

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.

Title:	Arm's Length Transaction Structures
Subtitle:	Recognizing and restructuring controlled transactions in transfer pricing - Volume 20 in the Doctoral Series
Author(s):	Dr Andreas Bullen
Date of publication:	April 2011
ISBN:	978-90-8722-088-4
Type of publication:	Print book
Number of pages:	878
Terms:	Shipping fees apply. Shipping information is available on our website
Price:	EUR 140 / USD 185 (VAT excl.)

Order information

To order the book, please visit www.ibfd.org/IBFD-Products/shop. You can purchase a copy of the book by means of your credit card, or on the basis of an invoice. Our books encompass a wide variety of topics, and are available in one or more of the following formats:

- IBFD Print books
- IBFD eBooks – downloadable on a variety of electronic devices
- IBFD Online books – accessible online through the IBFD Tax Research Platform



IBFD, Your Portal to Cross-Border Tax Expertise

Table of contents

Preface	vii
Abbreviations and Acronyms	xxiii
Part I Introduction	
Chapter 1: Introduction	3
1.1. Transaction structures and the arm's length principle	3
1.2. Main issues addressed by the study	4
1.3. Restructuring controlled transactions: Introduction	6
1.3.1. Fiscal purpose of restructuring controlled transactions	6
1.3.2. Pertinent stage of the tax examination	7
1.3.3. The fourth type of transfer pricing adjustment	7
1.4. Relevance of study	8
1.5. Methodology: An outline	9
1.5.1. A legal analysis	9
1.5.2. Primary issues discussed and answered from the perspective of Art. 9 OECD MTC	10
1.5.3. Reliance on domestic sources of law	11
1.5.3.1. Reasons for relying on domestic sources of law	11
1.5.3.2. The principle of common interpretation	12
1.5.3.3. Characterization of approach: Comparison with an assisting purpose	14
1.5.3.4. Choice of domestic laws	14
1.6. Terminology	15
1.6.1. Introduction; general approach	15
1.6.2. The as-structured principle	16
1.6.3. Restructuring and structural adjustments	16
1.6.4. The economic substance exception, the commercial rationality exception and the basic examples on their application	17
1.6.5. Valuation adjustments	18
1.6.6. The examined taxpayer and the related party	18
1.7. Delimitations	19
1.7.1. Intra-OECD delimitation	19

Table of Contents

1.7.2.	Other arm's length provisions contained in the OECD MTC	20
1.7.2.1.	Art. 7 OECD MTC	20
1.7.2.2.	Arts. 11(6) and 12(4) OECD MTC	20
1.7.3.	Para. 1.64's second recommendation: The freedom to choose transfer pricing method	22
1.8.	The 2010 revision of the OECD Guidelines	23
1.9.	Formalities	24
1.10.	Outline of the thesis	25
Chapter 2: Methodology		27
2.1.	Introduction	27
2.2.	Canons of interpretation applicable to DTCs	27
2.2.1.	Arts. 31-33 of the Vienna Convention on the Law of Treaties	27
2.2.2.	The treaty's "object and purpose"	29
2.2.3.	Different language versions	30
2.3.	The OECD Commentaries as a source of law	31
2.3.1.	Introduction	31
2.3.2.	The Commentaries' legal character	31
2.3.3.	The Commentaries' relevance to the interpretation of DTC provisions replicating Art. 9 OECD MTC	32
2.4.	The OECD Guidelines as a source of law	33
2.4.1.	The Guidelines' legal character	33
2.4.1.1.	Not legally binding	33
2.4.1.2.	Compliance recommendations	34
2.4.1.3.	The same interpretative value as the formal Commentaries on Art. 9 OECD MTC?	37
2.4.1.4.	Summary: A multilateral soft-law agreement	38
2.4.2.	The Guidelines' relevance to the interpretation of DTC provisions replicating Art. 9 OECD MTC	39
2.4.3.	The Guidelines' relevance to the interpretation of domestic arm's length provisions	41
2.4.4.	Canons of interpretation governing the interpretation of the Guidelines	42
2.4.4.1.	The issue	42
2.4.4.2.	Should the OECD Guidelines be interpreted?	43
2.4.4.3.	Are the VCLT's canons of interpretation applicable?	45
2.5.	Other OECD publications addressing the interpretation and application of the arm's length principle as sources of law	50

2.5.1.	Relevance under Arts. 31-32 VCLT	50
2.5.1.1.	Pre-Guidelines material	50
2.5.1.2.	The Guidelines' <i>travaux préparatoires</i>	51
2.5.1.3.	Post-Guidelines material	51
2.5.2.	Canons of interpretation governing their interpretation	52
2.6.	Which version of the OECD Commentaries and the OECD Guidelines?	53
2.7.	The renvoi clause: Art. 3(2) OECD MTC	56
2.7.1.	Autonomous or domestic law meaning of terms?	56
2.7.2.	The directive for application of domestic law	59
2.8.	Domestic sources of law	60
2.8.1.	The principle of common interpretation's legal foundation	60
2.8.2.	Common interpretation of Art. 9 OECD MTC, not of articles of concrete DTCs	61
2.8.3.	Categories of domestic sources of law relied upon	61
2.8.4.	Reliance upon domestic sources of law interpreting	62
2.8.4.1.	... Art. 9 OECD MTC or other parts of the OECD material	62
2.8.4.2.	... DTC arm's length provisions	63
2.8.4.3.	... domestic arm's length provisions	64
2.8.5.	The function of domestic sources of law	64
2.8.6.	Weight to be given to domestic sources of law	65
2.8.7.	Impact of the intra-OECD delimitation	66
Chapter 3:	Arm's Length Provisions	67
3.1.	Model and DTC arm's length provisions	67
3.1.1.	Overview	67
3.1.2.	Art. 9(1) OECD MTC's restrictive effect on domestic law	68
3.1.2.1.	Introduction	68
3.1.2.2.	Art. 9(1)'s contextual scope of application	69
3.1.2.3.	Situations falling under Art. 9(1)'s scope of application	70
3.1.2.4.	Situations falling outside of Art. 9(1)'s scope of application	72
3.2.	Domestic arm's length provisions	75

Part II
The As-Structured Principle

Part II.A
The As-Structured Principle's Legal Foundation

Chapter 4: The As-Structured Principle: Introduction	83
4.1. Point of departure: Tax law applies to actual transactions	83
4.2. The as-structured principle	84
4.3. The authority to restructure controlled transactions: Alternative levels of constraints	85
4.4. Outline of subpart II.A	87
 Chapter 5: The As-Structured Principle's Historical Development	 89
5.1. The League of Nations era	89
5.1.1. Introduction	89
5.1.2. The League 1927 and 1928 Draft Conventions	89
5.1.3. Art. IV DTC France–US 1932	90
5.1.4. The Carroll Report	92
5.1.5. The League 1933 and 1935 Draft Conventions	96
5.1.5.1. Associated enterprises	96
5.1.5.2. PEs	97
5.1.6. The 1943 Mexico Model and the 1946 London Model	98
5.1.7. Summary; present day relevance of the League of Nations' material	98
5.2. Early US case law	99
5.3. The 1975 IFA Resolution	104
5.4. The OECD 1979 Transfer Pricing Report and other OECD material preceding the OECD Guidelines	105
5.5. Was the as-structured principle imported into the OECD 1979 Transfer Pricing Report from US case law?	106

Chapter 6: The As-Structured Principle's Contemporary Expression	109
6.1. Contemporary expression: The OECD material	109
6.1.1. The wording of Art. 9(1) OECD MTC	109
6.1.1.1. The issue	109
6.1.1.2. Proposition 1: The term "conditions" only includes certain types of conditions, such as price conditions and/or the <i>accidentalia negotii</i>	109
6.1.1.3. Proposition 2: Art. 9(1) does not authorize adjustment of more than a single condition at a time	113
6.1.1.4. Proposition 3: Art. 9(1) only authorizes adjustments of "conditions", not of "commercial or financial relations"	113
6.1.1.5. Proposition 4: Art. 9(1) prevents the "two-stage operation" characterizing the process of restructuring controlled transactions	116
6.1.1.6. Proposition 5: Art. 9(1) does not authorize creation of income	116
6.1.1.6.1. The proposition	116
6.1.1.6.2. First counter-argument: Income is not necessarily created because the transaction is restructured	117
6.1.1.6.3. Second counter-argument: Art. 9(1) does not prevent creation of income	117
6.1.1.7. Summary	120
6.1.2. The Commentaries on Art. 9(1) OECD MTC	121
6.1.3. The OECD Guidelines	121
6.1.3.1. Para. 1.64	121
6.1.3.2. Other parts of the Guidelines and other OECD publications	122
6.1.3.3. Para. 1.64: A restrictive interpretation of the wording of Art. 9(1) OECD MTC?	123
6.1.4. The as-structured principle in the PE context	124
6.1.5. Is the as-structured principle inherent in the comparability requirement?	125
6.1.6. The Commentary on Art. 1 OECD MTC	126

6.1.7.	Summary	126
6.2.	Contemporary expression: Domestic law	127
6.2.1.	Canada	127
6.2.2.	Norway	127
6.2.3.	United States	130
6.2.4.	Other OECD Member and non-Member countries	131
6.2.5.	Summary	133

Part II.B

Which Adjustments Are Restricted by the As-Structured Principle?

Chapter 7: The Restricted Adjustments: Introduction	137
------------------------------------------------------------	------------

Chapter 8: Examination of whether the As-Structured Principle Restricts Various Adjustments Not Based on the Arm's Length Principle	139
--------------------------------------------------------------------------------------------------------------------------------------------	------------

8.1.	The issue	139
8.2.	General arguments suggesting that the as-structured principle does not restrict adjustments not based on the arm's length principle	140
8.2.1.	The arm's length principle is the stated legal authority for adjustments based on OECD Guidelines Para. 1.65	140
8.2.2.	The context	142
8.2.3.	Art. 9(1) OECD MTC's contextual scope of application	142
8.2.4.	Principle of equal treatment of associated and independent enterprises	143
8.2.5.	Summary; the way ahead	144
8.3.	Establishing the controlled transaction: Introduction	145
8.4.	Establishing the controlled transaction: Factual substance	145
8.4.1.	Introduction	145
8.4.1.1.	The issue	145
8.4.1.2.	"Lack of factual substance"	146
8.4.1.3.	The root of the difficulties: The OECD Guidelines' double-pronged notion of "economic substance"	147
8.4.1.3.1.	The arm's length prong	147
8.4.1.3.2.	The factual substance prong	148
8.4.1.3.3.	The issue created by the two prongs	149

8.4.2.	Are factual substance adjustments restricted by the as-structured principle?	150
8.4.2.1.	The OECD material	150
8.4.2.2.	Domestic laws	153
8.4.2.3.	Legal literature	155
8.4.2.4.	Summary and conclusion	156
8.4.3.	Special fact patterns involving factual substance adjustments	157
8.4.3.1.	True-earner cases	157
8.4.3.2.	Non-contributing intermediate companies	158
8.4.3.3.	Unremunerated transfers	159
8.4.3.4.	Fictitious transactions	162
8.5.	Establishing the controlled transaction: Interpretation of written material	162
8.6.	Establishing the controlled transaction: Filling in gaps in the contract	164
8.7.	Fiscal classification	165
8.7.1.	Introduction	165
8.7.1.1.	The issue	165
8.7.1.2.	The notion of “fiscal classification”	166
8.7.2.	The OECD material	167
8.7.3.	Domestic sources of law	169
8.7.4.	Summary and conclusion	170
8.8.	Application of general anti-avoidance rules	171
8.8.1.	Introduction	171
8.8.1.1.	General anti-avoidance rules	171
8.8.1.2.	The issue	172
8.8.2.	The OECD material	173
8.8.3.	Domestic sources of law	175
8.8.4.	Policy considerations	176
8.8.5.	Summary and conclusion	178
8.9.	Summary of conclusions	179
Chapter 9: Which Adjustments under Art. 9(1) OECD MTC’s Arm’s Length Test Are Restricted by the As-Structured Principle?		181
9.1.	The issue	181
9.2.	Qualitative criterion: Structural adjustments vs valuation adjustments	182
9.2.1.	The criterion’s existence	182

Table of Contents

9.2.2.	The criterion's content: The distinction between structural conditions and valuation conditions	184
9.2.2.1.	Introduction	184
9.2.2.2.	The OECD Guidelines' structure	184
9.2.2.3.	Domestic sources of law	187
9.2.2.4.	Casuistic examples of types of conditions deemed to be structural conditions	189
9.2.2.5.	Summary conclusion	190
9.3.	Quantitative criterion: Does the as-structured principle restrict all structural adjustments?	193
9.3.1.	The issue	193
9.3.2.	The OECD Guidelines: Paragraphs <i>openly</i> discussing structural adjustments	194
9.3.2.1.	The as-structured principle's stated subject matter: The "structure" of the controlled transaction	194
9.3.2.2.	The as-structured principle's stated rationale	194
9.3.2.3.	The economic substance exception	195
9.3.2.4.	The commercial rationality exception	196
9.3.2.5.	OECD Guidelines Para. 1.66	197
9.3.2.6.	OECD Guidelines Para. 1.69	198
9.3.2.7.	OECD Guidelines Paras. 8.29-8.30: Restructuring CCAs	199
9.3.3.	The OECD Guidelines: Paragraphs <i>covertly</i> discussing structural adjustments	199
9.3.3.1.	OECD Guidelines Para. 1.49: Risk reassignment	199
9.3.3.2.	OECD 1995 Guidelines Para. 1.27: Imputation of hypothetical hedging transactions	202
9.3.3.3.	OECD Guidelines Paras. 6.28-6.35: Valuation uncertainties at the time of intangible transfers	203
9.3.4.	The fundamental nature criterion proposed by the OECD 2008 Business Restructuring Draft	207
9.3.5.	Domestic sources of law	210
9.3.6.	Policy considerations	212
9.3.7.	Summary conclusion	212

Chapter 10: The Distinction between Structural Adjustments and Comparability Adjustments	215
10.1. Comparability adjustments	215
10.2. Comparability adjustments vs structural adjustments	215
Chapter 11: Structural Adjustments: Main Types and Techniques	219
11.1. Main types of structural adjustments: “disregard” and “substitution”	219
11.2. Overview of different techniques used to restructure controlled transactions	221
11.2.1. Introduction	221
11.2.2. Overt structural adjustments	221
11.2.2.1. Concrete findings of lack of economic substance or commercial rationality	221
11.2.2.2. Absolute reference structures	221
11.2.2.3. Rebuttable reference structures	222
11.2.3. Covert structural adjustments	223
11.2.3.1. Considering the examined taxpayer’s realistically available alternatives	223
11.2.3.2. Use of unadjusted, non-comparable uncontrolled transactions as comparables	224
11.2.3.3. Valuation adjustments not reflecting actual transaction structures	226
11.2.3.4. Safe-harbour rules	227
11.2.4. Techniques addressed in the present thesis	228

Part II.C

Examining the As-Structured Principle and Complementary Principles

Chapter 12: The As-Structured Principle’s Rationales	231
12.1. Introduction	231
12.2. Structural adjustments are not prevented by the wording of Art. 9(1) OECD MTC	231
12.3. Prevention of structural adjustments amounting to a “ <i>wholly arbitrary exercise</i> ”	232
12.3.1. Introduction	232

Table of Contents

12.3.2. Which adjustments could amount to a “wholly arbitrary exercise”?	233
12.3.2.1. In general	233
12.3.2.2. Restructuring “legitimate” business transactions	233
12.3.2.3. Structural adjustments undertaken under OECD Guidelines Para. 1.65 are not considered to be arbitrary; legitimate vs illegitimate transactions	234
12.3.3. Why could structural adjustments amount to a “wholly arbitrary exercise”?	235
12.3.4. Why should arbitrary structural adjustments be avoided?	237
12.3.5. Is the rationale satisfactory?	237
12.3.5.1. The risk of arbitrary adjustments is relative	237
12.3.5.2. Is the OECD material’s attitude to structural adjustments consistent with ...	238
12.3.5.2.1. ... its attitude to valuation adjustments?	238
12.3.5.2.2. ... its attitude to secondary adjustments?	239
12.3.5.2.3. ... its attitude to application of domestic GAARs?	241
12.3.5.3. Non-introduction of additional uncertainty	243
12.4. Avoidance of economic double taxation	243
12.4.1. The rationale	243
12.4.2. Is the rationale satisfactory?	245
12.5. Ability to pay considerations	246
12.6. Equal treatment of controlled and uncontrolled transactions	247
12.7. Freedom of contract	248
12.7.1. The freedom and the issue	248
12.7.2. An unauthorized limitation of the freedom?	250
12.8. Freedom of business judgment	253
12.8.1. The freedom	253
12.8.2. The freedom of business judgment granted by the common law “business judgment rule”	256
12.8.3. An unauthorized limitation of the freedom?	257
12.9. Tax administrations lack the associated enterprises’ business knowledge	259
12.10. The commercial interest of individual group members may conflict with that of the MNE group as such	261
12.11. <i>Pacta sunt servanda</i>	263

12.12. Avoidance of duplicative legal bases for restructuring controlled transactions	267
12.12.1. Introduction	267
12.12.2. Factual substance adjustments	267
12.12.3. Adjustments based on GAARs	268
12.12.3.1. The issue	268
12.12.3.2. Different thresholds for adjustments	268
12.12.3.3. Different legal effects	270
12.12.3.4. Reduced risk of double taxation	271
12.12.3.5. Summary	271
12.13. Is the as-structured principle a practical necessity? – The difficulty of shooting at a moving object	272
12.14. Summary	272
Chapter 13: The Subject Matter of the As-Structured Principle	275
13.1. The issue	275
13.2. Recognizing the rights and obligations created by the associated enterprises	275
13.3. Recognizing the associated enterprises' implementation of the controlled transaction	278
13.4. Recognizing the examined taxpayer's decision whether or not to terminate/renew a controlled contractual relationship	279
13.5. Recognizing the examined taxpayer's choice <i>not</i> to undertake a controlled transaction	281
13.6. Recognizing the examined taxpayer's role in the MNE's business structure (its business model)	283
13.7. Recognizing the examined taxpayer's group-company status	284
13.7.1. Introduction	284
13.7.1.1. The notion of "MNE-specific commercial circumstances" and their implications	284
13.7.1.2. The issue	287
13.7.2. The OECD material	287
13.7.3. Domestic sources of law	290
13.7.3.1. United States	290
13.7.3.2. Norway	295
13.7.3.3. Canada	299
13.7.3.4. Germany	301
13.7.3.5. Australia	301
13.7.4. Policy considerations	302
13.7.5. Summary	303

13.7.5.1. Conclusion	303
13.7.5.2. Relationship with the as-structured principle	304
Chapter 14: Principles Complementing the As-Structured Principle	305
14.1. Introduction: The actual <i>transaction</i> vs the actual <i>situation</i>	305
14.2. Recognizing the time of controlled transactions and business decisions	306
14.2.1. Introduction	306
14.2.1.1. The issue	306
14.2.1.2. Delimitations	307
14.2.2. The ex-ante approach as the international norm: the time of the controlled transaction and business decisions is recognized	309
14.2.2.1. Point of departure: The situation of unrelated parties negotiating a contract	309
14.2.2.2. The OECD material	309
14.2.2.3. Domestic law	311
14.2.2.4. Summary	314
14.2.3. Characteristics of the ex-ante approach	314
14.2.3.1. The “time” of transactions and business decisions	314
14.2.3.1.1. Transactions evidenced by written agreements	314
14.2.3.1.2. Transactions evidenced by oral agreements	316
14.2.3.1.3. Transactions deduced from actual conduct and/or background rules of law/customs	317
14.2.3.1.4. Business decisions	317
14.2.3.2. Restricting use of information: Only “known” and “reasonably foreseeable” facts	318
14.2.3.2. Restricting effect both for tax administrations and taxpayers	319
14.2.3.3. The approach does not establish a status quo regime	320
14.2.3.5. Actual outcomes as a pointer to further inquiry	321

14.2.3.6.	Adjusting the time of the transaction based on the arm's length principle	321
14.2.3.7.	Relationship with the as-structured principle	322
14.2.4.	Domestic modifications of the international norm:	
	Taking into account actual profit experience	323
14.2.4.1.	Introduction	323
14.2.4.2.	Stated rationales for emphasizing actual profit experience	323
14.2.4.3.	United States: The commensurate with income standard	326
14.2.4.3.1.	The standard	326
14.2.4.3.2.	Determining whether periodic adjustments are warranted	328
14.2.4.3.3.	The periodic adjustments	330
14.2.4.3.4.	Transfers not involving "intangible property"	332
14.2.4.4.	Germany: Mechanical imputation of price adjustment clauses	333
14.2.5.	Requirement to use contemporaneously undertaken comparables	335
14.3.	Recognizing the examined taxpayer's level of knowledge	336
14.3.1.	The relevance of knowledge	336
14.3.2.	Establishing the <i>actual</i> level of knowledge	336
14.3.3.	Imputing a higher than actual level of knowledge	337
14.4.	Recognizing the examined taxpayer's level of experience	339
14.5.	Recognizing uncontrolled circumstances	342

Part III

Structural Adjustments

Part III.A

The Exceptions: Common Issues

Chapter 15: Preliminary Issues Common to Both Exceptions from the As-Structured Principle	347
15.1. Introduction	347
15.2. Historical development within the OECD	348
15.3. The controlled transaction actually undertaken is always the point of departure for the examination	351

15.4. Are structural adjustments only authorized subject to explicit legal authority?	352
15.4.1. The level of the DTC	352
15.4.1.1. The associated enterprises context	352
15.4.1.2. The PE context	355
15.4.2. The level of domestic law	356
15.5. The authority to undertake structural adjustments: Mandatory or discretionary?	357
15.5.1. Introduction	357
15.5.2. Profit-increasing structural adjustments	358
15.5.3. Profit-decreasing structural adjustments	358
15.5.3.1. Introduction	358
15.5.3.2. Adjustments requested as a proactive argument	359
15.5.3.3. Adjustments requested as a defence argument	361
15.6. Basic features of the exceptions	365
15.6.1. Exceptions, not requirements	365
15.6.2. The exceptions must be interpreted subject to the wording of Art. 9(1) OECD MTC	366
15.6.3. Are the exceptions exhaustive?	367
15.6.4. Why are there <i>two</i> exceptions?	369
15.6.5. The interrelationship between the exceptions and their accompanying basic example	371
15.6.5.1. Are the basic examples exhaustive?	371
15.6.5.2. Are the exceptions and their accompanying basic example to be interpreted subject to the <i>ejusdem generis</i> canon of interpretation?	372
Chapter 16: Common Issues Pertaining to Concrete Analyses under the Exceptions	377
16.1. The threshold for undertaking structural adjustments	377
16.1.1. The exceptionality standard	377
16.1.2. A relative threshold?	379
16.1.2.1. Is the threshold lower for restructuring some categories of controlled transactions than others?	379
16.1.2.2. Does the threshold differ depending on the extensiveness of the adjustment?	380
16.2. The relevance of a tax-avoidance motive	381

16.2.1.	Is a tax-avoidance motive a <i>requirement</i> for structural adjustments to be authorized?	381
16.2.1.1.	The issue	381
16.2.1.2.	The general position	381
16.2.1.3.	The position in the area of structural adjustments	382
16.2.1.3.1.	The OECD material	382
16.2.1.3.2.	Domestic law	385
16.2.1.3.3.	Legal literature	386
16.2.1.3.4.	Conclusion	387
16.2.2.	Is a tax-avoidance motive <i>sufficient</i> for structural adjustments to be authorized? – The relevance of a less tax-efficient alternative	388
16.2.2.1.	The issue	388
16.2.2.2.	The OECD material	389
16.2.2.3.	Domestic law	390
16.2.2.4.	Conclusion	391
16.3.	Structural adjustments are not authorized if arm's length comparables are identified	392
16.3.1.	Introduction	392
16.3.1.1.	Point of departure; the issue	392
16.3.1.2.	The OECD Guidelines' transfer pricing methods are not applicable	392
16.3.2.	Comparison with concrete arrangements adopted by unrelated enterprises	393
16.3.2.1.	The method	393
16.3.2.2.	Comparability standard	394
16.3.2.3.	Focus of the examination: The feature allegedly lacking economic substance or commercial rationality	397
16.3.2.4.	The associated enterprises need not choose the most common structure	399
16.3.3.	Comparison with industry customs	399
16.3.4.	Comparison with bona fide uncontrolled offers	401
16.4.	Are structural adjustments authorized solely because arm's length comparables are not identified? – Unique transactions and transaction structures	403
16.4.1.	Introduction	403
16.4.1.1.	The issue; the notion of "unique" transaction(s) (structures)	403
16.4.1.2.	Reasons why uniqueness as such should not trigger structural adjustments	404

Table of Contents

16.4.2. Unique transaction structures in general	406
16.4.3. Unique transaction structures produced by MNE-specific commercial circumstances	411
16.4.4. Departures from industry customs	415
16.4.5. Uniqueness as a pointer to further examinations	416
16.5. Summary overview of the analysis under the exceptions	418
16.5.1. Two-step process rather than hierarchy of methods	418
16.5.2. <i>Hypothetical</i> tests in the absence of concrete arm's length comparables	419
16.6. Consequences of a structural adjustment	423
16.6.1. Primary consequence: Valuation adjustments shall be undertaken based on the <i>restructured</i> controlled transaction	423
16.6.2. Eliminating a restructured non-arm's length condition's profit-increasing effects	424
16.6.3. Corresponding adjustments	425
16.6.3.1. The commitment to undertake corresponding adjustments	425
16.6.3.2. Does the commitment cease if the restructured controlled transaction is considered to be abusive?	428
16.6.3.3. Does the commitment exist only to the extent that the structural adjustment is authorized under the other tax administration's domestic law?	429

Part III.B

The Economic Substance Exception

Chapter 17: The Economic Substance Exception: General Scope 433

17.1. Introduction	433
17.2. Different meanings of lack of "economic substance"	434
17.2.1. Introduction	434
17.2.2. Ordinary meaning: The anti-avoidance prong	435
17.2.2.1. Introduction	435
17.2.2.2. United States	435
17.2.2.3. Canada	437
17.2.2.4. Norway	438
17.2.2.5. Summary	439
17.2.3. Special meaning no. 1: The factual substance prong	441

17.2.4.	Special meaning no. 2: The arm's length prong	442
17.2.5.	The prong with which the economic substance exception is concerned	442
17.2.6.	<i>De lege ferenda</i> views on the OECD material's three-pronged notion of economic substance and the economic substance exception	445
17.3.	Domestic law approaches	447
17.3.1.	United States	447
17.3.2.	Canada	448
17.3.3.	Norway	450
17.3.4.	Other OECD Member countries	451
17.4.	Qualification of scope of the economic substance exception and requirements for an adjustment to be authorized under it	452
17.4.1.	Introduction	452
17.4.2.	The discrepancy between the form and economic substance must be caused by the community of interest	452
17.4.2.1.	In general	452
17.4.2.2.	Arrangements rebuttably presumed to be non-arm's length	453
17.4.3.	It suffices that the economic substance "differs" from the form	454
17.4.4.	The economic substance of <i>individual contractual conditions</i> can also be tested under the exception	454
17.4.5.	No practical impediment requirement	455
17.5.	The authorized structural adjustment	455
17.5.1.	Subject matter of the adjustment	455
17.5.2.	Point of reference for the adjustment: Relevance of arm's length behaviour	457
17.5.3.	Proportionality requirement	458
17.5.4.	Preference for non-extensive, non-counterfactual structural adjustments	458
Chapter 18: The Economic Substance Exception: Categories of Arrangements Potentially Lacking Economic Substance		461
18.1.	Introduction	461
18.2.	Thin capitalization: Form of investment inconsistent with risk level involved	462
18.2.1.	Determining whether the arrangement lacks economic substance	462
18.2.1.1.	The disputed feature	462

Table of Contents

18.2.1.1.1.	Debt form unacceptable to capital provider; borrowing capacity	462
18.2.1.1.2.	Debt form unacceptable to capital receiver; borrowing willingness	465
18.2.1.2.	Guaranteed and back-to-back loans	466
18.2.1.3.	Methods authorized under Art. 9(1) OECD MTC for determining whether a company is thinly capitalized	467
18.2.2.	The authorized structural adjustment	469
18.2.2.1.	Form of adjustment	469
18.2.2.2.	Subject matter of adjustment	470
18.2.2.3.	Amount of adjustment	471
18.2.2.4.	Treatment of interest and currency exchange losses	472
18.2.3.	Delimitation: Fiscal (re)classification of hybrid loans	472
18.3.	Allocation of risk after its outcome is known or reasonably knowable	476
18.3.1.	Determining whether the arrangement lacks economic substance	476
18.3.1.1.	The disputed arrangement	476
18.3.1.2.	Point of departure: The original risk allocation	477
18.3.1.3.	The “outcome”	479
18.3.1.4.	“[K]nown” or “reasonably knowable”	480
18.3.1.5.	Non-arm’s length feature	480
18.3.1.6.	Rebuttal of non-arm’s length presumption	481
18.3.2.	The authorized structural adjustment	481
18.4.	Risk-assuming party is financially incapable of bearing the risk	482
18.4.1.	Relevance of financial capacity	482
18.4.2.	Assessing whether the risk-assuming party’s financial capacity is adequate	484
18.4.2.1.	Financial capacity to what?	484
18.4.2.2.	Which losses should the risk-assuming enterprise be able to fund?; the time of the assessment	485
18.4.2.3.	How should the risk-assuming enterprise be able to fund the losses?	486

18.4.2.4. The risk-assuming enterprise's total risk exposure must be emphasized	488
18.4.3. Situations where third parties will suffer the consequences of expectable losses	489
18.4.4. Non-arm's length feature	491
18.4.5. Rebuttal of non-arm's length presumption	493
18.4.6. The authorized structural adjustment	494
18.5. Controllable risks allocated to a party incapable of controlling them	496
18.5.1. The control criterion	496
18.5.1.1. The criterion	496
18.5.1.2. The criterion's function: Descriptive or normative?	497
18.5.1.3. The criterion's soundness	499
18.5.2. The notion of "control"	501
18.5.2.1. Relevant control decisions	501
18.5.2.2. Outsourcing the risk management function	502
18.5.3. Uncontrollable risks; financial capacity vs control	504
18.5.4. Non-arm's length feature	504
18.5.5. Rebuttal of non-arm's length presumption	505
18.5.6. The authorized structural adjustment	506

Part III.C

The Commercial Rationality Exception

Chapter 19: The Commercial Rationality Exception: General Scope	511
19.1. Introduction	511
19.2. Historical background	511
19.2.1. Introduction	511
19.2.2. The US commensurate with income standard	511
19.2.3. The US sound business judgment standard	515
19.3. Domestic law approaches	517
19.3.1. Canada: Specific structural adjustment provision	520
19.3.2. Norway: The general arm's length provision	520
19.3.3. United States: The realistically available alternatives standard	523
19.3.4. Other OECD Member countries	526
19.3.5. Summary	527

Table of Contents

19.4. “[T]he form and substance ... are the same”; order of precedence between the exceptions	528
19.5. Cumulative requirements	530
19.6. The commercial irrationality requirement	530
19.6.1. In general	530
19.6.2. The subject matter of the examination	531
19.6.2.1. In general	531
19.6.2.2. “[T]he arrangements made in relation to” the controlled transaction	531
19.6.2.3. The arrangements should be “viewed in their totality”	533
19.6.2.3.1. Different elements of the same transaction	533
19.6.2.3.2. Different transactions (business restructurings, etc.)	533
19.6.2.4. Testing of outcomes, not of the process under which the controlled transaction was entered into	534
19.6.3. The yardstick: Commercially rational arrangements	536
19.6.3.1. In general	536
19.6.3.2. Commercially irrational for which of the associated enterprises?	537
19.6.3.3. The notion of commercial irrationality	540
19.6.3.3.1. Introduction: Attempts at defining commercial irrationality	540
19.6.3.3.2. The technique: The realistically available options standard	541
19.6.3.3.3. The RAO standard involves a two-step analysis	543
19.6.3.3.4. Use of expert witnesses	544
19.6.4. The RAO standard: Identification of “realistically available” options	544
19.6.4.1. Introduction: The option must be “realistically” available to the allegedly disadvantaged taxpayer	544
19.6.4.2. The option must respect the business of the MNE group as such	545
19.6.4.3. Are options that are commercially unattractive for the group “realistically available” to individual group members?	546

19.6.4.4.	Can strongly counterfactual options considered to be “realistically available” at the tax examination stage?	548
19.6.4.5.	Relevance of whether the option is readily available at the time of the transaction or business decision	551
19.6.4.6.	The option must be acceptable to the other party to the transaction	553
19.6.4.7.	The taxpayer must have knowledge of the option	554
19.6.4.8.	The option cannot be illegal	554
19.6.4.9.	Availability may be influenced by MNE-specific commercial circumstances	555
19.6.4.10.	Realistic availability is a relative concept	555
19.6.5.	The RAO standard: The clearly-more-attractive test	556
19.6.5.1.	The test	556
19.6.5.2.	Assessing levels of attractiveness	556
19.6.5.2.1.	Attractiveness	556
19.6.5.2.2.	Attractiveness must be assessed ex ante	557
19.6.5.2.3.	Attractiveness is influenced by degree of availability	558
19.6.5.2.4.	Attractiveness may be influenced by MNE-specific commercial circumstances	559
19.6.5.2.5.	Attractiveness is subjective	559
19.6.5.2.6.	Converting levels of attractiveness into monetary values	559
19.6.5.3.	Comparing the levels of attractiveness	561
19.6.5.3.1.	The comparison	561
19.6.5.3.2.	“Clearly” more attractive	562
19.7.	The practical impediment requirement	564
19.7.1.	Introduction	564
19.7.2.	Subject matter of impediment	565
19.7.2.1.	An appropriate “transfer price”	565
19.7.2.2.	An “appropriate” transfer price	566
19.7.3.	Qualification of the practical impediment	566
19.7.3.1.	Cause of the practical impediment: The commercially irrational arrangement	566

19.7.3.2. Why do irrational arrangements create a practical impediment?	567
19.7.3.3. Are practical impediments inevitable consequences of irrational arrangements?	570
19.7.3.4. Force of the practical impediment	572
19.7.4. The practical impediment requirement's relationship to Art. 9(1) OECD MTC	573
19.8. The authorized structural adjustment	574
19.8.1. The yardstick: Commercially rational arrangements	574
19.8.2. Proportionality requirement	575
19.8.3. Choosing one of several realistically available options	576
19.8.4. Aim to remove the practical impediment?	578
19.8.5. Excursus: The adjustment authorized under the US realistically available alternatives standard	579
 Chapter 20: The Commercial Rationality Exception: Categories of Potentially Irrational Arrangements	 583
 Chapter 21: Irrational Transfers of Profit Generators	 585
21.1. Introduction	585
21.1.1. The potentially irrational arrangement	585
21.1.2. Categories of profit-generator transfers	586
21.1.3. Tax incentives for profit-generator transfers	589
21.1.4. Alternative lines of attack	590
21.1.5. Do profit-generator transfers qualify as "commercial or financial relations"?	591
21.2. The transferor's realistically available options	593
21.3. The clearly-more-attractive test: Preliminary issues	595
21.3.1. Profit-generator transfers are not commercially irrational per se	595
21.3.1.1. Introduction	595
21.3.1.2. The OECD material	595
21.3.1.3. US domestic law	595
21.3.1.4. Norwegian domestic law	600
21.3.1.5. Canadian domestic law	601
21.3.1.6. Other domestic laws	602
21.3.1.7. Summary	603
21.3.2. Shifting of income vs shifting of sources of income	604
21.3.3. Group-level or company-level perspective?	605

21.4. The clearly-more-attractive test: Factors potentially affecting the transfer's attractiveness	608
21.4.1. Introduction	608
21.4.2. The consideration paid by the transferee	609
21.4.2.1. The amount of consideration	609
21.4.2.1.1. The arm's length amount or the actual amount?	609
21.4.2.1.2. Always an amount at which the transfer would have taken place?	612
21.4.2.2. The form of consideration: Share compensation	612
21.4.3. The transferor's post-transfer profits	614
21.4.3.1. Relevance of the anticipated drop in the transferor's profits	614
21.4.3.2. Consideration charged in the transferor's post-transfer controlled transactions	617
21.4.3.3. The make-or-buy decision	618
21.4.3.3.1. The intangibles owner's options	618
21.4.3.3.2. To license or not to license	619
21.4.3.3.3. Self-manufacturing or contracting manufacturing?	623
21.4.4. The transferor's desire to reduce its risk level	624
21.4.5. The post-transfer division of business activities	626
21.4.5.1. The issue	626
21.4.5.2. Relevance of independent enterprises having divided their business activities in a comparable manner	626
21.4.5.3. The post-transfer division of business activities is not "natural"	627
21.4.5.4. The post-transfer business activities are highly integrated	629
21.4.5.4.1. The OECD material	629
21.4.5.4.2. US forced-consolidation case law	630
21.4.5.4.3. Conclusion	638
21.4.5.5. The post-transfer business activities are interdependent	638
21.4.6. Sharing of input factors (officers, employees, premises, business assets, etc.)	639
21.4.7. The transferred profit generator has not previously been handled by the transferor	641
21.4.7.1. Introduction	641

Table of Contents

21.4.7.2. Start-ups of new business segments	642
21.4.7.3. Expansions of existing business segments: Capacity increases	644
21.4.8. CCAs: Self-development vs co-development	646
21.4.9. No change of use or performance: Circular transfers	648
21.4.9.1. Of assets (sale and license-back)	648
21.4.9.2. Of functions	653
21.4.10. Assistance provided by the transferor to the transferee	653
21.4.10.1. Funding assistance in relation to the transfer	653
21.4.10.2. Services provided after the transfer	654
21.4.11. Absence of group-level business purpose	655
21.4.12. Presence of tax-savings motive	656
21.4.13. Overall assessment	657
21.5. The practical impediment requirement	658
21.6. The authorized structural adjustment	659
 Chapter 22: Irrational Approaches to Valuation Uncertainty at the Time of Controlled Transactions	 663
22.1. Introduction	663
22.2. The basic example: Transfer of non-existing intangible property with highly uncertain profit potential	664
22.2.1. The actual arrangement	664
22.2.2. The realistically available option	665
22.2.3. The clearly-more-attractive test: The lump-sum transfer's unattractive features	665
22.2.3.1. Valuation uncertainty	665
22.2.3.2. Lump-sum structure	666
22.2.3.3. Unattractive for which enterprise?	667
22.2.4. Practical impediment	668
22.2.5. The structural adjustment	669
22.3. OECD Guidelines Paras. 6.28-6.35: Valuation uncertainty at the time of intangible transfers	671
22.3.1. Introduction	671
22.3.2. The actual arrangements	672
22.3.3. Realistically available options	673
22.3.4. The clearly-more-attractive test	674
22.3.4.1. Introduction	674
22.3.4.2. Low-level uncertainty: Future developments are predictable	675

22.3.4.3.	High-level uncertainty: Future developments are not predictable	676
22.3.4.4.	High-level uncertainty and unexpected developments	678
22.3.4.5.	Relevance of concrete arm's length comparables	678
22.3.4.6.	Unattractive for which enterprise?	679
22.3.5.	Practical impediment	679
22.3.6.	The structural adjustment	680
22.3.6.1.	Imputing a shorter-term agreement	680
22.3.6.2.	Imputing a price adjustment clause	681
22.4.	Valuation uncertainty outside of the intangibles area	682
Chapter 23:	Irrational Cost Incurrence: Qualitative Irrationality	685
23.1.	Introduction	685
23.1.1.	The issue	685
23.1.2.	Relationship between domestic deductibility rules and the arm's length principle	687
23.1.3.	Relationship between benefit tests and qualitative irrationality	688
23.1.3.1.	The services context	688
23.1.3.2.	The CCA context	690
23.2.	Analysis of qualitative irrationality under the commercial rationality exception	690
23.2.1.	The actual transaction and the realistically available option	690
23.2.2.	The clearly-more-attractive test	691
23.2.2.1.	The test	691
23.2.2.2.	Direct exploitation	691
23.2.2.3.	Indirect exploitation (sale, licence, lease, etc.)	692
23.2.2.3.1.	In general	692
23.2.2.3.2.	Indirect exploitation not possible	693
23.2.2.3.3.	Indirect exploitation possible	693
23.2.2.4.	Qualifications	694
23.2.2.4.1.	Must the exploitation ability exist at the time of the transaction?	694
23.2.2.4.2.	Ability to exploit or actual exploitation?	695

Table of Contents

23.2.3. Practical impediment	696
23.2.4. The structural adjustment	697
23.3. Partial qualitative irrationality: Excessive quanta	697
Chapter 24: Irrational Cost Incurrence: Quantitative Irrationality	701
24.1. Introduction	701
24.1.1. The issue	701
24.1.2. “Quantitative” irrationality	702
24.2. Actual transactions examined in Norwegian case law and administrative practice	702
24.2.1. The transactions	702
24.2.2. Category of transactions: Financial services	705
24.2.3. Role of the commercial rationality exception	705
24.3. Arm’s length comparables	706
24.3.1. Non-group external comparables	706
24.3.2. Reinsurance policies as arm’s length comparables	708
24.4. Realistically available options	709
24.5. The clearly-more-attractive test	709
24.5.1. Introduction	709
24.5.2. The area of agreement	710
24.5.2.1. Relevance to the analysis	710
24.5.2.2. Ability to determine an arm’s length supply or demand price does not evidence a positive area of agreement	711
24.5.3. The minimum arm’s length supply price	711
24.5.3.1. In general	711
24.5.3.2. Actual price below minimum arm’s length supply price	712
24.5.3.3. Moral hazard and insurance	713
24.5.4. Assessing whether the maximum arm’s length demand price is lower than the minimum arm’s length supply price	715
24.5.4.1. In general	715
24.5.4.2. Expensiveness does not evidence negative area of agreement	715
24.5.4.3. Expected, not actual, benefits	715
24.5.4.4. Assessing the benefits	717
24.5.4.5. Market information as indicia of negative area of agreement	718
24.5.4.6. Area of agreement is temporarily negative	720
24.6. Practical impediment	721

24.7. The structural adjustment	721
24.7.1. The adjustment	721
24.7.2. Elimination of profit-increasing effects	722

Part IV
Final Remarks

Chapter 25: Final Remarks	727
25.1. Introduction	727
25.2. Overview of the examination process under the exceptions from the as-structured principle	727
25.3. Structural adjustments are truly exceptional	731
25.4. The commercial rationality exception and the RAO standard	732
25.4.1. The RAO standard is a significant improvement	733
25.4.2. The RAO standard is equally relevant in the area of valuation adjustments	736
25.5. The economic substance exception: A case for deletion?	737
25.6. General remarks on the recent OECD developments in the area of structural adjustments	738

Appendix

References	743
Index	859
Other Titles in the IBFD Doctoral Series	877

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

taxation² – 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. Sørđal (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”); Andál (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 transaction⁸ 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* insist¹² 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.

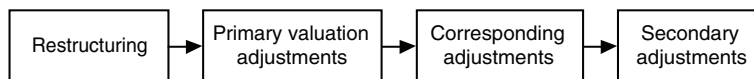
Second, the tax administration must determine whether the arm's length principle authorizes an adjustment of the price (or other valuation element of the controlled transaction). If the controlled transaction has been restructured, the purpose of the second step is to determine the arm's length price 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.

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 countries³² 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.

(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 literature³⁵ – 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 provision³⁷ 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 Franciscucci.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

40. See Franciscucci (2004a), at 71; David Franciscucci in Russo (2005), at 118; Franciscucci 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).

Notes

