers are subject to the application of the arm's length principle if the same interest, goal or purpose has been used by those taxpayers for arbitrarily shifting income or deductions in order to reduce, avoid or evade tax in the United States.

The US transfer pricing laws may also be applicable to transactions between independent parties. In 1999 the IRS confirmed its position in a series of Field Service Advice memoranda that Section 482 would apply to single transactions entered into by entirely independent parties.[970] Section 482 could be applied to transactions between two or more entities that are controlled by the same *interests* and where it can be shown that the transaction was carried out so as to result in the arbitrary shifting of income and deductions between those participating entities. The IRS applied Section 482 on the grounds that transactions between independent parties are controlled by the same interests.

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[967] 26 CFR Ch.1 (4-1-2009 Edition), Sec. 482-7T, paragraph (j) at 719.
[968] Sec. 1.482-1(a)(3).
[969] Sec. 1.482-1(a)(4).
[970] See also Rotondaro, C., "The Notion of 'Associated Enterprises'; Treaty Issues and Domestic Interpretations – An Overview", 7 *International Transfer Pricing Journal* 1, (Amsterdam: IBFD, January/February, 2000), p. 6.

To the extent that it can be shown that a transaction was carried out pursuant to a common design intended to effect an arbitrary shifting of income and deductions, the participants in the common design may be treated for purpose of the transaction as controlled by the same interests for the application of Section 482. Apparently, transactions between all entities without an existing shareholding could be potentially considered to be controlled by the same interests and subject to transfer pricing adjustment if the income or deductions have arbitrarily shifted between the entities.[971]

6.3.4. Cases

In US case law, certain cases have contributed to the interpretation and development of Section 482 and the concept of control. The US concept of control should be interpreted as the ability that, no matter how it is exercised, causes parties to conduct a particular transaction and make arrangements differing from those that would be made between unrelated parties.[972] I have already discussed some US cases in Chapters 3- 4 and the previous sections of this chapter. Below I will analyse the US case law in more detail.

In the *B. Forman Co. v. Commissioner* case, two partners of a 50/50 joint venture were competitors and not related parties. Both partners provided an interest-free loan to the joint venture. The Commissioner adjusted and increased the interest income of the two joint venture partners, based on a 5% interest rate. The Tax Court held that the two partners did not control the joint venture because the 50% shareholding of each partner was not sufficient to manipulate and affect the joint venture. However, the Court of Appeals reversed the decision of the first tax court and decided that Section 482 should be applied to the transaction of interest-free loans that were granted by the two 50% joint venture partners. The Court of Appeals was of the opinion that those interest-free loans to the joint venture were identical and therefore the two joint venture partners together had dictated every action for their common interest in the joint venture. The Court held that, although unrelated, the two joint venture partners had acted *in concert* with their dealings in the joint venture for their

[971] See also Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61 (Jönköping: Jönköping University, 2009), p. 172.

[972] Kelleher, M.F. & Wright, D.R., "Materials of the U.S. corporate income taxation course", held in IBFD, Amsterdam, the Netherlands, TP Supplement No. 25, October 1999, p. 297.

collective interest.[973] Apparently, the focus of the lower tax court was in this case on ownership, whereas the focus of the Court of Appeals was on the reality of control and the ability to arbitrarily shift income between the taxpayers rather than on the formal ownership. The Court of Appeals focused on the substance of control between the taxpayers rather than the form of ownership in which control was exercised.[974]

The *Brittingham* case discussed the application of Section 482 in transactions between taxpayers with family relationships.[975] The families of two brothers owned different shares in two enterprises. The income that had been shifted between the two enterprises resulted in a great gain to one part and a loss to the other part of the family. Although the owners of the enterprise were related by a family relationship, they lacked a common design or plan to shift income between them and therefore did not fulfil the "control by same interest" criterion under Section 482. The court focused on the reality of the situation rather than on the family relationship between the two enterprises to conclude the existence of "control by the same interests".

The *Forman* case should be compared with situations in which there is a clear adversity of tax or financial interests between two joint venture partners. In *R.T. French Co. v. Commissioner*, the US company French was owned by two unrelated British corporations on a 45-55% basis.[976] French entered into a licensing agreement with a 51/49 foreign joint venture MPP. The 51% of MPP was owned by a foreign corporation, A, that in turn was jointly owned by the same two unrelated British corporations that owned French's stock. Seeking to increase the amount of income subject to the US tax, the IRS attempted to allocate income from MPP to French. The IRS argued that the terms of the royalty agreement were not at arm's length because the royalties paid by French were excessive. Because the licensor MPP was 49%-owned by an unrelated party, the Tax Court held that it was unlikely that the shareholders of French would have agreed to an excessive royalty charge, even though French's shareholders held an indirect 51% interest in the licensor:

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[973] The B. Forman Co. v. Commissioner case, 453 F.2d 1144, 1155 (2d Cir. 1972, 407 U.S. 934 (1972).

[974] See also Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61 (Jönköping: Jönköping University, 2009), p. 174.

[975] The *Brittingham v. Commissioner* case, 66 T.C.373 (1976), 598 F.2d 1375 (5th Cir. 1979).

[976] *R.T. French Co. v. Comr.*, 60 T.C. 836 (1973).

"The Commissioner does not seriously contend that the 1946 agreement was not representative of an arm's length bargain. To be sure, the opportunity may have existed for petitioners, two unrelated British parent companies, which also jointly owned the company holding a majority of a majority of MPP's stick, to cause petitioner to agree to an arrangement that unfairly favored MPP, but it seems unlikely that petitioner's parent companies would have done so, because they would thus have been diverting funds from a corporation (petitioner) in which they were the sole stockholders to another corporation (MPP) in which an unrelated company owned 49 percent of the stock. The position of the unrelated company in the scheme of things are all likelihood assured the arm's length character of the transaction."[977]

Therefore, the Tax Court held that the IRS did not have the authority to reallocate amounts paid under the royalty agreement in 1963 and 1965, by which time French's shareholders had acquired 100% of the stock of MPP. It should be noted that the Court's reasoning would not have applied if the IRS had been seeking to allocate income to MPP, the 51%-owned entity, from French, the 100%-owned entity. In those cases where the common controlling person owns a greater proportion of the entity from which the IRS seeks to allocate income than of the entity to which an income allocation is sought, the relationship between the price and the common control can more easily be inferred.

According to the Tax Court, the *French* case was fundamentally different with the *Forman* case:

"The *French* case is entirely different from the superficially similar situation in *B. Forman Co. v. Comr.* [...]. The question before us is whether, as a practical matter, the 1946 agreement was in fact such as might have been entered into at arm's length, and in this respect the 49% interest of the unrelated company in MPP becomes highly relevant".[978]

In *Forman* two shareholders acted in concert and had identical interests with respect to transactions with their jointly owned company. In the *French* case the real economic adversity of interests assured the arm's length character of the

[977] 60 T.C. at 851. Cf., *Brittingham v. Comr.*, 66 T.C. 373 (1976) (two businesses owned and controlled by different by related individuals were not commonly controlled because there was no design to shift income among them), *aff'd*, 598 F.2d 1375 (5th Cir. 1979).
[978] 60 T.C. at 851, note 7.

transactions and contrasts sharply with the fundamentally different situation in *Forman*.

However, in *National Semiconductor Corp. v. Comr.* the court did not accept above reasoning due the absence of specific evidence as to the nature of the joint venture relationship and the specific motivation for the prices in question. [979] In this case the taxpayer owned 49% of a joint venture and an unrelated party owned the remaining 51%. According to the IRS, certain transactions between the taxpayer's foreign subsidiaries and the joint venture were uncontrolled transactions and, therefore, it was appropriate to use the cost plus mark-up percentage from these transactions to determine the arm's length price of devices sold directly from the subsidiaries to the taxpayer. The court declined to apply the mark-up percentage obtained in the transactions involving the joint venture, distinguishing *R.T. French* on the grounds that there was no evidence that the joint venture was not controlled by the taxpayer. The court concluded "the opportunity may have existed to favor [the joint venture] with lower than normal prices [...] and we cannot conclude that such pricing would have been detrimental to [the taxpayer]." The court did not give an elaboration on its conclusion. The court emphasized that the existence of control as defined by the regulations is a factual issue that depends on the circumstances of each individual case. Apparently, the party seeking to assert the absence of control between the taxpayer and a joint venture in which it owns a significant, but less than 50%, interest may have to establish that point by bringing forth specific evidence of the circumstances surrounding the transaction. This would also be the case even if the presence of control suggests transactional results opposite to those on which the transaction is being challenged.

Some authors argue that the decision in *Forman* is of limited scope.[980] Although *Forman* suggests that even a venture that does not own a majority interest may be considered to control a joint venture if the co-venturers act in concert, those authors state that this holding may be of limited scope.[981]
Where the IRS is unable to show that both co-venturers are engaging in non-arm's length dealings with the venture, it should not be able to argue that the co-venturers have acted in concert for purposes of Section 482. Its ability to show

[979] 67 T.C.M. 2849, 2872 (1994).
[980] Krupsky, K., "Chapter 10: Application of Section 482 to international Joint Ventures", 890 *BNA Tax Management* (2001).
[981] Davis, B. and Lainoff, S., "U.S. Taxation of Foreign Joint Ventures,"46 *Tax L. Review* (1991), pp. 165, 206.

common control will be impaired. The authors furthermore state, that as a practical matter, in the absence of a corresponding non-arm's length transaction by the co-venturer, a court certainly would ask why a rational business person intentionally would shift profits to an entity in which a material unrelated party owned a substantial interest, thus diluting one's share of those profits and therefore would require a much more convincing evidence of control in fact. While the presence of a material unrelated co-venturer does not automatically preclude the IRS from making a Section 482 adjustment on a transfer of property to the venture, the presence of the co-venturer certainly raises the burden to a level the government rarely be able to meet. [982]

The term "control" includes any kind of control, direct or indirect, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose.[983] It can be said that this is a codification of the position of the IRS in the *Forman* case. The Regulations seem to require an inquiry into whether income or deductions have been arbitrarily shifted, in order to decide if control exists and Section 482 can be applied. In order to conclude that there has been "arbitrarily shifting", it should be examined whether income or deductions in a particular transaction have been determined on a basis other than arm's length negotiations between parties with adverse economic interests (for instance, in a situation where the buyer seeks something other than the lowest price and/ or the seller seeks something other than the highest price).

In *DHL Corp. v. Commissioner* the conditions for control were satisfied in a situation where a US company sold a trademark to a foreign company, even though at the time of the transaction the companies were owned and controlled by different interests.[984] However, the sale took place in accordance with an option agreement which had been entered into at a time when the companies were owned and controlled by the same interests. According to the Court of Appeals, the conditions for control should be assessed at the time when the option agreement was entered into and the transfer price determined.

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[982] Ibid.

[983] Regs. Section 1.482-1(i)(4).

[984] *DHL Corp.v. Commissioner*, 285 F.3d 1210 (9th Cir. 2002). See also Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Series on International Taxation, Vol. 35 (London: Kluwer Law International, 2010), p. 65.

Interestingly, the arm's length standard is used as a test for control. However, Krupsky is of the opinion that this arm's length standard in the joint venture context means something "quite different" from the complex pricing methodologies for determining an arm's length price under the regulations. In this case, according to Krupsky, the issue is whether the joint ventures, and their joint venture entity, have structured particular transactions based on arm's length, adverse economic interests. If they have, then the regulatory pricing methods should not be applied to compel an arm's length price. Krupsky states that if the parties have acted *in concert* with a common tax interest, then control can be found and the price for the particular transaction arguably should be determined under the regulatory methodologies.[985]

6.3.5. Conclusions

The basic US transfer pricing provision is included in Section 482 of the US Internal Revenue Code. Section 482 reflects the arm's length principle. The reliance on the arm's length principle as the sole allocation norm in US federal tax law was recently confirmed in the *Xilinx* case.[986]
The first regulations interpreting the forerunner of Section 482, Section 45, were issued in 1934, as Article 45-1 of Regulations 86. These regulations remained virtually unchanged through repeated re-enactments of the revenue laws, including the Internal Revenue Codes of 1939 and 1954.[987] The Regulations were framed in very general terms, without attempting to define methods of allocation or their application to specific transactions. In these regulations "control" was explained as any kind of control whether direct or indirect. The Regulations stated that it is the reality of control that is decisive, not its form or the mode of its exercise. Therefore, association for transfer pricing purposes was based on a *de facto* control situation. In General Counsel's

[985] Krupsky, K.. "Chapter 10: Application of Section 482 to international Joint Ventures", 890 *BNA Tax Management* (2001).
[986] *Xilinx, Inc. v. Commissioner,* 567 F. 3d 482 (9th Cir. 2009). On 12 August 2009 the taxpayer filed a petition with the Court of Appeals for a rehearing. *Xilinx, Inc. v. Commissioner*, Nos 06-74246 and 06-74269. On 13 January 2010 the Court of Appeals for the Ninth Circuit withdrew its opinion. On 22 March 2010 the Court issued a revised opinion.
[987] See, e.g., Treas. Reg. 118 para. 39.45-1 (1953), the last published regulations under the Internal Revenue Code of 1939, and Treas. Reg. Para. 1.482-1 (a), (b) and (c), adopted by T.D. 6595, 1962-1 Cum. Bull. 49. See also Jenks, T., *Treasury Regulations under 482*, 23 Tax Law 279 (1969-1970), p. 279.

Memorandum 2856, it was stated that the Board of Tax Appeals had aptly described the terms "owned or controlled directly or indirectly by the same interests" as "doubtful and impossible of a strict definition".[988]

The scope of Section 482 is very broad. It applies to domestic as well as cross-border transactions of organisations and individual taxpayers. The concept of control between taxpayers as the legal basis for the application of Section 482 also covers transactions between independent parties that act in concert with a common goal or the same interest. A controlled taxpayer is understood to mean any one or more taxpayers who are owned or controlled directly or indirectly by the same interests. This includes taxpayers who own or control other taxpayers. A presumption of control arises if income or deductions have been arbitrarily shifted between taxpayers.
Because of the broad interpretation of control, the US tax authorities have substantial power to consider controlled transactions between taxpayers as being subject to Section 482.Various situations of business relationships between legally unrelated parties could therefore be subject to transfer pricing adjustments.

The current concept of *control,* included in the US Regulations, has the same broad meaning. It includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. The reality of control is decisive, not its form or the mode of its exercise. Therefore, it may be concluded that the concept of control in the United States is based on the substance of control rather than formal ownership. The US regulations focus on the actual control between any two or more taxpayers acting in a common interest regardless of the existence of a *de jure* relationship.

Several decisions of the US Tax Courts concerning the interpretation of control can be considered questionable. For example, in the *South Tex. Rice Warehouse Co.* case, the Tax Court relied in part on the proposition that the business operations of the partnership (drying and warehousing rice) were tied to the operations of the corporation (owning and leasing facilities for drying and storing of rice). However, there was no authority in the statute for concluding that businesses are commonly controlled merely because their

[988] VII-1 Cum. Bull. 128, 130 (1928).

operations were interdependent. If integration of business operations were in itself sufficient to show common control, as correctly noted by Murdoch, Section 482 would suddenly become significant in a host of situations where it has never been considered significant.[989] For instance, an automobile manufacturer and a franchised dealer would be considered under common control on the grounds that, without the products of the manufacturer, the dealer would have no inventory and that concomitantly, the manufacturer would have no outlet for his product in the dealer's area.
In *B. Forman v. Commissioner* the Tax Court's focus was on ownership, whereas the Court of Appeals focused on the reality of control and the ability to arbitrarily shift income between the taxpayers rather than on the formal stock ownership of the taxpayers.[990] In *Brittingham*, although the owners of an enterprise were related by a family relationship, they lacked a common design or plan to shift income between them and therefore did not fulfil the "control by same interests" criterion under Section 482.[991] The court in this case focused on the reality of the situation rather than on the family relationship between the two enterprises to determine whether the meaning of "*control by the same interests*" for the application of the transfer pricing laws existed.

On first sight, control in Sec. 482 seems to cover all kinds of control, including *de jure* and *de facto* control. This is confirmed by the US Regulations. According to the Regulations, the actual control between two or more taxpayers and the potential ability of the taxpayers to arbitrarily shift income and deductions between the taxpayers are decisive. In this regard, the form in which the control is exercised by the taxpayers is not decisive. However, although the definition of "associated enterprises" under Sec. 482 is broad and the US Regulations 1.482-1 (i) (4) supplement this broad concept with the terms "whether legally enforceable or not" and "including control resulting from [...] acting in concert [...]", this does not mean that US courts (will) interpret the term "control" in such way that adjustments can be made where an independent buyer has a

[989] See also Murdoch, C., "The Scope of the Power of the Internal Revenue Service to Reallocate Under Section 482", 6 *Boston College Industrial and Commercial Law Review* 717 (1965), p. 720.
[990] The *B. Forman Co. v. Commissioner* case, 453 F.2d 1144, 1155 (2d Cir. 1972), *certiorari denied*,407 U.S. 934 (1972), see Kelleher, M.F. & Wright, D.R., "Materials of the U.S. corporate income taxation course", held in IBFD, Amsterdam, the Netherlands, TP Supplement No. 25, October 1999, pp. 297-298; see also Hamaekers, H., "Introduction to Transfer Pricing", *Tax Treatment of Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), Chapter 5: Associated Enterprises.
[991] The *Brittingham v. Commissioner* case, 66 T.C.373 (1976), 598 F.2d 1375 (5th Cir. 1979).

dominating market position. As Judge Noonan stated in the *Xilinx case*, a pure application of the arm's length principle (tax parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions) prevails over the text of the US Regulations. The application of the arm's length principle does not cover *de facto* control.

6.4. Germany

6.4.1. Brief historical overview

In Germany transfer pricing adjustments may be made on different legal bases: Section 8 (3) of the Corporate Income Tax Act (*Körperschaftssteuer-gesetz*), Section 1 of the Foreign Tax Act (*Außensteuergesetz*) and Sections 4 (1) and 5 (6) of the Income Tax Act (*Einkommensteuergesetz*).

The *Außensteuergesetz* (hereinafter: Foreign Tax Act) was incorporated in 1972 and includes the arm's length principle *(Grundsatz des Fremdvergleichs)*.

In 1983 the Federal Republic of Germany became the first state outside the United States to adopt a comprehensive set of guidelines covering transfer pricing. The German Ministry of Finance provided general guidance through the 1983 Circular on the international allocation of income resulting from transactions between associated enterprises.[992] The 1983 Circular dealt with various types of intra-group transactions and the transfer pricing methods to be applied. It followed the 1979 OECD Report on Transfer Pricing and Multinational Enterprises.

In 2005 a Circular was introduced containing new transfer pricing rules. Section 90 (3) of the General Tax Code established specific documentation requirements with related parties as early as 2005. This was further specified by the 2005 Circular.[993] As a result, taxpayers need to prepare comprehensive documentation that describes the facts and circumstances of the business of the enterprise, and the commercial environment in which the enterprise operates. The taxpayers need to demonstrate that they are dealing at arm's length. If there is a failure to comply with these transfer pricing requirements, Sections 162 (2), 162 (3) and 162 (4) provide far-reaching authority to the tax administration to

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[992] Principles Governing the Examination of Income Allocation between Multinational Enterprises, 1983, BMF-Schreiben, 23 February 1983- *Verwaltungsgrundsatze Gewinnabgrenzung*.

[993] 2005 Transfer Pricing Circular (BStBl I 2005 569). Hidden distributions were initially valued on the basis of the ordinary market value (*gemeinen Wert)*. This could mean that the results would be contrary to the arm's length principle. See Bundesfinanzhof decisions of 18 October 1967, I R 262/63 (BStBl II 1968 105) and 27 November 1974, I R 250/72 (BStBl 1975 306). See also Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Series on International Taxation, Vol. 35 (London: Kluwer Law International, 2010). The 2005 Transfer Pricing Circular stated that the allocation norm for hidden distributions is the arm's length principle (valuation at their going concern value).

estimate the tax base and to impose penalties where due to a lack of documentation it is assumed that the taxpayer has understated the taxable income.

6.4.2. Section 1 Foreign Tax Act

The basis for the arm's length principle *(Grundsatz des Fremdvergleichs)* is included in Section 1 of the Foreign Tax Act (hereinafter: AStG). The text of Section 1 AStG reads as follows:

"(1) If a taxpayer's income from business dealings with foreign countries with a related person is reduced because the taxpayer's foundation for the determination of his income is based on other conditions, particularly prices (transfer prices), than those that would have been agreed upon between unrelated parties under the same or similar circumstances (arm's length principle), then, notwithstanding the other provisions, his income shall be determined as if it had accrued under conditions made between unrelated parties. For the application of the arm's length principle, it is assumed that the unrelated parties are aware of all essential circumstances of the business dealing and act on the principles of a prudent business manager. If the application of the arm's length principle causes any further adjustments than the other provisions, the further adjustments will have to be made in addition to the tax consequences of the other provisions."[994]

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[994] Translation from IBFD Transfer Pricing Database, Chapter Germany. The original German text reads as follows:

"Gesetz über die Besteuerung bei Auslandsbeziehungen

(1) Werden Einkünfte eines Steuerpflichtigen aus einer Geschäftsbeziehung zum Ausland mit einer ihm nahe stehenden Person dadurch gemindert, dass er seiner Einkünfteermittlung andere Bedingungen, insbesondere Preise (Verrechnungspreise), zugrunde legt, als sie voneinander unabhängige Dritte unter gleichen oder vergleichbaren Verhältnissen vereinbart hätten (Fremdvergleichsgrundsatz), sind seine Einkünfte unbeschadet anderer Vorschriften so anzusetzen, wie sie unter den zwischen voneinander unabhängigen Dritten vereinbarten Bedingungen angefallen wären. Für die Anwendung des Fremdvergleichsgrundsatzes ist davon auszugehen, dass die voneinander unabhängigen Dritten alle wesentlichen Umstände der Geschäftsbeziehung kennen und nach den Grundsätzen ordentlicher und gewissenhafter Geschäftsleiter handeln. Führt die Anwendung des Fremdvergleichsgrundsatzes zu weitergehenden Berichtigungen als die anderen Vorschriften, sind die weitergehenden Berichtigungen neben den Rechtsfolgen der anderen Vorschriften durchzuführen."

According to Section 1 AStG, the income of a taxpayer will be increased if the taxpayer's income from business dealings with a related person abroad is reduced because of transactions that are not at arm's length. If transfer prices differ from those that would have been agreed upon between unrelated parties under the same or similar circumstances, adjustments will be made by the German tax authority. In such a case, the income must be increased to a level commensurate with third-party conditions. Section 1 AStG refers to the arm's length principle.
In 2007 changes were made in Section 1 AStG. These changes entailed that not only prices being subject to the arm's length test, but also the agreement itself. Furthermore, the concept of the *prudent business manager* was introduced in the legislation. It is assumed that all information is available to the two prudent business managers who are engaged in the transaction. Section 1 AStG also deals with the priority of transfer pricing methods and the arm's length ranges. Finally, Section 1 AStG also deals with price setting methodology in case no third party data is available.[995]

With respect to the term "Nahe stehend" ("related") Vögele states:

"Nur wenn die ausländische Person, mit der der Steuerpflichtige in Geschäftsbeziehungen steht, dem Steuerpflichtigen "nahe steht", kommt eine Einkünftekorrektur in Betracht. Der Begriff "nahe stehend" wurde bereits vor Inkrafttreten des AStG in Zusammenhang mit der *verdeckten Gewinnausschüttung* entwickelt.[996] Eine verdeckte Gweinnausschüttung liegt vor, wenn eine Kapitalgesellschaft ihrem Gesellschafter einkommenswirksam einen Vorteil außerhalb der *gesellschaftsrechtlichen Gewinnverteilung* zuwendet, den sie bei Anwendung der Sorgfalt eines ordentlichen und gewissenhaften Geschäftsleiter einem Nichtgesellschafter unter gleichen Umständen nicht gewährt hätte.[997] Der Vorteil kann jedoch dem Gesellschafter auch mittelbar über eine dritte –dem Gesellschafter "nahe stehende"- Person gewidmet werden.[998]" [999]

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[995] Eigelshoven, A. and Kroppen, H., *Germany- Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), para. 2.1.1.
[996] See BFH 25.10.1963, BStBl. III 1964, 17.
[997] See BFH 22.2.1989, BStBL. II 1989, 631.
[998] See BFH 18.7.1985, BStBL. II 1985, 635.
[999] Vögele, A. et al., *Handbuch der Verrechnungspreise*, 2nd ed. (München: Verlag C.H. Beck, 2004), p. 82.

It should be noted that the concept of relationship in Section 1 AStG is different from that involved in a hidden profit distribution or a hidden capital contribution. Kroppen and Eigelshoven note that in these cases there is no specific statutory provision defining the relationship that must be present before the rules governing the hidden profit distribution and hidden capital contributions can be applied.[1000] However, the concept of hidden contribution (informal capital) was developed in several court cases by the Bundesfinanzhof.[1001] The size of the shareholder's participation is normally irrelevant in this context as any type of corporate relationship would qualify. This also includes portfolio-holdings.
Kroppen and Eigelshoven point out that in practice, however, the tax authorities' burden of proof increases if the participation of the recipient of the hidden profit distribution has no power through a substantial participation, or by other means, to influence the decision process of the company or by other means. In such cases, the shareholders usually would not allow another shareholder any extra benefit. Kroppen and Eigelshoven refer to the Bundesfinanzhof, which held the same view.[1002] If the benefit under consideration is not directly received by the shareholder but by another person, the question arises whether the shareholder is "related" to that other person. Such a relationship may be contractual or merely factual, and may include another corporate link (e.g. to a sister corporation of the taxpayer corporation).[1003]

The original intent of Section 1 of the Foreign Tax Act was to expand domestic law to enable the German tax authority to increase the income of a domestic taxpayer for all non-arm's length transactions.[1004] The second paragraph of Section 1 AStG describes when an association for transfer pricing purposes ("related person") can be established:

[1000] Eigelshoven, A. and Kroppen, H., *Germany- Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), para. 2.2.
[1001] See BFH 1.10.1986, BStBl. II 1987, 459; BFH 6.12.1967, BStBl. II 1968, 332; BFH 18.7.1985, BStBl. II 1985, 635; BFH 31.7.1974, BStBl. II 1975, 48; BFH 25.10.1963, BStBl. III 1964, 17. See also Vögele, A. et al., *Handbuch der Verrechnungspreise*, 2nd ed. (München: Verlag C.H. Beck, 2004), pp. 82-83.
[1002] See BFH 6.3.2003, DStRE 2003, p. 1374.
[1003] Eigelshoven, A. and Kroppen, H., *Germany- Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), para. 2.2.
[1004] Ibid., at 2.1.

"(2) A person is a person related to the taxpayer:
(1) if such person holds, directly or indirectly, a participation equal to or in excess of one fourth of the taxpayer's capital (substantial participation), or if such person is able to exercise a controlling influence, directly or indirectly, on the taxpayer, or, vice versa, if the taxpayer holds a substantial participation in such person's capital or is able to exercise a controlling influence, directly or indirectly, on such person; or
(2) if a third person holds a substantial participation in both such person's and the taxpayer's capital or is able to exercise a controlling influence, directly or indirectly, on both of them; or
(3) if such person or the taxpayer, in reaching agreement on the conditions of a business transaction, is able to exercise influence through channels outside such transaction, or if one of them has an interest of his own that the income accrue to the other party."[1005]

The Foreign Tax Act provides four forms of relationships:

(a) *Wesentliche Beteiligung*
A substantial participation of at least 25% in a domestic or foreign entity or a third entity having common control through a substantial participation in a domestic and a foreign entity.[1006] Vögele states in this context:

"Eine wesentliche Beteiligung liegt nur vor, wenn dem Steuerpflichtigen, der Person oder dem Dritten mindestens 25% der Gesellschaftsanteile

[1005] The original German text reads as follows:
[...]
(2) Dem Steuerpflichtigen ist eine Person nahestehend, wenn
1. die Person an dem Steuerpflichtigen mindestens zu einem Viertel unmittelbar oder mittelbar beteiligt (wesentlich beteiligt) ist oder auf den Steuerpflichtigen unmittelbar oder mittelbar einen beherrschenden Einfluß ausüben kann oder umgekehrt der Steuerpflichtige an der Person wesentlich beteiligt ist oder auf diese Person unmittelbar oder mittelbar einen beherrschenden Einfluß ausüben kann oder
2.eine dritte Person sowohl an der Person als auch an dem Steuerpflichtigen wesentlich beteiligt ist oder auf beide unmittelbar oder mittelbar einen beherrschenden Einfluß ausüben kann oder
3.die Person oder der Steuerpflichtige imstande ist, bei der Vereinbarung der Bedingungen einer Geschäftsbeziehung auf den Steuerpflichtigen oder die Person einen außerhalb dieser Geschäftsbeziehung begründeten Einfluß auszuüben oder wenn einer von ihnen ein eigenes Interesse an der Erzielung der Einkünfte des anderen hat.
[1006] According to the Administrative Regulations of 1983, profit-sharing loans and silent partnerships may also constitute a substantial participation.

zuzurechnen sind, die mit *Stimm- und Vermögensrecht* ausgestatted sind. Ohne entsprechenden Anteil am Nennkapital reicht ein Viertel des Stimmrechts nicht aus."[1007]

Parties are considered to be related if one entity, either resident or non-resident, directly or indirectly holds 25% or more capital in another entity, or if a third entity holds a substantial participation in the capital of both entities.
In the case of holding capital between two entities, the Foreign Tax Act concludes the existence of a substantial participation in capital when there is a 25% shareholding. However, the Foreign Tax Act does not elaborate on what "substantial participation" means in the case of two entities under common control of a third entity. According to Schnorberger, substantial participation by the third entity should be based on shareholding with a holding of at least 25% in the capital in both entities in order to constitute the ability to control and influence business activities of both entities.[1008] Under German transfer pricing laws, substantial participation covers not only shareholding participation but also participation in partnerships and participation in businesses carried on by individuals.[1009] Substantial participation can have various forms. For instance, a loan arrangement can be considered to be a substantial participation. The German transfer pricing laws also cover individuals.

(b) *Beherrschender Einfluss*
Either the resident or the non-resident entity can directly or indirectly exert a controlling influence on the other, or both are under the controlling influence of a third party.[1010] The tax administration has stated that, for instance, a managerial relationship would be covered by this. The concept of "Beherrschender Einfluss" can be interpreted as "die *absolute Abhängigkeit* auf Grund struktureller Gegebenheiten".[1011] However, as pointed out by Vögele, absolute dependency cannot easily be determined in every case:

[1007] See Vögele, A. et al., *Handbuch der Verrechnungspreise*, 2nd ed. (München: Verlag C.H. Beck, 2004), p. 83.
[1008] Schnorberger, S., "The Application of Transfer Pricing Rules and the Definition of Associated Enterprises", 6 *International Transfer Pricing Journal* 5 (1999), p. 191.
[1009] Administrative Principles for the Examinations of Income Allocation in the Case of Internationally Related Enterprises, German Federal Ministry of Finance, 23 February 1983, Section 1.3.2.2.
[1010] Section 1 (2) (1) of the Foreign Tax Act.
[1011] Ibid., p. 84.

"Einflussquellen können sich auch aus der Stellung als Darlehensgeber oder stiller Beteiligter, als Lieferant, als Lizenzgeber oder als marktbeherrschender Kunde ergeben. Im Einzelfall dürfte es jedoch äußerst schwierig sein, zu beweisen, dass die Einflussquelle tatsächlich strukturell zur absoluten Abhängigkeit führt. Denn in der Praxis bewirken oft besondere Marktverhältnisse ein gleichgerichtetes Handeln von Lieferant, Kunde und zu betrachtenden Unternehmen, die nicht zu beherrschendem Einfluss i.S.d. Sec. 1 AstG führen."

The meaning of "controlling influence" is not precisely defined in the German legislation, but in the literature it has been suggested that a controlling influence can exist if the voting rights in an enterprise qualify with the shares held of subscribed capital (25% shareholding) or if the voting rights represent at least 50% of all voting rights.[1012]According to the German Administration, a controlling influence can be based on legal relationships or on factual circumstances or on a combination of both.[1013] The Administrative Principles should, however, be considered to be a non-binding explanation.Controlling influence may also cover situations of *de facto* control arising from transactions between independent enterprises. According to subparagraph 3 of Section 1(2) of the Foreign Tax Act, an entity may be deemed to be related to another party subject to transfer pricing assessments if the entity is able to exercise an influence on the other entity in agreeing the terms of a business relationship. This is also the case if one entity has its own interest in the income earned by the other entity (see points (c) and (d) below).

(c) *Geschäftsfremde Einflussmöglichkeiten*

This criterion means that one party is able to influence the terms of a business relationship with another party through an outside channel. For instance, a German director of a German company provides an interest-free loan to his son, who lives abroad and is a director of a foreign company. The loan is being provided by the German company to the foreign company. In this case the personal relationship between the two directors influences this loan.

[1012] Schnorberger, S., "The Application of Transfer Pricing Rules and the Definition of Associated Enterprises", 6 *International Transfer Pricing Journal* 5 (1999), p. 191.

[1013] Administrative Principles for the Examinations of Income Allocation in the Case of Internationally Related Enterprises, German Federal Ministry of Finance, 23 February 1983, Section 1.3.2.4

(d) *Interessenidentität*

One party has an interest of his own in the income of another party.[1014] This covers among others financial and personal interests. Although the Foreign Tax Act did not provide a definition of "interests", the Bundesfinanzhof confirmed that besides formal, economic or financial interests,[1015] the term "interests" also covered personal interests. [1016]

In addition to the arm's length principle, the tax authorities are of the opinion that when a payment is deducted, this must be based on contractual agreements that were entered into in advance, in clear and unambiguous terms.[1017] This condition is considered to be an anti-avoidance measure and is a result of the jurisprudence of the Bundesfinanzhof. The jurisprudence focused on the business relationships between individuals belonging to the same family, but it later also covered payments made to controlling shareholders. The condition is now designed to prevent a group of related taxpayers from rearranging their tax situation to their advantage using the benefit of hindsight.[1018]

In its decision of 19 January 1994, the Bundesfinanzhof held that *de facto* control, in the case of one entity having its own interest in the income earned by the other entity, mainly arises between parties that have family relationships.[1019] The German courts have also ruled that a deemed dividend distribution may arise even in cases without direct participation in the capital of the distributing enterprise. The relationship between the recipient entity and the distributing entity may be based on the participation in capital, voting rights and family, contractual or other relationships.

[1014] See also Hamaekers, H., "Introduction to Transfer Pricing", *Tax Treatment of Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), Chapter 5: Associated Enterprises.

[1015] See BFH 19.1.1994, BStBl. II 1994, 725.

[1016] Vögele states that "Alleine ein Verwandtschaftsverhältnis i.S.d. Sec. 15 AO begründet noch keine Interessenidentität, folglich müssen zusätzliche Anhaltspunkte für eine Interessengemeinschaft vorliegen". See Vögele, A. et al., *Handbuch der Verrechnungspreise*, 2nd ed. (München: Verlag C.H. Beck, 2004), p. 86.

[1017] Sections 3.4.12.8., 3.4.20.e and 6.1.1. of the administrative principles procedures. See also Eigelshoven, A. and Kroppen, H., *Germany- Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), at 2.1.2.

[1018] See BFH 26.4.1989, BStBl. II 1989, 673; BFH 12.10.1995, BFH/NV 1996, p. 266; see also Eigelshoven, A. and Kroppen, H., *Germany- Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), at 2.1.2.

[1019] See BFH 19.1.1994 I R 93/94, Federal Tax Gazette II, 1994, p. 725.

6.4.3. Conclusions

Section 1 AStG is the provision in German tax law that explicitly mentions the application of the arm's length standard. This section contains a definition of the concept of associated enterprises. It can be concluded that the German transfer pricing laws cover relationships of both corporate and individual taxpayers. The German transfer pricing laws do not explicitly include the requirement of a participation in the management of an entity for the transfer pricing regulations to be applied. It focuses on the shareholding participation and covers not only *de jure* relationships, but also *de facto* control. The German tax courts have also ruled that family relationships between parties may be included when determining control. The expression "has an interest of his own" of Section 1 (2) (3) AStG refers to an anti-avoidance measure. From the wording of Section 1 AStG it may be argued that open market situations between legally non-related parties may be subject to transfer pricing adjustment in Germany, for instance where a buyer has a dominating negotiating power and for this reason can dictate the prices of the legally independent seller. However, it is doubtful whether the German tax courts will accept this: the jurisprudence focused mainly on family relationships and situations where already a relationship based on company law existed.[1020]

It may be concluded that the German concept of associated enterprises is a concept, still to be delineated by tax courts within the ambit of the arm's length principle. However, it is not likely that the term "control" will be interpreted by US and German courts to cover open market situations (for instance, a buyer with a very strong negotiating power). Such an interpretation would be in conflict with a pure application of the arm's length principle itself.

[1020] See BFH 26.4.1989, BStBl. II 1989, 673; BFH 12.10.1995, BFH/NV 1996, p. 266; BFH 19.1.1994 I R 93/94, p. 725. Eigelshoven, A. and Kroppen, H., *Germany- Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), at 2.1.2.

6.5. Sweden

6.5.1. Brief historical overview

Sweden applies the arm's length principle as a method to allocate profits between members of a multinational enterprise. Adjustments are made by applying the concealed dividend rules or by applying the rules concerning capital contributions. The arm's length principle is included in Section 19 and Section 20 of Chapter 14 of the Income Tax Act (ITA).[1021] Section 19 states (unofficial translation):

"If the result of an enterprise is reduced as a consequence of conditions being agreed that deviate from what would have been agreed between unrelated enterprises, the result will be defined as the amount to which it would have resulted if such conditions had not existed. This applies only if:
- the party that reports a higher result on account of the contractual conditions is not to be taxed on this result in Sweden pursuant to the provisions of the Income Tax Act or under an applicable tax treaty;
- there is reason to believe that there is a community of economic interests between the parties; and
- it is not obvious from the circumstances that the conditions have arisen for reasons other than the community of economic interests."

Section 20 of the ITA Chapter 14 reads:

"The community of economic interests referred to in Section 19 is deemed to exist if:
- an enterprise participates directly or indirectly in the management or control of another enterprise or owns a part of the capital of that enterprise; or
- the same persons participate directly or indirectly in the management or control of the two enterprises or own part of the capital of these enterprises.

Section 19 of ITA Chapter 14 provides the legal basis of the arm's length principle. An adjustment will be made when the result of an enterprise has been reduced in Sweden as a consequence of contractual terms that deviate from those that unrelated parties in similar circumstances would have agreed. There

[1021] The Swedish "Inkomstkattelagen".

are three additional conditions that must be fulfilled before an adjustment can be made.
The party that reports a higher result, in other words the party to whom the income is transferred, may not be liable to tax in Sweden pursuant to the provisions of the ITA or under an applicable tax treaty. Secondly, there should be a *community of economic interests* between the parties. Finally, the specific conditions used for the transactions were motivated by these common economic interests.

The adjustment provision as laid down in Sections 19 and 20 of the ITA Chapter 14 finds its origin in the early 1920s. In 1928 an adjustment provision was introduced. This provision was amended in 1965 to conform to Swedish income tax treaties. As from 1965 the article also applied to transactions regardless of whether the parent company was Swedish. In 1982 revisions of these Sections introduced the vague concept of probability. The tax authority had to prove that there was a *probable community of interests*. The wording of this adjustment provision was altered in 2001 in connection with the enactment of the ITA.[1022] However, it was emphasised in the preparatory work to the new ITA that the amendment was strictly editorial.

In the Swedish Tax Agency's regulations on documentation of transfer pricing between associated enterprises, a definition of the arm's length principle is provided. The arm's length principle is the principle that commercial and financial transactions must be based on the same terms and conditions that would have been applied between independent enterprises.[1023] The preparatory work to the Swedish transfer pricing documentation rules refers to the transfer pricing methods as described in the OECD TP Guidelines.[1024] Almost all treaties for the avoidance of double taxation between Sweden and other countries contain a rule similar to Art. 9 (1) OECD Model.

[1022] Arvidsson, R. and Bjarnas, S., *Sweden- Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), at 2.3.
[1023] SKVFS: 2007, Section 1. Translation by the Swedish Tax Agency. Only the Swedish text is authentic.
[1024] SKV M 2007: 4 by the Swedish Tax Agency.

6.5.2. Community of economic interests

The adjustment provisions of Sections 19 and 20 of the ITA Chapter 14 are directed at a contractual relationship. Section 19 of the ITA Chapter 14 requires the existence of a "community of economic interests". Two or more contracting parties should be involved in the transaction which results in the transfer of income. One of the two parties must be an enterprise subject to tax in Sweden. The other party may not be subject to tax in Sweden pursuant to the provisions of the ITA or under an applicable tax treaty. Although not clearly mentioned in the articles, the preparatory work indicates that this other party may also be either an individual or a legal entity. It is not necessary that this other party be an enterprise. This is different from Art. 9 OECD Model, which only deals with transactions between associated *enterprises*. According to Swedish law, an enterprise is an individual or a legal entity that is engaged in economic activity of a professional nature.[1025]

A "community of economic interests between the parties" is explained in Section 20 of the ITA Chapter 14. According to Swedish tax law, a community of interests is deemed to exist if an enterprise participates directly or indirectly in the management or control of another enterprise or owns a part of the capital of that enterprise. A community of interests is also deemed to exist if the same persons participate directly or indirectly in the management or control of the two enterprises or own part of the capital of these enterprises. This provision follows Art. 9 OECD Model:

"[...]a. An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
b. the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State [...]"

One of the enterprises may own, directly or indirectly, a part of the capital of the other enterprise or the same person may own a part of the capital of both enterprises. It should be noted that according to the earlier preparatory work, the foreign subject does not need to be an enterprise; it may also be an individual. The regulations do not mention the formal criteria for the participation in capital, such as a specific threshold required. Furthermore,

[1025] Arvidsson, R. and Bjarnas, S., *Sweden- Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), 2.6.

there are no detailed rules or guidelines in Swedish tax law concerning the interpretation of this form of community of interests.
Some Swedish authors hold the view that the proportion of the total capital that must be held in order to be regarded by the law as having owner influence could be very small. The larger the enterprise and the amount of capital involved, the smaller this proportion could be.[1026] In their opinion, the concept of "community of economic interests" is so broad that all forms of control which imply a substantive influence upon the company's operations seem to be included.

6.5.3. Conclusions

Sweden applies the arm's length principle as a method to allocate profits between associated enterprises. This is stated in Sections 19 and 20 of ITA Chapter 14. The Swedish concept of associated enterprises is based on a "community of economic interests between the parties". According to Section 20 of ITA Chapter 14, this community of interest is deemed to exist if:

- an enterprise participates directly or indirectly in the management or control of another enterprise or owns a part of the capital of that enterprise; or
- the same persons participate directly or indirectly in the management or control of the two enterprises or own part of the capital of these enterprises.

It seems that *de facto* control, as an independent criterion, is not covered by Section 20 of ITA Chapter 14. The notion of "community of interest" may represent the counterpart of "different interests". In an arm's length situation, two parties dealing with each other have different interests. One party (the buyer) wants to pay the lowest price possible for the product or service; the other party (the seller) wants to receive the highest price possible. This means that there is no community of interest where an independent buyer can dominate the prices of the independent seller because of his strong market position. For the above reasons I conclude that the Swedish concept of "associated enterprises" follows the OECD concept of "associated enterprises".

[1026] Ibid.

6.6. India

6.6.1. Brief historical overview

Prior to the introduction of the Finance Act 2001, India did not have specific transfer pricing regulations. The term "arm's length" was neither used nor explicitly defined in the Indian Income Tax Act 1961 (ITA 1961). However, several provisions in the ITA 1961 contained principles similar to the arm's length principle. For instance, profits of a business had to be computed under fair market conditions. Section 92 of the ITA 1961 could be regarded as a rule dealing with transfer pricing manipulation. This section was replaced by comprehensive legislation in 2001.

In one of the first decisions on transfer pricing regulations, an Indian Tax Tribunal commented the following:

"In mid 1991, India gave up its restrictive approach in matters of foreign import and foreign exchange and adopted liberalized economic and fiscal policies. This action paid good dividends and significant foreign multinational companies set up their business operations in India. With the opening up of economic prospects and the rise of "Brand India", international tax gained ground and it became imperative to make changes in the Indian tax structure. The multinational enterprises and their ability to allocate profits to sister concerns (association enterprises) outside Indian jurisdiction by controlling prices in group transactions became a matter of great concern."[1027]

In 1996 Zdanowicz analysed the figures on capital flight from India to the United States. One of the conclusions of this study was that substantial economic benefit could be obtained by detecting and deterring capital outflow related to abnormal transaction prices.[1028] These results lead to an increasing interest in transfer pricing by the Indian authorities, who invited the IBFD to conduct the first courses on transfer pricing for the officials in India. In 1999 the Indian Standing Committee on Finance observed that the legal provisions

[1027] Aztec Software & Technology Services Ltd (Bangalore Tribunal) 294 ITR 32.

[1028] Zdanowicz, J.S., "Capital Flight from India to the United States Through Abnormal Pricing in International Trade", 9 *Finance India* No. 3 (September 1995), pp. 609-628 and Zdanowicz, J.S., "Capital Flight from India to the United States Through Abnormal Pricing in International Trade: An Update", 10 *Finance India* No. 4 (December 1996), pp. 881-899.

contained in the Income Tax Act 1961 (ITA 1961) might not be effective enough to tackle transfer pricing abuse by MNEs. Prior to the amendment of Section 92 by the Finance Act 2001, the tax officer had the discretion to determine what should be the normal profit of the resident in a transaction with a non-resident, with whom it had a close business connection. An Expert Group on Transfer Pricing was set up in 1999 by the Central Board of Direct Taxes to determine whether any amendments to the ITA 1961 or new regulatory frameworks were needed. The Central Board of Direct Taxes issued a report in 2001. After analysing the conclusions of this report, the Ministry of Finance introduced the Finance Act 2001, a legislative framework to deal with transfer pricing issues. The explanatory memorandum of the Finance Bill 2001 discussed the introduction of the Indian transfer pricing regulations as follows:

"[...] the increasing participation of multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, thereby leading to erosion of tax revenues. With a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises, new provisions are proposed to be introduced in the Income Tax Act."[1029]

Although India is not a member of the OECD, Indian jurisprudence has examples of courts and tax tribunals that have endorsed reference to the OECD TP Guidelines and OECD Commentary. For instance, this can be illustrated by the following quote of the Indian Tax Tribunal:

"India is not a Member of the OECD. However, the organization has been supporting efforts of tax administration in India to properly and effectively administer and implement Transfer Pricing Policy. A useful reference can always be made to OECD Guidelines, for the purposes of resolving a dispute on transfer pricing in India, subject, however to statutory regulations."[1030]

[1029] Explanatory Memorandum of the Finance Bill 2001.

[1030] *Aztec Software & Technology Services Ltd*, Bangalore Tribunal. 294 ITR 32, 2007.

It should be noted that this Tribunal also upheld the relevance of the US Transfer Pricing regulations. The Tribunal stated:

"the US Transfer Pricing regulations are of universal application and there is no good reason why they should not be applied in transfer pricing determination in India".[1031]

In the *Aztec Software & Technology Services Ltd Sony* case and the *India Private Limited* case the Bangalore Tribunal and Delhi Tax Tribunal extensively relied on the US Transfer Pricing regulations, the first Tribunal stating that the "principles are of universal application and there is no good reason why they should not be applied in transfer pricing determination in India".[1032]

Section 92 of the ITA 1961 was only applicable to transactions between resident taxpayers and their non-resident associates. This Section provided that if the tax authorities believed that an international transaction resulted in less than ordinary profits for the resident owing to a "close connection" with a non-resident associate, the tax authorities could recompute the taxable income of the resident. This Section contained unclear terms, because the term "close connection" was not defined and detailed methodology to compute profits was not provided. Therefore, new Indian transfer pricing regulations were introduced by Sections 92 (amended) to 92F (new) in the Act and by Arts. 10A and 10E of the Income Tax Rules 1962.

The new detailed transfer pricing regulations came into effect as from 1 April 2001. From the definition of "the arm's length price" included in Section 92F (ii), it may be concluded that the existence of "associated enterprises" is required for the application of transfer pricing adjustment provisions:

"Arm's length price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions".

[1031] Ibid.

[1032] *Sony India Private Limited*, Delhi Tribunal, 2008 TIOL 439. See also Butani, M., "Chapter 15: India", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), p. 413.

6.6.2. Sections 92-92F ITA 1961

Section 92 of the ITA 1961 reads as follows:

"Section 92 – *Computation of income from international transactions having regard to the arm's length price*
1. Any income arising from an international transaction shall be computed having regard to the arm's length price.
2. Where in an international transaction, two or more associated enterprises enter into a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises, the cost or expense allocated or apportioned to, or, as the case may be, contributed by, any such enterprise shall be determined having regard to the arm's length price of such benefit, service or facility, as the case may be.
3. The provisions of this Section shall not apply in a case where the computation of income under Subsec. (1) or the determination of the allowance for any expense or interest under that Subsection, or the determination of any cost or expense allocated or apportioned, or, as the case may be, contributed under Subsec.(2), has the effect of reducing the income chargeable to tax or increasing the loss, as the case may be, computed on the basis of entries made in the books of account in respect of the previous year in which the international transaction was entered into."

It should be noted that the term "international transaction" includes a wide range of revenue and capital transactions between associated enterprises. Section 92B (2) provides that a transaction entered into by an enterprise with a person other than an associated enterprise must be deemed to be a transaction entered into between associated enterprises, "if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise".[1033] To

[1033] The full text of Section 92B reads as follows:
Sec. 92B – Meaning of international transaction
1. For the purposes of this Section and Secs. 92, 92C, 92D and 92E, international transaction means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing of money, or any other transaction having a

determine the existence of an international transaction, at least one of the parties to the transaction should be a non-resident.

Section 92A defines the notion of "associated enterprise" more broadly than the OECD Model. Section 92A provides a separate article containing the meaning of associated enterprise and Section 92F defines the term "enterprise".

The term "enterprise" is defined as follows:

"enterprise means a person [including a permanent establishment of such person] who is, or has been, or is proposed to be, engaged in any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights, or the provision of services of any kind, [or in carrying out any work in pursuance of a contract] or in investment, or providing loan or in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate, whether such activity or business is carried on directly or through one or more of its units or divisions or subsidiaries, or whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or places" [1034]

The above-mentioned definition of "enterprise" includes almost every type of business activity and covers all persons. Any enterprise that is a person in conformity with Section 2(31) and involved in the business activities as

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bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

2. A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of Subsec. (1), be deemed to be a transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise.

[1034] Section 92F III

mentioned in Section 92F (iii) is an enterprise for the application of Sections 92 – 92F.

It is important to note for this study that the Indian tax law provides an explanation of the notion of "associated enterprises":

"Sec. 92A – Meaning of associated enterprise

1. For the purposes of this Section and Secs. 92, 92B, 92C, 92D, 92E and 92F, associated enterprise, in relation to another enterprise, means an enterprise:

a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise."

The first paragraph of Section 92 A is very similar to Art. 9 OECD Model. However, Art. 9 OECD Model does not include the term "through one or more intermediaries" as this is covered by the word "indirectly". Furthermore, Section 92 A uses the following expression: "in the management *or* control *or* capital", whereas Art. 9 OECD Model uses this expression: "management, control *or* capital". By using the word "or" twice, Section 92 A seems to focus heavily on the independence of these three elements (management, control and capital).

Section 92 A includes a second subsection. Subsection 2 specifies the circumstances under which two enterprises must be deemed to be associated enterprises. I quote the second part of Section 92A:

Subsection 2 of Section 92A ITA 1961:

"2. For the purposes of Subsec. (1), two enterprises shall be deemed to be associated enterprises if, at any time during the previous year, (a). one enterprise holds, directly or indirectly, shares carrying not less than 26% of the voting power in the other enterprise; or

(b) any person or enterprise holds, directly or indirectly, shares carrying not less than 26% of the voting power in each of such enterprises; or

(c) a loan advanced by one enterprise to the other enterprise constitutes not less than 51% of the book value of the total assets of the other enterprise; or

(d) one enterprise guarantees not less than 10% of the total borrowings of the other enterprise; or

(e) more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise; or

(f) more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons; or

(g) the manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights; or

(h) ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or

(i) the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise; or

(j) where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or

(k) where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative; or

(l) where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than 10% interest in such firm, association of persons or body of individuals; or
(m) there exists between the two enterprises, any relationship of mutual interest, as may be prescribed."

The participation-in-capital criterion is described in Section 92A (2) (a). A participation in capital can be established when one enterprise holds, directly or indirectly, shares carrying not less than 26% of the voting power in the other enterprise. Looking to the participation in capital element, an enterprise should have at least 26% formal voting power in the other enterprise to be determined to be an associated enterprise. Or any person or enterprise should hold, directly or indirectly, shares carrying not less than 26% of the voting power in each of such enterprises. Apparently, to establish a participation in capital, the minimum threshold is 26% of the voting power in one enterprise. Compared to the OECD Model, this Indian participation criterion is more specific, as the OECD does not mention any minimum threshold. It can be considered to be a *de jure form* of control and is, besides the threshold element, in line with the OECD concept of associated enterprises.

Another form of participation in control can be found in Section 92A (c) and (d). If a loan is advanced by one enterprise to the other and this loan constitutes at least 51% of the book value of the total assets of the other enterprise, then the existence of association can be established. This is not a form of "participation in capital" or "participation in management" as described in Art. 9 OECD Model. It refers to a form of *factual* control which might arise when a loan (at least 51% of the book value of the total assets of the other enterprise) is advanced by one enterprise to the other. This criterion should be considered to be a form of association based on a *de facto* control.
Also, when one enterprise guarantees not less than 10% of the total borrowings of the other enterprise this may result in association. According to the Indian transfer pricing regulations, the guaranteeing of at least 10% of the total borrowings of the other enterprise falls within the concept of "associated enterprises". Apparently, these forms of "control" are not based on company law.

Subsections 92A (e) and (f) refer to the participation-in-management criterion under Art. 9 (1) OECD Model. The existence of associated enterprises can be concluded when more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise. Participation in management also exists when more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons.

Subsection 92A (g) applies another form of control. When the manufacturing or processing of goods of articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trademarks, licences etc. of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights, then, according to the Indian tax authorities, association exists. This refers to a *de facto* form of control. It is not shareholding or voting power that is the basis for determining the existence of associated enterprises under Subsection 92A (g). The *de facto* control is decisive in establishing the existence of associated enterprises.

Section 92A (h) provides that when 90% or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise, then the two enterprises must be deemed to be associated enterprises.

Section 92A (h) has two remarkable triggers to determine the existence of "associated enterprises". In case one enterprise supplies the other enterprise 90% or more (of the raw materials) *and* the prices and other conditions relating to the supply *are influenced* by the other enterprise, then the two are deemed to be associated enterprises. Section 92A (h) states that independent enterprises, the one having more than 90% of its business generated by the other, can be considered *associated.*

In Section 92A (h) India applies a broad concept of associated enterprises, based on *de facto* control.
The broad interpretation of *associated enterprises* can also be found in Section 92A(m), which considers two enterprises to be associated when there is a relationship of mutual interest. The term "relationship of mutual interest" may be a loose end, though the Central Board of Direct Taxes has not yet indicated any situations as specified in the said section.

Furthermore, it is interesting to observe that under the Indian Companies Act companies are required to prepare their financial statements in accordance with the Indian accounting standards, the Indian GAAP.[1035] These Indian accounting standards require companies to present the financial reports at a group level, consolidating the financial statements of subsidiaries.[1036] Consolidation should only be performed when the participation in share capital exceeds 50%. Under the Indian transfer pricing regulations, a participation of over 26% in the other enterprise can result in the existence of an associated enterprise. The Indian Companies Act empowers a majority shareholding group to carry on new activities which otherwise cannot be done by such a group unless they have 75% voting rights in the companies stocks. Hence, if one holds 26% voting rights, this person can veto all decisions of majority members.

6.6.3. Conclusions

Prior to the introduction of the Finance Act 2001, India did not have specific transfer pricing regulations. After the introduction of the Finance Act 2001, the concept of associated enterprises was included in Section 92A.

Section 92 states that any income arising from an international transaction must be computed as having regard to the arm's length price. The arm's length price means a price that is applied or proposed to be applied in a transaction between persons other than associated enterprises.

Section 92A (2) specifies under what circumstances two enterprises must be deemed to be associated enterprises. This includes not only situations of *de jure control*, for instance where one enterprise holds at least 26% of the voting power in the other enterprise, but also several *de facto* forms of control. Because of the broad Indian concept of associated enterprises, the arm's length principle may even be applied to open market situations. For example, when the manufacture of goods by one enterprise (assume an Indian company) is wholly dependent on the use of know-how of which the other enterprise (assume a non-Indian company) is the owner, the two enterprises must be deemed to be associated enterprises, even though the two enterprises are not related otherwise.[1037] The tax authorities in India may also, for instance, consider an Indian software developer and its large Dutch customer to be associated

[1035] Section 211 Companies Act, 1956.

[1036] Indian Accounting Standard 17.

[1037] Section 92A (2)(g) Income Tax Act 1961.

enterprises because of a strong market position of the Dutch customer, whereas the Netherlands tax authorities consider these two companies to be non-associated.[1038] As a consequence, the Indian tax authorities require heavy documentation requirements and may adjust the prices of the transactions between the two companies, whereas the Netherlands tax authorities will not apply their transfer pricing regulations to this situation.

[1038] Subsection 2 of Section 92A Indian ITA 1961, paras. H-I.

6.7. The Netherlands

6.7.1. Brief historical overview

The arm's length principle as incorporated in Art. 8b of the Corporate Income Tax Act of 1969 (CITA), became effective on 1 January 2002. Art. 8b CITA reads as follows: (unofficial translation)

"1. If an entity, directly or indirectly, participates in the management or supervision of an entity, or participates in the capital of an entity, and these entities have regarding their mutual legal relations agreed upon conditions that deviate from the conditions that would have been agreed upon between independent parties, the profit of these entities will be determined as if the previously mentioned conditions had been agreed upon.
2. Similarly, the first paragraph is also applicable if one person directly or indirectly participates in the capital of both entities, or participates in the management or supervision of both entities.
3. The entities referred to in the first two paragraphs shall include in their administrations information from which it is apparent in what manner the prices mentioned in these paragraphs have been determined and from which it may be concluded, whether conditions have been agreed which would have been agreed between independent parties." [1039]

[1039] The original Dutch text of Art. 8b Corporate Income Tax Act 1969 reads as follows:
"Artikel 8b
1. Indien een lichaam, onmiddellijk of middellijk, deelneemt aan de leiding van of het toezicht op, dan wel in het kapitaal van een ander lichaam en tussen deze lichamen ter zake van hun onderlinge rechtsverhoudingen voorwaarden worden overeengekomen of opgelegd (verrekenprijzen) die afwijken van voorwaarden die in het economische verkeer door onafhankelijke partijen zouden zijn overeengekomen, wordt de winst van die lichamen bepaald alsof die laatstbedoelde voorwaarden zouden zijn overeengekomen.
2. Het eerste lid is van overeenkomstige toepassing indien een zelfde persoon, onmiddellijk of middellijk, deelneemt aan de leiding van of aan het toezicht op, dan wel in het kapitaal van het ene en het andere lichaam.
3. De in het eerste en tweede lid bedoelde lichamen nemen in hun administratie gegevens op waaruit blijkt op welke wijze de in dat lid bedoelde verrekenprijzen tot stand zijn gekomen en waaruit kan worden opgemaakt of er met betrekking tot de totstandgekomen verrekenprijzen sprake is van voorwaarden die in het economische verkeer door onafhankelijke partijen zouden zijn overeengekomen."

Before the introduction of Art. 8b CITA the Netherlands Corporate Income Tax Act did not contain an explicit statement regarding the arm's length principle. A bill was submitted to the parliament on 8 October 2001 for the introduction of the above-mentioned Art. 8b CITA. According to the Technical Explanation of the Bill, the absence of an explicit provision had led to criticism in an international context that the application of the arm's length principle was not sufficiently guaranteed within the Netherlands. In order to avoid long-term damage to the position of the Netherlands as an international treaty partner, the Ministry of Finance considered the implementation of the arm's length standard in the Netherlands Corporate Income Tax Act. Furthermore, the Technical Explanation provides:

"It is proposed to include in the Corporate Tax Act of 1969 the codification of the 'arm's length principle'. With this codification it is acknowledged that the arm's length principle as laid down in Art. 9 OECD Model Treaty applies within the Netherlands. With this it is also aimed at achieving the result that the practical explanation of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) provided in Art. 9 of the OECD Model Treaty apply in Dutch legal practice. In a number of areas, practice demands an explanation of the OECD Guidelines. The Transfer Pricing Decree of 30 March 2001 (IFZ2001/295) provides insight into the Netherlands position and, where possible, removes any unclear aspects. In this Decree, attention is also paid to the mutual agreement and arbitrage procedures in order to resolve international double taxation that results from a transfer pricing adjustment imposed by the Netherlands tax authorities or one of the countries with which the Netherlands has a treaty for the avoidance of double taxation."[1040]

As early as 1935 the Netherlands Supreme Court confirmed the principle of the elimination of profits from the benefits and disadvantages originating from a shareholding relationship from the total profits. [1041] The Supreme Court concluded that in tax matters, substance rather than form or appearance is decisive. This could be considered to be an early reference to the application of the arm's length principle. With respect to the elimination of the advantages and disadvantages caused by the shareholding relationship, extensive case law has been developed in the Netherlands. The codification of the arm's length

[1040] Technical Explanation on Art. 8B Corporate Income Tax Act 1969.
[1041] Supreme Court, 16 July 1935, B. 5912.

principle in Art. 8b CITA is also based on a reference to Art. 3.9 Income Tax Act 2001(ITA), formerly Art. 7 ITA 1964.
Art. 3.8 ITA provides that profit is the amount of the total benefits that are derived from a business, under whatever name and in whatever form. If prices are not at arm's length, the difference between these non-arm's length prices and the arm's length prices should not be taken into account in the profit of the company.[1042] Depending on whether the company or the shareholder benefits from that difference, the amount concerned is qualified as an informal contribution to the capital or a constructive dividend.

Originally the case law that developed under the predecessors of Art. 7 ITA 1964 concentrated on the distinction between what constitutes an individual's private assets, income and expenses, as distinguished from his business assets, income and expenses. Because in the Netherlands tax law capital gains on the private assets were exempt and capital gains on business assets were subject to full taxation, the private expenditures were not deductible while the business expenses were deductible. Therefore, it was important to distinguish between the private assets and the business assets when an individual carried on a business.[1043] The arm's length principle was applied in those cases where assets were transferred from the business to the entrepreneur or vice versa. The fair market value of the asset should be taken into account for tax purposes.

An application of the principle of Art. 7 ITA 1964 to corporations can be found in the Supreme Court decision of 31 May 1978. In this case the benefit that a corporation obtained by having an interest-free loan from its shareholder was held not to constitute profit from a business, but a contribution by the shareholder to the corporation's capital. The application of this decision was restricted by the Supreme Court's decisions of 8 July 1986, which held that the elimination from taxable profits of a corporation of a benefit conferred by a shareholder is not permitted if the shareholder is an individual who is not required to include the benefit as income.
In the earlier case, the shareholder's loan to the Dutch company formed part of its business assets and therefore the benefit was included in the shareholder's income, although it was not taxed because the shareholder was a non-resident.[1044] Applicable from 1 January 1997, the Netherlands legislature has

[1042] See also Visser, E., *Verrekenprijzen: een drieluik* (Deventer: Kluwer, 2005), p. 9.
[1043] HR 31 May 1978, BNB 1978/252 ("the Swedish parent decision").
[1044] Taxability of the recipient was also decisive in the Supreme Court decisions of August and September 1995 regarding the deductibility of interest on loans between related

codified the case law. Where the benefit is not conferred by the shareholder but by a subsidiary, the courts have held that the benefit thus derived is part of the corporation's profit, and that the participation exemption may apply to it.[1045]
In the note regarding international treaty policy of the Netherlands, the Deputy Minister of Finance explicitly confirmed the following:

"The arm's length approach forms part of the Netherlands tax law. Specific regulations to implement the new OECD Guidelines are not necessary. After the publication of the revised OECD Guidelines on this area I (*the Deputy Minister of Finance, RD)* took the necessary steps to inform the Netherlands tax authority about the recent developments. The Guidelines are therefore translated into Dutch and training courses are organised for the Netherlands tax authority, courses which, besides providing practical explanation of the Guidelines, explain the aspects of a functional and comparability analysis."[1046]

Applicable from 1 January 2002 the arm's length principle has been codified in Art. 8b CITA. In addition to including the wording of Art. 9 (1) OECD Model almost literally, this article formally requires enterprises to prepare transfer pricing documentations if they are involved in transactions with associated enterprises. The Netherlands legislature provides several arguments for the introduction of Art. 8b CITA in the parliamentary proceedings.[1047]
By explicitly including the arm's length principle of Art. 9 OECD Model in Art. 8b CITA, the Netherlands confirm that the arm's length principle is applicable in the Netherlands. According to the legislator, the codification of the arm's length principle should have a positive effect on Dutch international business. Following the conclusion of the Supreme Court in 2002, it was unclear how the OECD TP Guidelines should be applied.[1048] Furthermore, the Deputy Minister of Finance confirmed in his Decision of 30 March 2001[1049] that by including

companies from the taxable income of a fiscal unity. Where non-resident recipients of interest were involved, the Supreme Court accepted for deductibility a reasonable foreign tax. See BNB 1996/5.

[1045] HR 23 April 1958, BNB 1958/179.

[1046] Unofficial translation by the author of Notitie 'Uitgangspunten van het beleid op het terrain van het international fiscal (verdragen)recht', Kamerstukken II 1997/98, 25 087, No. 4, p. 38, V-N 1998/22.3, p. 1989.

[1047] MvT, Kamerstukken II 2001/02, 28 034, No. 3, pp. 8,19,32 and 33.

[1048] Hof 's Hertogenbosch, 20 June 2000, No. 96/3012, V-N 2000, p. 3713 and Hoge Raad, HR 28 juni 2002, No. 36446, BNB 2002/343.

[1049] Decision Deputy Minister of Finance on 30 March 2001, No. IFZ2001/295M, V-N 2001/21.3:

the arm's length principle in Art. 8b CITA, the OECD TP Guidelines affected Netherlands law. [1050] Van Kalmthout and Visser conclude that the OECD TP Guidelines are not formal Netherlands law, do not form a part of the Netherlands law and are not directly applicable.[1051] The Supreme Court also speaks of "a vision laid down in the OECD Reports".[1052]

The Netherlands legislature has chosen to use the term "entity" instead of the term "enterprise" as used in Art. 9 OECD Model. By using the term "entities" the legislature applies the arm's length principle only in situations between entities, and not in situations between entities and persons. For the latter situation the legislature refers to the existing law.[1053] As the term "entities" was the commonly used terminology in the CITA 1969, the legislature decided to continue the use of the same term "entities" instead of using the OECD term "enterprises".

Art. 8b CITA deals with so-called horizontal association and vertical association. A vertical association exists when one entity has supervision through shareholding or management over the other entity, for instance association between a holding company and its subsidiary company. The first paragraph of Art. 8b CITA includes this vertical association. The second paragraph of Art 8b CITA includes the horizontal association; when two

"[...] Het uitgangspunt van het Nederlands beleid op het terrein van international fiscaal recht ten aanzien van het arm's length beginsel is dat dit beginsel deel uitmaakt van de Nederlandse fiscale rechtsorde via het ruime inkomensbegrip van artikel. 3.8 Wet IB 2001. In beginsel zijn de OESO-richtlijnen daarmee direct toepasbaar in Nederland op grond van artikel 3.8. Wet IB 2001".

[1050] MvT, Kamerstukken II 2001/02, 28034, No. 3 p. 8:

"Hiermee is tevens beoogd dat de invulling die in de Transfer pricing guidelines for multinational enterprises and tax administrations (OECD- Richtlijnen) wordt weergegeven aan artikel 9 van het OESO-modelverdrag doorwerkt in de Nederlandse rechtspraktijk.

However, after parlementiary questions the Deputy Minister of Finance stated that '*de vastleggingen in OESO-verband zijn in deze vergelijkbaar met opvattingen van gezaghebbende schrijvers en conclusies van advocaten-generaal bij de Hoge Raad. Op dit soort doorwerkingen is gedoeld in de Memorie van Toelichting*'.

[1051] Van Kalmthout, L.F., "Verrekenprijzen, Over de grenzen van vennootschapsbelasting", in: *Opstellen aangeboden aan prof. Mr. D. Juch ter gelegenheid van zijn afscheid als hoogleraar aan de Universiteit van Tilburg* (Deventer: Kluwer, 2002) and Visser, E., *Verrekenprijzen: een drieluik* (Deventer: Kluwer, 2005), p. 26.

[1052] HR 28 June 2002, No. 36.446, BNB 2002/343.

[1053] MvT, Kamerstukken II, 2001/02, 28034, No. 3, pp. 19 and 34.

entities are managed by the same management or owned by the same shareholder.
From the second paragraph of Art. 8b CITA it follows that a person or an enterprise can participate in two entities, whereas Art. 9 OECD Model uses the term "persons".

6.7.2. Forms of association covered

Similar to Germany, the adjustment mechanism in the Netherlands relied on the constructive dividend and informal capital approach, only applicable to shareholder relationships. A special condition developed in case law was, and still may be, the requirement that the taxpayer concerned be aware of the transfer of an advantage caused by the special relationship between a shareholder and a company.[1054]

As indicated above, there was no specific Netherlands transfer pricing legislation before 2002. Association could only be established in the case of shareholding. In 1988 the Dutch Ministry of Finance issued a publication dealing with general tax treaty policy.[1055] In this publication it was questioned whether the scope of the current Dutch concept of association should also include forms of *de facto* control. The Deputy Minister of Finance noted that the question arises whether there is a need to have, besides adjusting on the basis of the shareholding relationship, a possibility to adjust on the basis of forms of de facto control situations. In the Deputy Minister's opinion there is no need for this possibility to adjust because of the following reasons.
First, it should be noted, according to the Deputy Minister of Finance, that in countries that have a broader scope of associated enterprises the normal focus will be on shareholding relationships. In other cases of relationships, shareholders will be disadvantaged if a profit or benefit shifts on a non-arm's length basis from their company to another company in which these shareholders have no participation. It is therefore doubtful whether non-arm's length transactions between parties that are not associated with each other through shareholding, take place on a regular basis.

[1054] Hamaekers, H., "Introduction to Transfer Pricing", *Tax Treatment of Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), Chapter 5: Associated Enterprises.
[1055] Notitie "Algemeen fiscaal verdragsbeleid", Kamerstukken II 1987-1988, 20365, No. 5, pp 6-7.

In the event that a seller charges prices that are lower than the common market prices because the buyer is his main customer and has more negotiating power than others, this price qualifies as an arm's length price, according to the Deputy Minister of Finance.[1056]

Art. 8b of the Dutch Corporate Tax Act, effective from 2002, provides wording almost identical to Art. 9 (1) of the OECD Model.[1057] The parliamentary proceedings indicate the reasons for also making the arm's length condition applicable if there is common management or supervision (without a

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[1056] Notitie "Algemeen fiscaal verdragsbeleid", Kamerstukken II 1987-1988, 20365, No. 5, pp 6-7. The official Dutch text reads:
"De Hosson wijst in de genoemde artikelen op buitenlandse wetgeving ook dat vormen van feitelijke machtsuitoefening onder het gelieerdheidsbegrip worden gebracht. Naar aanleiding daarvan vraagt hij zich af, of het niet wenselijk zou zijn deze uitbreiding ook onder het Nederlandse gelieerdheidsconcept te brengen. Onder de huidige Nederlandse wetgeving kan gezegd worden, dat in Nederland de winst van vennootschappen steeds gecorrigeerd kan worden indien sprake is van bevoordeling door of van aandeelhouders. Dergelijke correcties kunnen echter niet worden aangebracht naar aanleiding van transacties, indien slechts dezelfde personen bij de leiding van of het toezicht op de onderneming zijn betrokken, zonder dat sprake is van aandeelhoudersverhoudingen. In deze situaties staat artikel 9, lid 1, van het OESO-modelverdrag weliswaar ook correcties toe, maar zij kunnen door Nederland niet worden aangebracht omdat onze wetgeving die mogelijkheid niet biedt. Artikel 9 schept daarvoor, in de Nederlandse optiek, niet een zelfstandige mogelijkheid. De vraag is nu, of er behoefte bestaat om naast de mogelijkheid van corrigeren in aandeelhoudersrelaties een correctiemogelijkheid te hebben bij andere vormen van meer feitelijke machtsuitoefening. Het antwoord op deze vraag dient ontkennend te zijn, en wel om de volgende redenen.
In de eerste plaats moet worden opgemerkt, dat de landen die verdergaande correctiemogelijkheden hebben toch veelal geconfronteerd zullen worden met situaties waarin in aandeelhoudersrelaties onzakelijk gehandeld wordt. Immers, in andere verhoudingen zullen de aandeelhouders van een vennootschap zich tekort gedaan voelen als op andere dan zakelijke gronden een voordeel gelaten wordt aan een vennootschap waarvan zij geen aandeelhouders zijn. Daarnaast moet worden betwijfeld of buiten aandeelhoudersrelaties onzakelijke transacties vaker dan incidenteel voorkomen. Indien bijvoorbeeld een leverancier op grond van feitelijke machtsverhoudingen aan een bepaalde afnemer tegen lagere dan gebruikelijke prijzen levert, is de conclusie dat zijn marktpositie de leverancier dwingt tot zo'n afwijkende prijsstelling en zal de overeengekomen prijs dus toch een zakelijke zijn. Een bijkomend probleem bij correcties buiten aandeelhoudersrelaties is, hoe men de correctie moet realiseren." See also De Hosson, F., "Het begrip 'gelieerde ondernemingen' in het nationale en internationale recht", *Weekblad Fiscaal Recht* (1987), 5799-5801 (1421).
[1057] Law of 14 December 2001, Stb. 2001/641

shareholder relationship).[1058] International enterprises have become larger and common management or supervision is provided on a worldwide scale by more companies.[1059] Therefore, it has become more difficult for the tax authorities to ascertain shareholder relationships between various parts of an enterprise. The Netherlands tax authorities are of the opinion that enterprises are increasingly making use of entities without share capital (for instance, foundations and trusts). According to the Netherlands legislature, using only the criterion of shareholder relationship would therefore lead to undesirable possibilities of avoiding application of the arm's length principle.[1060] [1061]

Until 2002 the courts never explicitly dealt with the question of whether an adjustment of the company's profit was possible if the degree of association or control was in doubt. For a long time it was generally assumed that a profit adjustment was possible *only* if the benefit had been conferred on a

[1058] See also Betten, R., *Netherlands – Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008).

[1059] See MvT Kamerstukken II 2001-2002, 28034, No. 3, pp. 20-21.

[1060] MvT Kamerstukken II, 2001-2002, 28034, No. 3 pp. 20-21.

[1061] Detailed information on the transfer pricing regulations of the Ministry of Finance can be found in the Transfer Pricing Decrees of 2001 and 2004, IFZ2001/295M and IFZ2004/680M. See also IFZ2001/993; Decree of 30 March 2001 on Transfer Pricing (IFZ2001/295);
- Decree of 19 December 2001 on Procedural Aspects of the EC Arbitration Convention (IFZ2001/993);
- Decree of 13 September 2002 on the Consequences of the Supreme Court decision of 28 June 2002 regarding Transfer Prices of an Importer (IFZ2002/830M);
- Decree of 11 August 2004 on Advance Pricing Agreements (IFZ2004/124M);
- Decree of 11 August 2004 on Advance Tax Rulings (IFZ2004/125M);
- Decree of 11 August 2004 on Companies that Provide Financial Services (IFZ2004/126M);
- Decree of 11 August 2004 on Questions and Answers regarding Decree on Companies that Provide Financial Services and Temporary Rules regarding Ruling Policy (IFZ2004/127M);
- Decree of 11 August 2004 establishing the Coordination Group for Transfer Pricing (DGB 2004/1339M);
- Decree of 11 August 2004 on Advance Pricing Agreements (APAs), Advance Tax Rulings (ATRs), Financial Services Activities, International Investors' Desk (APBI), Organization and Competence Rules (DGB2004/1338M);
- Decree of 11 August 2004 on Good Faith regarding a Country with which a Tax Treaty Has Been Concluded (DGB2004/1337M); and
- Amendment to the Decree on Arm's Length Transfer Prices of 21 August 2004 (IFZ2004/680M).

shareholder.[1062] The above-mentioned decisions of the Supreme Court in 1976 and 1986 have not sufficiently removed the uncertainty.
The purpose of the 2002 legislation is to broaden the possibility of making adjustments to situations of control through the management in another entity or joint management and other forms of supervision. Sufficient power to influence the transfer price is required for an adjustment.

As indicated, before the introduction of Art. 8b CITA association could only be determined when there was a participation in capital, and thus a shareholding relationship.[1063] Prices and therefore profits of enterprises could only be adjusted when there was benefit for or from the shareholders. Therefore, the Netherlands would not have been able to make transfer pricing adjustments in cases of mere managerial relationships, due to its narrow concept of association in its domestic law, although the wording of "associated enterprises" in Dutch tax treaties is broader. In 1988 the Ministry of Finance reconfirmed that association should be based on shareholding relationships *only*.[1064]
However, as a consequence of the introduction of Art. 8b CITA, association is no longer restricted to shareholding relationships. Participation in the management or the supervision of an entity can also lead to association.
Art. 8b CITA does not provide a definition of "participation in the management or supervision of an entity". The parliamentary documents indicate that it must be ascertained whether there is sufficient power for the enterprise or person concerned to influence the transfer pricing of intercompany transactions.[1065]

There is no minimum threshold for the participation in capital. In order to prevent manipulation, the Netherlands Council of State (*Raad van State*) advised the legislature not to quantify the percentage needed to establish a participation in capital.[1066]

[1062] Betten, R., *Netherlands – Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), at 2.2.
[1063] See 'Notitie Algemeen Fiscaal verdragsbeleid', Kamerstukken II 1987-1988, 20 365, No. 5, pp. 6-7.
[1064] See 'Notitie Algemeen Fiscaal verdragsbeleid', Kamerstukken II 1987-1988, 20 365, No. 5, pp. 6-7.
[1065] MvT Kamerstukken II, 2001-2002, 28034, No. 3, pp. 20-21.
[1066] Advice of the Council of State: Advies Raad van State en Nader Rapport, Kamerstukken II, 28034, A, p. 7. The original text reads as follows: " Zoals ook in de memorie van toelichting is uiteengezet, ontbreekt een dergelijke kwantificering ook in de op dit punt gewezen Nederlandse jurisprudentie. Bij welke mate van gelieerdheid partijen geneigd zullen zijn op onzakelijke voorwaarden met elkaar te handelen kan van geval tot geval verschillen.

However, with the introduction of Art. 8b CITA in 2002 association is no longer restricted to shareholding relationships. Participation in the management or the supervision of an entity can also lead to being qualified as an associated enterprise. Supervision will only lead to association when the supervisor has sufficient control to influence the prices of transactions between the enterprises concerned, for instance when a member of the supervisory board is appointed with managerial tasks.
It may therefore be concluded that the Netherlands applies an interpretation of "associated enterprises" which is based on *de jure* control (dominant participation in management or capital).

6.8. China

6.8.1. Brief historical overview

Chinese transfer pricing legislation has been effective since 1991, when both the Foreign Investment Enterprise and Foreign Enterprise Income Tax Law and the Detailed Implementation Rules were enacted. These laws provide general guidance on intercompany transactions between related parties. Additionally, the State Administration of Taxation periodically releases transfer pricing regulations covering aspects of transfer pricing compliance and enforcement. In 2007 China implemented its first unified Enterprise Income Tax Law and the Detailed Rules for Implementing Enterprise Income Tax Law. This was a full set of anti-avoidance rules in the Special Tax Adjustments chapter, which focuses on transfer pricing. In January 2009 the State Administration of Taxation released the Implementation Measures of Special Tax Adjustments. This new Circular contains detailed rules on administering all the aspects of those anti-avoidance rules including transfer pricing.[1072]

This Circular is the first comprehensive operating manual on anti-avoidance in China. As from 2009 transfer pricing regulations in China are in line with those in western countries.[1073]

The arm's length principle is codified in Art. 41 of the Enterprise Income Tax Law. The Chinese tax authorities are empowered to make adjustments to the taxable income of an enterprise when a transaction between this enterprise and its related parties is not based on the arm's length principle.

Dealing at arm's length is required in China for the purpose of all types of Chinese tax, such as VAT, customs duty, etc.

Chinese transfer pricing legislation applies to enterprises that enter into transactions with their related parties. The legislation does not limit the application of the arm's length principle to cross-border transactions.[1074]

The transfer pricing regulations in China follow to a great extent the OECD Transfer Pricing Guidelines, despite the fact that China is not a member of the

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[1072] Guo Shui Fa (2009), No. 2. Notice issued by the State Administration of Taxation Regarding the Printing and Distribution of the "Implementation Measures of Special Tax Adjustment".

[1073] See also Chapter 15: India", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), p. 320.

[1074] See also Jinyan Li and Tian Su, *China – Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), at 2.1.

OECD. However, the Chinese concept of associated enterprises is not similar to that of the OECD Model.

6.8.2. The concept of related parties

Art. 41 of the Chinese Enterprise Income Tax Law (EIT) uses the term "related party" instead of the OECD term "associated enterprise".[1075] Art. 41 EIT reads:

"Where business transactions between an enterprise and its related parties are not based on the arm's length principle, resulting in the reduction of the taxable income of the enterprise or its related parties, the tax authorities have the power to make adjustments based on any reasonable methods [...]"[1076]

Art. 41 EIT also covers partnerships and individuals.[1077] Art. 109 of the EIT Regulations states that a related party, as referred to in Art. 41 EIT, includes an enterprise, or any other entity or individual that has one of the following relationships with the enterprise:

- direct or indirect control of funds, operation, purchase and sales;
- both are directly or indirectly controlled by the same third person;
- other relationships due to associated interests.

Art. 110 EIT Regulations defines the arm's length principle as "the principle adopted by unrelated parties in carrying out transactions with each other according to a fair price and normal business practice".

The Chinese 2009 Implementation rules on special tax adjustments describe in detail situations where parties are considered to be related for transfer pricing compliance and adjustment purposes. Art. 9 of Chapter 2 *Reporting of Related Party Transactions* reads:

"A 'related party relationship' as stated in Article 109 of the Implementation Regulations of the Corporate Income Tax Law and in Article 51 of the Tax Collection Regulations shall mainly refer to any of the following relationships

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1075 Guan lian qi ye (associated enterprise) and guan lian fang (associated or related party).
1076 Art. 41, Law of the People's Republic of China on Enterprise Income Tax.
1077 See also Art. 109 EIT Regulations.

which the enterprise has with another enterprise, an organization or an individual:
1. One party directly or indirectly owns more than 25% of shares of the other party; or a common third party directly or indirectly owns more than 25% of shares of both parties. If one party indirectly holds the other party's shares through an intermediate party, as long as one party owns more than 25% of the shares of the intermediate party, the percentage of the other party's shares held by the intermediate party shall be applied to calculate the percentage of the other party's share held by that party.[1078]
2. Debt between one party and the other party (except for independent financial institutions) accounts for more than 50% of its total paid-in capital, or more than 10% of one party's debt is guaranteed by the other party (except for independent financial institutions).
3. More than half of the high level management (including members of the board of directors and managers) of one party or at least one senior board member who is able to control the board of directors of one party are assigned by the other party; or more than half of the high level management (including members of board of directors and managers) of both parties or at least one senior board member who is able to control the board of directors of both parties are assigned by a common third party.[1079]
4. More than half of the high level management (including members of board of directors and managers) of one party simultaneously hold the position as high level management (including members of board of directors and managers) in the other party; or at least one senior board member who is able to control the board of directors of one party simultaneously holds the position as senior board member of the other party.
5. The business operations of one party depend on the proprietary technologies (such as industrial property right, technology know-how etc.) provided by the other party.
6. The purchases and sales activities of one party are controlled by the other party.
7. The services received or provided by one party are controlled by the other party.

[1078] Unofficial English translation by PricewaterhouseCoopers of Art. 9, Chapter 2 Reporting of Related Party Transactions (as of 09 January 2009), see http://www.swisscham.org /bei/pdf/Implementation_Measures_of_Special_Tax_Adjustments_Unofficial_Translation_by_PwC.pdf.
[1079] Art. 9 (iii) 2009 Implementation rules on special tax adjustments.

8. One party has effective control over the other party's business operations and transactions; or there are other connections of interest between the two parties including circumstances where major shareholders of the two parties enjoy basically the same economic benefits, or they are family members and relatives, etc., even though the shareholding percentage is below the percentage prescribed in Item 1 of this article.[1080]

As indicated above, the Chinese concept of "related parties" covers also *de facto* control. For instance, in the event that a seller charges prices that are lower than the common market prices because the buyer is his main customer and has more negotiating power than others, the Chinese tax authorities consider the two enterprises to be related. As a result, this price will not qualify as an arm's length price. Thus, the arm's length principle is applied to transactions between independent enterprises. Also paragraph 5 refers to situations where independent enterprises are considered related for transfer pricing purposes. For example, an independent company in the United Kingdom buys software programs from an independent Chinese company that can only develop these programs by use of specific know-how of the independent UK company.

6.8.3. Conclusions

Art. 41 EIT is the provision in Chinese tax law that explicitly mentions the application of the arm's length standard. Art. 9 of the "Implementation Measures of Special Tax Adjustments", which is introduced in 2009, includes a definition of the concept of associated enterprises. From this article, it can be concluded that the Chinese transfer pricing laws cover relationships of both corporate and individual taxpayers. The Chinese transfer pricing laws do not only include a participation in the management or capital of an entity for the transfer pricing regulations to be applied. Art. 9 of the "Implementation Measures of Special Tax Adjustments" also provides that when a business operation of one party depends on the proprietary technologies of the other party, related parties exist. Also, parties are deemed to be related where the purchases and sales activities of one party are controlled by the other party. Therefore, the Chinese concept of association focuses not only on *de jure* relationships, but also on *de facto* control. Transactions carried out and contracts made between legally independent parties as well as family

[1080] Art. 9 (iii) 2009 Implementation rules on special tax adjustments.

relationships and any transaction between parties with mutual interests may lead to *association* for Chinese transfer pricing purposes and to transfer pricing adjustments. For the above reasons it may be concluded that the concept of related parties in Chinese tax law is very broad: even transactions between independent enterprises may be covered by Art. 41 EIT.

6.9. Brazil

6.9.1. Brief historical overview

Although Brazil is not a member of the OECD, the Brazilian tax treaties generally try to follow the OECD Model. However, the Brazilian transfer pricing rules include methodologies that dramatically differ from the OECD TP Guidelines. The introduction of transfer pricing rules, effective as from 1 January 1997, aimed at preventing income tax evasion through price manipulation.[1081] For instance, cost plus and resale price less profit methods are based on statutory profit margins provided by law.

Until 1996 Brazilian law lacked specific rules designed to address transfer pricing issues. The general transfer pricing rules of Brazil are laid down in Law 9, 430 of 27 December 1996 and in the 2002 Federal Revenue Service regulation, enacted by the Normative Instruction of the Federal Revenue Service 243 of 11 November 2002.[1082] The normative acts may not exceed the limits specified in Law 9,430/96, but merely regulate matters that are dealt with in a general way by this law.
Prior to the introduction of Arts. 18 to 24 Law 9, 430/96, there have been efforts to regulate transactions between related parties. In 1964 Law 4, 506 set forth a number of criteria to determine the occurrence of a hidden or disguised profit distribution (*regras de distribuição disfarçada de lucros*), including the non-deductibility of distorted prices in business carried on between related entities. Tax audits could also be carried out under the foreign exchange rules applicable to the acquisition of foreign currency, and under customs valuation rules (*regras de valoração aduneira)*.

[1081] The Brazilian IFA Report of 1992 illustrates this: "Transfer Pricing consists in the *manipulation* of costs, income and expenses in transactions carried out between related companies, in a way that differs from the one that would be adopted in normal market operations, with the aim of gaining a tax benefit." See Velloso, F.C. and Brigagao, G.A.M, *National Report Transfer Pricing in the absence of comparable market prices* IFA Cahiers 1992, Vol. 77a.

[1082] Law 9,430/96 has been amended by Law 9, 959 of 27 January 2000; Law 10,451 of 10 May 2002; Law 11, 727 of 23 June 2008. Law 11,116 does not amend Law 9, 430/96. Actually, Law 11,196 is the law that provides the possibility for the Minister of Finance to make adjustments to neutralise the effects concerning the currency changes. It does not effectively amend Law 9, 430/96, but rather refers to its provisions on its Art. 36.

Law 9, 430 and Regulatory Act 243 comprise the main legislative regulations of transfer prices in international transactions. According to the Ministry of Finance, the rules set forth in Arts. 18 to 24 Law 9, 430/96 represent a significant improvement in domestic legislation in view of the current globalisation process. In this specific case, certain rules have been proposed in order to control so-called "transfer pricing", to prevent the detrimental transfer of resources to foreign countries through manipulation of prices used in the importation or exportation of goods, services or rights in transactions with a non-resident related party.[1083] Regulatory Act 243 provides for the prices to be adopted in transactions for the purchase and sale of goods, services and rights carried out by individuals or legal entities resident or domiciled in Brazil with related individuals or legal entities resident or domiciled abroad.

The Brazilian legislation on transfer pricing includes deemed arm's length prices resulting from methodologies that differ from the OECD TP Guidelines. If the taxpayer wishes to utilize margins different from the statutory ones, either in the cost plus or in the resale price less profit methods, a specific application must be made to the Ministry of Finance. Rulings were published by the Brazilian Ministry of Finance at the end of each year to reduce the potentially adverse effects on the transfer pricing calculations caused by the appreciation of the Brazilian local currency over the US dollar. Taxpayers subject to Brazilian transfer pricing rules are allowed to adjust the export revenues recorded in the respective year up to a certain percentage.[1084] For example, if the actual value of exports to related parties was 100 Brazilian real, the taxpayer was allowed to use an amount equivalent to 120 Brazilian real as the deemed export amount for transfer pricing purposes. However, this additional factor could only be applied in specific cases:

- The possibility of using the additional factor could only be used in order to compare the actual price with the uncontrolled local price, to determine whether the 90% threshold was achieved;
- The additional factor was used to compare the actual price with the parameter price, where the taxpayer has elected to use the production cost plus 15% profit margin method, and

[1083] Law 9, 430/96.

[1084] These rulings were introduced in 2006. In 2008 the percentage was 20%. See also Dias Musa, S. et al., "Chapter 10: Brazil", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), p. 278.

- To calculate the average profit margin for the respective year where the taxpayer decides to apply the 5% net profit "safe harbour".[1085]

Applicable from September 2008, the Ministry of Finance introduced new rules concerning the possibility for taxpayers to request the tax authorities to change the statutory profit margins applicable when determining parameter prices on import and export transactions carried out between related enterprises.

Law 6, 404 of 15 December 1976 (Corporation Law) describes three categories of related parties. These categories are controlling corporations, controlled corporations and associated corporations.
As provided by Art. 23 Law 9, 430/96, the following parties are deemed to be related to a legal entity domiciled in Brazil:

(1) a non-resident parent company;
(2) a non-resident subsidiary or branch;
(3) a non-resident individual or legal entity whose holding in the capital of the Brazilian entity makes him/her/it the controlling or associated shareholder thereof, under Art. 243(1) and (2) of the Corporation Law. As this provision refers to an "associated shareholder", it seems that it does not apply to individuals;
(4) a non-resident legal entity that is defined as its subsidiary or associated company under Art. 243(1) and (2) Corporation Law;
(5) a non-resident legal entity which, together with the Brazilian company, is under common corporate or administrative control, or when at least 10% of the share capital of each one belongs to the same individual or legal entity;
(6) a non-resident individual or legal entity which, together with the legal entity domiciled in Brazil, has a holding in the capital of a third legal entity the sum of which makes them controlling or associated shareholders, under Art. 243(1) and (2) Corporation Law;
(7) a non-resident individual or legal entity that is associated to the Brazilian company in any business through a joint venture or co-ownership, as defined under Brazilian law;
(8) a non-resident individual who is a relative up to the third degree (as defined in the Brazilian Civil Code), spouse or cohabitant of its directors or officers, or of its direct or indirect controlling partner or shareholder;

[1085] Ibid.

(9) a non-resident individual or legal entity that is the exclusive agent, distributor or dealer of the Brazilian entity for the purchase and sale of goods, services or rights; and
(10) the person or legal entity, resident or domiciled abroad that has the Brazilian entity as exclusive agent or distributor to purchase or sell goods, services or rights.[1086]

The transfer pricing rules also apply in the case of transactions carried out by a Brazilian entity through an interposed party. Art. 2 (5) of Regulatory Act 243 provides that the interposed party transaction falls within the scope of the transfer pricing rules when such a third party deals with another party abroad who is considered a related party of the referred Brazilian entity.[1087]
Since 27 May 2009 association is deemed to exist when one corporation has a significant influence over the other. This means that one corporation should have the power to participate in financial and operational policy decisions of the other corporation, without controlling it.

Item 5 of Art. 23 Law 9, 430/96 provides that two companies are deemed to be related when the non-resident entity, together with the Brazilian entity, is under common corporate or administrative control. This is the case when the same individual or legal entity, regardless of the residence or domicile, is the holder of partner's or shareholder's right in both companies that permanently assure a prevailing vote in the decisions of these companies and the power to elect the majority of their management. Also, according to Art. 2, Regulatory Act 243 , a controlling corporation holds directly or through other controlled corporations, voting rights in a controlled corporation that permanently ensure a prevailing vote in corporate decisions in the controlled corporation and the power to elect a majority of the directors or officers of the controlled corporation. [1088]

[1086] Rezende, C. and Brigagao, A.M., *Brazil –Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008). See also Hamaekers, H., "Introduction to Transfer Pricing", *Tax Treatment of Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), Chapter 5: Associated Enterprises.
[1087] Art. 2, Para. 5 Regulatory Act 243/02.
[1088] The text of Regulatory Act 243 reads as follows (unofficial translation):
"Art. 2 For purposes of this Regulatory Act, the following persons shall be considered to be related to the legal entity domiciled in Brazil:
I. its parent company, when domiciled abroad;
II. its branch or affiliate, when domiciled abroad;

Common administrative control exists when (1) the chairman of the administrative council or the chief executive officer (CEO) of both companies is the same individual, (2) the chairman of the administrative council of one company and the CEO of the other is the same individual or (3) the same individual is an officer of both companies with decision making authority.

Art. 2 Regulatory Act 243 reads:

"Paragraph 1. For the purposes of item V., the company domiciled in Brazil and that domiciled abroad shall be considered to be:
I. under the same corporate control when the same individual or legal entity, independently of his or its residence or domicile, holds partner rights in each of the said companies, which rights permanently ensure them dominance in corporate resolutions of such companies and the power to elect a majority of its managers;
II. under the same management control:
(a) when the office of chairman of the board of directors or chief executive officer or both companies are held by the same person;

III. an individual or legal entity, resident or domiciled abroad, whose corporate interest in the company's capital classifies it as a controlling or associated company as defined in Art. 243, paragraphs 1 and 2 of Law 6, 404 of 15 December 1976
IV. a legal entity domiciled abroad that is characterised as the company's controlled or associated company as defined in Art. 243, paragraphs 1 and 2 of Law 6, 404 of 1976
V. a legal entity domiciled abroad, when such company and the company domiciled in Brazil are under the same corporate or administrative control, or when at least 10% of the corporate capital of each of them is owned by the same individual or legal entity;
VI. an individual or legal entity, resident or domiciled abroad, which together with a legal entity domiciled in Brazil, holds a corporate interest in the capital stock of a third legal entity; and the sum of these interests classifies them as controlling or associated companies of such third legal entity as defined in Art. 243, paragraphs 1 and 2 of Law 6, 404 of 1976
VII. an individual or legal entity, resident or domiciled abroad, that is its associate in a consortium or a condominium, as defined by Brazilian law, for any undertaking;
VIII. an individual resident abroad that is a direct relative or collateral up to the third degree, spouse or cohabitant of any of the company's officers, or its controlling partner or shareholder, through either a direct or indirect interest,
IX. an individual or legal entity, resident or domiciled abroad, that is afforded exclusivity as the company's agent, distributor or dealer for the purchase and sale of goods, services or rights; and
X. an individual or legal entity, resident or domiciled abroad, with regard to which the legal entity domiciled in Brazil is afforded exclusivity as an agent, distributor or dealer for the purchase and sale of goods, services or rights."

(b) when the positions of the chairman of the board of directors in one of the companies and that of chief executive officer in the other are held by the same person; and
(c) when the same person holds a management position with decision making power in both companies."[1089]

A cohabitant, as mentioned in item 8 of Art. 23 Law 9, 430/96, is a person who lives in marital status with an officer, partner or controlling shareholder of a company domiciled in Brazil, as defined in Law 9,278/96.

Items 9 and 10 of Art. 23 Law 9, 430/96 state that the parties will be deemed to be related only in connection with transactions that involve exclusive arrangements for the purchase and sale of goods, services or rights. Furthermore, an exclusive distributor or dealer will be deemed to exist if the individual or legal entity is entitled to exclusivity in an area, or in the whole, of the Brazilian territory. Exclusivity may be proved through written agreements or, if these are absent, through the practice of commercial transactions involving one specified type of goods, services or rights carried out exclusively between the two legal entities or exclusively through one of them.

Law 11,281/06 provides that importations made by a legal entity that acquires goods abroad for future sale to a predetermined domestic buyer are also subject to transfer pricing rules.
The Brazilian transfer pricing rules also apply to international transactions carried out with a person or legal entity located in a low-tax jurisdiction. The tax authorities of Brazil have issued a list of 50 jurisdictions which are considered to be tax havens or without disclosure of corporate ownerships.[1090] In that case, it is not required that the persons or legal entities be related in the sense of the

[1089] Unofficial translation from the IBFD Transfer Pricing Database.
[1090] Art. 1 of the Federal Revenue Service, Regulatory Act 188 of 6 August 2002 (revoked by Regulatory Act 1,037 of 04 June 2010) provides the list of included jurisdictions: Andorra, Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Barbados, Belize, Bermudas, British Virgin Islands, Campione d'Italia, Cayman Islands, Channel Islands (Alderney, Guernsey, Jersey and Sark), Cook Islands, Costa Rica, Cyprus, Djibouti, Dominican Republic, Gibraltar, Grenada, Hong Kong, Isle of Man, Labuan, Liberia, Liechtenstein, Luxembourg, Macau, Madeira, Maldives, Malta, Marshall Islands, Mauritius, Monaco, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, Saint Kitts and Nevis, Saint Lucia, Saint Vincent, Samoa, San Marino, Seychelles, Singapore, Tonga, Turks and Caicos Islands, United Arab Emirates, US Virgin Islands and Vanuata.

earlier mentioned provisions. A low-tax jurisdiction is deemed to be a country that taxes income at a maximum rate below 20%.
Paragraph 4 of Art. 24 Law 9, 430/96 has been applicable as from 1 January 2009. It provides that a tax haven is also considered to be a country or a location with favourable taxation where the legislation does not allow access to information relating to the corporate structure of the legal entity, its ownership, or identification of the beneficial owner of the income attributed to non-residents. [1091]
Two new articles to Law 9, 430/96 were added by Art. 23 Law 11,727/08. As from January 2009 the transfer pricing rules are also applicable to transactions performed under privileged tax regimes. Art. 24-A defines in its sole paragraph the privileged tax regime as one where:

- income is not taxed, or is taxed at a maximum rate lower than twenty percent (20%);
- tax advantages are granted to non-resident individuals or legal entities (i) without requiring any substantial economic activity to be carried out in the country or location; (ii) contingent to the absence of substantial economic activity in the country or dependency;
- access to information related to the corporate structure, ownership of the goods/rights, or the economic transactions performed, is not allowed;
- the income earned outside its territory is not taxed, or is taxed at a maximum rate lower than 20%.

On 27 May 2009 a new definition of associated enterprises was provided by Art. 37 Law 11,941. Two enterprises are deemed to be associated enterprises when one enterprise has significant influence over the other enterprise. This should be evidenced through the power of one enterprise to participate in financial and operational policy decisions of the other without controlling it. Such significant influence is presumed when one holds more than 20% of the equity capital of the other, without controlling it.[1092]

The impact of this new provision is unclear, however some authors argue that this new definition of associated enterprise should not apply to the concept of related parties for transfer pricing purposes, considering that the definition of

[1091] See also Dias Musa, S. et al., "Chapter 10: Brazil", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), p. 272.
[1092] Art. 243(1,4,5).

related parties should be the one provided by Art. 1,099 Civil Code. This article establishes that two companies are deemed to be associated when one holds more than 10% of the equity capital of the other without controlling it.[1093] They base their arguments on Art. 46 Law 11,941/09.

6.9.2. Conclusions

Art. 23 Law 9, 430/96 deals with transfer pricing adjustments and defines "related parties" in a cross-border situation.[1094] The definition of related parties for the purposes of the application of transfer pricing rules is broad and covers situations of *de jure* and *de facto* relationships. There is a low requirement of holding at least 10% of the shares by one entity in another entity or 10% or more shares of each one owned by the same entity for the two to be treated as associated parties.[1095] This is a *de jure* form of control. The Brazilian transfer pricing rules also consider various forms of *de facto* control to be a relationship or association for the purposes of transfer pricing. Various relationships such as partners of a joint venture, distributors or dealers between Brazilian and foreign entities, and exclusive agents fall within the scope of related parties. The broad scope of the Brazilian transfer pricing rules may create practical complications and compliance issues for Brazilian entities. For example, the rules also cover transactions carried out by Brazilian companies with entities resident in countries that are characterised by Brazilian law as tax havens or which allow secrecy with respect to corporate ownership.[1096] Brazilian entities are required to inform the Brazilian tax authorities when transactions are conducted with entities in tax havens or countries allowing secrecy relating

[1093] Rezende, C. and Brigagao, A.M., *Brazil –Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), para. 2.6.

[1094] Ibid. See also Hamaekers, H., "Introduction to Transfer Pricing", *Tax Treatment of Transfer Pricing* (Amsterdam: IBFD Transfer Pricing Database and loose-leaf publication, 2008), Chapter 5: Associated Enterprises.

[1095] See Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61 (Jönköping: Jönköping University, 2009), p. 181.

[1096] See also Nguyen, P.T., *Transfer Pricing, the Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing Countries*, Jibs Dissertation Series, Vol. 61 (Jönköping: Jönköping University, 2009), p. 181.

corporate ownership, even though the parties are wholly independent and the terms and conditions of the transactions were established at arm's length.[1097]

As a result of the broad scope of transfer pricing rules, the Brazilian tax authorities may make adjustments if they determine that the transfer prices between legally independent companies are not in accordance with the results derived from the application of the methods based on predetermined margins. This may lead to a significant number of import and export transactions between independent, unrelated parties that could be subject to transfer pricing adjustments and compliance with the Brazilian transfer pricing rules.[1098]

[1097] Ibid.

[1098] Ibid.

6.10. Summary and conclusions

The Finance Act 1915 of the United Kingdom provided transfer pricing rules focussing on a concept of control that originates from a close connection between two companies. One party should be able to arrange the course of business between two parties so that the first party would either have no profits or less than the "ordinary profits which might be expected to arise from that business". Control existed by means of the holding of shares or the possession of voting rights or by virtue of any powers conferred by the articles of association or similar documents. Control was based on *de jure* relationships.
In the United States however, the concept of associated enterprises has been formulated differently. As the arm's length principle was considered to be an anti-avoidance and anti-evasion measure, the concept of "control" was very broad. Although in other US tax law articles "control" was exclusively based on a *de jure* relationship, for transfer pricing purposes "control" included all forms of control including *de facto* control: any kind of control, direct or indirect, whether legally enforceable and however exercisable or exercised. For US transfer pricing purposes it was the reality of control which was decisive, not its form or the mode of its exercise. However, in the *Xilinx case* the judges stated that a pure application of the arm's length principle (tax parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions) prevails over the text of the US Regulations.

The question arises which of the two above-mentioned approaches, the UK or the US approach, has been adopted by the Fiscal Committee of the League of Nations. Chapter 9 will deal with this question.

The arm's length principle is applied in almost every country. From an analysis of the various domestic concepts of *associated* enterprises in this chapter, it can be concluded that there are three types of domestic interpretations. The first type is a concept of associated enterprises that is limited to *de jure* control, relationships generally covered by company law, for instance shareholding (partnerships) and management.[1099] This concept of associated enterprises is applied by the Netherlands, Sweden and the United Kingdom. These countries follow the OECD concept of "associated enterprises".

[1099] In some countries family relationships are also covered as a form of "de jure" relationships.

The second type of concept of associated enterprises is an open-ended concept based on control. This concept is applied by the United States and Germany. For instance, the US concept covers any kind of control between two or more taxpayers. It focuses on the reality of control, not its form or the mode of its exercise. The German concept applies the term "controlling influence". The scope of controlled taxpayers under US transfer pricing and German transfer pricing rules is broader compared with the scope of the transfer pricing laws of the Netherlands, the United Kingdom and Sweden. The scope of control under US rules covers any kind of control between two or more taxpayers, including enterprises and individual taxpayers. In this regard, any two or more taxpayers with no shareholding or managerial relationships could be considered taxpayers controlled "by the same interest" if a common design or a plan for arbitrarily shifting of income or deductions between them exists. However, as may be concluded from recent jurisprudence (for instance *Xilinx)*, it is not likely that the term "control" will be interpreted by US and German courts to cover open market situations (for instance, a buyer with a very strong negotiating power). Such an interpretation would be in conflict with a pure application of the arm's length principle itself.
The third type is a concept of associated enterprises that not only covers *de jure* relationships, such as shareholding and managerial relationships, but also *de facto* relationships that are contrary to the purposes of the arm's length principle. The scope of associated parties under the Chinese, Indian and Brazilian rules can be considered to fall within this third concept of associated enterprises.

It is interesting that emerging economies, such as China, Brazil and India, incorporate broad definitions of associated enterprises in domestic tax laws. Not only *de jure* relationships covering relationships based on company law result in associated enterprises, such as shareholding and managerial relationships, but also various forms of *de facto* relationships between companies and even individuals are covered by the scope of associated enterprises in the domestic tax laws of these countries. The Indian, Chinese and Brazilian transfer pricing regulations describe in detail situations where one party is considered to be associated with another party.
For instance, the Chinese and Indian rules specify various forms of *de facto* relationships such as transactions between parties concerning loans, guarantees, services or sales in the open market. Brazil expands its transfer pricing rules based on predetermined margins to transactions between entities in Brazil with entities resident in tax havens or in countries that allow secrecy

regarding corporate ownership even though the parties are completely independent and the terms and conditions in the transactions were established at arm's length. In addition, the Brazilian scope of associated parties also covers relationships between entities such as partners of joint ventures, and exclusive agents, distributors or dealers for the purchase and sales of goods, services or rights. The broad Brazilian scope is not exceptional. India characterises legally independent companies that are dependent in a commercial way from an otherwise unrelated foreign trading partner as associated.

It may be possible that the wording of the US Regulations and the lack of clarity on the term "control" in the formula of Art. 9 OECD Model and the UN Model have misled the Chinese and Indian legislator (but also other emerging economies, such as Vietnam), which carefully studied the US Regulations and OECD TP Guidelines before drafting their transfer pricing laws and regulations.

The different domestic concepts of associated enterprises also support the view that an autonomous interpretation of the notion of "associated enterprises" is necessary. Chapter 5 has discussed this matter. For the above reasons, I conclude that reference to domestic law fails to provide a solution to the problems caused by the interpretation of "associated enterprises". The findings of this chapter will be used for the final conclusion in Chapter 9.

Chapter 7: Customs and the Concept of Related Parties

7.1. Introduction

With respect to the concept of associated enterprises in customs, the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 (hereinafter: the Agreement) is relevant. The primary basis for customs value under this Agreement is the transaction value as defined in Art. 1 of the Agreement. In determining whether the transaction value is acceptable, the fact that the buyer and the seller are related within the meaning of Art. 15 of the Agreement may not in itself be grounds for regarding the transaction value as unacceptable. In such a case the circumstances surrounding the sale must be examined and the transaction value must be accepted, provided that the relationship did not influence the price. Basically, this situation is similar to the application of the arm's length principle for transfer pricing purposes.
An analysis of the differences and similarities between the concept of associated enterprises for transfer pricing purposes and the concept of related parties for customs is important, as various debates about convergence between transfer pricing valuation and customs valuation have taken place between the World Customs Organization and the OECD.[1100]

In this chapter I will analyse the concept of related parties for customs purposes and I will compare this concept with the concept of associated enterprises for transfer pricing purposes as incorporated in Art. 9 OECD Model. The differences and similarities of these concepts will be discussed. The findings of this chapter will be used for the final conclusions in Chapter 9.

7.1.1. Transfer pricing and customs

Customs valuation rules try to determine the correct tax basis for duties and other taxes applicable upon importation. The transfer price determines the amount of income that each party earns and thus the amount of income tax that is due in both the country of export and the country of import. As a result, a

[1100] WCO/OECD Joint Conference on Transfer Pricing and Customs Valuation, held in Brussels on 3 and 4 May 2006.

high transfer price reduces the income earned in the country of importation and increases the income earned in the country of export, while a low transfer price has the opposite effect. The transfer price has a direct effect on the customs valuation. In most cases the transfer price will establish the transaction value of the imported goods. The lower the transfer price, the lower the transaction value, which in turn means lower duty revenue for the import country.[1101]

Customs duties should be considered to be a tax on the import or export of goods and are a form of indirect taxation. Customs valuation concerns the valuation of individual dutiable transactions and products that are involved with importation or exportation.[1102] Transfer pricing is a direct tax concept. Transfer pricing is concerned with determining arm's length prices for controlled transactions: transactions between associated enterprises. With respect to the taxpayer, it may be argued that there are conflicting pricing interests. For customs purposes, a taxpayer may wish to establish a low import value for the products imported in order to reduce the amount of import duties. However, for transfer pricing purposes, a taxpayer may encourage charging high prices for the imported products in order to reduce his taxable profits.

Both disciplines have their own valuation methods and documentation requirements. Transfer pricing adjustments may have a potential effect on customs issues and vice versa. For instance, when there is an adjustment of transfer prices used by an importer, it can be asked whether the import value reported for the good was too high or too low. If this is the case, it can be argued that the distributor may have paid too much or not enough in customs duties. In many countries there is no mechanism to provide relief for the burden resulting from increased customs duties paid due to a transfer pricing adjustment.

7.1.2. Convergence between transfer pricing and customs

Since the early 1970s tax authorities and enterprises have been exploring convergence between valuation for transfer pricing and valuation for customs. For instance, in the *Ross Glove Co. v. Commissioner* case the US Tax Court

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[1101] Liu Ping, *Transfer Pricing and Customs Valuation: Exploring convergence*. Contribution to the Second Joint WCO/OECD Conference on Transfer Pricing and Customs Valuation, 22-23 May 2007.

[1102] Van Herksen, M., "Chapter 1: Introduction", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), pp. 16-21.

considered customs valuation indicative for determining an arm's length transfer price.[1103]Another example was Section 1059A of the US Internal Revenue Code. This section required importers in related party transactions to use the same valuation for the purposes of income tax and excise duties. Some authors therefore considered that a relationship was established between transfer pricing and customs duties in the United States.[1104]
In a private ruling in 2000, the US Customs Service held that a bilateral advance pricing agreement setting forth a method of establishing transfer prices between an importer and the associated parties might be used as a factor to determine that the transfer prices constitute the transaction value for purposes of appraising related party transactions under US customs law.[1105] In 2007 the US Customs and Border Protection issued a compliance publication to educate the public regarding certain aspects of customs valuation requirements for related party transactions. One of the topics was the relevance of advance pricing agreements and transfer pricing studies to the circumstances of the sale test in determining the acceptability of the transaction value for customs

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[1103] *Ross Glove Co. v. Commissioner*, 60 TC 569 (1973). Another US case is *Sunstrand v. Commissioner*, 96 TC 226 (1991). See also Van Herksen, M., "Chapter 1: Introduction", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), pp. 8-9.

[1104] Ibid., p. 6.
"The General Explanation to the Tax Reform Act provides in the relevant part:
Prior Law: Where a U.S. taxable entity imports goods into the United States for resale or use in its business, there may be an incentive to state a high price for the goods, thus reducing U.S. taxable income, particularly when the goods are purchased from a related foreign party that is not subject to U.S. tax. On the other hand, if imported goods are subject to a tariff or other import duty, there is an incentive to state a low value for U.S. customs purposes. [...]
Reasons for Change: Congress understood that some importers could claim a transfer price for income tax purposes that was higher than would be consistent with the transfer price claimed for customs purposes. [...] Congress was particularly concerned that such practices between commonly controlled entities could improperly avoid U.S. tax or customs duties. Changes in U.S. customs law after the 1979 Tokyo Round generally make transactions-based pricing the rule for customs purposes. In enacting the new provision, Congress did not express the view that valuation of property for customs purposes should always determine valuation of property for U.S. income tax purposes. Instead, Congress was concerned only with establishing a limit on the price an importer could claim for income of tax purposes. "

[1105] Private Ruling HQ546979 of 30 August 2000, see also Van Herksen, M., "Chapter 1: Introduction", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), p. 10.

purposes.[1106] The US Customs and Border Protection stated that the fact that an importer used a transfer pricing methodology, which is accepted by the IRS as a valuation method, does not imply that there is an acceptable transaction value for customs purposes. The Canadian Revenue Agency confirmed that customs valuation and transfer pricing require compliance with the arm's length principle.[1107] An example of (partial) integration of tax authorities and customs authorities can be found in the Netherlands. In Amsterdam and Rotterdam there are two combined teams of customs and transfer pricing officers. These teams also conduct joint tax audits.

An interesting example of the link between the concept of associated enterprises for transfer pricing and related parties for customs can be found in Mexico. Art. 106 Mexican Income Tax Law states:

"It shall be considered that two or more persons are related parties when one participates, directly or indirectly, in the management, control or capital of the other, or when a person or group of persons participates directly or indirectly in the administration, control or capital of such persons, or when a link exists *under the customs laws.*"[1108]

The discussion on a convergence of transfer pricing and customs valuation not only affects large multinational enterprises. Today even small enterprises are operating internationally. For example, in the textile sector, many small European enterprises are importing textile and clothes from Asia and are manufacturing in Asia. In the literature it is often argued that this delocalisation leads to new business models and business structures. Enterprises root their interest in foreign countries through location savings. Today's world market implies cross-border transactions between related enterprises and therefore implications for both the customs area and transfer pricing field.[1109]

[1106] The purpose of the circumstances of sale test is to conclude whether the transaction value between a related buyer and seller is acceptable and if the relationship between the buyer and the seller did not influence the price actually paid or payable.

[1107] Circular issued by the Canadian Revenue Agency on 5 October 2006.

[1108] Mexican Income Tax Law, Art. 106.

[1109] Fabio, M., "Chapter 4: Customs Valuation – European Union", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), pp. 116-118.

Some authors refer to the two different points of view and objectives of transfer pricing and customs valuation.[1110] They focus on the different expectations the tax authorities and the customs authorities may have. As mentioned above, from a transfer pricing perspective, costs borne by the buyer should be reasonably low in order to prevent profits from being transferred to countries with preferential tax regimes and to not adversely affect the determination of the taxable base for the purposes of direct taxation.[1111] From a customs revenue perspective, customs value should be reasonably high in order to determine a higher dutiable base to which the relevant rate applies.

As mentioned by some authors, the existence of two different tax authorities in charge of direct taxation and customs duties may lead to different determination of values, making cross-border trade more complicated and burdensome.[1112] Due to the increase of electronic declarations and the use of advanced databases containing many analysis and comparability functionalities, the customs authorities have tools that might be useful in the field of transfer pricing. There are also transfer pricing tools that might be useful for the customs authorities. For example, in more and more situations enterprises are asked by the customs authorities to submit their master files relating to transfer pricing analysis to justify the values indicated in their declaration.

For instance, the following example was provided in the literature. The amount of royalties and licence fees paid to US corporations has tripled from 1990 to 2004. On November 2005 the Wall Street Journal reported that in 2004 the total amount of taxable income of Microsoft's Round Island One, an Irish intellectual property holding company, was about USD 9 billion derived from the use of intangibles. In 2004 this company paid taxes to the Irish Revenue in an amount of more than USD 300 million. These figures may attract the attention of customs authorities with a view to evaluating whether such intangibles are liable to customs duties.[1113]

7.1.3. Arm's length principle in customs

Recently, the relationship between transfer pricing and customs valuation was discussed during two international conferences. The World Customs Organization and the OECD organised these conferences. The "Valuation on

[1110] Ibid.

[1111] Ibid.

[1112] Ibid., p. 117.

[1113] Ibid., p. 118.

Related Parties Transactions for Transfer Pricing, Customs and VAT" conferences were held in 2006 and 2007. It emerged that multinational enterprises are more and more aware that two different regimes may lead to a different determination of values. For example, customs traditionally cover supplies of goods and rarely intangibles. However, the Customs Co-operation Council provides that intangibles are also liable to customs duties (royalties) when they are related to imported goods and constitute a condition of the sale. For instance, if license-fees are paid as distinct from importation, it might not be considered that these fees should be liable to customs duties in any case. In this context transfer pricing might affect customs values.

The arm's length principle is not only applied in Art. 9 OECD Model, but also in Art. 1 Agreement in conjunction with Art. 15 Agreement. Tax authorities in the field of transfer pricing and customs search for the correct arm's length price that would have been applied if the transactions were performed between unrelated companies.

One of the important elements on which the growing interest in these two fields of tax law is based, is the "related parties" or "associated enterprises" concept. An essential part of the interrelationship between customs and transfer pricing is to be found in the application of the concept of associated enterprises/related parties in both areas. In order to apply the arm's length principle, the main condition should be met: parties should be associated (term used for transfer pricing purposes) or related (term used for customs purposes). With respect to the general objective of customs, which is the regulation of the international trade of goods, one author has stated:

"[...] the objective is for a fair, uniform and neutral system for the valuation of goods for customs purposes that precludes the use of arbitrary or fictitious values. To be even more specific, we can say that the objective of the related party provisions (Art. 1.2) of the GVC (Agreement on Implementation of Art. VII of the General Agreement on Tariffs and Trade) is to determine whether the relationship between buyer and seller influenced the price. [...] But then, if we focus on the transfer pricing provisions of income tax legislation, we can observe that their objective is to determine whether an element of the tax base of income taxes is subject to conditions which differ from those which would be made between independent enterprises. As we become more specific, the objectives converge to one single objective: determining whether the relationship influenced the prices."[1114]

Although the general objectives of customs and transfer pricing differ, the level of association between the parties is relevant for the application of the adjustment provisions for both customs as transfer pricing.

In as early as the 1970s, several consultations took place between the OECD and the Secretariat of the Customs Co-operation Council (CCC) for the 1979 OECD Report on Transfer Pricing and Multinational Enterprises.[1115] The OECD stated in this Report:

"In a multinational enterprise many transactions normally take place between members of the group [...]. The prices charged for such transfers do not necessarily represent a result of the free play of market forces, but may, for a number of reasons and because the MNE is in a position to adopt whatever principle is convenient to it as a group, diverge considerably from the prices which would have been agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions in the open market (hereafter referred to as arm's length prices). Tax factors may affect the nature and the amount of the payments since it is likely that MNEs will be more concerned with the total of their net earnings after tax than with the forms which these earnings take – whether for example they are received as royalties, cost charges, service fees, profits from intra-group sales, or dividends from their affiliates etc. On the other hand, it has to be recognized that in many instances tax considerations are unlikely to be paramount where, for example, enterprises are subject to conflicting pressures from various government departments – in the home as well as the host countries- including *customs authorities*, exchange or price control offices and others, or where the different entities of a group face the scrutiny of minority shareholders. Divergences from arm's length prices will not necessarily always occur: in some MNEs the members have a considerable amount of autonomy so that they can and often indeed do bargain with each other in a manner similar to that of independent entities – local managers wanting to show a good profit record for their

[1114] Jovanovich, J. M., "Chapter 6: Comparison between Customs Valuation and OECD Transfer Pricing Guidelines", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), p. 158.

[1115] OECD Committee on Fiscal Affairs, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979), para. 9.

subsidiaries may resist fixing excessive transfer pricing for goods, services, rights etc. if their local subsidiaries' profits would thereby be reduced. There may be other factors tending to cause their prices to approximate to arm's length prices."[1116] *(Italics, RD)*

The 1979 OECD Report on Transfer Pricing and Multinational Enterprise also stated the following:

"29. Customs administrations, broadly speaking, also apply the principle of arm's length pricing and use it also to provide a neutral standard of comparison between values attributable to goods imported by associated enterprises and values for similar goods imported by third parties. Since customs and income tax administrations are not always looking at the same sort of transfers (customs being concerned with transfers between entities) and since customs administrations have traditionally examined goods at the time of importation while income tax officials consider the price at the transfer of ownership some time after the transaction has taken place, and for other reasons, the approaches of the two administrations have sometimes differed. In more recent years, however, a number of customs administrations have found it increasingly impracticable to consider imports by MNEs on a consignment by consignment basis and have begun to apply methods analogous to those described in this report to reach an acceptable price for a range of imported goods. Co-operation between income tax and customs administrations in reaching such a price is becoming more common and this should help to diminish the number of cases where customs values are found unacceptable for income tax purposes or vice versa."[1117]

The OECD confirmed that customs administrations apply the arm's length principle to provide a "neutral standard of comparison" between values attributable to goods imported by *associated enterprises* and values for similar goods imported by non-associated enterprises. The question arises whether the concept of related parties for customs purposes is similar to the concept of associated enterprises as applied under Art. 9 OECD Model?

[1116] Ibid.

[1117] Ibid., para. 29.

A cooperation between those two areas, was also advocated by the OECD in the OECD TP Guidelines of 1995. Paras. 1.65-1.67 of the OECD TP Guidelines read as follow:[1118]

"1.65 The arm's length principle is applied, broadly speaking, by many customs administrations as a principle of comparison between the value attributable to goods imported by associated enterprises and the value for similar goods imported by independent enterprises.

1.66 Both customs officials and tax administrations, however, generally seek to determine the value of the products at the time they were transferred or imported. (For tax administrations, the relevant time is generally when the contract for transfer is concluded, but in many cases this coincides with the time of transfer.) Thus customs valuations, because they may occur at or about the same time the transfer takes place, may be useful to tax administrations in evaluating the arm's length character of a controlled transaction transfer price. In particular, customs officials may have contemporaneous documentation regarding the transaction that could be relevant for transfer pricing purposes, especially if prepared by the taxpayer.

1.67 Although customs officials and tax administrations may have a similar purpose in examining the reported value of cross-border controlled transactions, taxpayers may have competing incentives in setting values for customs and tax purposes. In general, a taxpayer importing goods is interested in setting a low price for the transaction for customs purposes so that the customs duty imposed will be low. (There could be similar considerations with respect to value added taxes, sales taxes and excise taxes.) For tax purposes, however, the taxpayer may want to report a higher price paid for those same goods in order to increase deductible costs. Co-operation between income tax and customs administrations within a country in evaluating transfer prices is becoming more common and this should help to reduce the number of cases where customs valuations are found unacceptable for tax purposes or vice versa. Greater co-operation in the area of exchange of information would be particularly useful and should not be difficult to achieve in countries that already have integrated customs and income tax administrations for income taxes and customs duties. Countries that have separate administrations may

1118 OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), paras. 1.65- 1.67

wish to consider modifying the exchange of information rules so that the information can flow more easily between the different administrations."

Before discussing both concepts of "associated enterprises", I will first provide a brief historical analysis of the World Customs Organization and I will give an overview of the relevant articles.

7.2. WCO: A brief historical analysis

The development of the World Customs Organization (WCO) began in 1947, when the thirteen European governments represented in the Committee for European Economic Co-operation agreed to set up a Study Group. This Study Group examined the possibilities of establishing one or more inter-European Customs Unions based on the principles of the General Agreement on Tariffs and Trade.[1119]

In 1947 the first agreement on general principles of customs valuation was reached. This agreement was embodied in Art. 7 of the General Agreement on Tariffs and Trade (GATT); however, it did not contain much guidance about the practical application of these principles.
In 1948 the Study Group set up two Committees: an Economic Committee and a Customs Committee. The Economic Committee was the predecessor of the Organisation for Economic Co-operation and Development (the OECD). The Customs Committee was the predecessor of the Customs Co-operation Council (the CCC). The Convention which established the CCC came into force in 1952. The Council is the governing body of the CCC and the inaugural Session of the Council was held in Brussels on 26 January 1953. Seventeen European countries were represented during this first Council Session of the CCC.
In that year the Convention on the Valuation of Goods for Customs Purposes (the Brussels Definition of Value) entered into force. This Convention focused on the principle that the customs value should be the value of the goods when those goods would be sold.
The Tokyo Round took place in Geneva between 1973 and 1979. The objective of these GATT multilateral trade negotiations was "to achieve the expansion

[1119] More information can be found on the official website of the World Customs Organization: http://www.wcoomd.org and ever-greater liberalization of world trade, inter alia, through the progressive dismantling of obstacles to trade".[1120] The Kyoto Convention included the following procedures and principles:

- Standardised and minimum data requests from importers/exporters for goods crossing the border;
- Minimum intervention and the use of risk management;
- Separation of release from clearance;
- A movement from border control to more post clearance audit-based control;
- Specially simplified procedures for authorised importers/exporters;
- Maximum use of information and communication technology; and
- Enhanced cooperation with other customs and tax agencies.

As a result the GATT Valuation Code (the Agreement on Implementation of Article VII of the GATT) was adopted that established a positive system of customs valuation based on the price actually paid or payable for imported goods.
In 1994, after years of membership growth, the Council adopted the working name "World Customs Organization" to more clearly reflect its transition to a truly global intergovernmental institution.[1121] [1122]
During the Uruguay Round, the GATT Valuation Code was replaced by the World Trade Organization Agreement on Implementation of Article VII of the GATT 1994. This Agreement does not differ from the GATT Valuation Code. It only applies to the valuation of imported goods for the purpose of levying ad valorem duties on such goods.
The World Customs Organization is now the voice of 177 Customs administrations, which operate on all continents and represent all stages of economic development. Today, WCO Members are responsible for processing more than 98% of all international trade.[1123]

The environment in which the WCO and its Members operate will continue to be defined by the core roles of Customs. The roles are:

[1120] See also Cremer, I. and Kitaura, M., "Chapter 3: Customs Value", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), p. 61.

[1121] See http://www.wcoomd.org/home_about_us_auhistory.htm

[1122] Customs Valuation Agreement, Part I, Art. 1

[1123] See http://www.wcoomd.org/home_about_us_auhistory.htm.

- Revenue collection;
- National security;
- Community protection;
- Trade facilitation; and
- Collecting trade data.

The WTO has a dispute settlement process whereby members can challenge another member on a WTO-related matter. Disputes can be solved through consultations or by having the dispute examined by a panel.
The Valuation Committee gives WCO members the opportunity to consult on matters relating to the administration of the customs valuation system by any member. One of the most important decisions issued by the Valuation Committee is Decision 6.1. Decision 6.1 confirms the procedure that should be adopted when a customs administration has reason to doubt the truth or accuracy of a declared transaction value. Decision 6.1 requires the customs authority to accord opportunity to the importer to respond when it has doubts about the value. If, after having received written response of the importer, the customs authorities still have reasonable doubts, or in the absence of a response, it may deem that the customs value cannot be determined under the provision of Art. 1, the transaction value.

The Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 provides the framework to determine the customs value. All WTO members are obliged to apply the provisions of the Agreement through their national legislation.[1124]

7.3. Objectives and principles of the Agreement

One of the main objectives of the Agreement is to establish a "fair, uniform and neutral system for the valuation of goods for Customs purposes that precludes the use of arbitrary or fictitious Customs values"[1125]
The members to the Agreement also recognise that the basis for valuation of goods for customs purposes should be, to the greatest extent possible, the

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[1124] See also Cremer, I. and Kitaura, M., "Chapter 3: Customs Value", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), p. 61.

[1125] General Introductory Commentary of the Agreement on Implementation of Article VII *of the General Agreement on Tariffs and Trade 1994* (the Agreement).

transaction value of the goods being valued and that the customs value should be based on simple and equitable criteria consistent with commercial practices. Furthermore, the valuation procedures should be of general application without distinction between sources of supply.[1126] It has to be noted that valuation procedures should not be used to combat dumping. By providing more predictability, stability and transparency for trade, the Agreement promotes and facilitates international trade and at the same time ensures compliance with national laws and regulations. The Agreement applies to all countries without regard to whether or not the exporting countries are signatories of the Agreement.

7.4. Rules on Customs Valuation: Part I of the Customs Valuation Agreement

Part I contains the main methodology for determining the customs value. The methods of valuation are set out in a sequential order of application. The primary basis for customs value is the "transaction value" as defined in Art. 1. The transaction value is the price actually paid or payable for the goods when sold for export to the country of importation, adjusted in accordance with the provisions of Art. 8 Agreement.[1127] Where the customs value cannot be determined on the basis of the transaction value, it will be determined using the other methods in hierarchical order:

(1) transaction value method (Art. 1)
(2) transaction value of identical goods (Art. 2)
(3) transaction value of similar goods (Art. 3)
(4) deductive value method (Art.5)
(5) computed value method (Art. 6)
(6) fall-back method (Art. 7).

Art. 4 contains one exception with regard to the hierarchical order. Some authors are of the opinion that, strictly speaking, Art. 7 is not a valuation method. The fall-back method instead defines the options and limitations on

[1126] Ibid.
[1127] See also World Customs Organization, *Brief Guide to the Customs Valuation Agreement*, Third Edition (Brussels: August 1996).

determining customs value when it has not been possible to use a previous method.[1128]

The text of Art. 1 of the Agreement reads as follows:[1129]

"The Customs value of imported goods shall be the transaction value, that is the price actually paid or payable for the goods when sold for export to the country of importation adjusted in accordance with the provisions of Article 8, provided:

(a) that there are no restrictions as to the disposition or use of the goods by the buyer other than restrictions which:

(i) are imposed or required by law or by the public authorities in the country of importation

(ii) limit the geographical area in which the goods may be resold; or

(iii) do no substantially affect the value of the goods;

(b) that the sale or price is not subject to some condition or consideration for which a value cannot be determined with respect to the goods being valued

(c) that no part of the proceeds of any subsequent resale, disposal or use of the goods by the buyer will accrue directly or indirectly to the seller, unless an appropriate adjustment can be made in accordance with the provisions of Art. 8; and

(d) *that the buyer and seller are not related, or where the buyer and seller are related, that the transaction value is acceptable for Customs purposes under the provisions of paragraph 2.*" (*Italics, RD*)

Paragraph (d) of Art. 1 Agreement refers to the arm's length principle. Paragraph (d) of Art. 1 Agreement requires that the buyer and seller should not be related, or if they are related, that both parties to the transaction apply a transaction value that is acceptable for customs purposes as mentioned in paragraph 2. This means that the relationship should not influence the price. In case buyer and seller are associated or related, then the transaction value is only acceptable if the conditions as described in paragraph 2 of Art. 1 Agreement are

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[1128] See also Cremer, I. and Kitaura, M., "Chapter 3: Customs Value", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), p. 68.

[1129] Customs Valuation Agreement, Art. 1.

met. Paragraph 2 of the Customs Valuation Agreement provides the following relevant text:[1130]

"(a) In determining whether the transaction value is acceptable for the purposes of paragraph 1, *the fact that the buyer and the seller are related within the meaning of Article 15* shall not in itself be grounds for regarding the transaction value as unacceptable. In such a case the circumstances surrounding the sale shall be examined and the transaction value shall be accepted provided that the *relationship did not influence the price*. If, in the light of information provided by the importer or otherwise, the Customs administration has grounds for considering that the relationship influenced the price, it shall communicate its grounds to the importer and the importer shall be given a reasonable opportunity to respond. If the importer so requests, the communication of the grounds shall be in writing. (*Italics, RD)*

(b) In a sale between related persons, the transaction value shall be accepted and the goods valued in accordance with paragraph 1, whenever the importer demonstrates that such value closely approximates to one of the following occurring at or about the same time:

(i) the transaction value in sales to unrelated buyers of identical or similar goods for exports to the same country of importation;
(ii) the Customs value of identical or similar goods as determined under the provisions of Article 5;
(iii) the Customs value of identical or similar goods as determined under the provisions of Article 6;

In applying the foregoing tests, due account shall be taken of demonstrated differences in commercial levels, quantity levels, the elements enumerated in Article 8 and costs incurred by the seller in sales in which the seller and the buyer are not related that are not incurred by the seller in sales in which the seller and the buyer are related.
(c) the tests set forth in paragraph 2(b) are to be used at the initiative of the importer and only for comparison purposes. Substitute values may not be established under the provisions of paragraph 2(b)."

[1130] Customs Valuation Agreement, Art. 1(b).

The above-mentioned article refers to Art. 15 Agreement for the interpretation of related persons. I will discuss Art. 15 in the next section. The Agreement applies the arm's length principle in the same way as the OECD does in Art. 9 OECD Model. Only if the relationship between the two parties has influenced the price, may the price then be adjusted to a price that would be applied by independent parties. Therefore, it is important that a relationship exists between the importer and the exporter. If there is no relationship or association, then the price should generally be accepted by the authorities.

With respect to the non-arm's length pricing, the Technical Committee provided the following case study.The case study dealt with the application of Art. 1.2 and with the facts of transaction between related enterprises. The following case was analysed:

ICO of country I purchased and imported two categories of ingredients used in the production of food flavourings from XCO of country X. At the time of clearing the goods, ICO declared to Customs in country I that XCO held 22% of the shares of ICO and that officers and directors of XCO were also represented on the Board of Directors of ICO. After importation, Customs in country I had doubts about the acceptability of the price and decided to conduct a review of the circumstances surrounding the sale of goods between XCO and ICO, pursuant to Art. 1.2 Agreement. To this end, Customs forwarded a questionnaire to ICO that sought information regarding the sale of products by XCO to other buyers in country I and, if necessary, justifications of any price difference as well as information relating to XCO's cost of production and profit. At the request of ICO, Customs also forwarded a questionnaire to XCO. From the responses received, facts as set out below were established.

ICO purchased many of the ingredients required for the production of food flavourings from XCO. The ingredients sold by XCO to ICO fall into two categories: (a) ingredients manufactured by XCO and (b) ingredients stocked by XCO, which have been acquired from other manufacturers and suppliers. Ingredients in this last category are not manufactured or processed by XCO. Some of these ingredients may, however, be packaged for resale by XCO.
According to Art. 15.2 Agreement, ingredients in category (a) are not identical or similar goods to the ingredients in category (b). The ingredients in category (a) are sold to unrelated buyers in country I for 100 and sold to ICO for 92. In respect of the ingredients in category (a), Customs found that unrelated buyers purchased the ingredients at the same commercial level and in similar quantities

as ICO and used the ingredients for the same purpose. Importations of these ingredients by unrelated buyers were appraised with a transaction value of 100. Furthermore, the costs incurred by XCO were the same in relation to sales to ICO and unrelated buyers in country I. Customs also established that there was no seasonal influence on the price of ingredients, which might explain the 8% difference in price (100-92). ICO and XCO, after being asked to do so by Customs, provided no additional information explaining the difference in prices. In respect of the ingredients of category (b), Customs established that the prices charged to ICO were adequate to recover all XCO's costs, including the costs of acquisition plus the costs of repacking, handling and freight charges, as well to recover a profit that was representative of the firm's overall profit over a representative period of time.[1131]

In determining the customs value of the ingredients, it should be concluded that ICO and XCO are related persons in terms of paras. (a) and (b) of Art. 15.4 Agreement. As provided by Art. 1.1 (d) in conjunction with Art. 1.2, the transaction value of sales between XCO and ICO will form the basis for the determination of Customs value only where it is established that the price was not influenced by the relationship. [1132] Under Art. 1.2 Agreement the responsibility for demonstrating that the association between parties has not influenced the price lies with the importer. While the Agreement requires Customs to provide reasonable opportunity to the importer to provide information that would indicate that prices are not influenced by relationship, it does not require the Customs administration to conduct an exhaustive enquiry for the purpose of justifying the price difference. Therefore, any decision in this regard must, to a significant degree, be based on the information provided by the importer. The information available in this case shows that the transactions between ICO and XCO are at prices lower than the prices at which the sales are effected to unrelated buyers. When asked to do so, XCO and ICO have failed to explain the price differences. The information obtained by Customs shows that ICO and the unrelated buyers purchase similar quantities of ingredients at the same commercial level and for the same purpose and that XCO's selling costs are the same for sales to ICO and unrelated parties. Based on the foregoing and on the nature of industry and goods, there are insufficient grounds to take the view that the price differential is not significant.[1133]

[1131] This example is described in Case Study 10.1 of the Technical Committee on Customs Valuation.

[1132] See also Case Study 10.1 of the Technical Committee on Customs Valuation, p. 11.

[1133] Ibid., p. 14.

With respect to the ingredients in category (a), the transaction value method would be applicable. Recourse to an alternative method for determining the customs value of category (a) ingredients would be necessary. In this regard, the transaction value of either identical or similar goods imported by unrelated buyers may form the basis of determination of customs value. With respect to the ingredients in category (b), which are sold only to ICO, the examination of the circumstances of the sale shows that the price is adequate to ensure recovery of all costs plus a profit representative of XCO's overall profit on goods of the same class or kind. In accordance with paragraph 3 of the Interpretative Note to Article 1.2 Agreement, transaction values in respect of this category of ingredients may be acceptable for customs purposes.[1134]

Apparently the text of Art. 1 (1), paragraph 1 provides that the customs value is the transaction value. However, if the buyer and the seller are related, the means of establishing the acceptability of a transaction value are provided in paragraph 2 of Art. 1 Agreement.
The transaction value of the related party transaction is only acceptable for customs purposes if the circumstances surrounding the sale are examined. Furthermore, the transaction value must be accepted as the customs value, *provided* that the relationship did not influence the price. Only when there are doubts about the acceptability of the price will such an examination be required. It follows from the explanatory note to paragraph 1 of Art. 1 Agreement that it is not intended that there should be an examination of the circumstances in all cases where the buyer and the seller are related.[1135] If the customs authorities have no doubt about the acceptability of the price, it should be accepted without requesting further information from the importer. This could be the case when the customs administration already examined the relationship between buyer and seller, or already had detailed information concerning the buyer and seller, or "may already be satisfied from such examination or information that the relationship did not influence the price".[1136]
When the customs administration has grounds for considering that the relationship influenced the price, it should give the importer the opportunity to supply detailed information as may be necessary to enable the customs administration to examine the circumstances surrounding the sale. The explanatory note to paragraph 2 of Art. 1 Agreement states that the customs

[1134] See also Case Study 10.1 of the Technical Committee on Customs Valuation, p. 17.
[1135] See Brief Guide to the Customs Valuation Agreement, WCO, explanatory note to Art. 1 para. 2.
[1136] Ibid.

administration should then be prepared to examine the relevant aspects of the transaction. To determine whether the relationship influenced the price, the following aspects might be examined:

- The way the buyer and seller organise their commercial relations;
- The way the price in question was arrived at.

If the relevant aspects of the transaction are analysed and if it may be concluded that the buyer and seller have dealt with each other "as if they were not related", and thus have dealt with each other on "arm's length basis", then the transaction value must be accepted.[1137]

Paragraph 2 (b) of Art. 1 Agreement gives the importer the opportunity to demonstrate that the transaction value closely approximates a "test" value previously accepted by the customs administration, and should therefore be acceptable under the provisions of Art. 1 Agreement. If the importer can demonstrate that the value closely approximates the transaction value that would be agreed upon by independent parties, or the other tests as mentioned in paragraph 2 (b) of Art. 1 Agreement are met, it is, according to the explanatory note to paragraph 2 of Art. 1 of the Agreement, not "necessary to examine the question of influence under paragraph 2 (a) of Article 1 of the Agreement". The factors that should be taken into account when determining whether one value "closely approximates" to another value are, for example, the nature of the imported goods, the nature of the industry itself, the season in which the goods are imported, and, whether the difference in values is commercially significant.[1138]
More importantly, the explanatory note to paragraph 2(b) of Art. 1 Agreement states that the term "unrelated buyers" means buyers who are not related to the seller in *any particular case*. However, it does not provide any explanation of the term "related" or "in any particular case". The explanation of the term "related persons" is dealt with in Art. 15 Agreement.

[1137] Ibid.
[1138] Ibid., para. 2 (b).

7.5. Art. 15 of the Customs Valuation Agreement

7.5.1. Art. 15

Commentary 14.1 deals with the application of Art. 1 (2) Agreement.[1139] This commentary examines the rights and obligations of customs administrations and importers under the Agreement, with respect to the treatment to be accorded to related party transactions in the application of Art. 1.2 Agreement. The General Introductory Commentary to the Agreement recognises that the basis for valuation of goods for customs purposes should, to the greatest extent possible, be their transaction value. The transaction value is, however, pursuant to Art. 1 Agreement, only acceptable as the customs value, if all of the four limitations set out in subparagraphs 1 (a) to 1 (d) of Art. 1 Agreement are satisfied.[1140] One of the limitations is provided in Art. 1, paragraph 1 (d) Agreement. This paragraph requires that the buyer and seller should not be related. In case they are related, the transaction value is acceptable subject to the provisions of paragraph 2 of Art. 1 Agreement. According to the Commentary of the Technical Committee on Art. 1(2) Agreement, this textual construal means that the existence of a relationship between buyer and seller raises a question that serves to alert the importer and customs as to the acceptability of the price as the basis of the transaction value.[1141] In cases where it can be shown that the provisions of Art. 1 paragraph 2(b) Agreement can be met, this would establish the acceptability of the price as the basis of transaction value and preclude the need for any enquiry under paragraph 2(a) of Art. 1 Agreement into the "circumstances surrounding the sale of those goods being imported".[1142]

Art. 15 Agreement provides the definitions of specific terms used in the Agreement. Paragraphs 4 and 5 are the most relevant parts of Art. 15 of the Customs Valuation Agreement.

I quote the text of Art. 15 of the Customs Valuation Agreement below:[1143]

1139 WCO, Technical Committee, Commentary 14.1, *Application of Article 1, paragraph 2.*
1140 Ibid., at 2.
1141 Ibid.
1142 Ibid., at 3.
1143 Customs Valuation Agreement, Art. 15 paras. 4 and 5.

"1. In this Agreement:
(a) "customs value of imported goods" means the value of goods for the purposes of levying ad valorem duties of customs on imported goods;
(b) "country of importation" means country or customs territory of importation; and
(c) "produced" includes grown, manufactured and mined.
2. [...]
3. [...]
4. For the purposes of this Agreement, persons shall be deemed to be related only if:
(a) they are officers or directors of one another's businesses;
(b) they are legally recognized partners in business
(c) they are employer and employee
(d) any person directly or indirectly owns, controls or holds 5 percent or more of the outstanding voting stock or shares of both of them;
(e) one of them directly or indirectly controls the other;
(f) both of them are directly or indirectly controlled by a third person;
(g) together they directly or indirectly control a third person; or
(h) they are members of the same family.
5. Persons who are associated in business with one another in that one is the sole agent, sole distributor or sole concessionaire, however described, of the other shall be deemed to be related for the purposes of this Agreement if they fall within the criteria of paragraph 4."

Apparently, paragraph 4 of Art. 15 Agreement provides the relevant situations of relationship or association between buyer and seller for customs purposes. This follows from the words "only if" in the phrase "persons shall be deemed to be related *only if* ".[1144] Only when one of these forms of relationship exists between buyer and seller will association between buyer and seller exist for the purpose of customs valuation.

The Technical Committee gives a negative answer to the question whether the existence of a relationship between the buyer and the seller, as defined in paragraph 4 of Art. 15 Agreement, gives customs the right to reject the transaction value. The relationship in itself is not a ground for rejecting the transaction value. This is also the case in Art. 9 OECD Model: the fact that

[1144] Customs Valuation Agreement, Art. 15 para. 4.

enterprises are associated does not mean that their transactions are not at arm's length.

The Technical Committee states that Art. 1, paragraph 2 (a) Agreement is clear on this point.[1145] The existence of a relationship should *alert* customs to the fact that there may be a need to enquire as to the circumstances surrounding the sale.[1146] Customs do not need to have grounds to enquire into the circumstances surrounding the sale.[1147] From Art. 1, paragraph 2 (a) Agreement it should be concluded that the circumstances surrounding a sale between related persons must be examined. However, the Interpretative Notes to Art. 1, paragraph 2 state that an examination of the circumstances will not be required in every case but *only* in those cases where customs has doubts about the acceptability of the price.[1148] The structure of the Agreement is such that the existence of a relationship itself gives cause to question whether the price between the seller and buyer is or is not influenced by the relationship as the price can only be used as the basis of transaction value in circumstances where the relationship has not influenced that price.[1149] Nothing in the Agreement prevents customs from satisfying itself as to the truth or accuracy of any statement, document or declaration.[1150]
Customs is not required by the Agreement to justify the reasons for its requesting information from an importer with regard to an import transaction.[1151] Paragraph 6 of Annex III to the Agreement and Art. 17 Agreement recognise that customs has the right to expect the full cooperation of importers in those enquiries. The Technical Committee states in its Commentary on the Application of Art. 1, paragraph 2 that "there is no pre-condition placed upon Customs to the effect that it must justify its reasons for enquiring into a transaction".[1152] However, where customs has grounds for considering the transaction value to be unacceptable because the relationship has influenced the price, customs must communicate its grounds to the importer.[1153]

[1145] WCO, Technical Committee, Commentary 14.1, *Application of Article 1*, at 4.
[1146] Ibid.
[1147] Ibid., at 5.
[1148] Ibid., at 8.
[1149] Ibid., at 10.
[1150] Customs Valuation Agreement, Art. 17.
[1151] WCO, Technical Committee, Commentary 14.1, *Application of Article 1*, at 12.
[1152] Ibid.
[1153] Ibid., at 13.

It is therefore the responsibility of the importer to ensure that the price has not been influenced by the relationship before declaring the goods to be valued under the provisions of Art. 1 Agreement. This is placed upon the importer by virtue of Art. 1 Agreement. Art. 1 Agreement stipulates that the transaction value must be used, provided that the buyer and seller are not related or, where the buyer and seller are related, it can be shown that the relationship did not influence the price.[1154]

[1154] Ibid., at 14.

7.5.2. Criteria for association

Paragraph 4 of Art. 15 contains the following criteria to determine whether there is a relationship between two parties. Persons are deemed to be related if and *only if*:

(a) they are officers or directors of one another's businesses;
(b) they are legally recognised partners in business;
(c) they are employer and employee;
(d) any person directly or indirectly owns, controls or holds 5 percent or more of the outstanding voting stock or shares of both of them;
(e) one of them directly or indirectly controls the other;
(f) both of them are directly or indirectly controlled by a third person;
(g) together they directly or indirectly control a third person; or
(h) they are members of the same family.

Apparently, it follows from Art. 15 Agreement and the explanatory note to its paragraph 4 that "persons" is not only restricted to enterprises. The explanatory note to Art. 15 provides the following relevant text:

"Note to Article 15

Paragraph 4
For the purposes of Article 15, the term 'persons' includes a legal person, where appropriate."

The term "persons" should be interpreted widely for customs purposes. Unlike the related parties concept in customs, Article 9 of the OECD Model states that it deals with "associated enterprises", as also the article is named "associated enterprises" and Article 9 OECD Model starts with:

"Where
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" and "and in either case conditions are made or imposed between the *two enterprises*"[1155]

[1155] See also Chapter 3.

Subparagraph (a) of Art. 15 of the Agreement includes the first relation criterion:

"(a) they are officers or directors of one another's businesses"[1156]

Depending on the nature of this relationship, it should be analysed whether the possibility exists of influencing the prices. For example, if one employer works for the buyer but also for the seller at the same time, but this employer has no influence or no possibilities at all to influence in any way the price of the goods, the existence of related parties cannot be established. However, when this person is able to dictate prices of the other company, then he is able to influence the pricing.
At first sight, this first form of relationship as mentioned in paragraph 4 of Art. 15 Agreement is similar to the participation in management criterion of Art. 9 OECD Model. However, it can be questioned whether an officer of another company is in a position to influence transfer prices, as an officer may not qualify as part of the management of a company. Despite the aforesaid, I am of the opinion that on this point the association concept of customs is in line with the OECD concept of associated enterprises. The main question is whether the officer of both businesses is able to influence the prices.

Criterion (b) refers to the expression "legally recognized partners in business". This term is used neither in the OECD Model nor in the OECD Commentary.
The Technical Committee issued an Advisory Opinion on how to interpret the expression "partners in business" as used in Art. 15 (4b) Agreement. In Advisory Opinion 21.1 the question arises whether sole agents, sole distributors and sole concessionaires are "legally recognized partners in business" in terms of Art. 15.4(b) Agreement.[1157] The position of the Technical Committee on Customs Valuation with regard to sole agents, sole distributors and sole concessionaires, is set out in Art. 15.5 Agreement, which provides that persons associated in business as sole agents, sole distributors or sole concessionaires are *only* deemed to be related persons under the Agreement if they fall within the criteria of Art. 15.4 Agreement.[1158]

[1156] Customs Valuation Agreement, Art. 15 (4a).
[1157] Technical Committee on Customs Valuation, *Advisory Opinion 21.1 Interpretation of the expression 'partners in business' in Article 15.4 (b).*
[1158] WCO, Technical Committee on Customs Valuation, Advisory Opinion 21.1, at 2.

Art. 15.4 (b) Agreement deems persons to be related "if they are legally recognized partners in business". The Technical Committee refers to Webster's Dictionary. Webster's Dictionary defines the word "partner" as:

"One who is associated with one or more persons in the same business and shares with them its profits and risks; a member of a partnership".[1159]

The word "partnership" is in turn defined as:

"An association of two or more people who contribute money or property to carry on a joint business and who share profits and losses in certain proportions".

The Technical Committee notes that in commercial law the simple definitions as set out by Webster's Dictionary, are usually backed up by a complex set of legal provisions and principles intended to define, interpret and codify through contract, tax and other laws the legal relationship implied in the term "partner". An association would be a partnership *only* where the national legal requirements for the creation of a partnership are satisfied. Therefore, persons are not related under the Agreement simply because one person is the sole agent, sole distributor or sole concessionaire of the other.[1160]

While it is true that sole agents, sole distributors and sole concessionaires may have a close association with their suppliers, this fact alone would provide no reason to treat them differently from any other unrelated party.[1161]
In its Advisory Opinion, the Technical Committee states that for the purpose of clarification, a Member State may choose to incorporate or refer to its national law of partnership in the valuation provisions of its customs law. However, it would not be appropriate for a Member State to devise a different definition of partnership specifically for the interpretation of the valuation provisions of its customs law.[1162] From the OECD Model it may be argued that two enterprises, which are partners in a joint venture, are not associated for the purpose of Art. 9 OECD Model in the case of transactions that lack the same interests. For example, if two independent car manufacturers (competitors of each other)

[1159] Webster's Dictionary, quoted by WCO, Technical Committee on Customs Valuation, Advisory Opinion 21.1, at 2.
[1160] WCO, Technical Committee on Customs Valuation, Advisory Opinion 21.1, at 2.
[1161] Ibid.
[1162] Ibid.

were to set up a joint venture, those two car manufacturers should in principle not be considered *associated* for transfer pricing purposes when dealing with each other, leading to a high compliance burden and possible unjustified adjustments.[1163] It seems that this customs criterion results in a broader concept of association than the concept under Art. 9 OECD Model.

The third criterion "they are employer and employee" (Art. 15 paragraph 4 (c)) is not a criterion that exists in the OECD Model. This criterion, which clearly does not focus on the participation-in- management criterion but on the employee of a company who is not a member to the management team, leads to a broader concept of association for customs purposes than the concept under Art. 9 OECD Model.

The fourth criterion of Art. 15 paragraph 4 (d) reads as follows:

"(d) any person directly or indirectly owns, controls or holds 5 percent or more of the outstanding voting stock or shares of both of them [...]"

This criterion focuses on the shareholding relationship. One of the main differences between the above-mentioned customs criterion and the *participation-in-capital* criterion of Art. 9 OECD Model is the clearly mentioned threshold of 5% in the Customs Valuation Agreement. Art. 15 (4) (d) requires the holding of at least 5% shares or voting stock by one person in the other or one person in both parties. Art. 9 OECD Model does not mention a minimum requirement, but as I have concluded in Chapter 5, the participation-in-capital criterion should be dominating or controlling. The concept of participation in capital as included in Art. 15 is a very wide concept: from the wording I conclude that not only controlling or dominating participations in capital result in a relationship for the purpose of Art. 15, but also participations in capital that can be considered as portfolio investments without any possibility to influence the transaction prices may lead to the existence of related parties for the customs authority. A reason for applying a certain threshold may be to prevent the administrative burden for customs authorities to find out whether there is a controlling relationship.

[1163] See Chapter 3.

The fifth criterion deals with "control"; persons are deemed to be related if one of them "directly or indirectly controls the other."[1164] In my view, this is one of the most interesting criteria. It mentions "control" as a single, independent criterion to establish association.

The explanatory note to Art. 15 provides the following relevant text:

"Note to Article 15

Paragraph 4(e)
For the purposes of this Agreement, one person shall be deemed to control another when the former is legally or operationally in a position to exercise restraint or direction over the latter."

The definition of paragraph 4 (e) of the explanatory note to Art. 15 Custom Valuation Agreement provides that control is not an additional qualification to the other criteria of association. It is an *independent* criterion. From the words "legally or operationally" it may be concluded that *control* does not only cover a *de jure* form of control (as referred to by the term "legally"), such as company law, but also *de facto* forms of control. This may be concluded from the words "operationally in a position to exercise".

The Technical Committee published a case study analysing the application of Art. 15.4 (e).[1165] In this study the following facts regarding the transactions were provided.

Company B in importing Country 1, has entered into a sales, service and distribution agreement with Company C, located in exporting Country 2. Company C is a subsidiary of a large multinational enterprise that manufactures heavy machinery and spare parts well known to consumers. The agreement between Company B and C provides:

(a) Both Company B's and Company C's main purpose in entering into the agreement is to develop and promote the sale of products and to provide a high

[1164] Customs Valuation Agreement, Art. 15 paragraph 4(e).
[1165] Technical Committee, Case Study 11.1, *Application of Article 15.4 (e)- related party transactions.*

standard of parts availability and mechanical service to ensure the satisfaction of product users.[1166]

(b) Company B shall be responsible for developing and promoting the sale of products to customers and prospective customers located within the agreed territory and for servicing the agreed range of products.

(c) The agreement between Company B and C is a personal contract entered into by Company C in reliance on the capability of Company B to provide sales and service to customers. Without the express written consent of Company C, Company B agrees not to appoint others to perform such sales and services responsibilities.

(d) Company C and Company B agree that Company B's effectiveness and ability in achieving the primary purpose for the agreement could be adversely affected by Company B's affiliation with another organisation, which is a substantial operator (end-user) of products. Company B agrees that during the life of the agreement, it will avoid any such affiliation whether by way of capital investment, source of capital, common management, common ownership, or otherwise, except to the extent that Company C may otherwise agree in writing.

(e) Company C relies upon the qualifications and abilities of certain individuals employed by Company B to promote, sell and provide maintenance in country 1. Company B agrees that those individuals will continue in the active management of Company B, or will continue to own a substantial financial interest in Company B. No substantial change shall be made in the management positions, ownership or voting control of those individuals without advance notice to and prior approval from Company C.

(f) Company B agrees that, unless Company C otherwise agrees in writing, its inventory of products purchased from Company C under the agreement shall remain unencumbered by security interests of any type in favour of any other creditor.

(g) Company B will maintain, to the satisfaction of Company C, a suitable place or places of business to provide an adequate source of products and mechanical

[1166] Ibid., para. 2 (a).

service for the benefit of the customers. Company B agrees to establish additional places of business or relocate existing establishments in order to adequately service customers. The location of additional places of business and the relocation of existing places of business may only be made with the written consent of Company C. All places of business shall be maintained by Company B in an attractive manner and stock adequate quantities of products to the satisfaction of Company C.

(h) Company B will employ an adequate number of qualified personnel to sell and service products to the satisfaction of Company C.

(i) Company B will maintain inventory and sales records in the manner specified by Company C and provide reports regarding inventory, sales and service to Company C at intervals specified by Company C.

(j) Within 30 days after the end of the fiscal year of Company C, and at any other time upon Company C's request, Company B will deliver to Company C such information as Company C may reasonably request respecting the ownership, financial condition and operations of Company B, together with any subsidiary and related companies.

(k) Unless otherwise agreed by Company C, within 90 days after the close of Company B's fiscal year Company B will deliver Company C audited financial statements and a statement of the results of operations for such fiscal year.

(l) It is the intention of the parties that the relationship between them shall be that of independent contractors and vendor and vendee; that nothing contained in the agreement or done pursuant thereto shall constitute Company B the agent of Company C for any purpose whatsoever; and that all the acts and things done or to be done by Company B pursuant to the agreement, unless expressly otherwise provided, shall be at Company B's own cost and expense.

(m) Either party may terminate the agreement, with or without cause, by notice of termination to the other party. [1167]

[1167] The facts of the transactions have been taken from Case Study 11.1 of the Technical Committee on Customs Valuation, *Application of Article 15.4 (e)- related party transactions.*

The other clauses of the agreement set out the manner in which goods are to be sold by Company C to Company B, as well as the terms and conditions of each sale made in accordance with the agreement, including dealer prices, end user prices, passing of title, method of payment and warranty. Furthermore, the agreement states that imports into Country 1 of goods supplied by Company C fall into the following four categories:

1. goods sold by Company C to Company B;
2. goods sold by Company C directly to customers (end users) pursuant to orders solicited by Company B;
3. goods sold by Company C to end users without the involvement of Company B or any other dealer; and
4. goods sold by Company C to two other dealers similar to the sales to Company B under category 1.[1168]

It may be concluded from the examination of the circumstances related to the two other dealers that Company B has a unique relationship with Company C. The other dealers

- are allowed to purchase goods only on their own account
- are not permitted to solicit orders from end-users of the type solicited by Company B under category 2;
- are not authorised to undertake diagnostic activities; or
- do not receive commissions in respect of sales by Company C to other buyers in country 1.[1169]

Furthermore, the terms of the contracts between these two dealers and Company C do not contain the above-mentioned clauses (a)-(m). Customs has also established that Company B and Company C are not related persons in terms of paragraphs (a), (b), (c), (d), (f), (g) and (h) of Art. 15.4 Agreement.[1170]

In the above-mentioned case study, the Technical Committee on Customs Valuation states that in respect of the sales between Company C and Company B the issue for determination is whether they are related persons under Art. 15.4 (e) Agreement. The Technical Committee analyses this case as follows.[1171]

[1168] Technical Committee on Customs Valuation, *Case Study 11.1, Application of Article 15.4 (e)- related party transactions*, at 4.
[1169] Ibid., at 5.
[1170] Ibid., at 7.
[1171] Ibid., at 9.

The Interpretative Note to Art. 15.4 (e) provides that "one party shall be deemed to control another when the former is legally or operationally in a position to exercise restraint or direction over the latter".[1172]

The Technical Committee's Explanatory Note 4.1 endeavours to provide additional guidance on the application of Art. 15.4 (e) and its Interpretative Note in relation to sole agency, sole concessionaire and sole distributor agreements. According to the Technical Committee, the same considerations on determining control arise in this case. Explanatory Note 4.1 observes that all buyer/seller and distribution arrangements allocate rights and obligations that are legally enforceable between the parties.[1173] This Explanatory Note also emphasises the importance of distinguishing the rights and obligations normally associated with the international sale and distribution of goods, from contractual rights and obligations that would establish a relationship between the parties as envisaged by Art. 15.4 (e). This may also be concluded from the following phrase as used in the Explanatory Note 4.1:

"the wording of the Interpretative Note to Article 15.4 (e) must normally be taken to apply to situations which " [...] *involve a position to exercise restraint or direction in respect of essential aspects relating to the management of the activities of the other person*" (*Italics added, RD*)[1174]

In order to determine whether Companies B and C are related for customs purposes on the basis of the distribution agreement, it is necessary to critically examine the effect of the provisions of the distribution agreement against this principle, Article 15.4 (e) and its Interpretative Note. For customs purposes, *control* should be considered as a separate, independent criterion for association. Therefore, it is relevant when one could speak of *control*. As will be shown in below analysis, there should be a *direction* or *restraint* by one party over the other.

In the analysis made by the Technical Committee on Customs Valuation, the Technical Committee states that many of the clauses contained in the distribution agreement between Companies C and B are typical of those usually encountered in distribution agreements. They do not involve *direction* or

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[1172] WCO, Interpretative Note to Article 15.4 (e).
[1173] Technical Committee on Customs Valuation, *Case Study 11.1, Application of Article 15.4 (e)- related party transactions*, at 9.
[1174] Technical Committee on Customs Valuation, *Explanatory Note 4.1*

restraint by one party over the other. For example, distribution agreements usually contain a termination clause (point m), clauses allocating responsibility (point b), a "best endeavours" clause (point h) and a statement of independence to limit liability (point l). However, some clauses of the distribution agreement need to be analysed more closely.[1175]

The Technical Committee elaborates on the following on clause (d) of the above-mentioned case study. Distribution agreements generally include provisions intended to prevent the establishment of associations by either party that may result in conflicts of interest. In the view of the Committee, in this case the parties have identified that any affiliation with end-users by Company B might adversely affect its ability to achieve the primary purpose for the agreement. From the agreement it follows that Company B agrees to avoid any such affiliations "by way of capital investment, sources of capital, common management, common ownership, or otherwise except to the extent that Company C may otherwise agree".[1176] The decisions regarding investment, sources of capital, management and ownership are essential aspects in the direction of an enterprise. However, the actual extent of this limitation must be evaluated in the context of the primary purpose for the agreement and the prevention of conflicts of interests. This clause restricts Company B's right to affiliate with or obtain capital from end-users. Company B is free to affiliate with other parties and to obtain capital from other sources without the prior agreement of Company C. In the Technical Committee's view, looking at the circumstances, it is reasonable for Company C to have the right to accept or reject any affiliation with an end-user proposed by Company B because of its potential adverse impact on Company's B priorities and/or loyalty.[1177]

Regarding clause (e) of the agreement, the Technical Committee holds the following view. According to the Committee, distribution agreements typically contain clauses requiring either party to provide notice to the other party of any significant change in ownership or management. In many cases such changes may provide grounds for termination of the agreement. However, in the opinion of the Technical Committee, clause (e) goes significantly further than a simple notification provision as it requires Company C's prior approval before

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[1175] Technical Committee on Customs Valuation, *Case Study 11.1, Application of Article 15.4 (e)- related party transactions*, at 10.

[1176] See clause d.

[1177] Technical Committee on Customs Valuation, *Case Study 11.1, Application of Article 15.4 (e)- related party transactions*, at 11(a).

any changes in management positions, ownership and voting control take place. Appointment of the management and decisions relating to the transfer of ownership and voting control are essential aspects relating to the management of Company B.[1178]

Clause (g) is also important to determine whether Company B and C are related persons under Art. 15.4 (e) Agreement. Requirements to maintain adequate places of business as well as adequate levels of stock and spare parts are commonly included in distribution agreements. Often the location of places of business may be discussed by supplier and distributor. The Technical Committee holds the view that in this case it is clear that Company C ultimately has the right to decide on establishment of new places of business and on the relocation of existing places of business. Decisions relating to the location of business activities are essential aspects of the management of Company B.[1179]

Furthermore, clauses (j) and (k) do not grant any specific decision-making rights to Company C. These clauses indicate that Company C monitors the financial status of Company B, its subsidiaries and related companies. Access to financial records is typically provided to enable one of the parties to audit and establish the accuracy of payments made to it by the other party, for example royalties, commissions and proceeds. As the precise nature of Company C's access to Company B's financial records is not clear from the facts of the case, further examination would be necessary to determine the practical extent and effect of this clause.[1180]

The Technical Committee concludes that this agreement goes beyond usual buyer/seller and distribution arrangements. Though all of the aspects of the agreement between Company B and C are consistent with commercial practice, the agreement puts Company C in a position to exercise direction or restraint over Company B in respect of a number of essential aspects of its management, such as management positions, ownership or voting control, the location of places of business. Company B and Company C would therefore, according to the Technical Committee, be related persons for the purposes of the WTO Customs Valuation Agreement because Company C has the capacity to directly or indirectly control Company B within the terms of Art. 15.4 (e) Agreement. As a consequence, an examination into whether that relationship

[1178] Ibid., at 11(b).
[1179] Ibid., at 11(c).
[1180] Ibid., at 11(d).

has influenced the price in accordance with Art. 1.2 and its Interpretative Note should be undertaken by the customs administration.[1181]
For the purposes of the Customs Agreement, it may be concluded that the criterion of "one of them directly or indirectly controls the other" is based on a *de facto* form of control. The essential question is whether one party is in a position to exercise restraint or direction in respect of essential aspects relating to the management of the activities of the other person. Subparagraphs (f), (g) and (h) should be interpreted accordingly.

Regarding clause (e), the Technical Committee is of the opinion that it requires Company C's prior approval before any changes in management positions, ownership and voting control at B take place. However, Company B does not need prior approval of Company C to make changes in management, ownership or voting control. Company B is the *only* party which can make these changes based on company law. The fact that if Company B does not consult Company C and Company B risks termination of the contract does not imply that this open market situation should be considered to be a transaction between associated enterprises.

From a transfer pricing perspective, the above transaction is a pure arm's length situation. There is no dominating or controlling participation of Company C in the management or capital of Company B. Although Company C has a strong influence on the prices of Company B, they do not have any relationship based on company law. If Company B so desires, it can terminate the contract with Company C at anytime. In the agreement between B and C there are different interests. Company C wants as much as possible to have an agreement that supports or protects the economic interests of C. Company B wants an agreement that protects B's interests as much as possible.

The Technical Committee on Customs Valuation issued an explanatory note titled "Consideration of relationship under Article 15.5, read in conjunction with Article 15.4".[1182]
Explanatory note 4.1 states that Art. 15 (4) Agreement expounds on eight situations *only* in which, for the purposes of the Agreement, persons are deemed to be related.[1183] The word "only" indicates a limited number of

[1181] Ibid., at 13.
[1182] WCO, Explanatory Note 4.1.
[1183] Ibid., para. 1.

situations which would trigger relationship between persons as mentioned by Art. 1 Agreement.

Explanatory note 4.1 also indicates that the "related party" concept covers *de facto* control. The explanatory note deals with Art. 15 (4) (e) Agreement. This subparagraph states that persons are be deemed to be related if one of them directly or indirectly controls the other. The Interpretative Note to Art. 15 (4) (e) of the Agreement provides that "for the purposes of this Agreement, one person shall be deemed to control another when the former is legally or operationally in a position to exercise restraint or direction over the latter".

The explanatory note states the following about the Interpretative Note to Art. 15(4e) of the Agreement:

"Obviously, caution must be exercised in this respect to ensure that unintended results do not occur through improper interpretations of this provision when considering the terms and conditions of contracts which have been freely entered into by otherwise unrelated parties. The examples given in paragraphs 6 and 7 above represent situations wherein the terms and conditions of the contracts are weighted in favour of one party over the other and the former would be legally in a position to enforce its contractual rights over the latter. However, in any contract, verbal or written, even of the most simple type, one party is always in a position to specify certain rights, obligations and other expectations which are legally enforceable on the other".[1184]

Explanatory Note 4.1 continues:

"For example, in a basic contract to deliver at a given price, both parties have an expectation that their legal rights and obligations will be honoured, that is, one must deliver and one must pay a certain price. This, however, would not create a relationship under Article 15 (4) (e) of the Agreement. Even in a more complex contractual arrangement where the seller, because of royalty payments on the imported goods, has the right to establish and audit the accounting systems the importer must use to account for the royalties, the exercise of this right would not in itself create a relationship under Art. 15(4) (e) of the Agreement.
It can be concluded that it is not the intent of the Agreement to create a relationship out of every contract or agreement which of their very nature

[1184] Ibid., para. 12

establish legal rights or obligations enforceable under national laws. Therefore the wording of the Interpretative Note to Art. 15 (4e) must normally be taken to apply to situations which go beyond usual buyer / seller or distribution arrangements and involve a position to exercise restraint or direction in respect of essential aspects relating to the management of the activities of the other person."[1185]

According to Explanatory Note 4.1, the consideration of control and the existence of a position to exercise restraint or direction require the determination of questions of fact and degree which must be based on the particulars of each individual situation.[1186]

7.6. Adjustments and timing differences

One fundamental difference between transfer pricing and customs valuation, besides the different concepts of association, is the timing. The compliance of the price of a controlled transaction with the arm's length principle is determined at the time the controlled transactions are undertaken or tested by the taxpayer on the basis of their actual outcome as part of the process for establishing the tax return at year-end.[1187] The examinations by tax administrations generally take place after filing of the tax return. This can be several years after filing. Customs valuations mostly take place upon import. Thus, there is a timing difference between transfer pricing and customs valuation. In case an upward or downward adjustment (based on Art. 9 OECD Model) is made to the transfer price initially charged in a controlled transaction, there is almost no guidance from a customs perspective on how this would affect the customs valuation.

Year-end adjustments in the light of customs valuation raise the question of whether they should give rise to a correction of the customs value reported and duties paid in the country of import, in case of a downward as well as an upward adjustment. With this in mind, some authors are of the opinion that customs authorities may refuse to retroactively reduce the customs duty basis to account for post-import downward price adjustments. For instance, in its

[1185] Ibid., para. 14

[1186] Ibid., para. 15

[1187] See also Silberztein, C., "Chapter 2: Brazil", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), p. 51.

Memorandum D13-3-6 Canada states that for customs purposes, reductions in the price paid or payable by the Canadian purchaser to the foreign vendor made after goods are imported will not be allowed.[1188]
Another question is whether the customs authorities of the country of import may retroactively increase the customs duties on the transaction when a primary adjustment is made in the country of export: for example, if the tax administration increases the transfer price charged by a taxpayer for an export transaction. If a corresponding adjustment is made in the country of import, the question arises whether the customs authorities of the country of import may retroactively increase the customs duties on the transaction.

7.7. Joint WCO/ OECD conferences

The increase of audit activities by customs authorities and the increase of global trade among members of MNEs have led to a significant administrative burden for MNEs. Therefore, the WCO and the OECD organised a Joint Conference on transfer pricing and customs valuation in Brussels in May 2006. The convergence between customs and transfer pricing was discussed during this conference. The two disciplines were compared and the complexity of convergence was analysed. The following recommendations were made:[1189]

- At national level, there is a need to encourage more dialogue between customs and tax authorities. Business organisations should also be consulted, with the possibility of establishing a mechanism of liaison;
- At international level, an appropriate joint forum for dialogue, study and possible liaison should be created, through the WCO and the OECD. Also the WTO, business and academics should be invited to this forum. There should be a more thorough comparison between the two sets of rules, an identification of areas for possible convergence of

[1188] Memorandum D13-3-6, Income tax transfer pricing and customs valuation, Canada Border Services Agency, 18 October 2006, Para. 110. See also Van Herksen, M., "Chapter 1: Introduction", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), pp. 16-21.
[1189] WCO/OECD Joint Conference on Transfer Pricing and Customs Valuation, Brussels 3th and 4th May 2006. See also Van Herksen, M., "Chapter 1: Introduction", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), p. 22.

rules and a coordinated approach, including the possible development of guidelines or explanatory notes, and there should be an examination of specific issues relating to the degree of acceptability by one agency of a value determination by the other;
- The recognition that there are regional variations that need to be taken into account in identifying needs and developing strategies for possible guidelines and a coordinated approach.

In the Second Joint WCO/OECD Conference on transfer pricing and customs valuation (2007), the divergence of valuation methods for transfer pricing, customs and VAT was examined more closely. The debate on the desirability and feasibility of having converging standards continued. There was a concern that customs authorities perhaps would not have the competence to deal with transfer pricing related valuation. The way to address this might be to clarify the transfer pricing methods used in terms of valuation methods that apply to determining customs duties. The most important obstacle to transfer pricing and customs convergence was the fact that customs valuation adheres to the moment of import and transfer pricing to the year-end profit. One of the conclusions of the Second Conference was that the different government departments responsible for transfer pricing and customs need to cooperate. It was recommended to explore the possibilities of a joint approach to audit, compliance and advance pricing agreements as a means to enhance cooperation and coordination between customs administrations and tax authorities.

7.8. Conclusions

In 2006 and 2007 the OECD and WCO held conferences on the similarities and differences between customs and transfer pricing. Some of the recommendations were that there should be a more thorough comparison between the two sets of rules, an identification of areas for possible convergence of rules and that there should be an examination of specific issues relating to the degree of acceptability by one tax authority of a value determination by the other.
This chapter aims to identify the differences and similarities between the concepts of association in customs regulations and Art. 9 OECD Model.

As also stated by the OECD in 1995 OECD TP Guidelines, the arm's length principle is applied, broadly speaking, by many customs administrations as a principle of comparison between the value attributable to goods imported by associated enterprises and the value for similar goods imported by independent enterprises. The customs authorities generally seek to determine the value of products at the time they were transferred or imported. Art. 15 of the Customs Valuation Agreement states that –for customs purposes- if the relationship between the two parties has influenced the price, may the price then be adjusted to a price that would be applied by independent enterprises.

With respect to the relevance of customs for the application of Art. 9 OECD Model, customs valuations may be useful to tax administrations in evaluating the arm's length character of a controlled transaction transfer price. Customs officials may have contemporaneous documentation regarding the transaction that could be relevant for transfer pricing purposes, especially if prepared by the taxpayer.[1190] Due to the increase of electronic declarations and the use of advanced databases containing many comparability functionalities, the customs authorities may have tools that may be useful for transfer pricing purposes.[1191]
Some countries, such as Mexico, apply laws that include both concepts of association:

[1190] See OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), paras. 1.65- 1.67

[1191] On the other hand, customs authorities may also request companies to submit their transfer pricing master files to justify the values indicated in their declaration. See Fabio, M., "Chapter 4: Customs Valuation – European Union", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), pp. 116-118.

"It shall be considered that two or more persons are related parties when one participates, directly or indirectly, in the management, control or capital of the other, or when a person or group of persons participates directly or indirectly in the administration, control or capital of such persons, or when a link exists *under the customs laws*."[1192]

One of the main objectives of the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 (the Agreement) is to establish a "fair, uniform and neutral system for the valuation of goods for Custom purposes that precludes the use of arbitrary or fictitious Customs values".[1193] This objective is based on equality and neutrality, general principles of international tax law also underlying Art. 9 OECD Model.

The Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 provides the primary basis for customs valuation. Under this Agreement the transaction value as defined in Art. 1 of the Agreement should be taken as starting point for the customs authorities. In determining whether the transaction value is acceptable, the fact that the buyer and the seller are related within the meaning of Art. 15 Agreement may not in itself be grounds for regarding the transaction value as unacceptable. In such a case the circumstances surrounding the sale must be examined and the transaction value shall be accepted, provided that the relationship did not influence the price.

Commentary 14.1 deals with the application of Art. 1(2) Agreement. It examines the rights and obligations of customs administrations and importers under the Agreement, with respect to the treatment to be accorded to related party transactions. The commentary provides that the existence of a relationship between buyer and seller raises a question that serves to alert the importer and customs authorities as to the acceptability of the price as the basis of the transaction value. Art. 15 of the Agreement provides the definition of "related parties" for customs purposes:

(a) they are officers or directors of one another's businesses;
(b) they are legally recognised partners in business;
(c) they are employer and employee;

[1192] Mexican Income Tax Law, Art. 106.

[1193] See also Compendium on the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994, General Chapter, Guidelines.

(d) any person directly or indirectly owns, controls or holds 5% or more of the outstanding voting stock or shares of both of them;
(e) one of them directly or indirectly controls the other;
(f) both of them are directly or indirectly controlled by a third person;
(g) together they directly or indirectly control a third person; or
(h) they are members of the same family.

The related parties concept deals with "persons" (also legal persons) and is, in contrast to Art. 9 OECD Model, not limited to "enterprises". It may be concluded that the first form of relationship (definition a) can be considered to be in line with the "participation in management criterion" of Art. 9 OECD Model. The main question should be, although this is not clearly stated in the Agreement, whether the director or officer is able to influence the prices of the transaction.
The second criterion (b) deems persons (including sole agents, sole distributors and sole concessionaires) to be related persons under the Agreement if they are legally recognised partners in business. In this context, partnership is defined as an association of two or more people who contribute money or property to carry on a joint business and who share profits and losses in a certain proportion. This criterion covers situations that are not covered by the OECD concept of associated enterprises.
The third criterion (c) characterises an employer and employee as related parties for customs purposes. On this point, it may be concluded that the concept of related parties for customs is broader than the OECD concept of associated enterprises. The associated enterprises concept of Art. 9 OECD Model does not cover this type of relationship. The relationship employer and employee should not be confused with the participation-in-management criterion of Art. 9 OECD Model.
The fourth criterion (d) focuses on the shareholding relationship and should be compared with the participation-in-capital criterion of Art. 9 OECD Model. The criterion differs from the participation-in- capital criterion of Art. 9 OECD Model as it does not require a *controlling* influence through the shareholding. Every kind of shareholding qualifies as "related parties" as long as the minimum requirement of 5% is met. This also includes, for instance, portfolio investments. Enterprises that are unable to influence the pricing or unable to control the company are still covered by the related parties concept of Art. 15 of the Agreement, as long as these enterprises hold at least 5% of the voting stock of the other enterprise. It must be concluded that the application of this

criterion results in a broader concept of related parties than the concept of associated enterprises applied under the OECD Model.
According to the fifth criterion (e), one person is deemed to control another when the former is legally or operationally in a position to exercise restraint or direction over the latter. Control is therefore not an additional criterion to other criteria, but an independent criterion for the related-parties concept under customs. This fifth criterion is not only based on company law, it also includes various forms of *de facto* control. From the words "or operationally in a position to exercise restraint or direction" it can be concluded that *de facto* control also forms a basis for the existence of related parties. Criterion (h) provides that the concept of related parties also includes family members. The concept of associated enterprises under Art. 9 OECD Model does not cover family relationships.

From the above analysis I conclude that the customs' concept of related parties is much broader than the concept of associated enterprises under Art. 9 OECD Model as discussed in Chapters 2-5. The above-mentioned differences between both concepts of association are fundamental obstacles to a possible convergence between valuation for transfer pricing and valuation for customs. Adjustment of prices can only take place when transactions have taken place between *associated enterprises* or *related parties.* Despite both areas serve the neutrality principle, customs by providing a fair, uniform and neutral system for the valuation of goods, and Art. 9 OECD Model by putting associated enterprises on the same footing for tax purposes as independent enterprises, tax authorities may reject or ignore the adjustments of customs authorities because the concept of associated enterprises differs from the concept of related parties in customs.

Therefore, I conclude that from the differences between both concepts as identified in this chapter, caution must be exercised when analysing a possible convergence between these two areas.

Chapter 8: The concept of associated enterprises in CCCTB

8.1. Common Consolidated Corporate Tax Base

8.1.1. Introduction

In the EU there are increasing problems in the area of transfer pricing. These problems consist essentially in potential double taxation for intra-group transactions and high compliance costs. There is also a tendency among EU Member States to impose increasingly onerous transfer pricing documentation requirements, as they fear manipulation of transfer prices. There are also substantial divergences in the application of transfer pricing methods between Member States. An EU study concluded that the combined effect of these difficulties for companies can be a significant increase in compliance cost for international activities. The study showed that while there is evidence of aggressive tax planning through transfer pricing by companies, there are equally genuine concerns for companies which are making a bona fide attempt to comply with the complex and often conflicting transfer pricing rules of different countries. Such concerns are becoming the most important international tax issue for companies.[1194] A solution would be to provide EU businesses with a single consolidated tax base for their EU activities. Advantages would be:

- The compliance cost resulting from the need to deal with many different EU tax systems would be significantly reduced.
- Transfer pricing problems on EU transactions within a group of companies would disappear.
- Profits and losses would in principle be automatically consolidated on an EU basis
- International restructuring operations would generally be fiscally simpler and less costly.

On 16 March 2011 the European Commission proposed a Directive on a Common Consolidated Corporate Tax Base. A Common Consolidated Corporate Tax Base (CCCTB) can be considered an alternative to the arm's

[1194] Commission of the European Communities, *Commission Staff Working Paper: Company Taxation in the Internal Market*, COM 582 (Brussels: 2001), p. 11.

length principle. Some of the main benefits of CCCTB are considered to arise from consolidation. By freeing companies from compliance with intra-group transfer pricing rules and allowing cross-border loss consolidation within the group, a consolidated base would contribute to create a highly attractive area in which to do business in Europe. This would help to secure a stable tax base in a competitive world environment.[1195]
In conformity with the principle of the supremacy of EU law, the common rules will generally take precedence over rights and obligations arising from agreements between Member States.[1196] A different treatment is envisaged for agreements between Member States and third countries concluded before the Directive enters into force. They may incorporate rights and obligations which are not in line with the Directive, and those agreements will not be affected.
One of the main questions for the application of a CCCTB is how the concepts of "group" and "associated enterprises" should be interpreted. In this chapter I will discuss the development of the CCCTB, the CCCTB definition of "group" and the proposed definition of "associated enterprises".

8.1.2. History

In 1992 the Ruding Committee underlined in its report that there should be some kind of harmonisation of the tax base of companies active within the European Union. The existence of many European tax systems leads to a great number of disadvantages for multinational companies. The Ruding Committee argued that a more or less harmonised concept of fiscal profit would enhance the economic prosperity in Europe. In 1992 the European Commission and the European Council were rather reluctant to put this concept prominently on the list of tax priorities. In 2001 the European Commission was invited to present an analytical study of company taxation in the European Community.[1197] The thoughts behind this were that, as stated by Ruding, a harmonised concept of

[1195] See European Commission, *Working Paper Workshop on the Common Consolidated Corporate Tax Base: Eligibility Tests for Companies and Definition of a CCCTB Group*, CCCTB\RD\001\doc\en (Brussels: 20 October 2010), p. 4.
[1196] See European Commission, *Working Paper Workshop on the Common Consolidated Corporate Tax Base: Transactions and Dealings between the Group and Entities outside the Group*, CCCTB\RD\003\doc\en (Brussels: 20 October 2010), p. 3.
[1197] The mandate for this study goes back to the call by the EU Ministers of Finance at their informal meeting in Vienna on 26 September 1998.

fiscal profit within the European Union would enhance economic prosperity in Europe.[1198]

On 23 October 2001 a study was published by the services of the European Commission, in compliance with an official mandate by the Council of Ministers. The mandate for this study goes back to the call for a comprehensive study of company taxation in the European Community by the EU Ministers of Finance at their informal meeting in Vienna of 26 September 1998. After preparatory discussions in the Taxation Policy Group and in the Council Financial Questions Group of 14 June 1999 and 24 June 1999, the Permanent Representatives Committee agreed the official mandate to the Commission for a study of company taxation in the European Community on 22 July 1999. This study was accompanied by a communication from the Commission to the Economic and Social Committee, the European Parliament and the Council. The Study and Communication published by the Commission dealt with a strategy for providing companies with a consolidated corporate tax base for their EU-wide activities.[1199] As a consequence, the development of a system based on a Common Consolidated Corporate Tax Base (CCCTB) has become one of the main priorities for the Commission.

During the French EU presidency, a proposal on CCCTB was planned for 2008. However, Member States such as Ireland opposed the CCCTB as they considered it as a step to harmonised tax rates.

In 2010 the Lithuanian Commissioner Semeta indicated that he wanted to reopen the CCCTB discussion in the framework of the enhanced co-operation procedure, which allows a small number of Member States to agree legislation amongst themselves under the Lisbon Treaty. At least one third of all EU Member States could agree to implement CCCTB in their territories. The work

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[1198] In as early as 1992 the Ruding Committee recommended in its Report a harmonisation of the different tax bases of companies active in the European Union. See Commission of the European Communities, *Report of the Committee of Independent Experts on Company Taxation*, (Luxembourg: March 1992). EU businesses were confronted in 2000 with a single economic zone in which 15 different company tax systems apply. According to the EU this has been causing losses of economic efficiency, generating specific compliance costs, and it has contributed to a lack of transparency. EU companies argued that their perception of the EU as their home market generally did not correspond to a tax reality, unlike the USA for US companies. See also Commission of the European Communities, *Commission Staff Working Paper: Company Taxation in the Internal Market*, COM 582 (Brussels: 2001), p. 2.

[1199] European Commission, *Towards an Internal Market without tax obstacles: A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities*, COM 582 final (Brussels: 2001).

on the legislative drafting is in progress and led to a proposal for a Council Directive on CCCTB on 16 March 2011.

8.1.3. Benefits of a CCCTB

A Common Consolidated Corporate Tax base would provide companies with establishments in at least two Member States with the possibility to compute their group taxable income according to one set of rules, those of the new EU tax base. This would reduce the tax-related compliance costs and effectively tackle most of the tax obstacles that are currently still hindering companies in developing their EU-wide activities, e.g. as resulting from transfer pricing rules.[1200] At the same time, it would in many areas effectively reduce the risk that Member States' tax law are declared to be unlawful restrictions to the fundamental freedoms of the Treaty by the European Court of Justice.

The CCCTB could be an important measure to:

- allow competition on a level playing field;
- simplify EU corporate restructuring;
- avoid double taxation;
- enhance economic efficiency and welfare;
- apply and revert to sound taxation principles;
- allow full intra-group consolidation;
- reduce compliance costs of the many different national tax systems within the EU; and
- remove transfer pricing problems.[1201]

The term "consolidation" in its original meaning is used in accounting for the aggregation of the individual financial statements of all group members with the elimination of all intra-group transactions affecting the profit and loss

[1200] European Commission, *Non-Paper to informal Ecofin Council- A Common Consolidated EU Corporate Tax Base*, (Brussels: 10 and 11 September 2004). See http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/cctbwpnon_paper.pdf

[1201] See the lecture of Krister Andersson at the International Tax Conference in Berlin on 15 May 2007.

account.[1202] For the CCCTB (and for Netherlands tax purposes as well) the term "genuine tax consolidation" means the aggregation of all individual pre-tax results of group members with the elimination of all intra-group transactions. The tax base is the overall net result of the group. As stated by the CCCTB Working Group, genuine tax consolidation is only applicable within the framework of a single tax base.

The CCCTB requires that the tax base be common across the EU. It consolidates the profits and losses of the companies participating in a group, to calculate a single tax base for "sharing".[1203]
Group taxation approaches require that each corporate group forms an economic unit and therefore should be treated as if it were a single company. As a consequence, a tax system aims to provide businesses the same treatment when carried out through separate dedicated legal entities as businesses operating through separate divisions of a single legal entity. The CCCTB Working Group is trying to extend this approach with the CCCTB in the case of groups operating in more than one Member State, both through subsidiaries and through permanent establishments. This should result in a group of companies determining a single tax base to be shared according to an apportionment key between participating Member States. Each Member State would then apply its tax rate to its share. The implementation of the CCCTB would among other things remove the need for a specific cross border relief scheme and transfer pricing problems.[1204] However, the concept of associated enterprises remains important for the application of CCCTB.

8.1.4. The 2001 CCCTB Working Paper

Part III of the 2001 Working Paper, entitled "Company Tax Obstacles to Cross-border Economic Activity in the Internal Market", deals with transfer pricing. In the introduction to Part III, the phrase "the remaining tax obstacles to cross-border economic activity in the Internal Market" is explained as "tax provisions

[1202] Common Consolidated Corporate Tax Base Working Group (CCCTB WG), *Issues related to group taxation*, Working Document, CCCTB\WP\035\doc\en, 5 May 2006, note 2.
[1203] Ibid., p. 4.
[1204] Ibid., p. 4.

that may hamper cross-border economic activity in the Internal Market".[1205] The study focuses on additional tax or compliance burdens that companies incur as a result of doing business in more than one Member State, and which therefore represent a barrier to cross-border trade, establishment and investment. The fact that each Member State is a separate tax jurisdiction has a number of consequences. In particular:

- companies are obliged to allocate profits to each jurisdiction on an arm's length basis by separate accounting;
- Member States are reluctant to allow relief for losses incurred by associated enterprises whose profits fall outside the scope of their taxing rights;
- cross-border reorganisations entailing a loss of taxing rights for a Member State, are liable to give rise to capital gains taxation and other charges;
- double taxation may occur as a result of conflicting taxing rights.[1206]

According to the Commission, these fundamental problems mean that European multinational companies are in a more difficult competitive situation compared to third country businesses. This is especially the case when the latter enter the European market for the first time, as they are free in their location decisions and can develop tax-optimal structures.
In Chapter 5 of Part III of the 2001 Working Paper, the Commission states that it goes without saying that transfer pricing issues need to be considered when analysing possible company tax obstacles to cross-border economic activity in the Internal Market. The Commission also identifies some fundamental questions, such as whether the arm's length principle and the separate accounting principle, lying at the heart of transfer pricing, are still the most appropriate bases for allocating tax revenues between Member States. The Commission states that many experts are questioning whether "these traditional means, as applied by tax administrations in the field of transfer pricing within the Internal Market, are still the most appropriate and efficient".[1207]

[1205] Commission of the European Communities, *Commission Staff Working Paper: Company Taxation in the Internal Market,* COM 582 (Brussels: 2001), p. 223. Working Papers are generally documents prepared by the services of the European Commission and do not prejudge the final form of any decision to be taken by the European Commission.
[1206] Ibid.
[1207] Ibid., p. 255.

The Commission also recognises problems arising from interpretation issues. With respect to the interpretation of the concept of "associated enterprises", I refer to the Commission:

"Furthermore, according to Article 3 (2) of the Convention any term not defined in the Convention shall, unless the context requires otherwise, have the meaning, which it has under the double taxation convention between the Member States concerned. Examples of terms not defined include 'enterprise', 'permanent establishment' and *when companies are 'associated'*. The Convention as it stands does not therefore guarantee relief of double taxation if Member States apply a different interpretation of these definitions."[1208]

The Working Group states that in a potential case where there is no double tax treaty between the Member States it is uncertain whether these terms will be interpreted in line with the OECD Model Tax Convention or according to domestic legislation. The Working Group states in the Working Paper:

"Furthermore, key definitions in the double tax treaties are not always defined in the treaty itself but refer back to the domestic legislation of each Member State. The term 'enterprise' and the question of when companies are 'associated' might therefore be defined according to each Member State's internal legislation. This lack of definition of 'associated' might be problematic as Member States apply different definitions in their domestic legislation. Some Member States require a fixed threshold of the direct and indirect holding of share capital and/or voting rights; the 'normal' threshold is 25%, but in some Member States it is higher (e.g. 51%). Other Member States take into account the facts and circumstances of each case, and apply a kind of de facto control. If, for instance, a Member State (applying a threshold of 25% according to domestic rules) makes an adjustment in a case where a parent company holds 45% of the shares in the subsidiary, whereas the other Member State in its domestic rules applies a threshold of 51%, then there would be a risk that this second State would not consider the companies to be associated and would thus consider the Convention to be inapplicable."[1209]

Although the Working Group describes the problem of the interpretation of associated enterprises in the context of the EU Member States, this problem

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1208 Ibid., p. 281.

1209 Commission of the European Communities, *Commission Staff Working Paper: Company Taxation in the Internal Market*, COM 582 (Brussels: 2001), p. 281.

would also exist between EU Member States and non-EU Member States. Defining an appropriate interpretation of "associated enterprises" would not only be relevant in the context of the CCCTB, but also in the context of EU groups dealing with non-EU companies.

In its analysis of the EU Arbitration Convention, the Working Group states that there are situations in which the EU Arbitration Convention is not clear. According to Article 3 (2) of the Convention, any term not defined in the Convention must, unless the context requires otherwise, have the meaning it has under the double taxation convention between the Member States concerned. The 2001 Working Paper identifies "associated (enterprises)" as a term not defined in the Convention. Therefore, as set out in the Working Paper, relief of double taxation is not guaranteed if Member States apply a different interpretation of these definitions. In this context, the Working Group states the following:

"Moreover, it should be made clear that thin capitalisation rules are covered. This, again, would in principle not require an amendment to the Convention. There are a number of different ways of addressing the problem, along with the other terms not defined in the Convention (e.g. 'enterprise', 'permanent establishment' and the question of association). One approach would be to refer interpretation problems to the Court of Justice or the European Commission. A disadvantage here would be that the duration of the dispute would be prolonged, as the interpretation problem would have to be solved in advance of the arm's length issue. Another way forward would be to deal with the interpretation problem and the arm's length issue in parallel. This would imply that the competence of the advisory panel under the Convention should be extended. A more pragmatic approach could be simply to try to identify some of the main problem areas, and then to solve them within the Convention. For instance, in cases where there is no double taxation agreement in place between the Member States concerned, one could make reference to the OECD Model Tax Convention. As regards the question of when companies are associated, a possible solution could be to determine this in accordance with the rules and practices of the Member States making the primary adjustment. Some Member States would probably argue that this would lead to an unbalanced solution, but as the number of adjustments is modest this does not seem to be a real concern. Another solution could be to try developing a common definition of when companies are associated.

Some of these problems are maybe more theoretical than of immediate practical importance. However, experience will show if this will remain the case and a working group at EU level could contribute to finding appropriate solutions that would benefit both businesses and Member States. The arbitration phase should be explained in more detail and more guidance provided for its functioning. Moreover, the Convention misses an opportunity to create a common transfer pricing jurisprudence. This could be solved by including rules providing for the mandatory publication of decisions from the advisory panel (and perhaps from mutual agreements between competent authorities), thus building up a common knowledge base in this area."[1210]

Apparently the Commission was of the opinion that the problems caused by the term "associated enterprises" were limited and of a more "theoretical" importance. However, nine years after the publication of the Working Paper a Member State indicated that there is a challenge to European growth from Brazil, Russia, India and China, and stated that "a well functioning corporate tax system is a key factor for growth".[1211] Also, as may be concluded from the words "to try developing a common definition of when companies are associated", the Commission was apparently not aware of any common definition or "autonomous interpretation" of the term "associated enterprises".[1212]
It may be expected that when the volume of transactions between the EU Member States and the above-mentioned countries increases, the need for an appropriate interpretation of "associated enterprises" will grow as well. As discussed in Chapter 6, these countries apply very broad concepts of associated enterprises, often based on *de facto* control. As I have shown in Chapter 5, an autonomous interpretation of the concept of associated enterprises can be derived from the OECD Model. As will be shown in the next sections, the Commission follows the concept of associated enterprises provided by the OECD.

[1210] Ibid., p. 354.
[1211] Summary Record by the Chair of Common Consolidated Corporate Tax Base Workshop (Brussels: 20 October 2010), at II.
[1212] See Chapter 5 for the autonomous interpretation of "associated enterprises".

8.2. Related parties in CCCTB

On 5 December 2006 the Common Consolidated Corporate Tax Base Working Group (hereinafter: Working Group) issued a working document, which dealt with related parties in CCCTB.[1213] The purpose of this document is to identify in which situations common rules for related parties will have to be agreed upon for the CCCTB purposes. In line with the OECD, this working document reaffirmed that the arm's length principle is the main principle that related parties should use in their commercial or financial relations. However, in CCCTB transfer pricing will not have to be at arm's length among companies consolidating their profits and losses in the same group. The overall profits and losses of consolidated groups will be allocated amongst members according to a specific agreed-upon mechanism.[1214] CCCTB companies and their related parties which are not part of the consolidated group should apply other rules, as Member States expressed the view that common rules for these related companies which are not in the same consolidated group is the "only way to combat distortions and inefficiencies in the corporate tax area effectively".[1215]
The working document examined the following four scenarios:

(i) both related parties are companies in CCCTB, consolidated in the same group
(ii) both related parties are companies in CCCTB, but not in the same consolidated group
(iii) one related party is a company in CCCTB and the other related party is a company not in CCCTB
(iv) one related party is a company in CCCTB and the other related party is an individual, for instance by definition outside of the CCCTB.

In the first scenario, the intra-group transactions and losses will be eliminated for companies in the CCCTB. As a consequence, the application of the arm's length principle is no longer required for transactions between associated enterprises within the same consolidated group. According to the CCCTB

[1213] Common Consolidated Corporate Tax Base Working Group , Related Parties in CCCTB, Brussels 5 December 2006, CCCTB\WP\041\doc\en.
[1214] Ibid., p. 2.
[1215] See the EU Working Document "International Aspects in the CCCTB: Common Consolidated Corporate Tax Base Working Group, Related Parties in CCCTB" (Brussels: 05 December 2006), CCCTB\WP\041\doc\en, at 2.

Working Group, the simplicity criterion should play the key role when selecting the most appropriate pricing method for recording the transactions.

The second scenario, companies in CCCTB not consolidated, would arise when the threshold for consolidation is higher than the qualifying participation for the determination of related parties. The arm's length principle should be applied and therefore this should not create any additional practical problem, since the current transfer pricing should have been at arm's length.

In the third situation ,where one related party is a company in CCCTB and the other related party is a company that is not in CCCTB, the Working Group is of the opinion that the arm's length principle will be the basis for the dealings between those companies as well. The main question in this scenario is what the requirements are of associated enterprises or related parties.

In the fourth scenario, a company in CCCTB and an individual as a related party, the Working Group states that the CCCTB will provide possibilities to introduce specific provisions at a personal level. An individual shareholder may have control over the decision making procedures of the company. Therefore, the CCCTB Working Group discussed:

"[....] that various deductions should be limited if they exceed usual or reasonable amounts, [...] to prevent companies from paying higher salaries, pension contributions, interest etc., that are generally tax deductible, to their shareholder, and at the same time employees of the company instead of profit distributions that are tax non deductible and in principle taxable at shareholders' level."[1216]

The Working Group also provides a definition of related parties and closely held companies in the working document. The Working Group refers to the so-called "framework of associated enterprises" that has been laid down in the OECD Model. Related parties are generally determined by a direct or indirect participation in management, control or capital of another enterprise or by the fact that the same persons participate directly or indirectly in the management, control or capital. The Working Group states that the national legislation gives more details of what the direct or indirect participation in the management, control or capital means. However, the Working Group did not investigate

[1216] Ibid.

whether the context of the Model provides clues as to how to interpret the term "associated enterprises". Instead, the Working Group was only of the opinion that a more detailed framework of the interpretation of related parties should be implemented in the CCCTB:

"The objective is to cover situations where companies and their associates are potentially able to present and/or treat some transactions in a different way than such transactions would be treated and/or presented between independent parties. Many Member States lay down the threshold for control that constitutes the control as a basic criterion and the most common threshold is 25% of the capital or voting rights."[1217]

It is here that the CCCTB Working Group states that many Member States interpret "participation in control" as a threshold of 25% of the capital or voting rights. According to the Working Group, these Member States do not consider "participation in control" as a *de facto* control, but as an influence or power that is derived from company law by holding at least 25% of the capital or voting rights. This view is contrary to the view held by many countries, such as India, China, Vietnam and Brazil that "control" -for the purposes of Art. 9 OECD Model- is an *independent* form of control based on *de facto control.*

However, the Working Group also explains that in addition to the phrase quoted above, companies may also be considered to be related if:

"it is proved that the *decisive influence* can be exercised, which may be determined by circumstances other than qualifying participation in capital, such as contractual relationships, representation of the same persons in the boards of directors, family links and other forms of decisive influence."[1218]

By adding this phrase to the interpretation of related parties, it was unclear whether the Working Group considered *de facto* control situations as situations of association. The Working Group did not elaborate further on the term "relationship", but the later proposal of the Working Group did provide more clues. I will discuss this in the following sections of this chapter.

[1217] Ibid., at 5.
[1218] Ibid.

According to the Working Group, a greater level of commonality would be required under the CCCTB than the framework definition provided by the OECD.
The Working Group was also of the opinion that the definition of related parties in the EU Member States was often extended to relatives of individual shareholders and persons participating in the management, for instance directors.

The Working Group also considered the closely held companies as a sub-category of related parties. This sub-category should also cover companies controlled by a limited number of persons having a share or interest in the capital or income of the company or a person who is entitled to acquire share capital or voting rights (and their relatives) who are also directors.[1219] The Working Paper reads:

"Control should be widely defined for this category to cover *any kind of control* or right to acquire control over the company's affairs as well as the right to the greater part of the share capital, voting rights or assets of the company available on distribution and on winding up. The rights of associates and relatives should also be taken into account in determining whether a person has control. Defining closely held companies would allow the CCCTB to keep the definition of a related party less complex."[1220]

It is interesting to note that the Working Group makes a comparison with financial accounting when analysing the related persons concept. The Working Group states that for accounting purposes, companies are not obliged to keep transactions with related parties at arm's length. However, IFRS requires these companies to disclose all related party transactions and defines "a related party" and "related party transaction" for this purpose in IAS 24.[1221] The Working Group also writes in the working document that for an associate reference is made to IAS 28, which presumes the investor holding:

"directly or indirectly (e.g. through subsidiaries), 20% or more of the voting power of the investee, to have a significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly (e.g. through subsidiaries), less than 20% of the voting power of

[1219] Ibid.
[1220] Ibid.
[1221] See also Chapter 3.

the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence and gives more guidance for what the significant influence shall mean for the purposes of application of accounting of an investment and application of the equity valuation method".[1222]

The quotes mentioned above show that the Working Group analysed the IAS/IFRS. It is not clear whether the Working Group took the term "decisive influence" from IAS/IFRS. But looking at the term "significant influence", it may be argued that the Working Group based its term "decisive influence" on the IAS term "significant influence". This indicates that IAS/IFRS has influenced the Working Group in preparing their definitions of the CCCTB terms with respect to associated enterprises and related parties.

8.2.1. Proposed group definition

The Working Group acknowledged that as a consequence of the increased integration of the activities of corporate groups, the growing importance of unique intra-group intangibles and services, and the sophistication of their financing operations, the application of the arm's length principle is becoming more complicated. Although the OECD has issued the transfer pricing guidelines and several reports on transfer pricing issues, according to the Working Group the CCCTB requires a greater level of commonality than the OECD principles provide.

8.2.1.1. Two approaches

There are two different approaches on which the definitions of the term "group" are based: a legal approach and an economic approach.
From a legal point of view, "group" could be interpreted and explained by looking at the legal ownership, which might be based on direct ownership only or also be extended to include indirect ownership. For example, if the

[1222] See the EU Working Document "International Aspects in the CCCTB: Common Consolidated Corporate Tax Base Working Group, Related Parties in CCCTB" (Brussels: 05 December 2006), CCCTB\WP\041\doc\en, at 5.

ownership threshold was 90% this may include only direct subsidiaries that held 90%, or include subsidiaries where the combined group holding of several group companies reached 90% through the addition of several holdings via several levels of companies.[1223]
From an economic point of view, all the entities that are commonly controlled and are related to one another as a single economically integrated business would be included. The CCCTB Working Group elaborates on this interpretation as follows:

"This approach implies as a first criterion ownership control. Then a second set of criteria related to a certain degree of operational and/or economic interdependence between the group units must also be met. These economic relationships could be defined in a number of ways."[1224]

In the opinion of the Working Group, this second approach could introduce subjectivity and thus create additional practical difficulties and complexities for the definition of group.

In the working document of 5 May 2006, the CCCTB Working Group provided elements that should be explained and studied in order to properly define the term "group" for CCCTB purposes. Interestingly, in its working document of 5 May 2006, the CCCTB Working Group referred to IAS/IFRS by stating that some principles as set out in IAS 27 could be *useful* to the definition of control of the parent company over a subsidiary. This shows the influence of the association and control concepts of IAS/IFRS on the CCCTB definitions of "group" and "control":

"Some of the criteria and principles set out in IAS 27 (for example paragraph 13) could be usefully examined to build the common definition of control of the parent company over a subsidiary (without necessarily keeping the threshold mentioned in the accounting standard). IAS 27 extends the criteria to cover some situations focusing on practical influence rather than ownership. Thus, under the following circumstances, control is deemed to exist even though the parent company does not hold the minimum percentage of voting rights: agreements with other investors, power to govern the financial and operating policies, power to appoint or remove the majority of the members of the board

[1223] Common Consolidated Corporate Tax Base Working Group (CCCTB WG), *Issues related to group taxation*, Working Document, CCCTB\WP\035\doc\en, 5 May 2006, at 5.
[1224] Ibid.

of directors or equivalent governing body or power to cast the majority of votes at meetings of the board or equivalent governing body."

However, in the Communication of the Commission to the Council of 5 April 2006, the Commission stated the following regarding the link between international accounting standards and the tax base:

"Although work on the CCCTB might be more straightforward if all companies, in all Member States, were permitted to use IAS/IFRS and therefore there were a single starting point for all companies, the Commission accepts that currently this is not the case. Given the importance of the CCCTB for the Lisbon Programme, the Commission cannot delay work on the CCCTB pending any future harmonization of company accounting. Furthermore, the CCCTB Working Group is a technical group of tax experts and its role is limited to technical tax matters. The rules governing the content of the CCCTB will be applicable whether, at the national level, the starting point for companies preparing their tax accounts is accounts prepared in accordance with IAS/IFRS or national accounting standards. *IAS/IFRS will therefore be used only as a tool in designing the base because they provide a common language and some common definitions. In particular, elements of these international standards which do not suit the CCCTB will not be imported into the CCCTB and there will be no direct formal link to the constantly changing standards (IAS/IFRS).*"[1225] *(Italics, RD)*

The CCCTB Working Group identifies two main approaches of how to eliminate intra-group transactions. The first approach is that each group company would continue to prepare its tax base calculation in the normal traditional manner, but with the application of the new CCCTB rules. Consequently, every intra-group transaction would be ignored when calculating the tax base. The tax bases would then be consolidated and companies would not need to justify transfer prices.[1226] For example, goods purchased by A, sold to B, then sold to C, then sold to a third party would be reflected as initial costs in A, nothing in B and income in C. The overall consolidated base would include A's costs and C's income.

[1225] European Commission, *Report from the Commission to the Council , the European Parliament and the European Economic and Social Committee: Implementing the Community Lisbon Programme: Progress to date and next steps towards a Common Consolidated Corporate Tax Base (CCCTB)*, COM (2006) 157, p.7.

[1226] Ibid., at 8.

In the second approach each group company would again prepare its tax base in the traditional manner. However, all transactions between associated enterprises would be recorded at cost. According to the CCCTB Working Group, this would remove intra-group profits on such transactions but preserve an audit trail in the tax base. This would not lead to a different outcome as in the above-mentioned example: the consolidated base would include A's costs, A's income from sale to B at cost, B's cost and income from sale to C at cost and income from sale to the third party. In this approach transactions would have to be valued at cost but would preserve information through the chain of companies in their tax bases.[1227]

8.2.1.2. Proposed required threshold

In the working document of 20 November 2006, the Working Group stressed that a high threshold (75% or more) of shareholding possession would be preferable to a lower one as a requirement to consolidate. In the document it was also recognised that, regardless of the concrete methodology of consolidation, this would imply elimination of intra-group transactions.[1228]

The EU Commission Services considered that the aim should be to cover as many entities as possible and thus to avoid as much as possible manipulation in order to keep entities outside the group.[1229] According to the EU Commission Services, it would be advisable to take into account either the ownership of shares or to take into account voting rights only. Relying on a cumulative condition would give much more leeway for groups to keep entities outside the group and restrict the scope of consolidation.[1230] In this respect, the Commission Services was of the opinion that the ownership of voting rights seemed to be consistent as it allows the majority shareholder to take the decision of including an entity into CCCTB and thus into full consolidation.

[1227] Ibid., at 9.

[1228] Common Consolidated Corporate Tax Base Working Group , *Progress to date and future plans for the CCCTB*, Brussels 20 November 2006, CCCTB\WP\046\doc\en, at 11.

[1229] Common Consolidated Corporate Tax Base Working Group, *An overview of the main issues that emerged at the second meeting of the subgroup on group taxation*, Brussels 23 November 2006, CCCTB\WP\048\doc\en.

[1230] Ibid., at 2.

In Communication COM 2007- final from the Commission to the European Parliament, the Council and the European Economic and Social Committee, the Commission issued annex 2.[1231] Annex 2 deals with some detailed technical issues that had been discussed in the CCCTB Working Group and that the Commission was still reflecting on in 2007. One of the issues that was discussed in 2006 was the group definition. The annex on this issue reads as follows:[1232]

"A detailed definition of what constitutes a group of companies for consolidation will be required. In addition to defining a common acceptable level of ownership, the range of *possible ownership structures* creates difficulties. Where, for example, a foreign company owns a series of EU companies, and is itself owned by an EU company, it seems preferable that all the EU companies in the group should be consolidated. However, some experts prefer to keep EU companies separate when the chain of ownership is broken by a foreign entity and a way of resolving this issue must be found."

On 26 July 2007 the Working Group issued a working document titled "CCCTB: possible elements of a technical outline".[1233] This paper sets out a possible outline of the principles of CCCTB. The paper merely represents work in progress and did not purport to be comprehensive. It listed a number of areas, which the Commission considered to be outstanding.[1234] The paper covers first the basic rules for a single company before moving on to the rules for groups of companies which qualify for consolidation. According to the paper, these consolidation rules would take precedence over some of the basic rules for the single company, for example transactions between consolidated companies *would not have to be valued at arm's length.*[1235]

The Working Group found it necessary to consider a number of situations that would be important for new rules:

[1231] Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee, *Implementing the Community Programme for improved growth and employment and the enhanced competitiveness of EU business: Further Progress during 2006 and next steps towards a proposal on the Common Consolidated Corporate Tax Base (CCCTB)*, (Brussels: 2 May 2007) COM (2007) 223 final.

[1232] Ibid., annex 2.

[1233] European Commission, *Common Consolidated Corporate Tax Base Working Group (CCCTB: possible elements of a technical outline)*, (Brussels: 26 July 2007) CCCTB/WP057.

[1234] Ibid., at 3.

[1235] Ibid.

- (i) single resident company in an EU Member State;
- (ii) single PE in the EU of a non-EU-resident company;
- (iii) single resident company with one or more PEs in the EU;
- (iv) single non-EU resident company with more than one PE in the EU;
- (v) groups of companies- where companies are related companies (>20% but <50%);
- (vi) groups of companies - where companies are related and although more than 50% owned are not consolidated (>50% , but <75%);
- (vii) consolidated companies (>75%).

The Working Group makes a distinction between (a) the group concept, a requirement for consolidation, and (b) associated enterprises, the required concept of the application of the arm's length principle. The paper identifies >20% owned companies as related companies. The paper also identifies companies that are > 50% but <75% owned as members of a "group" for the purposes of opting or not opting for the CCCTB but not for the purposes of consolidation, and companies >75% owned as members of a consolidated group.[1236]

In paragraph 11 of the working document, the Working Group held that companies within a group where each company is linked by at least more than 50% common ownership must either all opt for or all remain outside of the common base. The conditions for calculating the ownership threshold would be defined in the same way, for instance based on ownership of voting rights, as the (higher) ownership threshold for consolidation, which is dealt with below. This 50%+ threshold is to determine which companies qualify as a group that has to either opt, or not opt. The threshold for companies to consolidate within an opted group was suggested as 75%. An alternative would be to set the level for group companies covered by group opting for CCCTB at the same level as the level for consolidation (which is 75%).[1237]

Chapter 4 of the working document deals with related parties. In this chapter, the Working Group stated that it would be necessary to define related parties because transactions with related parties are measured by reference to the arm's

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[1236] Ibid., at 4.

[1237] European Commission, *Common Consolidated Corporate Tax Base Working Group (CCCTB: possible elements of a technical outline)*, (Brussels: 26 July 2007) CCCTB/WP057, p. 4 (see note 6).

length principle, unless the special rules for consolidated companies apply. On this point the working document reads:[1238]

"Parties are related where one controls the other or is controlled by the other, or they are in common control. A controlling party may be an individual. It seems appropriate to adopt a wide concept of control including situations where there is the potential for *significant influence*. It also seems preferable to opt for a fixed threshold rather than a case by case approach. An effective holding or voting rights of 20% or more might be appropriate. The threshold would be determined by multiplication of the successive rates of ownership. However, for the purposes of this calculation an entity which owns more than 50% of the voting rights of another entity is deemed to own 100% of the voting rights of this entity. Related parties also include directors and relatives of related parties."

The above text is evidence of the influence of IAS/IFRS on CCCTB definitions, in particular with respect to "control" and "association" definitions and interpretations. It seems that for the development of the definitions of "group", "control" and "association", the Working Group applies the IAS/IFRS term "significant influence" to the concept of "control". The Working Group advocated the application of a concept of association based on the holding of voting rights. It may therefore also be argued that the Working Group interpreted *control* from a company law basis. Control is deemed to exist when there is an effective holding of 20% of more of the voting rights.

The working document states that a company's voting rights would have to be owned directly or indirectly, for instance through a chain of participation, up to 75 % or more. To calculate the parent company's level of indirect ownership, each respective holding percentage should be multiplied. In case a direct holding was more than 75%, it would count as 100%. The Working Group stated that this ensures that all subsidiaries in which the parent controls directly or indirectly 75% of the voting rights are included in the consolidation. Without this, a chain held at 75% through a number of tiers would fragment into a number of overlapping groups.[1239] When a direct holding has 50% or less it would count as zero. This ensures group control of any companies in the indirect 75% ownership chain.

[1238] Ibid., p. 19.
[1239] Ibid., p. 23.

8.3. Eligibility tests for companies and the definition of a CCCTB group

Following the recent work of the CCCTB Working Group in 2010, companies that have opted for the CCCTB will be obliged to participate in a CCCTB group if they fulfil the requirements for consolidation. This is commonly referred to as the "all-in all-out" approach. In the event that the consolidation test is not passed, a taxpayer may still apply the Directive only for the purpose of determining its individual tax base according to the common set of rules.

According to the CCCTB Working Party papers of October 2010, an eligible taxpayer will be:

(1) a company established under the laws of a Member State
(a) which takes one of the forms listed in an annex to the Directive; and
(b) which is subject to a corporate income tax system (or other similar tax) in a Member State as listed in a further annex or to a similar tax introduced subsequently.

(2) a third country company which has a similar form to companies established under the laws of a Member State and which will be subject to one or more of the corporate income taxes listed in the further annex due to the fact that they maintain a presence qualifying as a permanent establishment.

A resident taxpayer/ company may form a group with:

- its permanent establishment located in (an)other Member State(s); and/or
- the EU-located permanent establishment(s) of its qualifying subsidiaries resident in a third country; and/or
- its directly or indirectly held qualifying subsidiaries resident in one or more Member States; and/or
- one or more other resident taxpayers if they are all directly owned by the same company in a third country once that company has a form similar to that set out in the Annex to the Directive.

A non-resident taxpayer, for instance a company resident in a third country which participates in a CCCTB group through its EU-located permanent establishment, will be entitled to form a group:

- in respect of its permanent establishments located in two or more Member States; and/or
- consisting of its directly or indirectly held qualifying subsidiaries resident in one or more Member States and its EU-located permanent establishment.

A three-part test addresses the three main aspects of economic ownership of a company. Initially the thresholds outlines would have to be met for nine months; otherwise the taxpayer would be considered to have never been part of the group. It should be noted that the thresholds need to be maintained throughout the tax year. If a company leaves a group during the course of a tax year, it will be out of the CCCTB group. The entitlement to consolidation by a group will be based upon the following three-part test:

- *ownership;*
- *control;*
- *rights to profit.*

In the final Proposal for the CCCTB Directive of 16 March, 2011 the European Commission applied a "two-part test" based on control and ownership. I will discuss this in section 8.4 of this study.

The above-mentioned *ownership* test is based on a *capital criterion.* The level of ownership exercised over a subsidiary by a company would be set at a threshold of 75% of the capital of a company. Once the threshold has been reached, it counts for 100% of the shareholding when calculating whether the threshold for capital has been reached in lower-tier subsidiaries. The Working Group notes that the inclusion of a capital participation requirement would bring the CCCTB in line with the Parent/Subsidiary Directive.[1240]

With respect to the *control* criterion, the Working Group stated the following. In order to be considered to be a qualifying subsidiary for the purposes of consolidation, a parent company would have to have the right to exercise more than 50% of the voting rights in a subsidiary. Once the threshold has been reached, it counts for 100% of the voting rights. This is the "all or nothing

[1240] Council Directive (EEC) 90/435 of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, (Brussels: 1990) OJ L225.

approach". When a direct holding is 50% or less, it would count as zero. This ensures group control of any companies in the indirect ownership chain. Again the rights in lower-tier subsidiaries that do not reach these thresholds would be calculated by multiplication.

It is important to note that "control" in this context does not refer to *de facto* control. It refers to the right to exercise more than 50% of the voting rights in a subsidiary. This can be identified as a relationship based on company law. Forms of control outside the 50% voting rights are not included in this second requirement. This is important, as it indicates that the Working Group also holds the view that "control" does not include *all* forms of control. The view that "participation in control" in Art. 9 OECD Model would include every form of *control*, even dominant buyer-seller relationships in the open market, should be rejected if the conditions of the three part- test are applied. It seems that "control" should be considered a qualification to the criterion of holding capital in a company.

The final requirement, *profit entitlement*, is the third part of the test for consolidation. The parent company must be entitled to more than 75% of any profits available from the immediate and lower-tier subsidiaries in order to qualify for consolidation. This last criterion would, for instance, take account of a right of usufruct of shares.

8.3.2. Criteria for associated enterprises

An essential part of the CCCTB provisions deals with the relations, transactions and dealings between the group and entities outside the group. One of those areas deals with the rules for the attribution of taxable profits from transactions between the group and entities outside the group that are associated enterprises. With respect to the interpretation of "associated enterprises" the CCCTB Working Group states the following:

"An important feature of corporate tax systems relates to the concept of 'association' between taxpayers, companies, entities etc. The content of these rules is critical, because, in practice, it also delineates the scope for the application of transfer pricing rules. As a matter of principle, if two or more enterprises qualify as 'associated' but are not part of the same CCCTB group, they have to apply transfer pricing rules, which implies that transactions and/or dealings among themselves will have to be priced at arm's length."[1241]

According to the Working Group, the rules under the CCCTB generally follow the principles of Art. 9 OECD Model. However, the Working Group did not make any formal reference to the OECD Model, as not all Member States participate in the OECD. Another reason for the absence of a clear reference is that the text of the Model is not available in all languages.

The Directive will provide more details on the concept of associated enterprises than the OECD Model. The CCCTB Working Group applies the following concept of associated enterprises:

- A taxpayer participates directly or indirectly in the management or control or capital of a non-taxpayer or a taxpayer not in the same group.
- The same persons participate directly or indirectly in the management or control or capital of a taxpayer and a non-taxpayer or a taxpayer not in the same group.
- The relations between a head office and its permanent establishment (situated in a Member State or in a third country).

[1241] See European Commission, *Working Paper Workshop on the Common Consolidated Corporate Tax Base: Transactions and Dealings between the Group and Entities outside the Group*, CCCTB\RD\003\doc\en (Brussels: 20 October 2010), p. 3.

The Directive follows the formula of associated enterprises as provided in Art. 9 OECD Model. However, with respect to the above, the CCCTB Working Group interprets "control" as a holding of more than 20% of the voting rights, and "capital" as a participation exceeding 20% of ownership rights. Furthermore, "management" is defined as a position to exercise significant influence in the management of the associated enterprise.

The Working Group also states that in indirect participations, the above-mentioned requirements relevant to capital and control will be fulfilled if the thresholds are reached by multiplying the rates of holding through successive tiers. For the purpose of calculating voting rights, a holding of more than 50% of the voting rights is deemed to qualify as a holding of 100%. In calculating indirect participations this would, in the view of the Working Group, better reflect the reality than the actual rate of holding.

According to the Working Group, it is also necessary in the case of influence or control exercised by an individual, to assign the same consequences when family members are involved. It could be defined that influence or control exercised by the spouse and lineal ascendants and descendants has the same effect as if it were exercised by the individual itself.

Looking at the first participation criterion, the participation in capital, it can be concluded that the Working Group applies 20% as a minimum threshold. However, a minimum required percentage of shares in the capital of one company by another company may lead to problems. For example, situations exist where a company owns 10% shares in another company and controls this company, because the other shares are listed on the stock exchange. On the other hand, a participation in the capital of a joint venture of 50% often is not controlling if the two partners are competitors. None of the partners are able to influence the transfer prices. Therefore, as I also argued in the previous chapters of this study, the question should not be whether a minimum required participation in capital is met, but whether there is a *controlling* or *dominating* participation in capital. This would also be in line with the concept of associated enterprises in Art. 9 OECD Model. A minimum required percentage of shares in the capital of one company by another company would therefore be irrelevant.

It may be explained why the Working Group opted for a minimum threshold. In the opinion of the Working Group, subjectivity might create additional practical difficulties and complexities for the definitions. By applying a specific percentage to determine participation in capital, the Working Group tries to prevent such situations.

It must also be noted that the Working Group interprets "control" as holding more than 20% of the voting rights. This means that "control" should not be interpreted as a *de facto* control. Accordingly, "control" is interpreted as a qualification to "participation in capital": there must be a *controlling* participation in the capital. Open market situations are left outside the scope of associated enterprises.
The Working Group does not provide an explanation of the term "significant influence". When looking at the 2006 and 2007 documents of the Working Group, it might be argued that the explanation of "significant influence" is taken from IAS/IFRS. IAS24 (and IAS29) defines "significant influence" as the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies. Significant influence may be gained "by share ownership, statute or agreement".

8.4. Proposal for a Council Directive on a CCCTB

On 16 March 2011 the European Commission proposed a Council Directive on a CCCTB.[1242] In this seection I will discuss specific articles of this proposed Directive that are relevant for this study. The content of those articles does not differ much from the earlier proposals of the Working Group.

The proposal for a Council Directive on a CCCTB of 16 March 2011 states that eligibility for consolidation should be determined in accordance with a two-part test (instead of a three-part test). This test is based on control (more than 50% of voting rights) and ownership (more than 75% of equity) or rights to profits (more than 75% of rights giving entitlement to profit).[1243] Art. 54 of the Directive provides the following list of for consolidation qualifying subsidiaries:

"Qualifying subsidiaries shall be all immediate and lower-tier subsidiaries in which the parent company holds the following rights:
(a) a right to exercise more than 50% of the voting rights;

[1242] Proposal for a Council Directive on a Common Consolidated Corporate Tax Base, 2011/0058 (CNS), COM 2011 1214
[1243] Ibid., para. 16.

(b) an ownership right amounting to more than 75% of the company's capital or more than 75% of the rights giving entitlement to profit."

For the purpose of calculating the above-mentioned thresholds, Art. 54 states that once the voting-right threshold is reached in respect of immediate and lower-tier subsidiaries, the parent company will be deemed to hold 100% of such rights. Furthermore, entitlement to profit and ownership of capital must be calculated by multiplying the interests held in intermediate subsidiaries at each tier.

Chapter XIII "*Transactions between associated enterprises*" of the CCCTB Directive deals with associated enterprises. Art. 78 (1) reads as follows:

"1. If a taxpayer participates directly or indirectly in the management, control or capital of a non-taxpayer, or a taxpayer which is not in the same group, the two enterprises shall be regarded as associated enterprises.
If the same persons participate, directly or indirectly, in the management, control or capital of a taxpayer and a non-taxpayer, or of taxpayers not in the same group, all the companies concerned shall be regarded as associated enterprises. A taxpayer shall be regarded as an associated enterprise to its permanent establishment in a third country. A non-resident taxpayer shall be regarded as an associated enterprise to its permanent establishment in a Member State."

According to Art. 4 of this Directive, "taxpayer" means a company which has opted to apply the system provided for by this Directive. A "non-taxpayer" means a company which is ineligible to opt or has not opted to apply the system provided for by this Directive.

Art. 78 (2) states:

"(a) participation in control shall mean a holding exceeding 20% of the voting rights;
(b) participation in the capital shall mean a right of ownership exceeding 20% of the capital;
(c) participation in management shall mean being in a position to exercise a significant influence in the management of the associated enterprise.
(d) an individual, his spouse and his lineal ascendants or descendants shall be treated as a single person.

In indirect participations, the fulfilment of the requirements in points (a) and (b) shall be determined by multiplying the rates of holding through the successive tiers. A taxpayer holding more than 50% of the voting rights shall be deemed to hold 100%."

I refer to section 8.3.2 of this study for an analysis of the criteria of "associated enterprises". From Art. 78 (2) (a) it follows that also the European Commission interprets "participation in control" - the expression taken from the OECD Model- as a criterion based on *company law*. Therefore, the concept of associated enterprises in the CCCTB is based on *company law*.

8.5. Conclusions

On 16 March 2011 the European Commission proposed a Directive on a Common Consolidated Corporate Tax Base (CCCTB). The development of a system based on CCCTB has become one of the main priorities for the European Commission. The European Commission questions whether the arm's length principle and separate accounting principle are still the most appropriate and efficient principles to be applied in the field of allocation of taxable results to group members within the Internal Market. The implementation of CCCTB would remove, among other things, the need for a specific cross-border relief scheme and transfer pricing problems. The CCCTB provides companies with establishments in at least two Member States with the possibility to compute their group taxable income according to one set of rules. The aim of the proposal is to significantly reduce the administrative burden, compliance costs and legal uncertainties that businesses in the EU currently face in having to comply with up to 27 different national systems for determining their taxable profits.
The CCCTB replaces the arm's length principle with regard to intra-group dealings. The CCCTB requires a group-definition and, as does the arm's length principle, a definition of associated enterprises. If two or more enterprises are associated but are not part of the same CCCTB group, they have to apply transfer pricing rules.

In 2001 the CCCTB Working Group identified "associated enterprises" as a term not defined in the Convention:

"As regards the question of when companies are associated, a possible solution could be to determine this in accordance with the rules and practices of the Member States making the primary adjustment. [...] Another solution could be to try developing a common definition of when companies are associated."[1244]

The Working Group was –in that stage- of the opinion that the problems caused by the notion of "associated enterprises" were limited and of a more "theoretical" importance. However, in 2010 EU Member States acknowledged the increase of transactions between Europe and Brazil, China, Russia and India. With the different concepts of associated enterprises applied by the latter countries it can be concluded that there is a growing need for a common interpretation of associated enterprises so as to avoid situations of double taxation or additional unjustified taxation.
Probably because of these developments the Working Group's opinion about the importance of the concept of associated enterprise changed in 2010. The Working Group stated:

"An important feature of corporate tax systems relates to the concept of "association" between taxpayers, companies, entities etc. The content of these rules is critical, because, in practice, it also delineates the scope for the application of transfer pricing rules."[1245]

In 2006 the Working Group discussed the so-called "framework of associated enterprises" of the OECD Model and stated that a more detailed framework of the interpretation of related parties should be implemented in the CCCTB. With respect to consolidation, the Working Group stated that the principles of IAS 27 could be relevant for the definition of control of the parent company over a subsidiary. In this context "control" refers to the right to exercise voting rights in a subsidiary. Therefore, "control" is based on *company law*: mere economic dominance is not covered.
In the following years the Working Group stated that the CCCTB would have no formal link to the "constantly changing IAS/IFRS standards".[1246]

[1244] Commission of the European Communities, *Commission Staff Working Paper: Company Taxation in the Internal Market*, COM 582 (Brussels: 2001), p. 354.
[1245] See European Commission, *Working Paper Workshop on the Common Consolidated Corporate Tax Base: Transactions and Dealings between the Group and Entities outside the Group*, CCCTB\RD\003\doc\en (Brussels: 20 October 2010).
[1246] However, several authors are of the opinion that although IAS/IFRS are not decisive for tax accounting within the framework of the CCCTB, they should be explicitly acknowledged

Art. 54 of the proposed Directive on a CCCTB states that eligibility for consolidation should be determined in accordance with a two-part test. This test is based on control (more than 50% of voting rights) and ownership (more than 75% of equity) or rights to profits (more than 75% of rights giving entitlement to profit).

With regard to the concept of "associated enterprises"", Art. 78 of the proposed Directive on a CCCTB reads as follows:

"1. If a taxpayer participates directly or indirectly in the management, control or capital of a non-taxpayer, or a taxpayer which is not in the same group, the two enterprises shall be regarded as associated enterprises.
If the same persons participate, directly or indirectly, in the management, control or capital of a taxpayer and a non-taxpayer, or of taxpayers not in the same group, all the companies concerned shall be regarded as associated enterprises.
A taxpayer shall be regarded as an associated enterprise to its permanent establishment in a third country. A non-resident taxpayer shall be regarded as an associated enterprise to its permanent establishment in a Member State."

According to Art. 4 of this Directive, "taxpayer" means a company which has opted to apply the system provided for by this Directive. A "non-taxpayer" means a company which is ineligible to opt or has not opted to apply the system provided for by this Directive.

Art. 78 (2) states:

"(a) participation in control shall mean a holding exceeding 20% of the voting rights;
(b) participation in the capital shall mean a right of ownership exceeding 20% of the capital;
(c) participation in management shall mean being in a position to exercise a significant influence in the management of the associated enterprise.
(d) an individual, his spouse and his lineal ascendants or descendants shall be treated as a single person.

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as a starting point. See Essers, P.H.J., et al., *The Influence of IAS/IFRS on the CCCTB, Tax Accounting, Disclosure and Corporate Law Accounting Concepts, A Clash of Cultures*, EUCOTAX Series on European Taxation, Vol. 23 (London: Kluwer Law International, 2009), p. 44.

In indirect participations, the fulfilment of the requirements in points (a) and (b) shall be determined by multiplying the rates of holding through the successive tiers. A taxpayer holding more than 50% of the voting rights shall be deemed to hold 100%."

The CCCTB Working Group stated that the Directive followed the concept of associated enterprises as laid down in Art. 9 OECD Model. The CCCTB concept of associated enterprises only includes criteria based on *company law*. The term "control" should therefore not be interpreted as *de facto* control, but only as a holding of 20% or more of the *voting rights*, probably to prevent practical difficulties and complexities.

I conclude that the concept of associated enterprises in CCCTB has a *de jure* basis and does not cover situations of mere economic dominance, outside relationships vested in company law. A relationship based on shareholding or voting rights is essential in determining the existence of associated enterprises. The term "control" is used under the CCCTB, however it does not refer to *de facto* control, such as a dominating buyer/seller relationship in the open market. According to the CCCTB Working Group, the concept of associated enterprises in Art. 9 OECD Model forms the basis of the concept of associated enterprises in CCCTB. Therefore, I conclude that the CCCTB Working Group, in line with the conclusions drawn in Chapters 3 and 5, considers the concept of associated enterprises in Art. 9 OECD Model as a concept based on company law, not covering open market situations.

Chapter 9: Summary and conclusions

9.1. Introduction

The main purpose of this study was to analyse how the concept of "associated enterprises" should be interpreted in the context of the OECD Model. The concept of "associated enterprises" is laid down in Art. 9 (1) OECD Model. Art. 9 (1) OECD Model deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises on other than arm's length terms.

The arm's length principle is the underlying principle of this article and of transfer pricing laws of many countries. The arm's length principle requires that prices set for transactions between associated enterprises should – for tax purposes – be derived from prices that would have been applied by unrelated parties in similar transactions under similar conditions in the open market. The arm's length principle is only applicable to transactions between *associated enterprises*. Under the OECD Model and virtually all tax treaties, the concept of associated enterprises covers a direct or indirect participation in management, control or capital of an enterprise in another enterprise or direct or indirect participation in management, control or capital of the same person(s) in other enterprises.

Art. 9 (2) OECD Model provides for a corresponding adjustment in order to remove or reduce the double tax that may be caused by the (primary) adjustment.

The following quote of the CCCTB Working Group shows the importance of the concept of "associated enterprises":

"An important feature of corporate tax systems relates to the concept of "association" between taxpayers, companies, entities etc. The content of these rules is critical, because, in practice, it also delineates the scope for the application of transfer pricing rules."[1247]

[1247] European Commission, *Working Paper Workshop on the Common Consolidated Corporate Tax Base: Transactions and Dealings between the Group and Entities outside the Group*, CCCTB\RD\003\doc\en (Brussels: 20 October 2010), p. 3.

Those transfer pricing rules commonly include transfer pricing documentation obligations, other compliance requirements and adjustments and penalties when transactions are not at arm's length.

The problem on which this thesis focuses is twofold. First, different interpretations and applications of the concept of associated enterprises may result in economic double taxation, in particular where in a country with a relatively broad concept of associated enterprises (for instance with a participation-in- capital criterion of over 20%) a transfer pricing adjustment is made and the other country involved refuses to apply a corresponding adjustment, because it applies a narrow concept of associated enterprises (for instance based on a 51% participation-in-capital criterion as a minimum).

Secondly, several countries apply a very broad concept of associated enterprises, which not only covers *de jure* relationships such as participation in capital or management, but also purely *de facto* control situations. Such a broad concept of associated enterprises may result in transfer pricing adjustments in cases to which the arm's length principle is not applicable, for instance in situations of a mere dominant market position. The following example illustrates this problem.
An Indian software development company has a customer in the Netherlands which is responsible for more than 90% of the turnover of the Indian software developer. The Dutch customer is able to dictate the prices of the Indian software developer. The Indian software developer is therefore only able to charge a price with a 1% margin/mark-up, which is very low compared to his Indian competitors (which apply for instance 6% as average mark-up).
According to Indian transfer pricing law, if the goods or articles manufactured or processed by one enterprise, are sold to an other enterprise abroad or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise, the two enterprises shall be deemed to be associated enterprises.[1248]
The Indian tax authorities consider the Indian software developer and its Dutch customer to be associated. They may adjust the prices and tax an unrealised profit, i.e. the difference between the real result and a result based on prices derived from other software developers in India. The Netherlands does not consider the companies to be associated as it applies a narrow concept of associated enterprises that does not include "*de facto* control" as a criterion for

[1248] Sec. 92 A (2) (i) ITA 1961

association. Although both companies are unrelated and the prices are a result of open market negotiations, the arm's length principle is applied by the Indian tax authorities, *because of their domestic concept of associated enterprises.* As a result, the Indian company has to pay taxes over profits that have not been made, it faces heavy documentation requirements, other transfer pricing compliance requirements and moreover it faces a penalty for not applying the "correct" prices.

It is to be expected that the problems caused by the various different interpretations of "associated enterprises" will increase. Important emerging economies, such as Brazil, China, India and Vietnam, and important traditional industrialised countries, such as the United States, Germany, the Netherlands and the United Kingdom apply different concepts of "associated enterprises". As business transactions and direct investments between these countries increase, the problems caused by different interpretations of "associated enterprises" may also increase.

This study aims at finding an appropriate interpretation of the concept of "associated enterprises" in the OECD Model in the light of its history and its purposes, which is able to remedy the above problems. While recognising the importance of the UN Model, the focus of this study is on the OECD Model and the TP Guidelines because of their leading role in transfer pricing all over the world.

For achieving this aim, the following research questions are presented:

- Do the historical development and the purposes of the arm's length principle provide clues as to how to interpret "associated enterprises"?
- How is the concept of "associated enterprises" interpreted in Art. 9 OECD Model?
- Should an autonomous interpretation of "associated enterprises" be applied under the OECD Model?
- How is the concept of "associated enterprises" interpreted in the domestic tax legislation of the United Kingdom, the United States, Germany, Sweden, India, the Netherlands, China and Brazil?
- How is the concept of "associated enterprises" interpreted and applied in customs regulations, CCCTB and IFRS?

The first research question discusses the historical development of the arm's length principle and its purposes. Chapter 2 of this study examines the first research question. The second research question, as discussed in Chapter 3, focuses on whether Art. 9 OECD Model provides a definition of "associated enterprises". It also covers various aspects of company law, such as the EC Directives on company law and IFRS, which may be relevant for the concept of "associated enterprises". The third research question asks whether an autonomous interpretation of "associated enterprises" should be applied under the OECD Model. In this context, tax treaty interpretation is discussed in Chapter 4 and an historical analysis of Art. 9 OECD Model is provided in Chapter 5.

The fourth research question, discussed in Chapter 6, deals with the domestic interpretations of the concept of "associated enterprises" in the United Kingdom, the United States, Germany, Sweden, India, the Netherlands, China and Brazil. The fifth research question analyses the concept of associated enterprises in customs regulations (Chapter 7) and the CCCTB (Chapter 8).

This final chapter will deal with the main aim of this study, finding an appropriate interpretation of the notion of "associated enterprises" in the context of the OECD Model, and will provide a summary, conclusions and recommendations.

9.2. Summary

9.2.1. The arm's length principle

As early as 1872 descriptions were provided of arm's length dealing. In the United States courts related the notion of arm's length dealing to the doctrine of "undue influence".[1249] The arm's length principle was introduced in the early reports of the League of Nations as a corollary of the separate accounts principle. The separate accounts principle was introduced for the allocation of taxable income to permanent establishments, which at that time included branches and subsidiaries. Since its introduction in the early reports of the League of Nations, the separate accounts principle and the arm's length

[1249] Baker, R. and Baker, D., "The Pricing of goods in International Transactions between Controlled Taxpayers", 10 *Tax Executive* 23 5 (1957-1958), pp. 247-248 and *Parfitt v. Lawless* (1872), L.R.2 P & D. 462, 468.

principle have become the fundaments of Art. 7, concerning the taxation of permanent establishments, and Art. 9 of the OECD Model.

When a special article for the taxation of affiliated companies (associated enterprises) was introduced in the League of Nations reports of 1933, the arm's length principle became the underlying principle of this article. In this context, Carroll wrote:

"The legal transactions between the parent and the subsidiary should be conducted in the same manner as similar transactions between independent legal persons."[1250]

With respect to the tax treatment of permanent establishments, Carroll also referred to the arm's length principle:

"The fundamental principle laid down is that, for tax purposes, permanent establishments must be treated in the same manner as independent enterprises operating under the same or similar conditions, with the corollary that the taxable income of such establishments is to be assessed on the basis of their separate accounts."[1251]

According to the OECD and the United Nations, arm's length transfer pricing is since many years the international standard for the allocation of taxable income to members of MNEs and to permanent establishments. The arm's length principle requires associated enterprises to deal with each other as if they were independent enterprises. The concept of associated enterprises is essential for the application of the arm's length principle. No re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms.[1252] When enterprises are *associated*, only then may the arm's length principle be applied if the prices between the enterprises are not *at arm's length*. *A contrario*, it may be concluded that if enterprises are *not* associated, prices and

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[1250] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV (Geneva: League of Nations Document No. C.425(b).M.217 (b).1933.II.A., 1933); p. 109.

[1251] League of Nations, *Report of the Fiscal Committee to the Council*, Fourth Session, Document No. C.399.M.204.1933.II.A (Geneva: League of Nations 1933), p. 2.

[1252] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995).

transactions reflect an open market situation that is "automatically" at arm's length. Thus, the concept of associated enterprises can be considered as "the trigger" for the application of the arm's length principle.
As shown in the example of section 9.1, the concept of associated enterprises also delimits the application of the arm's length principle. If the concept of associated enterprises is relatively broad it will cover more enterprises and, as a consequence, the arm's length principle will be applicable to the transactions between those enterprises. A large number of taxpayers runs the risk of profit adjustments and is required to meet documentation obligations.

When independent enterprises deal with each other, the conditions of their commercial and financial relations are established by open market forces.[1253] When associated enterprises, for instance members of an MNE, deal with each other, their commercial and financial relations may not be directly affected by external market forces in the same way as independent parties. When transfer prices do not reflect market prices, the tax liabilities of the associated enterprises and the tax base of the countries concerned may be distorted. Therefore, associated enterprises are required to apply the arm's length principle when dealing with each other. As a consequence, the effects and distortions of their special commercial and financial conditions on their intra-group transactions should be eliminated.[1254] This results in tax parity between MNEs and independent enterprises. As the concept of associated enterprises is an essential part of the arm's length principle, it should be interpreted in conformity with the purposes of the arm's length principle.

As elaborated on by the League of Nations and the OECD, the application of the arm's length principle has the following purposes:

- To make the correct application of the separate entity approach possible and therefore secure the appropriate tax base in each jurisdiction involved;
- To eliminate effects and distortions of the associated enterprises' special commercial and financial conditions on the levels of profits;
- To provide broad parity of tax treatment for MNEs and independent enterprises, that is to provide a tax treatment which is neutral towards the type of entity;

[1253] See Section 2.3.; see also OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.2.
[1254] Ibid.

- In the light of the previously mentioned purposes: to put associated enterprises and independent enterprises on an equal footing for tax purposes;
- To serve the general principles of equality and neutrality in tax law;
- To avoid a distortion of the relative competitive positions between associated and independent enterprises;
- To promote international trade and investment by removing tax considerations from economic decisions.

The "boundaries" of the concept of associated enterprises are determined by the main purposes of the arm's length principle; that is, to put associated enterprises and independent enterprises on a more equal footing for tax purposes (equality) and to avoid the creation of tax advantages that would otherwise distort the relative competitive positions of either type of entity (neutrality).

As a principle, the price established between two independent enterprises is of an arm's length nature. Both parties to the transactions have their own interests. A buyer would like to pay the lowest price possible. A seller would like to receive the best price possible. The negotiation process determines the final price. The price between two independent enterprises needs not be necessarily or usually similar to prices charged/paid between other unrelated parties. There are many valid reasons for the existence of differences with respect to commercial and financial conditions in business transactions between different independent parties. An important difference may be the negotiating power of parties.

As indicated above, one of the consequences of a broad concept of associated enterprises is that the arm's length principle may be applied to open market situations. Looking at the purposes and the historical development of the arm's length principle, the arm's length principle has never aimed at adjusting prices of independent enterprises. With regard to above-mentioned example of the Indian software developer, although both companies are unrelated and the prices are the result of negotiations in the open market, the arm's length principle may be applied by the Indian tax authorities. This example shows that a broad scope of associated enterprises covering various forms of *de facto* control relationships between independent parties engaging in business on an open market may lead to the risk of application of the arm's length principle to situations for which it is not meant.

9.2.2. Distinction between the arm's length principle and anti-avoidance measures

Whereas the arm's length principle is considered to be an anti-tax avoidance and anti-tax evasion measure by various countries, the OECD considers the arm's length principle as a general principle of international tax law. From the early 1920s, the arm's length principle has developed into a separate, important principle of taxation in drafts and reports of the League of Nations, the OEEC and the OECD. The following text of the Fiscal Committee of the OEEC in 1960 is illustrative:

"[...] The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of European double taxation Conventions concluded since the war, and it is fair to say *that the solutions adopted have generally conformed to a standard pattern*. It is generally recognised *that the essential principles* on which this standard pattern is based are well founded [...]"[1255]

In the 1979 OECD Report on Transfer Pricing and Multinational Enterprises, the Committee on Fiscal Affairs states that the need to adjust the actual price to an arm's length price, in order to arrive at a proper level of taxable profits, arises *irrespective* of any contractual obligation undertaken by the parties to pay a particular price, or of any *intention* of the parties to *minimise tax*. Hence, 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.[1256]

Neutrality and parity of treatment are the fundaments of the arm's length principle. Hamaekers stated in 1992:
"Taxpayers with a controlling interest in a company are placed in the same position as other taxpayers through the application of the arm's length principle which neutralises the advantage of the former"[1257]

[1255] See also OEEC, FC(60), annex E, p. 22, para. 2, (Paris: 25 May 1960) FC(60) 157.
[1256] Ibid., see also OECD,Committee on Fiscal Affairs, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises*, (Paris: OECD, 1979), para. 3.
[1257] Hamaekers, H., "The Arm's Length Principle and the Role of Comparables", 12 *Bulletin of International Fiscal Documentation* (1992), p. 602.

In 1995 the OECD TP Guidelines formulate as a basis for the arm's length principle for the first time:

"[...] 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 purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity."[1258]

The arm's length principle seeks to avoid a distortion of the relative competitive positions between associated and independent enterprises, and therefore promotes international trade and investment.[1259] In this context, the arm's length principle itself can be considered a general principle of taxation. The arm's length principle contains features which are based on general principles of tax law recognised in most industrialised countries. In 2010 the revised OECD TP Guidelines reaffirm the arm's length principle as being the most reasonable means for achieving equitable results and minimising the risk of unrelieved double taxation. In line with the 1979 OECD Report on Transfer Pricing and Multinational Enterprises, the OECD stated that 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.[1260]

Also, from the purpose of Art. 9 (2) OECD Model it may be concluded that the arm's length principle is not meant to be an anti-avoidance measure. Art. 9 (2) OECD Model is an integral part of the arm's length principle. The application of the arm's length principle may cause economic double taxation when adjustments are made to correct the prices of the transaction. For example, as a consequence of special conditions within the meaning of Art. 9 (1) OECD Model, the profits of one associated enterprise are increased in one Contracting State via an upward adjustment of the profits. of the enterprise resident in this State and imposes tax on the increased profits. The increased element of profit bears tax in both Contracting States, albeit in the hands of different

[1258] Ibid., para. 1.7

[1259] Ibid., para. 1.3

[1260] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), para. 1.2.

taxpayers.[1261] This is the result of the arm's length principle. Art. 9 (2) OECD Model was introduced in order to eliminate the resulting economic double taxation.

If the arm's length principle were a mere anti-tax avoidance and anti-tax evasion measure, there would be no reason for avoiding double taxation. Anti-tax avoidance measures do generally not go with measures to relieve double taxation arising from the application of these anti-tax avoidance measures.

If the main purpose of Art. 9 (1) OECD Model were to prevent tax avoidance and tax evasion, it seems that this does not correspond with Art. 9 (2) OECD Model, a rule dealing with the avoidance of economic double taxation.

Looking at Art. 9 OECD Model, I conclude that the arm's length principle is a general principle of taxation based on the equality and neutrality principles that prevents double taxation (through Art. 9 (2) OECD Model) and achieves an equitable inter-nation allocation of taxing rights.[1262] The view that Art. 9 OECD Model is a mere anti-avoidance measure and that therefore the concept of associated enterprises may be broadly interpreted so as to cover various situations of tax avoidance and evasion must be rejected. The usefulness of a distinction between application of the arm's length principle and anti-tax avoidance and –evasion measures will be demonstrated in section 9.2.8.

[1261] See also Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 553.

[1262] See Chapter 2.

9.2.3. Art. 9 OECD Model

As indicated in the previous section, the concept of associated enterprises delimits the application of the arm's length principle. According to Art. 9 OECD Model, "associated enterprises" exist when one enterprise participates directly or indirectly in the management, control or capital of the other enterprises, or when the same persons participate directly or indirectly in the management, control or capital of both enterprises.
Art. 9 OECD Model implies a two-step analysis: tax authorities should first determine the existence of "associated enterprises" and if associated enterprises exist, then it should be examined whether the conditions which are made or imposed between the two enterprises are at arm's length.

Art. 9 (1) OECD Model gives two forms of association:

(a) One enterprise participates directly or indirectly in the management, control or capital of the other enterprise (Art. 9 (1) (a) OECD Model); or
(b) The same persons participate directly or indirectly in the management, control or capital of both enterprises (Art. 9 (1) (b) OECD Model).

A definition of what participation in management, control or capital means is not given. Also the Commentary and the OECD TP Guidelines do not provide a definition of associated enterprises. The 1979 OECD Report states that it was not thought to be necessary to define expressions such as "associated enterprises" and "under common control" as a *broad basis of common understanding* of what was meant was assumed to exist.[1263] This indicates that there must be an autonomous interpretation of "associated enterprises".

Art. 9 OECD Model only deals with profit adjustments between *enterprises*.[1264] A specific phrase from Chapter IV concerning the Foreign Enterprise with Local Subsidiary of the 1933 Report supports this view:

[1263] OECD Committee on Fiscal Affairs, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises*, (Paris: OECD, 1979)

[1264] See also Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 524.

"To verify this declaration and accounts, the tax authorities may enquire into the current of business between the local subsidiary and the parent company or other subsidiary companies of the parent, which may for convenience be termed *associated companies*."[1265]

At this point Carroll introduces the term "associated companies" for "convenience purposes". He did not refer to *persons*, but only to companies and subsidiaries. Also the OECD TP Guidelines refer to enterprises: "Transfer Pricing Guidelines for *Multinational Enterprises* and Tax Administrations".
The Commentary on Arts. 11 and 12 OECD Model indicates that Art. 9 OECD Model does not cover relationships by blood or marriage. Paragraph 34 of the Commentary on Art. 11 OECD Model provides examples of relationships that are covered by Art. 11 OECD Model but that are not covered by Art. 9 OECD Model.

Art. 9 (1) (b) OECD Model provides that if the *same persons (P)* participate directly or indirectly in the management, control or capital of an enterprise (A) of a Contracting State and an enterprise (B) of the other Contracting State, and the transactions between company A and B are not at arm's length, then the tax authorities involved could adjust the profits of A and B.
From the words "and in either case conditions are made or imposed *between the two enterprises*" (*Italics, RD*) it may be concluded that an adjustment is only allowed with regard to transactions between enterprises and not between an enterprise and a person who is not carrying on a business.
Art. 9 (1) (a) OECD Model covers the transactions between P and A or B only if P is an enterprise.

For the above reasons I conclude that 9 OECD Model only covers transactions between enterprises.[1266]

The "bracket definition" in the Commentary cannot be considered to be a proper definition of "associated enterprises".[1267] The term "bracket definition"

[1265] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV, League of Nations Document No. C.425(b).M.217 (Geneva: 1933), p. 109.
[1266] See also Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 524.

refers to the definition between brackets of "associated enterprises" in the Commentary on Art. 9 OECD Model:

"This Article deals with [...] associated enterprises (*parent and subsidiary companies and companies under common control*) [...]"

The bracket definition cannot be considered to be a comprehensive proper definition of "associated enterprises", but it indicates that a mere "*de facto*" control situation is not covered by Art. 9 (1) (a) OECD Model. The term "common control" used for explaning the situations under Art. 9 (1) (b) OECD Model remains unexplained. It must be concluded that –if a broad meaning covering also "*de facto*" control would be covered- this would have been stated explicitly.

The OECD Model does not elaborate on the specific order of the terms "management, control or capital". Though a participation in capital through a sole or majority participation including voting rights in the capital of an enterprise is the most common form of association (in particular parent-subsidiary relationships), the OECD Model does not explain why the term "capital" is mentioned as last criterion. One would expect that participation in capital would be the first criterion mentioned for associated enterprises in Art. 9 OECD Model.

According to the OECD, the term "capital" should be understood as it is understood in *company law*.[1268] Company law covers the shareholders' relationships and the relationships between management, shareholders and the company. Therefore, company law is very important for the concept of associated enterprises. It deals with various aspects of "capital" and "management". From a company law perspective, the criteria "participation in capital" and "participation in management" refer to the controlling power that shareholders (may) have and management has over the enterprises.

[1267] See Section 3.3.

[1268] See also the OECD Commentary on Art. 10 (2) (a) OECD Model and Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With Particular Reference to German Tax Treaty Practice*, 3rd ed. (London: Kluwer Law International, 1997), p. 525.

The term "participation in capital" refers to shareholding and voting power. The question arises whether the shareholder has sufficient voting power to be able to influence or control the company, or -in the context of Art. 9 OECD Model- whether this shareholder is able to control the transfer prices.
Company law generally identifies two types of shareholding: a passive, non-controlling shareholder and a shareholder that has sufficient voting power to be able to influence or control this company. In this context, control can be defined as the power to direct the strategic financial or operating activities of an entity, and thus the right to exercise whatever discretion in strategic decision-making exist.
Art. 9 OECD Model focuses on those "participants in capital and management" who are able to influence the transfer prices, so those that have sufficient power to be able to influence or control the company. By requiring minimum thresholds (with regard to a participation in capital) to determine whether there is a participation in capital for transfer pricing purposes, tax authorities may confuse foreign portfolio investment (FPI) with foreign direct investment (FDI) and vice versa. Holding a specific amount of shares does not always imply that the holder has the *power* to control the company.
For instance, share certificates holders generally have no voting power to influence or control the company.

In the light of the aforesaid, company law provides also various "mechanisms" that delimit the power of majority shareholders or increase the power of minority shareholders. For instance, control-enhancement mechanisms may result in minority shareholders who control enterprises or majority shareholders that do not posses control over an enterprise because a minority shareholder does. Control-enhancement mechanisms allocate control rights and may give minority shareholders control over the enterprise. Control-enhancement mechanisms available in company law may limit the control of an enterprise participating in the capital of another enterprise, for example through multiple-voting rights, voting-rights ceilings, ownership ceilings, non-voting shares etc. Specifically because of the so-called separation of ownership and control in company law, I conclude that a specific required percentage to fulfil the participation-in-capital criterion is not decisive to determine whether one enterprise can influence or control the transfer prices of the other enterprise. The concept of control and power are related to the structure of decision-making within the company; the influence of control-enhancing mechanisms on the control or decision-making power of a shareholder is ignored when the transfer pricing legislation applies specific thresholds for participation in capital (for instance, where a country applies a minimum of 25% participation in capital to determine the existence of associated enterprises).

Another aspect of company law illustrates its relevance for Art. 9 OECD Model: the protection of minority shareholders under company law. As shown in the *Ford Canada* case, company law may restrict the control of majority shareholders with respect to the transfer pricing system if the rights of minority shareholders are damaged (minority shareholders' protection).[1269]

The above shows that company law is relevant for the application of Art. 9 OECD Model, as it may restrict the control of majority shareholders and/or provide minority shareholders control.
Economic control/voting models, for instance dealing with voting power indices, may be useful to measure the formal shareholder's voting power and control.

Although the word "or" in Art. 9 OECD Model seems to indicate that "participation in control" is a separate, independent criterion for association, the presence of control is required for identifying whether one holds a "participation in capital or management" that has the possibility to influence the transfer prices. For instance, control is required to identify whether there is a FDI or a FPI.

On the basis of the above I conclude that –for the sake of clarity- the terms "participation in management" and "participation in capital" should be supplemented with the adjective "controlling". The matter whether "participation in control" is a criterion independent from the other designations of "associated enterprises" will be discussed in section 9.2.5.

[1269] *Ford Motor Company of Canada, Limited v. Ontario Municipal Employees Retirement Board* et al., Ontario Superior Court of Justice (Commercial List), [No. 98-CL-3075], decision filed 22 January 2004.

9.2.4. The concept of associated enterprises in IFRS

The concepts of "control" and "related parties" are explained in detail by the IASB for the purpose of financial accounting standards (IAS and IFRS). Although IAS/IFRS deal with financial accounting, an analysis of the control and related parties concepts in this area provides interesting clues as to the interpretation of associated enterprises in tax law.

The objective of IAS 27 (2008) is to enhance the relevance, reliability and comparability of the information that a parent entity provides in its financial statements. It defines "control" as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. A "subsidiary" is defined as an entity that is controlled by another entity, known as the parent. According to IAS 27, control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting powers of an entity. Furthermore, IAS 27 also provides for situations when the parent owns half or less of the voting power of an entity but still controls the latter entity, for instance where a shareholder holds 10% of the capital and the other shareholdings are very small and those shareholders are not able to form an alliance against the decisions of the 10% shareholder. Control is based on *company law* and can therefore be considered as a *de jure* criterion.

The objective of IAS 24 (2011) is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit and loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties. IAS 24 considers parties related when one enterprise has control or joint control over the reporting entity, or has significant influence over the reporting entity, or is a member of the key management of the reporting entity.

IAS 24 states that "control" should not be confused with "significant influence". Significant influence can be defined as "the ability to participate in the decisions of how to use or manage the assets and liabilities of a legal entity so as to benefit from them that is not sufficient to control that entity".

The concepts of control and significant influence are both based on *de jure* relationships, not *de facto* relationships. IAS 24 states that a customer, supplier, franchisor or general agent with whom an entity transacts a significant volume of business, cannot be considered "related" simply by virtue of the resulting

economic dependence.[1270] IAS 24 rejects the view that open market situations, such as a mere economic dominance, may qualify as transactions between related parties, as the basis for disclosure is company law.
The IASB expects to introduce the new IFRS 10 in 2011. This IFRS will replace IAS 27. IFRS 10 addresses a revised definition of control that is based on a "power" criterion and a "returns" criterion. In this context power need not to be absolute; power need not have been exercised and power precludes others from controlling an investee. Power without a majority of voting rights may exist when the reporting entity has more voting rights than any other party and these voting rights are sufficient to give the reporting entity the ability to determine the entity's strategic operating and financing policies.

According to the IASB Board, control of the strategic operating and financing policies of a legal entity is meaningless "when the constituting documents or other contractual agreements of a legal entity restricts the powers available to the governing body of a legal entity". This indicates the strong influence of company law on IFRS.
The assessment of "control" focuses on which party, if any, is able to exercise sufficient voting rights to direct the investee's operating and financial policies. Control exists when an investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. It can be concluded that also the control concept in IFRS 10 is based on *de jure* forms of control, originating from company law, for example rights in the form of voting rights and rights to appoint, reassign or remove key management members.

From the above I conclude that the concept of associated enterprises or related parties in IAS/IFRS has a *de jure* basis. A relationship based on shareholding or voting rights is essential in determining the existence of associated enterprises. The term "control" is used in IAS/IFRS but this term should not be confused with control originating from *de facto* situations, such as mere economic dominance. Although the differences between tax accounting and financial accounting remain significant, the concept of control and association in financial accounting favour rejection of the view that control covers mere economic dominance, outside relationships vested in company law.

[1270] IAS 24 (2011), para. 9.

9.2.5. Tax treaty interpretation: an autonomous interpretation?

Tax treaties recognise that each Contracting State applies its own law. The most widely-held view has been that treaty obligations limit the Contracting States' application of that law. Tax treaties do not attribute the "right to tax" to the Contracting States. According to the Vienna Convention on the Law of Treaties (hereinafter: VCLT), the ordinary meaning of a term is not to be determined in the abstract but in the context of the treaty and in the light of its object and purpose. According to the VCLT, it is not the function of interpretation to revise treaties or read into them what they do not contain, expressly or by implication. Contracting States are to be presumed to have that intention which appears from the ordinary meaning of the terms used by them.

The purpose of the OECD Model is removing the obstacles that double taxation presents to the development of economic relations between countries and promoting the exchange of goods and services and movements of capital, technology and persons by avoiding double taxation and preventing tax avoidance. The OECD states that when Member countries conclude or revise bilateral conventions, they should conform to the OECD Model Tax Convention as interpreted by the Commentaries thereon, taking into account the reservations contained therein. The OECD emphasises that "although the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, which *unlike the Model* are legally binding international instruments, they can nevertheless be of great assistance in the application and *interpretation* of the conventions and, in particular, in the settlement of any disputes."[1271]

The worldwide recognition of the provisions of the Model Convention and their incorporation into a majority of bilateral conventions have helped make the Commentaries on the provisions of the Model Convention a "widely-accepted guide to the interpretation and application of the provisions of existing bilateral conventions".[1272]

Art. 3 (2) of the OECD Model states that any term not defined in the convention shall have the meaning that it has at that time under the law of that State, *unless the context otherwise requires.*

[1271] Introduction OECD Commentary, para. 29.1

[1272] Ibid., para. 15.

The phrase "unless the context otherwise requires" refers to situations where a reference to an interpretation according to domestic law fails to provide a clear solution to the particular tax issue.
With regard to "context" Lang states:

"[...] the object and purpose of the OECD Model suggests putting considerable weight on the phrase "unless the context otherwise requires" and that the term "context" may have a very broad meaning. It covers not only the whole OECD Model but also the preparatory work of the OECD Model such as the Commentary. All historical, systematical and teleological aspects that are important for the interpretation of the OECD Model may be taken into account."[1273]

As stated in section 9.1, almost all tax treaties contain the same formula for associated enterprises as the OECD Model: participation in management, control or capital. None of the OECD Member States has made reservations on Art. 9 (1) OECD Model.

As indicated in Chapter 6, various countries have different and broad concepts and interpretations of "associated enterprises" in their domestic legislation. Double taxation may arise because of different interpretations of the concept of associated enterprises under domestic transfer pricing rules. For instance, in country A a 26% shareholding is covered and an adjustment is made, whereas country B's transfer pricing legislation requires at least a 50% shareholding for the existence of associated enterprises. Country B may therefore not be prepared to apply a corresponding adjustment.
Reference to domestic law for the interpretation of "associated enterprises" may also lead to the risk of application of the arm's length principle to situations for which it is not meant, in particular "*de facto* control" situations, based on a strong negotiation position in the open market.

Therefore, it may be concluded that reference to domestic law fails to provide a clear solution. An autonomous interpretation of associated enterprises avoids the reference to the domestic laws. This seems to be the appropriate way to reach a common interpretation by the Contracting States, which may be followed also by non-OECD Member States.[1274]

1273 Lang, M., Burgstaller, E. and Haslinger, K. (eds.), *Conflicts of Qualification in Treaty Law* (Vienna: Linde Verlag Wien, 2007), p. 32.
1274 Ibid., p. 31.

As has been shown in Chapter 5, the OECD assumption that a broad basis of common understanding exists as to what is meant by the term "associated enterprise" and "under common control" supports the argument for an autonomous interpretation of "associated enterprises".[1275] Furthermore, in the 1960s the Fiscal Committee of the OEEC stated that with regard to the question of how to allocate profits to a permanent establishment and how to allocate profits from transactions between enterprises under common control, it was fair to "say that the solutions adopted have generally conformed to a standard pattern. It is generally recognised that the essential principles on which this standard pattern is based are well-founded".[1276] From this "standard pattern" and the "well founded essential principles", the statement of the Fiscal Committee that "this Article seems to call for very little comment" and the purposes of the arm's length principle that indicate the "boundaries" of the concept of associated enterprises, I conclude that an autonomous interpretation of "associated enterprises" must exist.

Because of the view that treaty obligations limit the Contracting States' application of that law, a domestic interpretation of "associated enterprises" broader than that of the OECD Model will be "overruled" by the narrower concept of associated enterprises in the OECD Model.

[1275] See also Wittendorff, J., *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Series on International Taxation, Vol. 35 (The Netherlands: Kluwer Law International, 2010), p. 215.

[1276] See also OEEC, FC(60), annex E, p. 22, para. 2 (Paris: OEEC, 25 May 1960), FC(60) 157.

9.2.6. Historical analysis of Art. 9 OECD Model

The phrase "participation in management, control or capital" in Art. 9 OECD Model seems to indicate that the concept of associated enterprises consists of three independent elements. However, when one analyses the development of Art. 9 OECD Model, it becomes clear that "control" is not a separate, independent criterion. The two criteria for the concept of associated enterprises are the participation-in-management criterion and the participation-in-capital criterion. This conclusion is based on the following.

Several years before the first meetings of the Fiscal Committee of the League of Nations were held, the term "control" was used in the domestic legislation of two countries that played an important role in the work of this Committee: the United Kingdom and the United States.
The Finance Act 1915 of the United Kingdom provided transfer pricing rules focussing on a concept of control that originates from a close connection between two companies. One party should be able to arrange the course of business between two parties so that the first party would either have no profits or less than the "ordinary profits which might be expected to arise from that business". Control existed by means of the holding of shares or the possession of voting rights or by virtue of any powers conferred by the articles of association or similar documents. Control was apparently based on *de jure* relationships.
However, in the United States the concept of associated enterprises has been formulated differently. As the arm's length principle was considered to be an anti-avoidance and anti-evasion measure, the concept of "control" was very broad. Although in other US tax law articles "control" was exclusively based on a *de jure* relationship, for transfer pricing purposes "control" included all forms of control including *de facto* control: any kind of control, direct or indirect, whether legally enforceable and however exercisable or exercised. For US transfer pricing purposes it was the reality of control which was decisive, not its form or the mode of its exercise.
The question arises which of the two above-mentioned approaches, the UK or the US approach, has been adopted by the Fiscal Committee of the League of Nations.

The Committee of Economic Experts of the League of Nations used the term "control" in their 1923 report to indicate managerial control and a so-called "final" control.[1277] However, the first League of Nations drafts did not need any provisions along the lines of Art. 9 OECD Model as affiliated companies were considered permanent establishments. In 1929 the International Chamber of Commerce requested to the League of Nations inclusion of a separate article concerning the taxation of associated enterprises in the Model:

"The fact that an undertaking has business dealings with a foreign country through a local company the stock of which it owns in whole or in part should not be held to mean that the undertaking in question has a permanent establishment in that country".[1278]

In order to discuss this issue, a Subcommittee drafted a detailed questionnaire on the rules for apportionment of profits from undertakings operating in several countries. The term "control" was used in this questionnaire without any explanation. It may therefore be argued that the term "control" was already generally understood and probably applied by the Member countries, as their answers to the questionnaire did not include any comments on the term "control". Apparently, the Member countries accepted the term "control", even though the term was not explained in the earlier Reports.

The Committee stated that the issue of taxation of associated enterprises, though of great importance, only affected a small number of cases. This may be one of the reasons why the League of Nations did not focus earlier on the taxation of associated enterprises.
In 1933 Carroll recommended in his report to include a separate article dealing with the taxation of associated enterprises in the Draft Convention. In the Draft Convention of the 1933 Report the predecessor of Art. 9 OECD Model was included as Art. 5. This Art. 5 reads as follows:

[1277] League of Nations Economic and Financial Commission, *Report on Double Taxation, submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*, Document E.F.S. 73.F.19. (Geneva: 5 April 1923).

[1278] Id, p. 5. The correct resolution was given in the 1930 Report, Fiscal Committee of the League of Nations, *Report to the Council on the work of the second session of the Committee*, held in Geneva on 31 May 1930, Document number C.340. M.140, p. 5, ad 1. The text of the Resolution voted by the ICC at the Amsterdam Congress in July 1929 reads: "The fact that an undertaking has business dealings with a foreign country through a local company the stock of which it owns in whole or in part, should not be held to mean that the undertaking in question has a permanent establishment in that country."

"When an enterprise of one contracting State has a *dominant participation in the management or capital* of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and as the result of such situation there exists, in their commercial or financial relations, conditions different from those which would have been made between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the law of the State of such enterprise".

Carroll applied the following interpretation of the concept of associated companies:

"To verify this declaration and accounts, the tax authorities may enquire into the current of business between the *local subsidiary and the parent company or other subsidiary companies of the parent*, which may for convenience be termed associated companies."[1279]

Although Carroll had worked in the US Treasury, he interpreted the concept of associated enterprises in accordance with the UK approach: as a concept based on a capital/managerial criterion (subsidiaries). The Commentary on Art. 5 states:

"Article 5 deals with *subsidiaries* which will be taxed as independent enterprise provided no profits or losses are transferred as a result of the relations between the affiliated companies."[1280]

The main textual difference with the current Art. 9 OECD Model is the absence of the term "participation in control". Art. 5 also includes the term "dominant" in the phrase "*dominant* participation in the management or capital of an enterprise of another Contracting State". These differences are very important for this study as they give a clue as to how to interpret the current participation

[1279] League of Nations, *Taxation of Foreign and National Enterprises- Methods of Allocating Taxable Income*, Volume IV, League of Nations Document No. C.425(b).M.217 (b).1933.II.A (Geneva: 1933), p. 109.

[1280] Fiscal Committee of the League of Nations, *Report to the Council on the fourth session of the Committee, held in Geneva from June 15th to 26th, 1933*, League of Nations Document number C.399. M.204 (Geneva: 1933), annex p. 4.

criteria of Art. 9 OECD Model. Not every level of participation results in association for the purpose of this transfer pricing article. Association only exists if there is a participation in capital or management that can dominate or control the other company. The second part of Art. 5 considered a situation where both enterprises are owned or controlled by the same interests. In Art. 9 OECD Model the term "interests" was replaced by the term "persons". As a consequence, Art. 9 OECD Model would not cover situations where one person controls both enterprises. It seems that this would not be in line with the other parts of Art. 9 OECD Model and apparently the OECD did not take into account that replacing "interests" with "persons" would exclude some forms of association. Therefore, the term "persons" must be interpreted as "interests".

I conclude that the first predecessors of Art. 9 OECD Model did not consider "control" to be a separate independent criterion. Carroll referred to an interconnection envisaged under company law for the application of Art. 5. The expression "owned or controlled by the same interests" did not refer to *de facto* control. Carroll considered the concept of associated enterprises to be a concept based on company law: subsidiary companies that are "*control(led) through ownership of stock in a local company*". The "associated enterprises" article did not change in the 1946 London Draft. In the London Draft the articles concerning the taxation of dividend and royalties referred to the concept of "associated enterprises" by using the phrase "dominant participation in management or capital".

In the early 1960s the Fiscal Committee submitted a draft convention for the avoidance of double taxation with respect to taxes on income and capital to the Council of the OEEC. The Fiscal Committee introduced Art. XVI, the precursor of Art. 9 OECD Model. This Art. XVI was based on Art. VII of the Protocols of the 1943 Mexico Draft and of the 1946 London Draft. Art. VII of the London Draft reads as follows:

"When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and, as the result of such situation, there exist in their commercial or financial relations conditions different from those which would have existed between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise."[1281]

The Fiscal Committee of the OEEC reformulated Art. XVI as follows:

"Where
a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State [...]"

The expression "dominant participation in management or capital" used by the League of Nations was replaced by the expression "participation in management, control or capital".

Evidence to support the conclusions that Art. XVI was still based on a *dominating* or *controlling* participation in management or capital and that Art. XVI did not consider "participation in control" to be an independent criterion for association is a statement of the Fiscal Committee of 1961, confirming that neither Article (XV and XVI) is strikingly novel or particularly detailed:

"The question ...how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of European double taxation Conventions concluded since the war, and it is fair to say that the solutions adopted have generally conformed a standard pattern."[1282]

This "standard pattern" has developed since the 1920s, when the first League of Nations reports were published. From the above analysis of the various Reports written by the Fiscal Committee it appears that the Fiscal Committee used the word "control" as a generally accepted term. The Fiscal Committee did not provide any explanation of the term "control", using the term in specific phrases such as "where one enterprise *controls* the other or both enterprises are under common *control*". Especially because the Fiscal Committee emphasised

[1281] Fiscal Committee of the League of Nations, *London and Mexico Draft Model Tax Conventions, Commentary and Text*, Document number: C.88.M. 88.1946 II.A (Geneva: November 1946), p. 83, Art. VII of the Protocol of the Mexico and London Draft Model Tax Convention.
[1282] OEEC, FC(60), annex E, p. 22, para. 2 (Paris: 25 May 1960), FC(60) 157.

that it had readopted the underlying principles of the Mexico and London Model Conventions it can be concluded that the Fiscal Committee did not intend to make "control" a separate, independent criterion; otherwise it would have mentioned this in its reports or drafts. The term "participation in control" should be considered to have the same function as the term "dominant" has had in the London and Mexico Drafts; a qualification only to the criteria of *participation in capital and management*.

Also, the Commentaries on the articles concerning the taxation of interest (Art. 11) and royalties (Art. 12) indicate that the concept of association in Art. 9 OECD Model is narrower than the "special relationship" concept of those articles:

"On the other hand, the concept of special relationship also covers relationships by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise [...]".

It must therefore be concluded that the associated enterprises concept, reformulated by the OEEC, was still based on a dominating or controlling participation in the management or capital, and that "participation in control" was not a separate, independent criterion for association. This conclusion is also supported by the "bracket definition" in the OECD Commentary that refers to relationships based on company law (parent and subsidiary companies and companies under company law), and paragraph 7 of the 1979 Report on Transfer Pricing and Multinational Enterprises:

"The report covers not only transfers between *parent and subsidiary companies* but also between companies under common control though the problems arising specifically from transactions between companies under common control have not been dealt with and indeed some countries would regard such transactions as passing *through the common parent* insofar as the price deviates from arm's length."[1283] *(Italics, RD)*

In 1963 the Fiscal Committee presented Art. XVI as Art. 9 in the 1963 Draft Double Taxation Convention on Income and Capital of the OECD. The text of

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[1283] OECD, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises*, adopted by the Committee on Fiscal Affairs in January 1979, approved by the Council of the OECD for publication. The Council of the OECD adopted the Recommendation annexed to it on 16 May 1979, para. 7.

the Commentary on this Art. 9 stated that this "Article seems to call for very little comment". The conclusion must therefore be drawn that the underlying concept of "associated enterprises" of 1946 remained unchanged in the new Art. 9 OECD Model.

For the above reasons I conclude that the concept of associated enterprises under Art. 9 OECD Model is based on a *dominating* or *controlling* participation in capital or management. The term "participation in control" is not meant to be an independent criterion for association, but the term is a substitute for the term "dominating" used in Art. 5 of the 1933 Report. Therefore, the concept of associated enterprises is a concept based on *de jure* control that follows from company law. The view that the concept of associated enterprises under Art. 9 OECD Model covers *de facto* control must –for the above-mentioned reasons- be rejected.

9.2.7. Art. 9 (2) OECD Model and the concept of associated enterprises

There is also evidence in Art. 9 (2) OECD Model that calls for a restricted interpretation of the concept of "associated enterprises". Assume again an independent Indian company A, selling its product mainly to an independent company B in the Netherlands. The Indian tax authorities may consider the Indian company and the Dutch company associated, because the price is effectively influenced by the Dutch company.[1284] Because company B is the main (and largest) customer of company A, company B managed to obtain a price that was lower than the prices charged by other companies in India. Both companies agreed on a price of 900 for the goods. However, the Indian tax authorities may adjust this price to 1000, the price charged by other Indian enterprises, on the basis of Section 92A (2) (H-I) ITA 1961.
India applies a broader concept of associated enterprises than the concept laid down in Art. 9 OECD Model. As shown in this study, the OECD concept requires a "dominant or controlling participation in the management or capital", whereas the concept of associated enterprises in India also includes various forms of *factual* control. The Netherlands considers both companies to be independent companies. From a Netherlands tax law perspective, associated enterprises only exist when there is a participation in management, supervision or capital of an entity. According to the Netherlands interpretation, Art. 9 OECD Model and Art. 9 of the India- Netherlands tax treaty do not cover dominating buyer-seller relationships without a shareholding or managerial aspect and are therefore not applicable.

The question arises whether Art. 9 (2) of the treaty could be applied to provide a corresponding adjustment in the Netherlands.

The Commentary on the Model notes that an adjustment is not automatically to be made in State B simply because the profits in State A have been increased. The adjustment is due *only* if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. Only if State B considers that the adjustment made in State A is justified both in principle and as regards the amount is State B committed to make an adjustment of the profits of the associated enterprise.

[1284] Based on Subsection 2(H) or 2(I) of Section 92A ITA 1961.

The Netherlands does not recognise the Indian company and the Dutch company as associated enterprises, so in the opinion of the Netherlands authorities no corresponding adjustment can be agreed to.

In my opinion – apart from the legal reasoning above – there is no material reason for a corresponding adjustment. It may be argued that there is no double tax: the Indian company suffers from additional tax because of the adjustment, but in this case there is no group or other party that suffers from this additional tax. It would even constitute an anomaly if the Dutch company were to be entitled to an additional tax deduction to the amount of the adjustment in India.

However, it may also be argued that this situation constitutes economic double taxation in a broad sense. International economic double taxation is the imposition of taxes in two (or more) states on the same economic transaction, item of income or capital during the same period, but in the hands of different taxpayers.[1285] The adjusted amount of 100 is not included in the cost price by the Netherlands tax authorities. The Netherlands tax authorities and company B consider only 900 as costs for goods. According to this view, the amount of 100 is economically double taxed: a profit in India, but no costs in the Netherlands. Company B and the Netherlands tax authorities may not be interested in the amount of taxes paid by the Indian company. However, the fact that India charges an additional amount may affect the business relationship concerned. For instance, Indian company A might try to include the extra taxes in the price of the goods sold to the Dutch company. For this reason, the position of the Indian tax authorities would be in conflict with the purpose of the (OECD Model) double tax convention.[1286]
The two above-mentioned opinions do not impede a solution under the OECD Model and the applicable tax treaty, however. As shown in Chapter 4, treaty obligations are to be interpreted to limit the content of the tax law of the two countries.[1287] They limit the Contracting States' application of that law. As a

[1285] Kemmeren, E.C.C.M., *Principle of Origin in Tax Conventions- A Rethinking of Models* (Dongen: mr. Eric C.C.M. Kemmeren/Pijnenburg vormgevers en uitgevers, 2001), p. 14.
[1286] According to this view, Art. 25 (1) of the Model refers to "taxation not in accordance with the provisions of this Convention". Company A should claim domestically that the Indian legislation on the concept of associated enterprises is in conflict with the double tax convention, and this legislation should therefore not be applied. Art. 25 (3) of the double tax convention between Netherlands and India may be a possibility for the Netherlands to raise this issue.
[1287] Vogel, K., *Klaus Vogel on Double Taxation Conventions- A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital. With*

result, broader concepts of associated enterprises will be overruled by the narrower concept of associated enterprises of the appropriate tax treaty. In this case the broader concept of associated enterprises in India will be overruled by the restrictive interpretation of the Indian-Dutch tax treaty that follows the OECD Model.

The above leads – in my opinion – to the conclusion that (non-) applicability of Art. 9 (2) is a test for the boundaries of the concept of associated enterprises: if there is no party in the transaction concerned that suffers from economic *double* taxation as I have indicated above, the parties concerned are not associated within the meaning of Art. 9 OECD Model.

9.2.8. Domestic interpretations in the United Kingdom, the United States, Germany, Sweden, India, the Netherlands, China and Brazil

The arm's length principle is applied in almost every country. Under virtually all tax treaties, the concept of associated enterprises covers a direct or indirect participation in management, control or capital of an enterprise in another enterprise or direct or indirect participation in management, control or capital of the same person(s) in other enterprises. Under domestic tax laws, the definition of associated enterprises is in many cases even broader and more explicit, covering a wide range of *de jure* relationships between enterprises as well as a number of *de facto* forms of control between enterprises or between enterprises and individuals.

From the historical analysis of the UK Finance Act in Chapter 6, it appears that the concepts of "associated enterprises" and "control" were already applied in the United Kingdom at the beginning of the 20th century. The Finance Act of 1915 used the term "substantial control" in one of the early (transfer pricing) laws dealing with transactions between associated enterprises. Apparently, this may indicate that there was a domestic understanding of the interpretation of "control" with respect to associated enterprises. For the interpretation of the concept of associated enterprises, the United Kingdom developed a detailed concept of control, covering only *de jure forms* of control. This concept of

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Particular Reference to German Tax Treaty Practice, 3rd ed. (London: Kluwer Law International, 1997), p. 32.

control has not changed since its incorporation in ICTA 1952, which took place before the introduction of the 1963 OECD Model.

The first US regulations interpreting the forerunner of Section 482, the basic US transfer pricing provision, were issued in 1934, as Article 45-1 of Regulations 86. These regulations remained virtually unchanged through repeated re-enactments of the revenue laws, including the Internal Revenue Codes of 1939 and 1954.[1288] In these regulations "control" was explained as any kind of control whether direct or indirect. The US Regulations stated that it is the reality of control that is decisive, not its form or the mode of its exercise. Therefore, association for transfer pricing purposes was based on a *de facto* control situation. It should be noted that in General Counsel's Memorandum 2856, it was stated that the Board of Tax Appeals had aptly described the terms "owned or controlled directly or indirectly by the same interests" as "doubtful and impossible of a strict definition".[1289]
The current concept of *control*, included in the US Regulations, has the same broad meaning.

Carroll, who had worked in the US Treasury, interpreted the concept of associated enterprises in the League of Nations Reports in accordance with the UK approach, as a concept based on a capital/managerial criterion (parent-subsidiaries):

"Article 5 deals with *subsidiaries* which will be taxed as independent enterprise provided no profits or losses are transferred as a result of the relations between the affiliated companies."[1290]

From an analysis of the different domestic concepts of *associated* enterprises in Chapter 6, it can be concluded that there are three types of domestic interpretations. The first type is a concept of associated enterprises that is in line with the OECD concept and is limited to *de jure* control, relationships

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1288 See for instance Treas. Reg. 118 para. 39.45-1 (1953), the last published regulations under the Internal Revenue Code of 1939, and Treas. Reg. Para. 1.482-1 (a), (b) and (c), adopted by T.D. 6595, 1962-1 Cum. Bull. 49. See also Jenks, T., *Treasury Regulations under 482*, 23 Tax Law 279 (1969-1970), p. 279.

1289 VII-1 Cum. Bull. 128, 130 (1928).

1290 Fiscal Committee of the League of Nations, *Report to the Council on the fourth session of the Committee, held in Geneva from June 15th to 26th, 1933*, Document number C.399. M.204 (Geneva, 1933), annex p. 4.

generally covered by company law, for instance shareholding (partnerships) and management. This concept of associated enterprises is applied by the Netherlands, Sweden and the United Kingdom.

The second type is a concept of associated enterprises that is an open-ended concept based on control. This concept is applied by the United States and Germany. For instance, the US concept covers any kind of control between two or more taxpayers. It focuses on the reality of control, not its form or the mode of its exercise. Germany applies the term "controlling influence". The scope of controlled taxpayers under US transfer pricing and German transfer pricing rules is broader compared to the scope of the transfer pricing laws of the Netherlands, the United Kingdom and Sweden. The scope of control under US rules covers any kind of control between two or more taxpayers, including enterprises and individual taxpayers. In this regard, any two or more taxpayers with no shareholding or managerial relationships could be considered taxpayers controlled "by the same interest" if a common design or a plan for arbitrarily shifting of income or deductions between them exists. However, as may be concluded from recent jurisprudence (for instance *Xilinx)*, it is very doubtful whether the term "control" will interpreted by US and German courts as covering open market situations (for instance, a buyer with a very strong negotiating power) as this would be in conflict the arm's length principle itself.

The third type is a concept of associated enterprises that not only covers *de jure* relationships, such as shareholding and managerial relationships, but also *de facto* relationships that are contrary to the purposes of the arm's length principle. The scope of associated parties under the Chinese, Indian and Brazilian rules can be considered to fall within this third concept of associated enterprises.

It is interesting that in particular emerging economies, such as China, Brazil and India, incorporate broad definitions of associated enterprises in domestic tax laws. Not only *de jure* relationships covering relationships based on company law result in associated enterprises, such as shareholding and managerial relationships, but also various forms of *de facto* relationships between companies and even individuals are covered by the scope of associated enterprises in the domestic tax laws of these countries. The Indian, Chinese and Brazilian transfer pricing regulations describe in detail situations where one party is considered to be associated with another party.

For instance, the Chinese and Indian rules specify various forms of *de facto* relationships such as transactions between parties concerning loans, guarantees, services or sales in the open market. Brazil expands its transfer pricing rules based on predetermined margins to transactions between entities in Brazil with entities resident in tax havens or in countries that allow secrecy regarding corporate ownership even though the parties are completely independent and the terms and conditions in the transactions were established at arm's length. In addition, the Brazilian scope of associated parties also covers relationships between entities such as partners of joint ventures, and exclusive agents, distributors or dealers for the purchase and sales of goods, services or rights. The broad Brazilian scope is not exceptional. India characterises legally independent companies that are dependent in a commercial way from an otherwise unrelated foreign trading partner as associated.

It may be possible that the wording of the US Regulations and the lack of clarity on the term "control" in the formula of Art. 9 OECD Model and the UN Model have misled the Chinese and Indian legislator (but also other emerging economies, such as Vietnam), which carefully studied the US Regulations and OECD TP Guidelines before drafting their transfer pricing laws.

From the above analysis the conclusion can be drawn that in several jurisdictions there is a "hotchpotch" of application of the arm's length principle and anti-avoidance and anti-evasion rules, for instance the United States with a control concept based on a common design or plan for arbitrarily shifting of income and Brazil with a concept of associated enterprises that even may cover the relationships between otherwise unrelated partners in a joint venture. Other examples are India and China, which apply the arm's length principle to transactions between independent enterprises, where one party has a dominant negotiation position.[1291]

As indicated above, problems arise from the lack of a sharp distinction between application of the arm's length principle and anti-tax avoidance/evasion rules, and the lack of clarity on the concept of "associated enterprises" and in particular "control" in the formula of Art. 9 OECD Model and the UN Model.
Confusion about the scope of associated enterprises and application of the arm's length principle could be avoided by proper definitions in domestic laws, on the one hand including a definition of "associated enterprises" based on

[1291] For instance, Australia applies the arm's length principle to all "connections between any two or more parties", including independent parties.

control through shareholding or management, and on the other hand specific anti-tax avoidance and anti-tax evasion measures.

9.2.9. The concept of related parties in customs

In 2006 and 2007 the OECD and WCO held conferences on the similarities and differences between customs and transfer pricing. Some of the recommendations were that there should be a more thorough comparison between the two sets of rules, an identification of areas for possible convergence of rules and that there should be an examination of specific issues relating to the degree of acceptability by one tax authority of a value determination by the other.
This chapter aims to identify the differences and similarities between the concepts of association in customs regulations and Art. 9 OECD Model.

As also stated in the 1995 OECD TP Guidelines, the arm's length principle is applied, broadly speaking, by many customs administrations as a principle of comparison between the value attributable to goods imported by associated enterprises and the value for similar goods imported by independent enterprises. The customs authorities generally seek to determine the value of products at the time they were transferred or imported. Art. 15 of the Customs Valuation Agreement states that if the relationship between the two parties has influenced the price, the price then may be adjusted to a price that would be applied by independent enterprises.

With respect to the application of Art. 9 OECD Model, customs valuations may be useful to tax administrations in evaluating the arm's length character of a controlled transaction transfer price. Customs officials may have contemporaneous documentation regarding the transaction that could be relevant for transfer pricing purposes, especially if prepared by the taxpayer.[1292] Due to the increase of electronic declarations and the use of advanced databases containing many comparability functionalities, the customs authorities may have tools that may be useful for transfer pricing purposes.[1293]

1292 See OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), paras. 1.65- 1.67

1293 On the other hand, customs authorities may also request companies to submit their transfer pricing master files to justify the values indicated in their declaration. See Fabio, M., Some countries, such as Mexico, apply laws that include both concepts of association:

"It shall be considered that two or more persons are related parties when one participates, directly or indirectly, in the management, control or capital of the other, or when a person or group of persons participates directly or indirectly in the administration, control or capital of such persons, or when a link exists *under the customs laws*."[1294]

One of the main objectives of the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 (the Agreement) is to establish a "fair, uniform and neutral system for the valuation of goods for Custom purposes that precludes the use of arbitrary or fictitious Customs values".[1295] This objective is based on equality and neutrality, general principles of international tax law also underlying Art. 9 OECD Model.

The Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 provides the primary basis for customs valuation. Under this Agreement the transaction value as defined in Art. 1 of the Agreement should be taken as starting point for the customs authorities. In determining whether the transaction value is acceptable, the fact that the buyer and the seller are related within the meaning of Art. 15 Agreement may not in itself be grounds for regarding the transaction value as unacceptable. In such a case the circumstances surrounding the sale must be examined and the transaction value shall be accepted, provided that the relationship did not influence the price.
Commentary 14.1 deals with the application of Art. 1(2) Agreement. It examines the rights and obligations of customs administrations and importers under the Agreement, with respect to the treatment to be accorded to related party transactions. The commentary provides that the existence of a relationship between buyer and seller raises a question that serves to alert the importer and customs authorities as to the acceptability of the price as the basis of the transaction value. Art. 15 of the Agreement provides the definition of "related parties" for customs purposes:

"Chapter 4: Customs Valuation – European Union", in: Bakker, A. and Obuoforibo, B. (eds.), *Transfer Pricing and Customs Valuation* (Amsterdam: IBFD, 2009), pp. 116-118.

1294 Mexican Income Tax Law, Art. 106.

1295 See also Compendium on the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994, General Chapter, Guidelines.

(a) they are officers or directors of one another's businesses;
(b) they are legally recognised partners in business;
(c) they are employer and employee;
(d) any person directly or indirectly owns, controls or holds 5% or more of the outstanding voting stock or shares of both of them;
(e) one of them directly or indirectly controls the other;
(f) both of them are directly or indirectly controlled by a third person;
(g) together they directly or indirectly control a third person; or
(h) they are members of the same family.

The related parties concept deals with "persons" (also legal persons) and is, in contrast to Art. 9 OECD Model, not limited to "enterprises". It may be concluded that the first form of relationship (definition a) can be considered to be in line with the "participation in management criterion" of Art. 9 OECD Model. The main question should be, although this is not clearly stated in the Agreement, whether the director or officer is able to influence the prices of the transaction.

The second criterion (b) deems persons (including sole agents, sole distributors and sole concessionaires) to be related persons under the Agreement if they are legally recognised partners in business. In this context, partnership is defined as an association of two or more people who contribute money or property to carry on a joint business and who share profits and losses in a certain proportion. This criterion covers situations that are not covered by the OECD concept of associated enterprises.

The third criterion (c) characterises an employer and employee as related parties for customs purposes. On this point, it may be concluded that the concept of related parties for customs is broader than the OECD concept of associated enterprises. The associated enterprises concept of Art. 9 OECD Model does not cover this type of relationship. The relationship employer and employee should not be confused with the participation-in-management criterion of Art. 9 OECD Model.

The fourth criterion (d) focuses on the shareholding relationship and should be compared with the participation-in-capital criterion of Art. 9 OECD Model. The criterion differs from the participation-in- capital criterion of Art. 9 OECD Model; every kind of shareholding qualifies as "related parties" as long as the minimum requirement of 5% is met. This also includes, for instance, portfolio investments. Enterprises that are unable to influence the pricing or unable to control the company might still be covered by the related parties concept of Art. 15 of the Agreement, as long as these enterprises hold at least 5% of the voting stock of the other enterprise. It may be concluded that the application of this criterion results in a broader concept of related parties than the concept applied in the OECD Model.

According to the fifth criterion (e), one person is deemed to control another when the former is legally or operationally in a position to exercise restraint or direction over the latter. Control is therefore not an additional criterion to other criteria, but an independent criterion for the related-parties concept in customs. This fifth criterion is not only based on company law, it also includes various forms of *de facto* control. From the words "or operationally in a position to exercise restraint or direction" it can be concluded that *de facto* control also forms a basis for the existence of related parties. Criterion (h) provides that the concept of related parties also includes family members. The concept of associated enterprises of Art. 9 OECD Model does not cover family relationships.

From the above analysis I conclude that the customs' concept of related parties is much broader than the concept of associated enterprises in Art. 9 OECD Model. The above-mentioned differences between both concepts of association are fundamental obstacles to a possible convergence between valuation for transfer pricing and valuation for customs. Adjustment of prices can only take place when transactions have taken place between *associated enterprises* or *related parties.* Despite the fact that both areas serve the neutrality principle, customs by providing a fair, uniform and neutral system for the valuation of goods, and Art. 9 OECD Model by putting associated enterprises on the same footing for tax purposes as independent enterprises, tax authorities may reject or ignore the adjustments of customs authorities because the concept of associated enterprises differs from the concept of related parties in customs.

Because of the differences between these two concepts of association, caution must be exercised when analysing a possible convergence between the customs valuation and transfer pricing valuation.

9.2.10. CCCTB and the concept of associated enterprises

On 16 March 2011 the European Commission proposed a Directive on a Common Consolidated Corporate Tax Base (CCCTB). The development of a system based on a CCCTB has become one of the main priorities for the European Commission. The European Commission questioned whether the arm's length principle and the separate accounting principle are still the most appropriate and efficient principles to be applied in the field of allocation of taxable results to group members within the Internal Market and proposes system of formulary apportionment. The implementation of the CCCTB would remove, among other things, the need for a specific cross-border relief scheme and transfer pricing problems. The CCCTB provides companies with establishments in at least two Member States with the possibility to compute their group taxable income according to one set of rules. The CCCTB requires that the tax base be common across the EU. It consolidates the profits and losses of the companies participating in a group, to calculate a single tax base for "sharing".

The aim of the proposal is to significantly reduce the administrative burden, compliance costs and legal uncertainties that businesses in the EU currently face in having to comply with up to 27 different national systems for determining their taxable profits.

The CCCTB replaces the arm's length principle with regard to intra-company dealings. The CCCTB requires a group definition and, as does the arm's length principle, a definition of associated enterprises. If two or more enterprises are associated but are not part of the same CCCTB group, they have –of course- to apply transfer pricing rules.

In 2001 the CCCTB Working Group identified "associated enterprises" as a term not defined in the Convention:

"As regards the question of when companies are associated, a possible solution could be to determine this in accordance with the rules and practices of the Member States making the primary adjustment. [...] Another solution could be to try developing a common definition of when companies are associated."[1296]

[1296] Company Taxation in the Internal Market, COM (2001) 582 final, Brussels 23 October 2001, SEC (2001), 1681. p. 354.

The Working Group was –in that stage- of the opinion that the problems caused by the term "associated enterprises" were limited and of a more "theoretical" importance. However, in 2010 EU Member States acknowledged the increase of transactions between Europe and Brazil, China, Russia and India.
With the broad concepts of associated enterprises applied by the latter countries it can be concluded that there is a growing need for a common interpretation of associated enterprises so as to avoid situations of double taxation or additional unjustified taxation.
Probably because of these developments the Working Group's opinion on the importance of the concept of associated enterprise changed in 2010. The Working Group stated:

"An important feature of corporate tax systems relates to the concept of "association" between taxpayers, companies, entities etc. The content of these rules is critical, because, in practice, it also delineates the scope for the application of transfer pricing rules."[1297]

In 2006 the Working Group discussed the so-called "framework of associated enterprises" of the OECD Model and stated that a more detailed framework for the interpretation of related parties should be implemented in the CCCTB. With respect to consolidation, the Working Group stated that the principles of IAS 27 could be relevant for the definition of control of the parent company over a subsidiary. In this context, "control" refers to the right to exercise voting rights in a subsidiary. Therefore, "control" is based on *company law*: mere economic dominance is not covered. In the following years the Working Group stated that the CCCTB would have no formal link to the "constantly changing IAS/IFRS standards".[1298]

[1297] European Commission, *Working Paper Workshop on the Common Consolidated Corporate Tax Base: Transactions and Dealings between the Group and Entities outside the Group*, CCCTB\RD\003\doc\en (Brussels: 20 October 2010), p. 3.

[1298] However, several authors are of the opinion that although IAS/IFRS are not decisive for tax accounting within the framework of the CCCTB, they should be explicitly acknowledged as a starting point. See Essers, P.H.J., et al., *The Influence of IAS/IFRS on the CCCTB, Tax Accounting, Disclosure and Corporate Law Accounting Concepts, A Clash of Cultures*, EUCOTAX Series on European Taxation, Vol. 23 (London: Kluwer Law International, 2009), p. 44.

Art. 54 of the proposed CCCTB Directive states that eligibility for consolidation should be determined in accordance with a two-part test. This test is based on control (more than 50% of voting rights) and ownership (more than 75% of equity) or rights to profits (more than 75% of rights giving entitlement to profit).
For the relations of the consolidated group with non-consolidated entities a concept of associated enterprises is required, which is given in Art. 78 of the proposed Directive:

"1. [...] taxpayer participates directly or indirectly in the management, control or capital of a non-taxpayer, or a taxpayer which is not in the same group, the two enterprises shall be regarded as associated enterprises. [...]"

According to Art. 4 of this Directive, "taxpayer" means a company which has opted to apply the system provided for by this Directive.

Art. 78 (2) states:

"(a) participation in control shall mean a holding exceeding 20% of the voting rights;
(b) participation in the capital shall mean a right of ownership exceeding 20% of the capital;
(c) participation in management shall mean being in a position to exercise a significant influence in the management of the associated enterprise.
(d) an individual, his spouse and his lineal ascendants or descendants shall be treated as a single person.
In indirect participations, the fulfilment of the requirements in points (a) and (b) shall be determined by multiplying the rates of holding through the successive tiers. A taxpayer holding more than 50% of the voting rights shall be deemed to hold 100%."

The CCCTB Working Group stated that for the relationships between the consolidated group and other parties the Directive followed the concept of associated enterprises as laid down in Art. 9 OECD Model. The CCCTB concept of associated enterprises only includes criteria based on *company law*. The term "control" should therefore not be interpreted as a *de facto* control, but only as a holding of 20% or more of the *voting rights*.

As already shown in Chapter 3 and Section 9.2.3, a disadvantage of a threshold requirement is that controlling relationships based on shareholding or voting rights lower than 20% are ignored. For instance, an enterprise may have power to influence the prices and conditions of intra-company transactions with less than 20% of the ownership rights. If one shareholder holds 10% of the shares of a company, then this may result in control of the transfer prices if the other shareholders have not organised their interests in such a way that they exercise more votes than the minority holder. The minority holder (<20%) can still control the company.

I conclude that the concept of associated enterprises in CCCTB has a *de jure* basis and does not cover situations of mere economic dominance, outside relationships vested in company law. A relationship based on shareholding or voting rights is essential in determining the existence of associated enterprises. The term "control" is used in the CCCTB, however it does not refer to *de facto* control, such as a dominating buyer/seller relationship in the open market. According to the CCCTB Working Group, the concept of associated enterprises in Art. 9 OECD Model forms the basis of the concept of associated enterprises in CCCTB. Therefore, I conclude that the CCCTB Working Group, in line with the conclusions drawn in Chapters 3 and 5, considers the concept of associated enterprises in Art. 9 OECD Model as a concept based on company law, not covering *"de facto"* control.

9.3. Conclusions and recommendations

From this study the following final conclusions are drawn:

- The arm's length principle is a general principle of tax law and not a mere anti-tax avoidance or anti-evasion measure. It puts associated enterprises and independent enterprises on a more equal footing for tax purposes (equality) and avoids the creation of tax advantages that would otherwise distort the relative competitive positions of either type of entity (neutrality). The view that Art. 9 OECD Model is an anti-tax avoidance measure and that therefore the concept of associated enterprises may be broadly interpreted must be rejected. Anti-avoidance or anti-evasion measures must be formulated outside the scope of the arm's length principle.
- Problems arise from the lack of a sharp distinction between application of the arm's length principle and anti-tax avoidance/evasion rules; as a result the arm's length principle may be wrongly applied to open market situations without any intentions of tax avoidance or evasion. The problems are expected to increase because several emerging economies, such as India, China, Brazil and Vietnam, apply a broad, incorrect interpretation of associated enterprises.
- The concept of associated enterprises delimits the application of the arm's length principle. A broad concept of associated enterprises may lead to the risk of application of the arm's length principle to situations for which it was not intended. The arm's length principle is not meant to cover legally independent enterprises.
- An autonomous interpretation of "associated enterprises" under Art. 9 OECD Model exists and therefore reference to domestic tax law for the meaning and scope of this concept must be rejected. Reference to domestic law for the interpretation of "associated enterprises" may lead to the application of the arm's length principle to situations for which it was not intended, in particular to *de facto* control situations.
- Since its introduction in 1933 the concept of associated enterprises has been based on a *dominating* or *controlling* participation in capital or management. The term "participation in control" is not meant to be an independent criterion for association, but the term is a substitute for the term "dominating" used in Art. 5 of the 1933 Report. Therefore, the concept of associated enterprises is based on *de jure* control that follows from company law. The view that the concept of associated

enterprises covers *de facto* control, such as mere economic dominance, outside relationships vested in company law, must be rejected. The current wording of Art. 9 OECD Model is only a textual modification of Art. 5 of the 1933 Report and does not contain any material differences from the 1933 Report, the 1946 London Draft and the OEEC Report of 1960.
- As company law provides various "(control-enhancement) mechanisms" that delimit the power of majority shareholders or increase the power of minority shareholders, the term "participation in capital" and the term "participation in management" should be supplemented with the adjective "controlling". A participation based on company law (participation in capital or management) must have sufficient (voting) power to control the company.
- The (non-) applicability of Art. 9 (2) OECD Model is a test for the boundaries of the concept of associated enterprises.
- The concept of associated enterprises under Art. 9 OECD Model and the concept of related parties under Art. 15 Customs Valuation Agreement are not similar and have significant differences. Because of these differences, caution must be exercised when analysing a possible convergence between transfer pricing valuation and customs valuation.
- The concepts of associated enterprises in the CCCTB and IFRS have a *de jure* basis; they are based on company law.
- Because of the view that treaty obligations limit the Contracting States' application of domestic law, a domestic interpretation of "associated enterprises" broader than that of the OECD Model as described above will be overruled by the narrower OECD concept as included in tax treaties.

The above conclusions lead to the following recommendations:

- A distinction should be made between the pure application of the arm's length principle – a general principle of international tax law with a restricted interpretation of the concept of "associated enterprises"– and anti-tax avoidance and tax evasion rules. Distinct from the concept of associated enterprises as formulated above, countries may include various anti-tax avoidance and anti-evasion measures in their tax legislation, such as measures that cover individuals, CFCs, thin capitalisation and also relationships with tax havens. As these rules

against tax avoidance and tax evasion fall outside the scope of transfer pricing and the arm's length principle, they should be formulated separately.
- It is recommended to include the below definition of "associated enterprises" in the OECD Model, the UN Model, in tax treaties and in the domestic transfer pricing legislation of countries.
- This concept of associated enterprises should not be broadly interpreted. Therefore, in the proposed definition of associated enterprises the element of "control" is required, but not as an independent criterion.
- Only relationships based on shareholding, voting rights and management, covered by domestic company law, which provide sufficient control to influence prices and conditions should be included in this concept of associated enterprises.
- When an enterprise has a minority participation in the capital or management of the other enterprise, the tax authorities should prove that this participation provides a dominating or controlling influence if they disagree with the taxpayer.

Taking into account the above recommendations, the concept of associated enterprises in Art. 9 OECD Model could be defined as follows:

"Where
a. an enterprise of a Contracting State has a direct or indirect *controlling* participation in the capital or management of an enterprise of the other Contracting State, or
b. the same persons have a direct or indirect *controlling* participation in the capital or management of an enterprise of a Contracting State and an enterprise of the other Contracting State [...]".

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