*Andreas Bullen*

# Arm's Length Transaction Structures

## Recognizing and restructuring controlled transactions in transfer pricing

IBFD DOCTORAL SERIES 20

# Arm's Length Transaction Structures

**Why this book?**
If associated enterprises make or impose special conditions in their controlled transactions which differ from those independent enterprises would have made, the arm's length principle may authorize a profit adjustment. Such special conditions will not necessarily only be the price conditions, but may also include any other conditions. Hence, associated enterprises may not only value or price their transactions differently from independent enterprises, but may also structure them differently, and even enter into transactions independent enterprises would not contemplate undertaking at all.

The OECD has nevertheless recommended its Member countries as a general rule to adjust only price conditions and other valuation elements of controlled transactions based on the arm's length principle. This general rule is sometimes referred to as the "as-structured principle". The first main issue examined in this thesis is the obligation under the as-structured principle to recognize the controlled transaction actually undertaken by the associated enterprises as it has been structured by them.


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# Introduction

## 1.1. Transaction structures and the arm's length principle

Both associated and unrelated enterprises negotiating a contract will frequently face numerous ways of structuring their contractual relationship. To be sure, certain aspects of the contract structure are predetermined. For instance, when a manufacturer negotiates a contract with a distributor, it is normally predetermined that the former will perform a manufacturing function, whereas the latter will perform a distribution function. A number of other aspects, however, are more or less negotiable. These could include, e.g. the volume and quality of the transferred property or service, the form of the contract (e.g. as sale or license), the allocation of risks, remedies available in case of breach of contract, the extent of warranties provided by the transferor, the time of payment, the duration of the contractual relationship, the right to terminate the contract, the place of delivery, and so on. After having established the transaction structure, the enterprises, of course, must also agree on the price to be paid by the transferee.

Associated enterprises sometimes make or impose special conditions in their commercial or financial relations ("controlled transactions") which differ from those comparably placed unrelated enterprises would have made. When this is the case, the arm's length principle may authorize a domestic tax administration to include in the profits of an enterprise, and tax accordingly, any profits which would have accrued to this enterprise in the absence of such special conditions. These special conditions will not necessarily only be the price conditions, but may also extend to any other conditions (establishing the contract structure). Hence, associated enterprises may not only *value or price* their transactions differently from independent enterprises, but may also *structure* them differently, and even enter into transactions which independent enterprises would not contemplate undertaking at all.

Traditionally, the Organisation for Economic Co-operation and Development (OECD) – an international organization currently consisting of the world's 33 most developed countries and devoted, inter alia, to removing barriers to world trade through elimination of international double

taxation[2] – has nevertheless recommended Member countries, in other than exceptional cases, to adjust only *price conditions and other valuation elements* of controlled transactions based on the arm's length principle.[3] This narrowing of the examination under the arm's length principle is well reflected in the terminology conventionally used to describe the process of determining whether the conditions of a controlled transaction satisfy the arm's length principle, i.e. transfer *pricing*.[4] As artificial pricing is presumably the most obvious means available to associated enterprises to shift profits between themselves it is understandable that examinations under the arm's length principle have primarily focused on the prices agreed between associated enterprises. In contrast, the *marginal focus* traditionally devoted to transaction structures adopted by associated enterprises is perhaps less understandable. The governing norm is not denoted the "transfer pricing principle", but rather – and less restrictively – the "arm's length principle".

## 1.2. Main issues addressed by the study

The present study will address two primary issues, as its subtitle indicates: "[r]ecognizing and restructuring controlled transactions in transfer pricing". These issues will be discussed and answered in light of the arm's length principle as authoritatively stated in Art. 9(1) of the OECD Model Convention with respect to Taxes on Income and on Capital (the OECD MTC), as interpreted, in particular, by the accompanying Commentaries (the OECD Commentaries) and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines); see infra at 1.5.2.

The first issue is to establish the extent to which domestic tax administrations, in applying the arm's length principle, must recognize the controlled transaction actually undertaken by the associated enterprises. In

2. See Art. 1(c) and Art. 2(d) OECD Convention; OECD 2010 Report, Introduction, Para. 1; OECD Guidelines, Preface Para. 4, Para. 1.8; OECD Council Recommendation (OECD MTC), Preamble, fourth sentence; OECD Council Recommendation (OECD Guidelines), Preamble, fourth sentence.

3. See e.g. OECD 1979 Transfer Pricing Report Para. 23; EU 2006 CCCTB Working Document Para. 21.

4. Some commentators, however, include both the process of examining price conditions and other contractual conditions of controlled transactions in the phrase "transfer pricing", see e.g. Sørdal (2004), at 47; Markham (2005), at 10 (reports that the Australian Deputy Commissioner of Taxation has stated that "transfer pricing ... covers the structuring of transactions and financial relationships"); Andal (2006), at 55.

discussing this, OECD Guidelines Para. 1.64, which recommends domestic tax administrations ordinarily to examine controlled transactions "based on the transaction actually undertaken by the associated enterprises as it has been structured by them",[5] will play a prominent role. The second issue concerns the extent to which the arm's length principle authorizes domestic tax administrations to restructure the controlled transaction actually undertaken. In discussing this, OECD Guidelines Para. 1.65 is key to the extent that it refers to "two particular circumstances in which it may, exceptionally, be both appropriate and legitimate ... [to disregard] the structure adopted by a taxpayer in entering into a controlled transaction".[6]

These two issues are highly interrelated. Thus, the extent to which the arm's length principle authorizes domestic tax administrations to restructure controlled transactions depends on the extent to which they are required to recognize the controlled transaction actually undertaken, and vice versa. Their common theme can be formulated as an issue of how broad authority the arm's length principle grants to domestic tax administrations. The subject matter of the present study is, thus, the *outer limits* of the authority granted by the arm's length principle. In contrast, the present study will not focus upon the arm's length principle's *core area of application*, i.e. adjustment of price conditions and other valuation elements examined under the transfer pricing methods established by the OECD Guidelines.[7]

Whereas certain other studies of transfer pricing examine a specific type of controlled transaction[8] or industrial sector,[9] the present study examines a specific type of adjustment under the arm's length principle, i.e. adjustments of transaction structures. The present study will generally examine its primary issues and underlying secondary issues irrespective of transaction type. Unless otherwise stated or follows from the context, the conclusions arrived at are therefore in principle relevant to all types of controlled transactions. A different matter is that certain types of perceived-to-be non-arm's length behaviour may occur more frequently in the context of one type of controlled transaction than others.

5. OECD Guidelines Para. 1.64(1).
6. OECD Guidelines Para. 1.65(1).
7. See OECD Guidelines Chap. II.
8. See e.g. Boos (2003) (examines intangible transfers); Markham (2005) (the same).
9. See e.g. Wündisch (2003) (examines the ethical pharmaceutical industry).

## 1.3. Restructuring controlled transactions: Introduction

### 1.3.1. Fiscal purpose of restructuring controlled transactions

To a smaller or greater extent, the structure of controlled – and uncontrolled – transactions affects the profits realized (or losses incurred) by their parties.

First, transaction structures affect the amount of the consideration to be paid by a transferee;[10] for example, a seller of goods will request a higher price if it is to assume currency exchange risk than if the buyer does so. The arm's length price is thus likely to change if the transaction structure changes.[11] This interrelationship between structure and price explains why the OECD Guidelines inter alia insist[12] that the functional allocation, risk allocation and contractual terms in an uncontrolled transaction be sufficiently comparable to those of a controlled transaction for the former to serve as a comparable uncontrolled transaction under the arm's length principle. Further, as the consideration directly affects both the transferor's and the transferee's profits,[13] the transaction structure will – in a chain reaction – indirectly affect their profits.

Second, the transaction structure may also affect the profits (losses) otherwise than through the amount of the consideration. In particular, the allocation of a certain risk factor will determine which party suffers adverse economic consequences should the risk materialize.

Consequently, although most tax jurisdictions tax profits, not transaction structures, the restructuring of controlled transactions serves a fiscal purpose. If a controlled transaction structure is perceived to affect one of the enterprises' profits negatively and therefore be unacceptable to a comparably placed independent enterprise, it is not surprising that the tax administration competent to tax this enterprise may wish to challenge the structure under the arm's length principle.

10. See TR 97/20 (Austl.) Para. 2.43; Fløystad (1990c), at 81; Culbertson (1995), at 1519; (Skinner 2005-2006), at 182.
11. See e.g. Skaar (1998), at 202 (states that "[t]he terms of ... [an insurance] policy affect the premium rate in the broadest sense"); McCart and Purdy (1999), at 643; Zorzi and Turner (1999), at 5, note 29.
12. See OECD Guidelines Para. 1.33.
13. See e.g. *Roche Products v. Commissioner*, (2008) 70 ATR 703, Para. 114; IC 87-2R (Can.) Para. 6.

Importantly, the restructuring of controlled transactions does not serve a fiscal purpose as such: such adjustment is not the ultimate aim of a tax examination. For example, it would serve no fiscal purpose if a tax administration only disregarded the associated enterprises' assignment of market risk, while doing nothing more. Rather, the fiscal purpose of restructuring controlled transactions is, as explained in the following subsection, to "prepare" the transaction for any subsequent adjustment of the price condition or of other valuation elements.

### 1.3.2. Pertinent stage of the tax examination

If a domestic tax administration considers restructuring a controlled transaction, the transaction will be examined in a two-step process. First, the tax administration must examine the controlled transaction actually undertaken in order to determine whether it can be restructured. If the transaction is restructured, the restructured transaction will be examined in the second step; if it is not, the actual transaction itself will be examined in the second step.

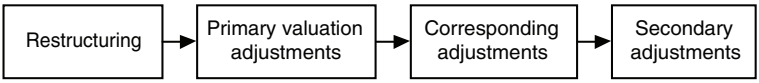
Second, the tax administration must determine whether the arm's length principle authorizes an adjustment of the price (or other valuation element of the controlled transaction). If the controlled transaction has been restructured, the purpose of the second step is to determine the arm's length price on the *restructured*, not the actual, controlled transaction; see infra at 16.6.1. If the actual controlled transaction is disregarded in its entirety, the arm's length price will be nil and thus most often differ from the arm's length price on the actual transaction (if at all determinable, see infra at 19.7.). If the actual controlled transaction is substituted with a differently structured transaction, the arm's length price on the restructured controlled transaction is also likely to differ from that on the actual controlled transaction (if determinable), as different transaction structures normally produce different prices. In sum, the restructuring of controlled transactions is likely to affect whether a price adjustment is authorized as well as the amount of the adjustment.

### 1.3.3. The fourth type of transfer pricing adjustment

Commentators sometimes include three types of adjustment as transfer pricing adjustments,[14] i.e. primary valuation adjustments under Art. 9(1)

14. See e.g. Pedersen (1998), at 266-289; Skaar (2006), at 340-342; Wittendorff (2009b), at 253-259.

OECD MTC (e.g. of prices or margins), corresponding adjustments under Art. 9(2) OECD MTC (see infra at 16.6.3.) and secondary adjustments (see infra at 12.3.5.2.2.).[15] The adjustment of transaction structures, as endorsed by OECD Guidelines Para. 1.65, amounts to a fourth type, and is undertaken prior to the other three types (see figure below).




The adjustment of transaction structures can be regarded as a preliminary adjustment undertaken prior to primary (valuation) adjustments. However, it can also be regarded as a second type of primary adjustment under Art. 9(1), in addition to conventional primary valuation adjustments of e.g. price conditions.

## 1.4. Relevance of study

An in-depth examination of the primary issues of the present thesis is justified for several reasons. First, although these issues are addressed in a separate subsection,[16] the OECD Guidelines leave a number of issues unaddressed and unresolved.[17] Nor are they dealt with extensively in other OECD publications.[18]

Second, the literature on these issues is scant, albeit the OECD's current work on transfer pricing aspects of business restructurings has admittedly generated a number of articles touching upon the issues. Indeed, as Bakker and Cottani pointed out as late as in 2008, the "[t]ax literature on the topic is not very extensive".[19] Many commentators confine themselves essentially to replicating and briefly commenting the pertinent parts of the

15. An additional type of adjustment is the "compensating adjustment"; see OECD Guidelines Paras. 4.38-4.39.
16. See OECD Guidelines Chap. I, D.2.
17. See also OECD 2008 Business Restructuring Draft Para. 208; SfS (P.C.L. 2007), at 3 (states that the conditions for restructuring a transaction in the second circumstance referred to in OECD Guidelines Para. 1.65 are not entirely clear); Baumhoff and Puls (2009), at 77.
18. But see OECD 2008 Business Restructuring Draft, Issues Note No. 4, now converted into new OECD Guidelines Chap. IX, Part IV.
19. Bakker and Cottani (2008), at 280 note 33. Cf. Wittendorff (2009a), at 107.

OECD Guidelines.[20] By way of comparison, the present writer has not been able to identify a comprehensive study of these issues.

Third, in practice, the determination of whether the arm's length principle authorizes the restructuring of controlled transactions has proven to be difficult. It is, according to the UK Her Majesty's Revenue and Customs (HMRC), "a very difficult area".[21] Echoing this, commentators note the widely differing views of OECD Member countries.[22] The issue of restructuring controlled transactions is also considered to be very controversial.[23] Despite these challenges, controlled transaction structures have received increasing attention from the OECD and domestic tax administrations alike. There is therefore clearly a need for elaborative guidance in this area.

Fourth, nowadays, tax planning in the area of transfer pricing tends not so much to be concerned with intentional manipulation of prices as with the creation of transaction – and even group – structures which can justify tax-efficient profit allocations. In practice, the scope of the power to restructure controlled transactions is therefore very important, as the broader the power the greater the limitation on tax-planning possibilities.

In sum, an in-depth study of this particular area of transfer pricing is therefore appropriate. Hopefully, the analyses of the present study will ease the understanding of tax administrations, courts and taxpayers of the topic.

## 1.5. Methodology: An outline

### 1.5.1. A legal analysis

Whereas the present study's methodology will be explained in detail in Chapter 2, it would be useful to outline the methodology's main features already at this age.

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20. See e.g. Runge (1995), at 507; Schwarz (1994), at 163; von Koch (1996), at 268; Wiman (1997), at 505; Tremblay and Williamson (1998), at 9:3; Chip (a) in Feinschreiber (2001), at 33-7; Li (2002), at 830; Thomas Borstell in Vögele (2004), at 140; Rohatgi (2007), at 119; Hammer, Lowell and Levey (2009), Sec. 3.03[6].
21. INTM464130 (UK). See also Bloom (2006), at 1 (refers to the Canadian provision authorizing the restructuring of controlled transactions (ITA (Can.) Para. 247(2)(b)) as an "arcane recharacterization rule whose genesis, purposes and ambit are shrouded in mystery").
22. See Newby et al. (2008), at 17; Preshaw et al. (2008), Sec. I.D.1.
23. See e.g. Zorzi and Turner (1999), at 5; Boidman (2007), at 784; Elliott (2008), at 389; Kessler (2008), at 518.

The present study will undertake a *legal* analysis of the two primary issues under discussion, including a number of derivative issues thrown up in the process of determining whether a controlled transaction must be recognized or can be restructured under the arm's length principle. The present study will therefore not pursue the issues in light of economic theory or conduct empirical studies of how unrelated parties structure their transactions, nor apply other non-legal methodology.

The study's approach is best described as a *de lege lata* approach, i.e. it aims at clarifying the law as it is. It can also be described as a *constrained* approach, in that some sources, e.g. the wording of Art. 9(1) OECD MTC, are per se attributed more weight than others, e.g. the OECD Guidelines' *travaux préparatoires*. This is to be contrasted with a *de lege ferenda* approach, which aims at clarifying the law as it should be and can be described as an *unconstrained* approach under which no source is per se awarded greater weight than others and identified arguments are attributed weight solely on an assessment of their merits.

### 1.5.2. Primary issues discussed and answered from the perspective of Art. 9 OECD MTC

As indicated supra at 1.2., both primary issues of the present study will be discussed and answered from the perspective of Art. 9 OECD MTC as interpreted, inter alia, by the accompanying Commentaries, the OECD Guidelines and other OECD publications. These publications originating from the OECD are jointly referred to as "OECD material" for the purpose of this study.

This approach delimits the scope of the thesis in four directions. First, the issues are not examined from the perspective of *model* tax conventions other than the OECD MTC, such as the United Nations Model Double Taxation Convention between Developed and Developing Countries (UN MTC) or national model tax conventions (such as that of the United States). Due to great textual similarities (see infra at 3.1.1.) and as the OECD material is also relevant to the interpretation of the parallel Art. 9 UN MTC,[24] the present study's analyses will, however, generally be relevant to the interpretation of Art. 9 UN MTC. Second, the issues are not examined from the perspective of any one *concrete* double taxation convention (DTC)

24. See UN Commentaries Art. 9 Paras. 1-8.

entered into between two or more countries. The relevance of the present study's analyses to the interpretation of DTC parallels of Art. 9 OECD MTC depends on whether differences in the wording of the DTC provision and Art. 9, if any, can justify a different interpretation of the former respectively, the latter, and whether the OECD material and the domestic law material relied upon by the present study (see infra at 1.5.3.) are attributed the same weight as by the present study. Third, the issues are not examined in light of the domestic law of any one particular OECD Member (or non-Member) country. Fourth, and finally, the study will not examine arm's length provisions – whether treaty based or domestic – governing other than income taxation, such as other direct taxes, e.g. net wealth taxes, real estate taxes and stamp duties, or indirect taxes, e.g. value added taxes, customs and special duties.

## 1.5.3. Reliance on domestic sources of law

### 1.5.3.1. Reasons for relying on domestic sources of law

For several reasons, relying on domestic sources of law will benefit the present study. First, there is currently no international tax court or tribunal deciding DTC disputes. Such disputes have generally also not been referred to the International Court of Justice. True, the EU Arbitration Convention provides for arbitration in transfer pricing cases within the European Union. Opinions rendered under its aegis, however, are not made public. The primary interpreters of Art. 9 OECD MTC, its DTC parallels and other parts of the OECD material, which also publish their interpretations in some form or another, are therefore domestic courts, tax administrations and legislators. Second, the OECD material provides no (clear) answer to many of the secondary questions examined by the present study. Rather than explicating an issue, the OECD material often creates one by issuing ambiguous recommendations which themselves are in need of interpretation. In such cases, domestic sources of law addressing the pertinent issue may provide valuable guidance.[25] Third, as DTC provisions can normally not create domestic law,[26] many countries have found it necessary to enact a domestic parallel to Art. 9(1) OECD MTC. Domestic sources of law interpreting domestic arm's length provisions may provide qualified guidance

25. See also Baker (Release no. 0, June 2001), at E-27.
26. See e.g. Klaus Vogel in Vogel and Lehner (2008), at 129 note 72. In principle, however, whether this is correct for a particular country depends on the domestic law of that country.

as to the interpretation of the arm's length principle, and in turn may assist the interpretation of Art. 9(1). Fourth, the OECD Guidelines (as well as their predecessor)[27] are significantly influenced by domestic transfer pricing law developments, in particular those of the United States. Domestic sources of law may therefore provide valuable insight as to the historical background of the Guidelines' recommendations.

### 1.5.3.2. The principle of common interpretation

In line with the reasons noted above, the present study will rely on relevant domestic sources of law. The so-called "principle of common interpretation" justifies this approach. In its purest form, under this principle, the tax administration and courts of one DTC contracting state should look to decisions made by the tax administration and courts of the other contracting state when interpreting and applying the DTC, and vice versa.[28] The rationale of this principle is that the proper functioning of DTCs, in particular the goal of avoiding double taxation, can only be achieved if they are applied consistently by the courts and tax administrations of each of the contracting states.[29]

Although it does not fit easily into the canons of interpretation as set out by the Vienna Convention on the Law of Treaties (see infra at 2.8.1.), the principle is widely recognized.[30] Thus, the principle is de facto relied upon by the domestic courts of the main OECD Member countries covered by the present study (see infra at 1.5.3.4.),[31] of several other OECD

27. The OECD 1979 Transfer Pricing Report.
28. See General Reporters Klaus Vogel and Rainer Prokisch in IFA (1993), at 63; Klaus Vogel in Vogel and Lehner (2008), at 143 note 115.
29. See Vogel and Prokisch in IFA (1993), at 62; Skaar (2006), at 66; Klaus Vogel in Vogel and Lehner (2008), at 142 note 114; Zimmer (2009a), at 75.
30. See IFA Resolution 1993 (Subject I) Sec. 2; Vogel et al. (1989), at 28-30; General Reporters Klaus Vogel and Rainer Prokisch in IFA (1993), at 63; Rohatgi (2002), at 26; N. Shelton (2004), at 171 note 4.34; Niels Winther-Sørensen in Winther-Sørensen et al. (2009), at 47-49. The desirability of a common interpretation is also emphasized in OECD 2010 Report, Introduction, Para. 5.
31. For Canada, see *Crown Forest Industries Ltd. v. The Queen*, [1995] 2 S.C.R. 802, Paras. 49 and 72; *The Queen v. The Bank of Nova Scotia*, [1981] C.T.C. 162 (F.C.A.), Para. 11; *Qing Gang K. Li v. Canada*, [1994] 1 C.T.C. 28 (F.C.A.), Para. 59; *Dudney v. The Queen*, [2000] 2 C.T.C. 56 (F.C.A.), Para. 25, *leave to appeal refused*, 264 N.R. 394 (note); *Canadian Pacific Ltd. v. The Queen*, [1976] C.T.C. 221 #2 (F.C.T.D.), Para. 36, *rev'd* (on another issue) [1977] C.T.C. 606 (F.C.A.) and [1977] C.T.C. 615 #1 (F.C.A.); *Hunter Douglas Ltd. v. The Queen*, [1979] C.T.C. 424 (F.C.T.D.), Para. 30; *Utah Mines Ltd. v. The Queen*, [1991] 1 C.T.C. 387 (F.C.T.D.), Para. 28, *aff'd* [1992] 1 C.T.C. 306 (F.C.A.); *GlaxoSmithKline Inc. v. The Queen*, 2008 D.T.C. 3957 (Eng.)

Member countries[32] and of a non-Member country such as India.[33] It is also widely recognized in legal literature.[34] Admittedly, to establish the relevance of domestic case law for the purpose of interpreting DTCs by way of referring to domestic case law which has adopted this approach may appear akin to circular reasoning. Notwithstanding this, the pertinent case law does establish that the principle of common interpretation is applied in practice and is thus not merely a theoretical construct. The present study's reliance on the principle therefore represents a realistic approach. The study's use of the principle of common interpretation is explained in greater detail at 2.8.

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(T.C.C.), Para. 78, *reversed*, 2010 CarswellNat 2409 (F.C.A.), Paras. 63, 80; *No. 630 v. M.N.R.*, 22 Tax A.B.C. 91, 94, 95 (1959); and cf. *CanWest MediaWorks Inc. v. The Queen*, [2007] 1 C.T.C. 2479 (T.C.C.), Para. 24, *rev'd* [2008] 2 C.T.C. 172 (F.C.A.), *leave for appeal refused*, 387 N.R. 392 (note). For Norway, see Rt. 1984/99, *Alaska*, at 105; Rt. 1995/124, *Dowell Schlumberger*, at 132; Rt. 2008/577, *Sølvik*, Para. 53; Utv. 1981/285 City Court, *Creole*, at 290; and cf. Rt. 2001/512, *Safe Service*, at 522. For the US, see *Donroy, Ltd. v. the US*, 301 F.2d 200, 206-207 (9th Cir. 1962); *Riley v. Commissioner*, 74 T.C. 414, 424-426 (1980); *Taisei Fire and Marine Ins. Co., Ltd. v. Commissioner*, 104 T.C. 535, 551 and 556-557 (1995); and cf. *Air France v. Saks*, 470 US Reports 392, 404 (1985) (non-tax international convention); *US v. A. L. Burbank & Co., Ltd.*, 525 F.2d 9, 15 (2nd Cir. 1975) (the US Court of Appeals for the Second Circuit declined to accept the interpretation allegedly adopted by Canada).

32. For Australia, see *Thiel v. Commissioner,* (1990) 171 CLR 338, 349, 352, 356 and 360; *Lamesa Holdings v. Commissioner* (1997) 36 ATR 589, 603; Case 10,267, 95 ATC 341 (1995), Para. 20. For Denmark, see UfR 1993/143, *Texaco*, at 157. For Germany (the principle of common interpretation is often referred to as *Gebot der Entscheidungsharmonie*), see BFH, 16 March 1994, I B 186/93, BStBl. II 1994, 696, at 697 (Sec. II(2)(b)); BFH, 24 March 1999, I R 114/97, BStBl. II 2000, 399, at 403 (Sec. B(IV)(1)(e)(bb)); BFH, 17 November 1999, I R 7/99, BStBl. II 2000, 605, at 607 (Sec. II(3)(d)(cc)); BFH, 9 August 2006, II R 59/05, DStRE 2007, 28, at 34 (Sec. II(8)(b)(bb)). For the UK, cf. *Fothergill v. Monarch Airlines Ltd.*, [1980] 2 Lloyd's Rep. 295, 301, 306 (non-tax international convention); *I.R.C. v. Commerzbank*, [1990] S.T.C. 285, 302 (Ch.D.) (relevance of foreign judgment (US Court of Claims) rejected not as a matter of principle, but rather based on a concrete consideration of its persuasiveness); *Memec plc v. I.R.C.* [1998] S.T.C. 754, 767-768 (the same ( judgment of the German Federal Tax Court)). For New Zealand, see *Case 5*, [1965], 3 NZTBR 49, 57; *CIR v. United Dominions Trust*, [1973] 2 NZLR 555, 574 (C.A.); *CIR v. JFP Energy*, [1990] 14 TRNZ 617, 623-624 (C.A.).

33. See *CIT Andhra Pradesh v. Visakhapatnam Port Trust,* [1983] 144 ITR 146 (AP), Para. 50; *M/s Sony India (P) v. DCIT*, 11 ITLR 236, 287 (2008).

34. See e.g. Vogel and Prokisch in IFA (1993), at 62-64; Edwardes-Ker (Interpretation) (July 1994), Chap. 29 at 1-4; Baker (Release no. 0, June 2001), at E-27; Rohatgi (2002), at 26; Zimmer in Lødrup et al. (2002), at 954; N. Shelton (2004), at 171; Pötgens (2006), at 80-81; Skaar (2006), at 64, 66-67; Ward in Maisto (2007), at 175; Klaus Vogel in Vogel and Lehner (2008), at 142-145 notes 113-120; Zimmer (2009a), at 77. Somewhat more critical to the approach, see Rosenbloom (1982), at 31-37; van Raad (1996), at 4-5.

#### 1.5.3.3. Characterization of approach: Comparison with an assisting purpose

The present study uses domestic sources of law primarily to assist the interpretation of Art. 9(1) OECD MTC and other parts of the OECD material. This approach is properly characterized – using a phrase found in Swedish legal literature[35] – as a comparison with an *assisting* purpose (Swedish: *tjänande syfte*). Its purpose is to use sources of law from one or more tax systems (in the present study, domestic laws of selected countries) in order to clarify rules of another tax system (in the present study, Art. 9 OECD MTC, albeit the OECD MTC does not strictly qualify as a "tax system"). Comparisons with an assisting purpose must be distinguished from comparisons with a *prevailing* purpose (Swedish: *härskande syfte*), under which the comparison serves a purpose as such and is performed in order to identify differences and similarities between the rules of two or more jurisdictions in a specific area, so as e.g. to determine the best manner by which to regulate this particular area. This approach is not adopted by the present study.

Because the area of transfer pricing examined by the present thesis has been given modest attention up to now, many of the issues raised by it are not addressed by the examined domestic laws. The domestic law of a particular country is only interesting to the present study if it actually addresses the issues raised by it. If it does not address one of the issues, it will not be capable of assisting in the interpretation of Art. 9(1) OECD MTC in this particular respect and will therefore not be drawn upon.

#### 1.5.3.4. Choice of domestic laws

The scope of the present study would be too comprehensive were it to examine a large number of domestic laws under all headings. I have therefore selected three countries whose domestic law will be primarily examined. In selecting these countries I focused on the extent to which the domestic law of the country, based on a preliminary examination, appeared to address the issues of the present study. Further, only OECD Member countries were considered. Additionally, language barriers have played a role.

The first country is the United States. The domestic transfer pricing law of the United States has had a great influence on the OECD in the area

35. See e.g. Wiman (2005), at 510.

of transfer pricing ever since the work to draft the OECD 1979 Transfer Pricing Report started in the 1970s. Many OECD developments in the area of transfer pricing are either directly influenced by US domestic law or the result of compromise between the United States and the other OECD Member countries. As a result, it may be difficult to achieve a good understanding of the OECD's approach to transfer pricing without examining the relevant US domestic law. The particular area of transfer pricing examined by the present study is no exception in this respect.[36] The study will only examine US *federal* tax law. The second selection is Canada, mainly because Canada has adopted a specific provision[37] akin to a codification of the second circumstance referred to in OECD Guidelines Para. 1.65.[38] Canadian domestic law thus provides legislative material of significant interest to the present study. This material has attracted interesting comments from the tax community. The study will only examine Canadian *federal* tax law. The third country is Norway. Apart from the obvious reason, given the present author's nationality, the issues raised by the present study have been addressed in a number of Norwegian court and administrative cases – this being the factor which attracted my interest in the first place.

While the study concentrates on three *main* countries, domestic sources of law originating from other countries have not been ignored. On the contrary, I have been at pains to take into account domestic sources of law capable of assisting the present study's examinations, regardless of national origin, including sources originating from Australia, Denmark, Germany, the Netherlands, Sweden and the United Kingdom. Their domestic laws, however, have been examined in less detail.

## 1.6. Terminology

### 1.6.1. Introduction; general approach

This thesis predominately uses the transfer pricing terminology of the OECD Guidelines and other parts of the OECD material, as opposed e.g. to US terminology.[39] Notwithstanding the Guidelines' extensive glossary, the

36. See e.g. Treas. Reg. (US) § 1.482-1(d)(3)(ii)(B), -(1)(f)(2)(ii).
37. ITA (Can.) Para. 247(2)(b).
38. See Bloom (2006), at 1.
39. Although the OECD and US terminologies are generally very similar, there are certain differences; e.g. "cost contribution arrangements" in OECD Guidelines Para. 8.1 are referred to as "cost sharing arrangements" in the US Treasury Regulations (§ 1.482-7T(a)).

terminology in the area of transfer pricing examined by the present study is not fully developed. This section will therefore present certain fundamental terms and phrases used throughout the thesis that are not used (or defined) by the OECD material. The choice of terminology is ultimately a matter of taste. Nothing should therefore be inferred from the chosen terminology itself.

### 1.6.2. The as-structured principle

The principle established by OECD Guidelines Para. 1.64 has no specific term in the OECD material. For reference purposes, the present study will refer to it as the "as-structured principle". The term was apparently devised by David Francescucci.[40] An alternative sometimes used is the "actual transaction principle".[41] An objection to this term, however, is that it may be read so as to suggest that all aspects of the actual transaction, e.g. even the price, should only be adjusted in exceptional cases. The "as-structured principle" better reflects the recommendation of OECD Guidelines Para. 1.64 ordinarily to recognize the *structure* of the controlled transaction.

### 1.6.3. Restructuring and structural adjustments

A number of terms are used to describe the type of adjustment endorsed by OECD Guidelines Para. 1.65, including "re-characterisation" ("recharacterization"),[42] "transactional re-characterisation",[43] "transactional adjustment",[44] "non-recognition",[45] "re-writing",[46] "recasting",[47] "restructuring",[48] "structural reallocations"[49] and "contract censorship".[50]

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40. See Francescucci (2004a), at 71; David Francescucci in Russo (2005), at 118; Francescucci and Tepe (2006), at 310.
41. See Ossi (1999), at 1003; Kirschenbaum (2001), at note 15. Cf. Smith (1990-1991), at 142; Baillif (1994-1995), at 310.
42. See e.g. McLachlan (1998), at 12:6; (Bloom) 2006, at 1; Adams and Coombes (2003), at 12; García (2006), at 438.
43. See e.g. (Wilkie) 2000, at 77-78.
44. See Wittendorff (2009a), at 115.
45. See OECD Guidelines Paras. 9.162, 9.165, 9.168, 9.181, 9.184, 9.187.
46. See e.g. Adams and Coombes (2003), at 12.
47. See e.g. *Claymont Investments v. Commissioner,* 90 T.C.M. (CCH) 462, 467 (2005); Bowen and Carden (2006), at 36; Toaze (2006), at 7:8.
48. See e.g. OECD Guidelines Paras. 1.64(3), 1.69(1); Chip (a) in Feinschreiber (2001), at 33-7.
49. See Warner (1992), at 12.
50. See Syversen (1997), at 320, 322 (Norwegian: *avtalesensur*); Eide (2003), at 42. Cf. Jensen et al. (2009), at 1666.

The present study will use that of the OECD Guidelines,[51] i.e. "restructuring". As a parallel, similar to the terminology used to describe the three traditional types of transfer pricing adjustments (primary adjustments, corresponding adjustments and secondary adjustments), the study will also use the term "structural adjustments", but see the discussion infra at 9.3. of whether the as-structured principle restricts all or only extensive structural adjustments.

The most widely used alternative term is "recharacterization". I have decided against using this terminology for two reasons. First, "recharacterization" is a generic term, used to describe a variety of different lines of actions, many of which are qualitatively different from that endorsed by OECD Guidelines Para. 1.65. The term therefore risks evoking the wrong connotations. Second, the Guidelines themselves do not use "recharacterization" as the general term describing the line of action endorsed by OECD Guidelines Para. 1.65, but rather only to describe the type of adjustment authorized under the first circumstance referred to in Para. 1.65.[52]

### 1.6.4. The economic substance exception, the commercial rationality exception and the basic examples on their application

I will call the first circumstance referred to by OECD Guidelines Para. 1.65 the "economic substance exception" for present purposes, and the second circumstance the "commercial rationality exception". The OECD Guidelines establish two requirements for the commercial rationality exception to apply. For the purpose of the present thesis, the first requirement (i.e. that "the arrangements made in relation to the transaction ... differ from ..." (see infra at 19.6.)) is referred to as the "commercial irrationality requirement". The second requirement (i.e. that the "actual structure practically impedes ..." (see infra at 19.7.)) is referred to as the "practical impediment requirement". Each of the examples accompanying the exceptions is referred to as the "basic example" (on the relevant exception) in the singular and the "basic examples" in the plural.

51. See e.g. OECD Guidelines Paras. 1.64(3), 1.69(1). The term is also used by domestic law material, see infra at 9.1.
52. See OECD Guidelines Para. 1.65(3).

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