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The Functional Fallacy – The ALP and the Limits of the Conduct-Based Approach

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This article provides a critical examination of the reliance on functional activity or conduct in the transfer pricing exercise. The changes made in the BEPS Project significantly boosted the focus on functional activity in assessing related-party transactions. This new approach is largely delivered in the "accurate delineation" process which is at the heart of the BEPS changes to the OECD Transfer Pricing Guidelines.

Under the new approach, the rights and obligations expressed in intercompany contracts are no more than the "starting point" in determining the transactional relationship between the parties, and those terms are subject to verification based on the actual conduct of the parties. The idea that legal/contractual arrangements can be modified – or constructed – based on the conduct of the parties is not new, and it is seen by many as a relatively uncontroversial idea. However, the conceptual, technical and practical challenges it poses have never been subject to any serious examination in the course of framing the relevant OECD guidance, contributing to an uncertain landscape in which the core principles being applied have become contested, and in which the standards to which taxpayers and tax authorities should expect to be held are difficult to discern. This article explores these themes, taking into account the historical development of the reliance on conduct, the current requirements and the experience of applying the conduct-based approach in practice.

Contents

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1. Overview

In recent years there has been a significant increase in the number of transfer pricing disputes in which the issues at stake concern the entitlement to returns from assets, and in particular intellectual property assets. Disputes concerning intellectual property have been a feature of the transfer pricing landscape for decades, but certain changes introduced into the OECD Transfer Pricing Guidelines[1] as part of the base erosion and profit shifting (BEPS) initiative, notably the risk control framework and the DEMPE guidance,[2] have led to the emergence of a particular set of issues, several of which the authors have explored in previous articles.[3] A common feature of the more recent transfer pricing disputes is a marked

1. OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Publishing, 2022) (OECD Transfer Pricing Guidelines). All references to the OECD Transfer Pricing Guidelines are, unless otherwise expressly stated, references to the 2022 version of those guidelines.
2. DEMPE functions are those functions pertaining to the development, enhancement, maintenance, protection and exploitation of intangibles – *see* OECD Transfer Pricing Guidelines 6.32.
3. The authors have explored the detailed operation of this guidance in previous articles – *see* Richard S. Collier and Ian F. Dykes, "The Virus in the ALP: Critique of the Transfer Pricing Guidance on Risk and Capital in the Light of the COVID-19 Pandemic", *Bulletin for International Taxation* 74, no. 12 (2020), https://doi.org/10.59403/5ec69y; and Richard S. Collier and Ian F. Dykes, "On the Apparent Widespread Misapplication of the OECD Transfer Pricing Guidelines: Risk and Post-BEPS Problems for the Arm's Length Principle", *Bulletin for International Taxation* 76, no. 1 (2022), https://doi.org/10.59403/3c7s063. Several other commentators have addressed problematic issues arising from the new guidance – *see*, for example, Caroline Silberztein and Manon Guillaume, "Does Intangible Ownership Move with the People That Perform the DEMPE Functions?" *International Transfer Pricing Journal,* 29, no. 7 (2022):

difference in the perspective of the disputants: the central assertion of the tax authorities in many of these cases is that it is the functional conduct of the parties, notably the "control of risk" and "DEMPE" functions, that creates an entitlement to returns from intellectual property, while the taxpayer will typically assert that the entitlement to the returns should take greater account of the relevant legal arrangements in place.

In this article, the authors focus on a set of issues which is highly relevant to these recent disputes (and the different perspectives referred to above), and which concerns the "accurate delineation" process which is at the heart of the changes introduced as part of the BEPS updates to the OECD Transfer Pricing Guidelines. Key to the process of the "accurate delineation" of the transaction entered into by the taxpayer is the idea that the rights and obligations expressed in intercompany contracts and legal registrations are no more than the "starting point"[4] in determining the transactional relationship between the parties, and that the terms and conditions of such formal arrangements are subject to verification based on the actual conduct of the parties. Where the verification process determines that conduct and contractual terms are not sufficiently aligned, it is provided in the OECD Transfer Pricing Guidelines that modifications to the contractual terms of the taxpayer transaction are required to bring them into alignment with conduct, thereby delivering the "accurate delineation" of the transaction for the purposes of the transfer pricing rules.

The main conclusions the authors draw in their analysis of these issues are as follows:

(1) Establishing the "accurately delineated" set of rights and obligations in a taxpayer transaction is an essential step in the transfer pricing process, but this requirement is in practice often ignored or short-circuited by tax authorities.

(2) The idea that legal/contractual arrangements can be modified based on the conduct of the parties is not new and, though seen by many as a relatively uncontroversial idea, the practical challenges it poses have never been subject to examination. In practice, it is far from obvious that it will always be easy, or even possible, to infer rights and obligations from the conduct of the parties.

(3) The OECD Transfer Pricing Guidelines rely on, yet do not clarify, the process by which actual conduct may be translated into or used to determine the existence of specific rights and obligations, and the examples provided in the Guidelines, (and in particular the examples of accurate delineation based on DEMPE functionality) raise several difficult issues.

(4) The contractual modifications which may form part of the accurate delineation process arise where the conduct of the parties is misaligned with the legal arrangements in place between them. The Guidelines appear to suggest that contractual features can also be modified if they differ from those that "would have been" entered into between third parties, based on the options realistically available to them. The relationship between these two strands of the OECD guidance is unclear.

1, https://doi.org/10.59403/28f6e65; and Romero J.S. Tavares and Isabel Verlinden, "Domestic Transfer Pricing Laws versus Global Standards: Harmonizing in Dissonance within the G20 and Beyond", *Bulletin for International Taxation* 78, no. 11 (2024), https://doi.org/10.59403/1x4rv4p; and Eyal Gonen, Leonid Karasik and Michael McDonald, "Control Over Risk and DEMPE Functions And the Remuneration of R&D Service Providers", *Tax Notes International* 102 (June 2021).

4. OECD Transfer Pricing Guidelines, para. 1.42.

(5) All these factors contribute to a very uncertain landscape in which the core principles being applied have become contested, and in which the standards to which taxpayers and tax authorities should expect to be held are difficult to discern. In the view of the authors, the issues go a long way to accounting for the rise in transfer pricing disputes referred to above.

2. Introduction

The theoretical approach of the ALP is based on the notion of "transactional comparability" – that is, broadly, an approach which, as a first step, involves identifying the "controlled transaction" entered into by associated enterprises and which then, as a second step, compares the identified transaction to the results that would have been achieved hypothetically by independent parties entering into a corresponding transaction.[5] Certain features of the controlled transaction are particularly important in deciding which transfer pricing method will be appropriate as part of the second step of the analysis. The OECD Transfer Pricing Guidelines place special emphasis both on the basis on which the parties assume the risk associated with the transaction and the extent to which the parties contribute and use assets (such as intangibles) in the transaction. In the case of transactions or arrangements entered into by unrelated parties, the allocation of risks and the provision and use of assets will almost invariably be reflected in the relevant legal documentation (and the same is commonly true in the case of related-party transactions). In the case of risk, the rights and responsibilities of the parties will usually be reflected in contracts between the parties. In the case of assets such as intangibles, the legal ownership will normally be reflected in registrations (where this is legally possible) or in other legal documentation. Where the respective rights and obligations have not been fully documented it will, in the event of a legal dispute, be the role of the courts to determine whether the parties in question intended to establish an actionable set of rights and obligations between them, and if so, the nature of those rights and obligations.

Determining the nature of the rights and obligations in a transaction or arrangement involving related parties is critical for the same reason that it is critical in a transaction or arrangement between independent parties: this is because it is impossible to tell what compensation one party owes to the other (or what returns are properly due to each of the parties) unless it is possible to specify the terms on which the parties transact – including which party (or parties) bears the financial consequences of risk associated with a transaction and which party is entitled to the profit (or is responsible for costs and other liabilities) associated with the relevant assets/rights/intangibles, etc. used in the transaction. In a transfer pricing context, establishing the core features of the transaction or arrangement under consideration is an essential part of the first step in the two-step approach outlined above. As the OECD Transfer Pricing Guidelines recognize, the second step (the process of selecting valid third-party comparables and identifying an appropriate transfer pricing method to price the transaction) cannot be completed without first having made these determinations.[6]

5. That approach is reflected in the definitive statement of the ALP in article 9 (transfer pricing) of the OECD Model Tax Convention on Income and on Capital (OECD Model).
6. OECD Transfer Pricing Guidelines, para 1.81: "it is the determination of how the parties actually manage and control risks which will determine the assumption of risks by the parties, and consequently dictate the selection of the most appropriate transfer pricing method".

In recent years, and particularly as a result of the changes made by the BEPS Project, there has been a marked shift in how the OECD Transfer Pricing Guidelines specify that "the controlled transaction entered into" should be established. In large part, this shift in the interpretation of the ALP is a response to concerns about avoidance activity.[7] The ALP is now to be applied with a materially increased emphasis on human functional activity or conduct, through which filter the relevant legal/contractual or booking arrangements as transacted by the taxpayer are to be examined.[8] Where those legal arrangements are found to be insufficiently consistent with the actual conduct of the parties, it is the conduct that will determine for each of the parties the nature of the relevant "controlled transaction entered into". Thus, following the changes to the transfer pricing guidance made by the BEPS Project, the nature and existence of controlled transactions are now in practice much more commonly to be constructed or inferred from the relevant human functional activity/conduct in a manner that appears to be materially different to the largely contractually determined approach set out in the early OECD guidance on applying the arm's length principle (ALP).

As indicated above, at the core of the new approach is the OECD's "risk framework" rules in the OECD Transfer Pricing Guidelines. Under these rules there is a requirement to test the contractual arrangements presented by the taxpayer and to "re-delineate" (that is, reconfigure) them if the party legally assuming risk under the relevant contractual arrangements does not "control" that risk.[9] Whether or not a party "controls" a risk is determined by testing the presence of human functional activity/conduct, chiefly the act of taking decisions relating to risk assumption and risk management. However, though the requirement to re-delineate a transaction is in practice commonly associated with these requirements of the control of risk rules, the reliance on conduct to determine the nature of the controlled transaction goes far beyond being restricted to the assumption of risks alone. Rather, the OECD Transfer Pricing Guidelines provide the broad rule that: "If the characteristics of the transaction that are economically relevant are inconsistent with the written contract between the associated enterprises, the actual transaction should generally be delineated for purposes of the transfer pricing analysis in accordance with the characteristics of the transaction reflected in the conduct of the parties."[10] And again: "Where no written terms exist, the actual transaction would need to be deduced from the evidence of actual conduct provided by identifying the economically relevant characteristics of the transaction."[11] Further, in the specific context of intangibles, the DEMPE guidance includes a six-step process which operates in a similar way to the risk framework, but in addition to reconfig-

7. The BEPS Project was driven by an anti-avoidance agenda and, as the discussion in sec. 3.3. will show, anti-avoidance concerns were also the reason for the increased reliance on a functionally based approach in connection with the application of article 7 of the OECD Model. *See* Mirna Screpante, *The OECD Transfer Pricing Guidelines and Value Creation: Income Allocation or Anti-Avoidance Tool?* (IBFD Doctoral Series 2024), https://doi.org/10.59403/2y89y8z.
8. *See* Raffaele Petruzzi, "The Arm's Length Principle: Between Legal Fiction and Economic Reality" in *Transfer Pricing in a Post-BEPS World* edited by Michael Lang, Alfred Storck, and Raffaele Petruzzi (Kluwer Law International 2016), p. 18 et seq.
9. *See* sec. D.1.2.1.5 of the OECD Transfer Pricing Guidelines. A re-delineation is also required where the party legally assuming the risk does not have the financial capacity to assume the risk, though in practice this is less commonly an issue.
10. OECD Transfer Pricing Guidelines, para. 1.45. The nature of the "characteristics" of the transaction is discussed in sec. 4.
11. OECD Transfer Pricing Guidelines, para. 1.49. As will be discussed in sec. 4., other than in relation to risk and the DEMPE rules, there is little guidance on what the process of "deducing" requires or involves.

uring risk allocation, it determines the entitlement to intangible-related returns. It is also true that financing returns to a capital provider are similarly based on a functionally based enquiry into the level of risk assumed and that the terms of financial transactions more generally must take account of the conduct of the parties.[12] The result is that the nature (or as expressed in the OECD Transfer Pricing Guidelines, the "accurate delineation") of a transaction is tested (and, if the test is failed, determined chiefly)[13] by reference to the relevant human functional activity/conduct. The authors refer loosely to all these instances in the OECD Transfer Pricing Guidelines where reliance is placed on the conduct of the parties to determine the controlled transaction as the "conduct-based approach".

In accurately delineating a transaction, the OECD Transfer Pricing Guidelines take the written contractual terms and legal registrations, etc. as the starting point for the analysis. The analysis then shifts to a consideration of the conduct of the parties. Where the nature of the relevant conduct indicates that it is appropriate to infer a different commercial or financial relationship than the one specified in the relevant contracts/legal arrangements, the OECD Transfer Pricing Guidelines state that "the actual transaction should generally be delineated … in accordance with the characteristics of the transaction reflected in the conduct of the parties".[14] The OECD Transfer Pricing Guidelines are thus not abandoning the need to establish the respective rights and obligations of the parties in the event of a re-delineation based on conduct: rather, they indicate that the true terms of the transaction (as expressed in the Guidelines, the "characteristics of the transaction") are the ones revealed by the conduct of the parties, and that the "accurately delineated" rights and obligations in the true terms/characteristics of the transaction are the ones that should be used in moving on to step two of the transfer pricing analysis.

The significance of the conduct-based approach discussed above can be illustrated by a brief discussion of what is currently a common area of controversy. In practice, following the introduction of the "risk framework" and the DEMPE rules, it is now common for tax authorities to challenge a broad range of intra-group support services arrangements. For example, in cases concerning research and development support services activities, tax authority challenges are frequently made on the basis that, having regard to the (decision-making) conduct of those involved in their territory in providing such services, the arrangement is not consistent with the claimed contractual arrangement (which contemplates, say, a simple cost-plus service provision to the legal owner of the intangible property). Rather, the challenge commonly made is that "in reality" the observed conduct gives rise to an entitlement to some, or all, of the profits from any developed intangible property to which they have contributed, including an entitlement to profits on the disposal of the intangible property in question.

There are many ongoing cases with features of this nature. It is common for tax authorities to assert that they are not changing the terms of the arrangements but merely determining the appropriate price for the service. However, if the terms of the relevant services contract did not confer on the service provider an entitlement to some or all of the proceeds on the sale of the asset, or to the upside and downside outcomes that would otherwise belong to

12. OECD Transfer Pricing Guidelines, paras. 1.103, 6.61-6.64, 10.22, 10.25.
13. The accurate delineation is also determined by economically relevant characteristics other than functional conduct. This aspect is explored in detail in sec. 4.
14. OECD Transfer Pricing Guidelines, para. 1.45. These issues are discussed in some detail in sec. 4.

the legal owner, then the rights and obligations contained in the contract are essentially being ignored. In that event, it would seem to defeat the object of the risk control framework if these highly price-sensitive features could simply be assumed away (i.e. ignored) as part of the pricing exercise, without having first specified what they are and how they are reflective of the observed behaviour. In other words, it seems very hard to understand how a conduct-based re-delineation of a transaction can be meaningfully used as a basis for the second step in the transfer pricing process (the comparability and pricing exercise) unless the re-delineation process leads to a clear picture of the terms and conditions ("characteristics") of the revised transaction in the light of the relevant conduct. (As a practical matter, this would not require the production of a highly detailed revised contract, but it would mean that the critical economically relevant features or terms/characteristics of the revised transaction would need to be stipulated.)[15]

In circumstances where adjustments to the actual legal rights and obligations of a transaction are licensed by the OECD Transfer Pricing Guidelines, it seems to be assumed in the guidance that any such re-delineation based on the conduct or functions[16] of the parties will be a straightforward exercise that can readily be applied. In relation to the service provider example discussed above for example, the requirements of the Guidelines should lead to the tax authorities specifying what they believe the entitlement-defining features of the "actual" amended contract between the parties to be, which in turn would require them to state how they have translated the observed conduct or behaviour into a set of rights and obligations. Thus, in the example above, it would presumably be necessary to infer that there is a licence in place between the parties, or a co-development agreement, or that there is some other agreement with a contingent return to the "service provider" linked to the financial performance of the IP. Any such arrangements would obviously contain different terms and conditions to the contract entered into by the taxpayer.

In the experience of the authors, however, the basic requirement of the OECD Transfer Pricing Guidelines to base the transfer pricing exercise on the terms and conditions or "characteristics" of the actual transaction (either as executed by the taxpayer, or, as revealed by the conduct of the parties) is largely being ignored in practice. Rather, in practice, tax authorities in these "re-delineation" situations are, broadly, adopting one or more of the following alternative approaches instead: first, a tax authority might seek to characterize an entity with a particular generic classification, such as "an at-risk distributor" with a profit expectation corresponding to that characterization, thereby dispensing with any process of specifying what the features of the "new" or revised contractual relationship are, and how they link to behaviour. Second, a tax authority might simply assert that that the observed conduct requires the application of a profit split method (rather than a cost-plus return), and that this revised transfer pricing method selection does not involve altering the capacity in which the parties have contracted and their contractual rights and responsibilities. Third, a tax authority might adopt one of the various "outcomes" suggested by the detailed examples in the OECD Transfer Pricing Guidelines (for example, that the return to a no-substance IP owner might be limited to a risk-free return, or that an entity

15. The critical economically relevant features or terms/characteristics of the revised transaction could perhaps be identified in the form of a summarized "heads of terms" governing the re-delineated transaction.
16. For the purposes of the guidance on transfer pricing, the term "functions" means "activities" that are performed – *see* OECD Transfer Pricing Guidelines, para. 1.51 and the OECD 2010 Report, The Attribution of Profits to Permanent Establishments, Part I, para. 57.

undertaking DEMPE functions might participate in sales proceeds from the ultimate sale of the asset), again dispensing with the need to work through the process of establishing the revised rights and obligations that would give rise to that outcome. Fourth, there may be an assertion that the parties "would" or "would not" have agreed to a particular set of contractual terms based on the options realistically available to them, with a test based on the hypothetical behaviour of similarly situated parties rather than on the actual conduct of the tested parties in question.[17]

The common feature of all these different tax authority approaches is the absence of any attempt to construct or recognize the "actual" contractual rights and obligations or characteristics of the "re-delineated" transaction, notwithstanding that (as explained below)[18] this is what is seemingly required by the OECD Transfer Pricing Guidelines and notwithstanding the apparent assumption in the Guidelines that this process of inferring terms and conditions based on the conduct of the parties is straightforward. To a greater or lesser extent, these approaches instead coalesce what are intended to be separate processes, namely the process of accurately delineating the transaction on the one hand and the process of pricing the transaction on the other hand. It is the contention of the authors that tax authorities are in practice adopting these approaches because of the (largely unaddressed) challenges in inferring important contractual features from decision-making conduct or behaviour. For example, where a transaction does fall to be "re-delineated" on the grounds that the legal allocation of risk is not sufficiently aligned with the functional control of risk, it seems difficult to assign any plausibility to the assumptions in the OECD guidance that conduct or behaviour (in this case, the exercise of the control of risk functions) can readily be used as the basis for deducing entitlement to intangible-related profits,[19] legal relations or the terms and conditions of contracts. The legal ownership of rights and assets, and the capacity in which parties act, and indeed the detailed terms of contracts (such as contract duration, repayment schedules, notice periods and so on) are all important (and price-determining) matters on which the conduct or behaviour of the parties seems to offer little if any information.

It is notable that in cases beyond the transfer pricing domain, courts have recognized the difficulty involved in inferring such contractual features based on conduct. In one well-known estoppel case, the clothing manufacturer William Baird sought to have the court recognize an obligation on the part of the retailer Marks and Spencer, with whom they had had a long-term relationship, to compensate them for deselecting them as a supplier. In that case there was no contract between the parties. Baird lost the case because (amongst other

17. Some of these practical approaches have been the subject of trenchant criticism – *see* for example Andrew Hickman, "Arm's length principle mutations: control of risk in the OECD guidelines and variations in practice", *MNE Tax*, 13 January 2021.
18. *See* the discussion in sec. 4.
19. *See* for example OECD Transfer Pricing Guidelines, para. 6.34 et seq. (and in particular at para. 6.42), where DEMPE activities appear to attract an *entitlement* to intangible related profit. If it was the intention of the OECD Guidelines to imply that owners of intangible property may have to pay for the services of R&D providers for their contribution, that this will inevitably reduce the profit that they earn from their intangible property ownership, and that this could represent a substantial outlay, it would not have been difficult to make this point unambiguously. Instead, the OECD Guidelines envisage that parties who have contributed to the development of intangible property might participate in the disposal proceeds on the sale of that intangible property - *see* footnote 3 to para. 6.32. This kind of right would not be common in a typical services agreement, and the inference of such a right could not be said to be simply a pricing matter. These issues are discussed in more detail in sec. 4.

reasons) "the obligations arising from the implied contract would have to be sufficiently certain to be enforceable"[20] and in the judgement of the court, the kind of features which would have to be inferred by the court in order to create an enforceable agreement (product specifications, product prices, volumes, etc.) could not be ascertained based simply on analysing the behaviour of the parties.[21]

The challenges in and limitations to the use of conduct to infer terms and rights in private law are instructive.[22] The fact that remedies of this nature exist may explain why some commentators assume that the modification of contracts by reference to conduct is unexceptional.[23] It is clearly true that in some instances rights and obligations will be inferred based on factors beyond the legal arrangements in question (for example in cases where there is a "course of dealing" which is judged to create additional legal rights or obligations). It is, however, also the case that whilst the principles applied in the conduct-based approach of the OECD Transfer Pricing Guidelines share superficial similarities to such doctrines applied in private law, the two are clearly distinct. It also seems evident that the licence to infer rights and obligations in the Guidelines goes well beyond what is permitted in private law. Had the OECD Transfer Pricing Guidelines simply sought to specify that legal/contractual relationships are governed by private law, that they should not be taken at face value, and that in some cases the behaviour of the parties may invalidate, or modify the contractual arrangements, that would have been relatively uncontroversial.

Given the apparent difficulties inherent in "re-delineation" cases in specifying what the alternative terms and conditions of the accurately delineated transaction would be, the most common consequence in practice has been the widespread use by default on the part of the tax authorities of a profit split approach (typically based on a profit allocation factor based on "people" contributions). The result is therefore one in which the contractual relationship between the parties is, essentially, treated as irrelevant and is arguably more akin to a formulary-based approach using a people functions metric as the critical profit allocation fac-

20. *Baird Textile Holdings Ltd v. Marks & Spencer plc* [2001] EWCA Civ 27, para. 24.
21. Ibid., at para. 67. Similarly, while it is under common law clearly possible for the conduct of the parties to result in the creation of an implied trust, whereby a beneficial ownership interest is created separate from the legal ownership of an intangible, the circumstances in which this may be deemed to occur are governed by a body of case law, and the courts will generally be slow to impute an ownership interest other than the one legally specified (*see*, for example, *Stack v. Dowden* [2007] 2 AC).
22. This article does not include a comprehensive review of matters such as waiver by conduct, variation by conduct, estoppel, course of dealing, implied terms and good faith and fair dealing. These important legal concepts will always be of potential relevance in establishing the transaction to be priced. In sec. 5., the authors do include a brief summary of circumstances in which contract law may permit terms and conditions to be inferred.
23. *See*, for example, Michael McDonald, "Let's Not Overthink This: Recharacterization Under the OECD Guidelines", *Tax Notes International* 117, 3 March 2025, at 1429-1435: "For example, if a taxpayer does not in fact consistently follow its contractual terms, then a revenue authority could impute those terms. This particular 'violation' would seemingly not require disregarding the transaction, but instead would require modifying it to better reflect the facts. Thus, it would seem an innocuous and even obvious adjustment". Andreas Bullen, *Arm's Length Transaction Structures*, Volume 20, Doctoral Series IBFD – Academic Council (2011), section 8.4.3.1.: "the reallocation is based on the 'transaction actually undertaken' as evidenced by the associated enterprises' actual conduct and is best explained as a rather uncontroversial outcome of a functional analysis" (contrast this, however, with section 8.4.2.4. of the same thesis, where Bullen notes that "it will sometimes be difficult to determine which contractual arrangements to impute from the associated enterprises' actual conduct" before going on to list examples of the sort of rights and obligations which will potentially be difficult to infer from conduct.

tor. In such cases it may be hard to conclude that the outcome is consistent with the ALP.[24] Nevertheless, this does seem to be the approach adopted by the courts in some recent cases, as the authors explore in section 5.

The principal theme of this article concerns the issues introduced above – namely, the reliance of the OECD Transfer Pricing Guidelines on conduct to infer the terms that should apply in situations (i) where no contract exists; (ii) where there are gaps in an existing contract; or (iii) where conduct is inconsistent with an existing contract. The analysis in this article seeks to explore these issues by addressing several questions concerning the construction of "transactions" based on the conduct of the parties, as reflected in the OECD's "accurate delineation" approach.

Following this introduction, the analysis seeks to understand (in section 3.) how the thinking on the role of conduct in determining "transactions" has been developed over time by the OECD. The discussion then shifts to examining the requirements of the current version of the OECD Transfer Pricing Guidelines in relation to the re-delineation exercise (section 4.). The discussion in that section addresses the explicit objective of the accurate delineation exercise as explained in the OECD Transfer Pricing Guidelines as well as the relationship between the conduct-based approach in the accurate delineation process and other fundamental requirements of the Guidelines. Consideration is also given to the practical operation of the accurate delineation process and how that process interacts with the guidance on the "non-recognition" of a transaction. The analysis proceeds (in section 5.) to consider the practical experience of applying the conduct-based approach, and the outcomes of some recent court cases in this area. Conclusions are drawn in section 6.

3. Historical Development of the Thinking on Contracts and Conduct

3.1. Introduction

As noted above, the ALP-based income allocation rules under the OECD Model have over the last 50 years or so increasingly come to rely on the location of human functional activity as the anchor point (or points) for income/profits.[25] This reliance on the location of functional activity (or, more correctly, this reliance on the location of certain designated types of functional activity) has over time increasingly displaced the approach of relying on – or deferring to – the contractual/legal arrangements. As will be discussed below, this shift in approach has largely been a response to concerns about avoidance.

This section seeks to understand how this approach to the application of the ALP developed over time as reflected in successive OECD reports, and to what extent that increasing reliance on human functional activity identified possible difficulties or challenges in the approach.[26]

24. The point that the OECD's delineation/re-delineation approach leads to results that are akin to formulary approaches is in stark contradiction to the early discussion in Chapter I of the OECD Transfer Pricing Guidelines (*see* at para. 1.14-1.32) which contains a spirited rejection of formulary apportionment approaches.
25. The current position which involves a high level of reliance on the use of functional activity is seen most clearly in the development of the "authorised OECD approach" (AOA) in respect of article 7 of the OECD Model and in the development of the BEPS notion of value creation in respect of article 9 of the OECD Model. The emphasis in this article is on the article 9 position.
26. For reasons of available space, the discussion of historical OECD papers is inevitably selective. Some material that forms part of the current version of the OECD Transfer Pricing Guidelines may be relevant

3.2. *The 1979 OECD report, Transfer Pricing and Multinational Enterprises*

The first OECD report on transfer pricing, the 1979 OECD report Transfer Pricing and Multinational Enterprises,[27] reflects a strong emphasis on the principle of basing the transfer pricing analysis on the "actual transactions" (as reflected in the relevant legal arrangements), and on the (legal) ownership of assets. The report warns specifically against substituting "hypothetical transactions" for those actual transactions. There is also a significant emphasis on the ability to gather evidence concerning the facts in any case from the relevant legal documents.[28] Nonetheless, the report notes that there may be some situations "where the form of the transaction has effectively to be ignored", in which case it may be necessary to address the "reality" of a transaction. (The reference to "form" is clearly intended to refer to the relevant legal arrangements including contracts.)[29]

However, the OECD report includes some mixed messages about the extent of those situations where the legal form of the transaction should be ignored, and the "reality" of the transaction needs to be considered. As it explains at the outset, the 1979 OECD report is intended to respond to the fundamental point that the prices charged on transactions within the same group do not necessarily represent a result of the free play of market forces and so "may diverge considerably from the prices which would have been agreed upon … in the open market".[30] In a discussion about intra-group contracts and arrangements, the report also makes a more general point about such MNE arrangements, namely that associated enterprises can by their nature make a greater variety of contracts and arrangements than third parties and also that "associated enterprises may, and frequently do conclude arrangements of a specific nature that are not or are very rarely encountered between unrelated parties". It is also said that contracts within an MNE "could be quite easily altered, suspended, extended or terminated" and that such alterations may even be made retroactively.[31] The report notes that the consequence is "in such circumstances tax authorities would have to determine what is the underlying reality behind an arrangement in considering what the appropriate arm's length price would be".[32]

These points seem to suggest a more pervasive need to recast contracts between associated enterprises based on whatever is the underlying "reality" of the transaction. Nonetheless,

to the historical development of thinking but is considered in sec. 3. as part of the analysis of the current requirements in the OECD Transfer Pricing Guidelines in relation to the conduct-based approach.

27. OECD, *Transfer Pricing and Multinational Enterprises,* Report of the OECD Committee on Fiscal Affairs, OECD, 1979 [hereinafter 1979 OECD Report]. The report has no legal force as such, but its significance stems from being referred to in the 1992 revisions to the OECD Model as representing internationally agreed principles and providing valid guidelines for the interpretation of article 9. Also, all OECD state ministries of finance adopted the 1979 report without reservation.
28. 1979 OECD Report at paras. 15, 17, 23, 25, 89 and 113.
29. The example given to illustrate this point is the situation where an interest payment is to be regarded as "in reality a dividend or other distribution of profit" – 1979 OECD Report at paras. 15 and 23. Para. 23 is an early version of what was later to become the guidance in the OECD Transfer Pricing Guidelines on the "recognition" of transactions, which guidance has always been framed to apply on an exceptional basis.
30. 1979 OECD Report, para. 2. Another example discusses a production and sale of a turnkey factory where "in fact" the purported seller provides only minimal co-ordination services, with the risks and responsibilities being carried on elsewhere. In such a case, it is suggested the more appropriate pricing treatment of the seller may be by reference to a payment for services. *See* para. 35.
31. 1979 OECD Report, para. 24.
32. 1979 OECD Report, paras. 24 and 32. A similar comment is made in para. 170, namely that it may be necessary "to determine what is the underlying reality" behind an intra-group services arrangement. It is not clear how these comments fit in with the comment that is a made in para. 23 of the report that transactions should be recast only in "exceptional cases".

the report states that only in "exceptional cases" should actual transactions be disregarded or replaced by substitute transactions.[33] The emphasis given to the potential manipulation of contracts by associated enterprises therefore seems at odds with the nature of the suggested response as being confined to "exceptional cases". This apparent conflict in the guidance becomes more accentuated in the later 1995 OECD Transfer Pricing Guidelines, as will be discussed in section 3.4.

The reason for stating that transactions should be recast on an "exceptional" basis is the recognized difficulty of what would be involved practically in overriding the form of the transaction – i.e., that it would require a substitution of the judgement of the tax authorities for the judgement of the business concerned.[34] However, there is no further elaboration of the nature and scale of the difficulties that would be involved and no comments on what might be involved in determining such an "alternative" transactional reality.

At the same time, there is a clear recognition in the report that legal rights *in themselves* are a source of value and determine prices. For example, it is recognized that while it is always useful to analyse the functions performed by the entities concerned, identifying functions alone may not be sufficient for the transfer pricing analysis – as in cases where the *legal capacity* of functions may determine their value or price. The report illustrates this point with an example that concerns selling activities either as a principal (which accepts all the risks, and which is entitled to all the profits of the activity) or alternatively as a seller acting in the capacity of an agent (which has limited risks and a limited return). The clear implication of the discussion is that the functions may be the same or similar but that the *legal capacity* in which those functions are performed may have a material impact on the relevant value or price in any case. It is therefore also implied that an examination of conduct alone cannot shed light on "capacity" issues because they are determined by an analysis of legal, not conduct, factors.[35] Thus, from the first OECD transfer pricing report there is a recognition of the limitations of any analysis of conduct alone. The report also recognizes that the *nature* of the legal right created under the law concerned (for example, the legal protection in relation to the rights to use a patent) can affect its value/price.[36] Again, the implication is that the nature of the legal right can only be assessed through a legal, not conduct-based, analysis.

In relation to these points, there is no recognition in the 1979 OECD report that there is any kind of tension or difficulty here – that is, there is no recognition of the tension between the acknowledged need to rely on the legal analysis and the suggestion that it may (exceptionally) be jettisoned. The report does not therefore deal with the consequential point that if legal rights can be critical to value and pricing under the ALP, how should one proceed in determining "the underlying reality" when those rights are to be ignored or in some way

33. 1979 OECD Report, para. 23. These comments appear in a separate section of the report but immediately following the comments about intra-group contracts and arrangements discussed above. The reference to the application of the rule only in "exceptional cases" is of course not itself a rule, but it seems to be a recommendation or observation on what is considered by the drafters of the report to be an appropriate approach in cases where the transaction entered into is disregarded or replaced by substitute transactions.

34. This is a concern that is reflected in the discussion – for example, *see* paras. 15 and 23 of the 1979 report. A similar concern is referred to the Commentary to Article 7 in the 1977 OECD Model (which at para. 11 warns that "there is no justification for tax administrations to construct hypothetical profit figures in vacuo").

35. 1979 OECD Report, para. 17.

36. 1979 OECD Report, para. 127.

recast? Rather, nothing further is said on what the construction of any alternative reality might involve, or how the task should be delivered.

The explanation is that the thinking in the report is probably rather more limited than might be assumed from a contemporary perspective. The references in the report to the "reality" of a transaction or arrangement are rather vague and seem to be used in different ways. For example, the test by which interest is "in reality" determined to be a dividend or other distribution of profits is clearly not the same sort of test that determines whether a contracted service has "in reality" been provided. (The former is a "reality" test based on an economic appraisal of substance (and a test in which conduct does not feature) whereas the latter seeks to test the "reality" of a legal agreement by examining whether the contracted service or conduct has in fact been delivered.)

No consideration is given in the 1979 OECD report to the task of constructing any "alternative" reality and its consequences. Rather, the implicit thinking in the report seems to be that any misalignment between conduct/functional activity and legal form would be simple pricing mischiefs that can be corrected by changing the contractual price where required under the transfer pricing rule[37] – as where, for example, the contract price charged is to be reduced because the contracted service has in reality not been provided or not been fully provided.[38] In that sense, the test that is being applied is a corroboration check to ensure that conduct/activity that is the subject of a contract is actually taking place. In other words, the conduct test seems more about testing a contract by ensuring there is no absence of the contracted service or "substance", rather than about *constructing* a contract based on human functional activity or conduct. The comments about resorting to the "reality" of the transaction seem therefore essentially reflective of the report's apparent wish to resist being slavishly bound in all cases to accept the relevant contractual or legal position in the face of the facts of what has actually happened.[39]

The thinking is a long way removed from current thinking on the importance of people and decision-making.[40] The discussion in the 1979 report therefore introduces the suggestion of a possible "alternative reality" to that of the actual transaction as reflected in the contractual arrangements, but this is vague and undeveloped and offers almost nothing to explain when recourse to an alternative reality might be required; what any alternative reality might involve; or the process by which that alternative reality might be determined. There is, in consequence, no recognition of any tensions and difficulties arising from what is being suggested. The report therefore represents a very limited step in the development of a functional or activity-based approach to determine the basis on which income or profits arising from controlled transactions or arrangements might properly be allocated.

37. *See*, for example, 1979 OECD Report, para. 23: "The aim in short is, for tax purposes, to adjust the price for the actual transaction to an arm's length price". *See also* paras. 41, 44 and 75 of the same report.
38. 1979 OECD Report, para. 18. *See also* para. 173, which suggest the chief focus is on the evidence available to support the provision of a service or the allocation of a cost.
39. This arguably explains why the comments are rather vague and seem to have different meanings and implications in different circumstances, as in what must presumably be an "economic" reality in cases of thin capitalisation and a factual reality where contracted services are not in fact delivered.
40. This seems to be confirmed by the suggestion in the 1979 report that the decision-making of the MNE's top executives in the parent company might be acting for the benefit of the shareholders – *see* 1979 OECD Report, para. 157.

3.3. *The 1984 OECD report, The Taxation of Multinational Banking Enterprises*[41]

Though the focus in the period leading up to the publication of this 1984 OECD report was overwhelmingly concerned with the development of thinking on the transfer pricing system and article 9, it was in relation to the attribution of profit to permanent establishments (PEs) for the purposes of article 7 of the OECD Model that the initial step was taken proactively to use activity tests as an anchoring point for income and profits.

A practical issue that arose in the latter part of the 1970s was concerned with what was then described as the "loan parking" issue, a practice under which banks, which typically operate under a branch structure, might carry out significant preliminary work (including negotiating the terms of the loan with a borrower) in bringing a loan asset into existence in one branch of the bank (such as in a branch in one of the major financial centres of the world) before then making the advance of funds under the loan from a different branch of the same bank (for example, located in a low-tax state) thereby "parking" or "booking" that loan asset (and the income that would subsequently arise from the loan) in that low-tax state.[42] Tax authority concerns about these issues were arguably loosely analogous to the "alternative reality" issue discussed in the 1979 OECD report. This is because, whilst there is no "legal form" concern as there is with transfer pricing (because legal arrangements and contracts are obviously irrelevant to intra-entity arrangements such as those involving two PEs of the same legal entity) there was a wide reliance in practice on following the booking (accounting) arrangements for the purposes of article 7. In a loose sense at least, following the booking arrangements in an article 7 context might be seen as analogous to following the contractual arrangements in an article 9 context.[43]

To address this situation, the OECD included in its 1984 report a short section dealing with the attribution of income in the case of banks operating through branches.[44] In the context of the attribution of income, this guidance identifies as a "decisive" factor the test of whether the income produced by the relevant assets can be regarded as having been "substantially generated" by the activities of the PE. It is then explained that "this will depend on the extent to which the negotiation and conclusion of the transaction has been the work of that permanent establishment". The guidance then proceeds to identify six specific functional activities that are normally involved in the negotiation and conclusion of a loan transaction.[45] The guidance then concludes that the carrying on of these activities by a

41. OECD, *Transfer Pricing and Multinational Enterprises, Three Taxation Issues*, OECD, 1984 [hereinafter 1984 OECD Report]. The report was written to supplement the OECD's 1979 report (which has been discussed in sec. 3.2.) and in part because the position of banks was not considered in the earlier report – see para. 1 of the 1984 OECD Report. The Three Taxation Issues volume contains three reports, being *Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure; The Taxation of Multinational Banking Enterprises;* and *The Allocation of Central Management and Service Costs.*
42. The issue was recognized as potentially highly significant given the bourgeoning of the global wholesale banking markets and the internationalization of the business and networks of banks, also raising wider questions about where profits properly belong in an international banking business – *see* 1984 OECD Report, paras. 14, 24-25, 29 and 32.
43. For example, the first proposition in the then current guidance in the OECD Model, Commentary on Article 7(2) is that the profits of the PE are normally expected to be those reflected in "good business accountancy" which would involve at least starting with the profits booked in the PE – *see* 1977 Model Double Taxation Convention on Income and on Capital, Commentary on Article 7, para. 10.
44. The guidance referred to is included at pages 68-69 of the 1984 OECD Report.
45. These functional activities are: (i) obtaining the offer of new business; (ii) establishing the potential borrower's credit rating, and the risk involved in providing credit; (iii) negotiating the terms of the loan with the borrower; (iv) deciding on whether to make or extend the relevant loan and, if so, on what terms and

particular branch would thus form a firm foundation for the attribution of the profits from the relevant transactions to that branch, notwithstanding that the assets themselves might have been transferred to another branch.[46]

It is notable that the guidance expressly grounds the attribution or anchoring of assets (and therefore the corresponding income) based on these functional activity tests, emphasizing that the critical activity is negotiating and concluding the contract – and meaning that the required focus is on the relevant substantive decision-making (rather than the formalizing of the agreement and the administration of the advance of the funds).[47] In this sense, the 1984 guidance presaged the approach that would subsequently be adopted in the OECD's 2010 PE report and in the control of risk rules developed in the BEPS Project (both of which are discussed below – *see* sections 3.5. and 4. respectively).

It would seem incorrect to interpret the guidance as intended by the OECD to be an extension or development of what is said in the 1979 report. This is because the guidance seems self-contained and designed to respond solely to the particular concerns about the loan parking issue.[48] Indeed, it seems to have been assumed at the time of this guidance that banks practically represented the *only* case in which PE structures were commonly used, meaning that it was never considered that thought was required on the wider suitability of the approach for non-bank PEs[49] (and nor was there any recognition of the relevance of the discussion to a transfer pricing context).

This also means that potential difficulties from any wider application of this nascent conduct-based approach were never considered, much less explored. For example, one of the difficulties from any broader application of the approach would be the suitability of the negotiation and conclusion of contracts test. This arguably makes good sense in the context of financial trading businesses which are concerned with abstract products which are essentially a bundle of legal rights and obligations which determine the cash flows under the contract, and which come into existence as the terms of the contract are negotiated and agreed. There is therefore a strong relationship between the act of negotiating and agreeing the contract and the existence of the financial asset thereby created and the nature of the cash flows thereby generated, such that income/profits can reasonably be seen as "substantially generated" by the negotiation and conclusion of contracts as the guidance expressly assumes. It also helps that in a banking business there is a relatively homogenous process for the negotiation and conclusion of a loan asset involving readily identifiable front-office staff with the result that the six critical functional activities involved in negotiating and

conditions; (v) concluding the contract and dispersing the proceeds of the loan; (vi) administering the loan, and holding and controlling the securities pledged. The guidance notes that the first four activities are of decisive economic importance.

46. It is notable that the topic of risk features in the discussion. Specifically, it is noted that the reliance on the identified functional activities is especially strong if the risk of default on the loan remained to be borne by the first branch, or was in any case, not assumed by the branch to which the business had been transferred. However, it is notable that there is no guidance on how the location of any such "risk of default "might be identified – presumably, because it was assumed it would be readily ascertainable.

47. This explains why it is stated that the functional activities (i) – (iv) above are of decisive economic importance whereas activities (v) and (vi) are of lesser importance.

48. The activity-based approach developed in the 1984 OECD Report can only ever be relevant for allocations within a single legal entity whereas what is said in the 1979 OECD Report is potentially much broader, with impacts on other legal entities in the group (depending on how the "alternative reality" approach is applied). This also means that the OECD's suggested 1984 approach operates simply as a sourcing rule.

49. 1984 OECD Report, para. 4.

concluding a loan could be identified and readily tested in other bank lending cases.[50] A further helpful factor is that the relevant asset in the bank lending instance is a distinct loan asset, with defined cash flows at defined times, and which can readily be benchmarked by reference to market data (there is a rich base of market pricing information on loans, etc.). In the case of other industries, where the business process can be much more complex, or involve different types of assets (including internally created assets) or be highly bespoke or extend over a very lengthy period, the approach identified in the 1984 guidance could potentially be much more difficult to apply or possibly be inappropriate.[51]

3.4. The 1995 OECD Transfer Pricing Guidelines[52]

The 1995 – and first – version of the OECD Transfer Pricing Guidelines is relevant to the discussion here for three reasons: first, the guidance addresses the nature of the relevant legal (contractual) arrangements and their relationship to the functions/conduct of the parties; second, there is some discussion about reconfiguring contracts to reflect "economic substance"; and third, there are comments on the relevance of conduct to the analysis of risks assumed.

3.4.1. Contractual arrangements and functions

The 1995 OECD Guidelines introduce five factors that are intended to be used to determine comparability for the purposes of the transfer pricing exercise.[53] One of these factors concerns "contractual terms". The discussion of contractual terms[54] notes that in arm's length dealings the contractual terms of a transaction generally define how the responsibilities, risks and benefits are to be divided between the parties, making the analysis of contractual terms important in the transfer pricing exercise. It is noted that the terms of a transaction may also be found in correspondence or communications between the parties outside of a written contract.

Significantly, the guidance notes that where no written terms exist, "the contractual relationships of the parties must be deduced from their conduct and the economic principles

50. As a matter of practice following the 1984 OECD Report, adjustments in bank branches would commonly involve "loans booked out" and "loans booked in" based on these activity tests – the process became relatively straightforward once the type of activity that must be considered was identified and agreed.
51. Note how the six activity functions in the case of a bank's loan business are needed to explain what should be taken as the activities that comprise the "negotiation and conclusion" of contracts. This suggests a double problem – first, whether the "negotiation and conclusion of contracts" test would be suitable if the test were applied more widely and second, whether it would be possible to articulate in other business sectors more developed explanations of what that negotiation and conclusion activity comprises in a manner analogous to the six activity factors.
52. 1984 OECD Report and OECD *Thin Capitalization*, OECD, 1987. References to the 1995 OECD Transfer Pricing Guidelines are normally, as here, intended to include the OECD guidance that was released (pursuant to a phased work plan to deliver the first version of the Guidelines) over the period July 1995 to October 1999. The 1995 OECD Transfer Pricing Guidelines constitute a significant overhaul of the transfer pricing guidance first given in the previous OECD transfer pricing reports of 1979, 1984 and 1987.
53. The intention is that these five comparability factors (characteristics of property or services, functional analysis, contractual terms, economic circumstances and business strategies) are to be used in two ways – first, to assist in understanding the important "conditions" of a transaction between associated enterprises and, second, to facilitate the comparison of that transaction with a corresponding (comparable) transaction between third parties. *See* 1995 OECD Transfer Pricing Guidelines, paras. 1.15 – 1.18.
54. 1995 OECD Transfer Pricing Guidelines, paras. 1.28 -1.29.

that generally govern relationships between independent enterprises".[55] This is a development of what seems to be suggested in the 1979 OECD report, i.e. that a test of conduct can be used to check or corroborate the validity of contractual terms (as in the case referred to earlier where a check can be made to ensure contracted services are in fact provided). The suggestion here seems to be that conduct can be used to *construct* a contract (and not simply corroborate an existing contract).[56] However, the proposition is not explained further, so does not deal with *how* contractual relationships are to be deduced from conduct or what is meant by the reference to the "economic principles that generally govern relationships between independent enterprises".

Given that the Guidelines seem to assume what is being suggested here is not at all problematic, the guidance may (following what seems to be the case in the 1979 report) simply be contemplating here relatively simple cases such as where, say, a routine service – such as for example a bookkeeping service – is provided from one associated enterprise to another but with no contract (and no charge). In such a situation, a contract for the provision of that service (and an arm's length charge for its provision based on available third-party data) could be inferred based on the direction discussed above that where no written terms exist, the contractual relationships must be deduced from the relevant conduct. What makes such cases simple is that legal capacity issues – and legal ownership issues – are not relevant to the analysis as an appropriate transfer price can readily be determined based simply on the nature of the activities carried on.

However, deducing the contractual relationships from the conduct of the parties would clearly be more problematic in those cases where the nature and value of the relevant conduct goes beyond simple functional activity and turns on the *legal capacity* in which the functions are delivered, a point that is expressly acknowledged in the discussion in the 1979 OECD report considered earlier.[57] Similarly, it would (presumably) be very difficult to infer the ownership (or absence of ownership) of legal rights and obligations (let alone detailed terms of the contract) from the mere conduct of the parties. The guidance does not recognize or comment on any such difficulties, though it is notable that the guidance echoes the points made in the 1979 OECD report about the importance of understanding the relevant legal capacity in which functions are performed.[58] These unresolved difficulties and apparent contradictions do little to suggest that the use of conduct and its relationship with contractual terms in the transfer pricing exercise has been fully thought through.

What is contemplated throughout this discussion of conduct in the context of the analysis of contractual terms is the need to identify the "true" *legal relationship* between the parties – hence the references to determining the real contractual relationship and the "true terms" of the transaction. What this makes clear is that if the contract or legal agreement between associated entities is in some way to be recast, what needs to be posited is an alternative legal agreement or arrangement with its own set of legal terms. The discussion of contracts and

55. 1995 OECD Transfer Pricing Guidelines, para. 1.28. As in the 1979 OECD Report, it is not at all clear how this suggested deducing of the terms of the contract fits in with the separate guidance on the "recognition of the actual transactions undertaken" (which appears in the 1995 Guidelines at 1.36 -1.41).
56. The 1995 OECD Transfer Pricing Guidelines also contain comments that seem to echo what is said in the 1979 OECD Report about using a conduct check to corroborate the validity of related-party contracts – *see* para. 1.29.
57. *See* the discussion in sec. 3.2.
58. 1995 OECD Transfer Pricing Guidelines, para. 1.20.

conduct in the 1995 OECD Guidelines therefore clearly suggests that a consideration of conduct may be needed in order to identify the "true terms" or reality of the transaction agreed by the parties.[59] However, what this process involves, and how the attendant difficulties are to be addressed (such as how findings of legal ownership or legal capacity and detailed contractual terms are to be derived from conduct alone), are matters on which nothing is said, and which do not seem to be recognized as matters raising difficulties.

3.4.2. Reconfiguring contracts to reflect "economic substance" – Recognition of the actual transactions undertaken

The guidance discussed in section 3.4.1. is followed a couple of pages later in the 1995 OECD Guidelines with some commentary on the "recognition of the actual transactions undertaken".[60] This "recognition" guidance largely repeats points made in the earlier 1979 OECD report including the need to adopt an "exceptional" approach to ignoring or adjusting the (legal) form of taxpayer transactions. This point is made more forcibly through the (now heightened) warnings that such restructuring "would be a wholly arbitrary exercise the inequity of which would be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured".[61]

The "exceptional" approach to reconfiguring a transaction that was first proposed (in rather vague and undefined terms) in the 1979 OECD report becomes in the 1995 OECD Transfer Pricing Guidelines limited to two circumstances in which it is now acknowledged as being "both appropriate and legitimate" for a tax authority to consider disregarding the (legal) structure adopted by the taxpayer.[62]

The first circumstance is where there is a difference between the legal form and what is now referred to as the "economic substance of a transaction". The notion of "economic substance" is not explained, though it is illustrated by an example where interest-bearing debt

59. *See* the discussion of contractual terms in 1995 OECD Transfer Pricing Guidelines, paras. 1.28-1.29. The implication of the discussion (which arises from a comparison of the general position of independent enterprises with the general position of associated enterprises) seems to be that this consideration of conduct is generally relevant in the case of contracts or arrangements involving associated enterprises.
60. 1995 OECD Transfer Pricing Guidelines, para. 1.36.
61. 1995 OECD Transfer Pricing Guidelines, para. 1.36. As in the 1979 OECD Report, the insistence on the need for an "exceptional" approach does not seem consistent with what is said about the need to check the conduct of the parties because of the ease of altering contracts between associated enterprises (see the discussion above). The apparent inconsistency seems even more glaring in the 1995 OECD Transfer Pricing Guidelines given the heightened warnings in support of the "exceptional" recognition approach and the apparently broad relevance of the comments about the importance of conduct in the discussion of contractual terms. However, it is possible that the explanation may be due to an assumption that the checking of contracts by reference to the conduct of the parties would overwhelmingly lead only to price adjustments, with no required adjustment of or disturbance to the nature (i.e., legal form) of the transaction entered into – such as in the case previously mentioned where contracted services under a services agreement between associated enterprises are not provided in full and so there is a reduction in the price under the contract to arrive at an arm's length amount (but no alteration to the form of the services agreement itself). The discussion in 1995 OECD Transfer Pricing Guidelines, para. 1.34 seems to support this interpretation. Presumably, cases where goods or services were provided from one associate to another but without any contract (and therefore without any consideration) would already be catered for by the guidance on contractual terms discussed above – i.e. meaning that the absence of a contract in these cases would lead to a contract being imputed based on the conduct of the parties.
62. 1995 OECD Transfer Pricing Guidelines, paras. 1.36-1.41. The guidance here is a development of the guidance in the 1979 OECD Report at para. 23. This guidance is controversial and has been the subject of arguments that it is not validly part of the ALP guidance – Bullen, *Arm's Length Transaction Structures*.

is, having regard to the circumstances of the borrowing company, treated by the tax authorities as a subscription of capital.[63] However, it is not clear how wide is the intended interpretation of the term "economic substance" – and whether, for example, it would encompass situations where contracted services are not provided, or are provided in a way or at a level that is different to the contract stipulation.[64] The second circumstance is of much less relevance to the analysis here of the relationship between legal form and conduct, although the authors touch on it in dealing with the analysis of the current guidance in section 4.[65]

There is virtually no guidance on how taxpayer transactions could or should be reconfigured in the (exceptional) cases where this is deemed necessary, though there is no suggestion or recognition this will be difficult. Indeed, the examples given in the comments on the "recognition" of transactions seem to suggest a ready confidence in the ability to do this.[66]

3.4.3. Risks assumed

Whereas the 1979 OECD report has relatively little to say about risks assumed,[67] the 1995 OECD Transfer Pricing Guidelines include a rather more detailed discussion of the topic, which initially points out the relevance of risk assumed to profit potential (i.e. the greater the risks assumed, the greater the expected return) and the variety of risks that may need to be considered in the transfer pricing analysis.[68] This discussion of risks assumed is relevant here because it contains some specific comments about the role of conduct in determining the location of "risks assumed". More generally (though this is not a point made in the guidance), the analysis of "risks assumed" is important because if it were possible to apply a conduct test to identify the appropriate location of risks assumed, this would largely obviate the need otherwise arising to address in the transfer pricing analysis matters of legal capacity.

63. 1995 OECD Transfer Pricing Guidelines, para. 1.37.
64. Based on comments made in a webinar by Diane Hay, formerly of HMRC, who participated in the early work of the OECD on transfer pricing, the intentions behind the first circumstance referred to in the OECD guidance seem to have been rather limited and specific: the first circumstance was proposed by the UK delegation to address specifically the thin capitalization issue. (It was also stated that the second circumstance was originated by the US delegation): University of Amsterdam, Centre for Transfer Pricing and Income Allocation, webinar "Has the new risk framework approach killed off the transactional comparability approach?" 21 May 2025.
65. The second circumstance concerns the situation where, while the form and substance of the transaction are the same, "the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises, behaving in a commercially rational manner, and the actual structure practically impedes the tax administration from determining an appropriate transfer price." – 1995 OECD Transfer Pricing Guidelines, para. 1.37.
66. *See* 1995 OECD Transfer Pricing Guidelines, paras. 1.36 and 1.37. Also, para. 1.38 includes the confident assertion that "Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have obtained, had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm's length". At para. 1.40 it is suggested that tax administrations might find it useful to refer to third-party transaction structures in determining whether a related-party transaction satisfies the arm's length principle, though this is surely of limited practical assistance given, as is emphasized in the guidance, the ability of MNEs to enter into transactions that are not seen in the case of third parties.
67. The 1979 OECD Report does refer to the need to find out which parties "undertake" the risks – *see* 1979 OECD Report, para. 17.
68. 1995 OECD Transfer Pricing Guidelines, paras. 1.23 - 1.24. The discussion introduces some of the important themes that are later taken up in the BEPS work on the control of risk. For example, it is also noted in para. 1.27 that in arm's length dealings it "generally makes sense" for parties to be allocated a greater share of those risks over which they have relatively more control and in the same paragraph there is also an early concern about the booking of risks assumed in low-tax jurisdictions.

The first substantive proposition in the guidance on risks assumed is the statement that "[t]he functions carried out (taking into account the assets used and the risks assumed) will determine to some extent the allocation of risks between the parties, and therefore the conditions each party would expect in arm's length dealings".[69] The language used seems to advance the notion that risk allocation is determined by "functions carried out". That impression is bolstered by the subsequent comments in the guidance which address the question whether "a purported allocation of risk" (which is presumably referring to a contractual allocation) is consistent with the economic substance of the transaction. In this regard, it is stated that "the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk".[70] These comments suggest that a transfer pricing analysis based on the parties' conduct will be preferred to the contractual analysis in the event of a clash.[71] There is, however, nothing in the discussion which comments on *how* conduct is to be interpreted in assessing whether or not a risk is assumed by that conduct (for example, what aspects of conduct determine whether certain risk management activity is to be interpreted as that party managing its own risk or as that party managing the risk of another party, as it might do in the context of the provision of a service?). In any event, the discussion in the later 1998 OECD report, The Taxation of Global Trading of Financial Instruments,[72] indicates that these matters had not been resolved by the OECD at this time, meaning the 1995 OECD Transfer Pricing Guidelines could not realistically advance a consensus approach on this point.

3.5. The 2010 OECD PE report[73]

The 2010 OECD PE report represents a significant overhaul of the guidance on the application of article 7 of the OECD Model based entirely on a functional approach, meaning that assets and risks (and indirectly capital) are allocated for the purposes of article 7 by reference to the location of what are termed the "significant people functions". Similarly, transactions (or, more correctly in a PE context, "dealings") are also determined chiefly

69. 1995 OECD Transfer Pricing Guidelines, para. 1.25. The proposition is illustrated by the example of a distributor risking its own resources in "taking on responsibility" for marketing and advertising, the result being that it is entitled to a greater reward than if acting just as an agent.
70. 1995 OECD Transfer Pricing Guidelines, para. 1.26. An example is given to illustrate what is said about the parties' conduct, though, again rather oddly, the example seems more concerned with conflicts between contractual terms (being the risk allocated under the contract and the price paid under the contract) than a conflict between conduct and contractual terms.
71. This position of course also applies for the purposes of the article 7 profit attribution exercise – *see* OECD, *2010 report on the Attribution of Profits to Permanent Establishments*, OECD, 2010, Part I, para. 68 [hereinafter 2010 PE Report].
72. OECD, *The Taxation of Global Trading of Financial Instruments*, OECD, 1998 [hereinafter 1998 OECD Report]. The discussion in the 1998 OECD Report leads to some difficult – and at that stage unresolved – questions about capital and risk. In both cases, the discussion addresses whether the required transfer pricing approach to capital and risk should be functionally based or based on the legal ownership of capital or the legal/contractual assumption of risk. In relation to capital, the question addressed is whether the value of capital is reflected in capital used (which seems to mean capital owned) or capital put at risk (i.e. the functional management of capital). A similar question is addressed in relation to risk assumed (which is identified in the report as the most difficult question to resolve). It is noted that the OECD Transfer Pricing Guidelines require consideration of the functions performed, taking into account assets used and risks assumed, but the report then candidly admits "there is no consensus on what the risk factor is intended to measure". The choice is between "risk exposure" and "risk management". In broad terms, the choice is between a legal ownership perspective (ownership of capital and therefore exposure to risk) and a functional perspective (based on risk management functions). The report draws no conclusion but notes that further work on the topic is required.
73. *See supra* n. 72.

based on an analysis of functional activity. The report therefore materially advances the reliance on a detailed conduct-based approach and introduces activity-based (or value creation) standards that have clearly influenced the post-BEPS OECD Guidelines.[74]

The general approach requires a two-step process to be followed. Under the first step, a full functional analysis is used to hypothesize the PE and the remainder of the enterprise as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks and entering into dealings with each other and transactions with other related and unrelated enterprises.[75] Under the second step, the remuneration of any dealings between the hypothesized enterprises is determined by applying by analogy the article 9 comparability analysis and transfer pricing tools (as articulated in the OECD Transfer Pricing Guidelines for separate enterprises) by reference to the functions performed, assets used and risk assumed by the hypothesized enterprises.[76]

In applying step 1, assets are to be attributed to the part of the enterprise which performs the "significant people functions" relevant to the determination of economic ownership of assets. This clearly assumes that the functional and factual analysis will always lead to the identification of the factors to be taken into account to determine which part of the enterprise should be regarded as the economic owner of the assets actually owned by the enterprise.[77] A similar approach is taken in attributing risks:[78]

> In the absence of contractual terms between the PE and the rest of the enterprise of which it is a part, determining what assumption of risks should be attributed to the PE will have to be highly fact-specific. Following, by analogy, paragraph 1.52 of the Guidelines, the division of risks and responsibilities within the enterprise will have to be "deduced from their [the parties'] conduct and the economic principles that generally govern relationships between independent enterprises". This deduction may be aided by examining internal practices of the enterprise (*e.g.* compensation arrangements), by making a comparison with what similar independent enterprises would do and by examining any internal data or documentation purporting to show how that attribution of risk has been made.[79]

74. Romero J.S. Tavares and Isabel Verlinden, "Domestic Transfer Pricing Laws versus Global Standards: Harmonizing in Dissonance within the G20 and Beyond", *Bulletin for International Taxation* 78, no. 11 (2024), 4, https://doi.org/10.59403/1x4rv4p.
75. 2010 PE Report, Part I, para. 15.
76. 2010 PE Report, Part I, para. 10. Under the required approach to applying article 7, the OECD Transfer Pricing Guidelines are applied by analogy as unlike article 9 it is necessary under this approach to hypothesize the PE as a separate enterprise distinct from the rest of the legal entity – *see* para. 54 of the 2010 PE Report.
77. 2010 PE Report, Part I, para. 18. It is recognized in para. 19 that the consequences of attributing economic ownership of assets under the first step for determining profits under the second step may depend upon the type of asset and the type of business in which the asset is used. For example, economically owning a tangible asset used in a manufacturing process does not necessarily, of itself, attribute to the economic owner of the asset the income from selling goods produced by using the asset. Attributing economic ownership of financial assets, on the other hand, attributes the income and expenses associated with holding those assets or lending them out or selling them to third parties.
78. 2010 PE Report, Part I, para. 21. Being attributed risks in the article 7 context means the equivalent of bearing risks for income tax purposes by a separate enterprise, with the attendant benefits and burdens, in particular the potential exposure to gains or losses from the realisation or non-realisation of said risks. It is clarified that the significant people functions relevant to the assumption of risks are those which require "active decision-making" with regard to the acceptance and/or management (subsequent to the transfer) of those risks. The extent of the decision-making will depend on the nature of the risk involved – 2010 PE Report, Part I, para. 22.
79. 2010 PE Report, Part I, para. 69.

Given that the required capital of a PE is determined by the assets and risks attributed to the PE, this means that the functional approach indirectly determines the amount of required capital base of the PE. The functional analysis is also used to determine the recognition and characterization of dealings between the PE and other parts of the enterprise to which it belongs.[80]

It can be seen from the above description that the authorised OECD approach (AOA) is fundamentally rooted in the use of specified "people functions" to determine the location of assets, risks and indirectly capital, and also that people functions are also used to determine the "dealings" of the PE.[81]

Significantly however (and of particular relevance to the discussion here), though the guidance seeks to take the hypothetical separate and independent enterprise approach based on the functional approach as far as it will go,[82] it does recognize that the approach set out in the OECD Transfer Pricing Guidelines cannot just be about functions:

> The guidance on comparability in Chapter I of the Guidelines identifies a number of factors in addition to a functional analysis which may have to be taken into account when undertaking a comparison of conditions: characteristics of property or services, contractual terms, economic circumstances and business strategies. By analogy, such factors should also be considered when undertaking the functional and factual analysis to determine the "conditions" of the hypothesised separate and independent enterprise and to ensure that they are "same or similar" to those of the PE. So under the authorised OECD approach, care needs to be taken to ensure that the attribution of profit takes into account the conditions of the enterprise to the extent those conditions are relevant to the performance of the PE's functions.[83]

Having regard to the breadth of what might be encompassed within the notion of "conditions" (such as obligations, entitlements, characteristics, capacities, etc.), there is little if any guidance on how all these relevant "conditions" are to be considered under the functionally driven approach. What is evident though is that the task of identifying the relevant "conditions" is clearly not seen as problematic and, again, the assumption is that a sufficiently detailed functional and factual analysis based on the relevant facts and circumstances will resolve any open issues.[84] The confidence on this point in the report seems very high. For example, in the case of assets, the report assumes it will readily be possible to determine based on the relevant factual and functional analysis, not just the assets used by the PE but also the "conditions" under which any assets are used – and, specifically, whether those

80. 2010 PE Report, Part I, para. 177: "A functional and factual analysis should be used to determine whether … an event has occurred and should be taken into account as an internal dealing of economic significance. And ultimately it is the functional and factual analysis which determines whether the dealing has taken place, not the accounting records or other documentation provided by the enterprise." The approach is to undertake a comparison of *dealings* between the PE and the enterprise of which it is a part, with *transactions* between independent enterprises.
81. The 2010 PE Report reflects a more complete reliance on functional activity than is seen in the transfer pricing sphere. In particular, the treatment and reward to capital is different with a contractual allocation of capital being generally respected in the subsidiary (transfer pricing) case while in the branch case capital essentially follows assets which are in turn allocated almost exclusively on the basis of functions. The same is true of intangibles, where the branch case involves an allocation of intangibles based on functions and assets with no respect given to "contractual" allocations whereas in the subsidiary case contractual allocations are respected provided conduct is consistent with the contract.
82. 2010 PE Report, Part I, para. 3.
83. 2010 PE Report, Part I, para. 63:
84. 2010 PE Report, Part I, paragraphs 64 and 67.

assets are used in the capacity of joint owner or sole owner or licensee or member of a cost contribution agreement.[85]

Given the unresolved difficulties with the conduct-based approach to reconstituting or "re-delineating" a transaction that were identified in section 3.4. (and which are pursued below) this high level of confidence coupled with the absence of any mention of possible difficulties does seem somewhat puzzling. Given the controversy created by the development of the AOA at the time,[86] it is possible that the 2010 OECD PE Report seeks to present the new approach to article 7 in as positive and problem-free a manner as possible.[87] Another possibility is that the dominance of the financial sector issues and analysis in the shaping of the new article 7 approach might have led to an assumption that the functional or conduct-based approach in other sectors would be correspondingly straightforward. Certainly, it is striking how many references there are to the financial sector position in Part I of the report (notwithstanding that it is intended to address "General Considerations", i.e. those relevant to all sectors).[88] This is relevant because, as the report itself seems to acknowledge, the application of the AOA is generally recognized to be materially easier in the financial sector due to a number of factors, including the fact that the assets analysis and the risks analysis are usually tied together (because the financial products traded are simultaneously the relevant assets and risks of the business),[89] and because the relevant income arising is generated by those assets/risks and usually easy to identify, as well as by the relatively commoditized features of much financial sector business and the regulatory requirements for capital which make the capital attribution exercise much less difficult than in non-financial sector businesses.[90]

3.6. Conclusions on the historical material

What conclusions may be drawn based on the consideration of this historical material? There is arguably some discernible progression of thinking about the role of conduct in appraising or constructing contracts and transactions. From a transfer pricing perspective, this can be seen in the initial limited recourse to conduct in the 1979 OECD report and the increasingly expanded role of conduct (as for example in the comments on risk and the conduct of the parties in the 1995 OECD Transfer Pricing Guidelines), that would ultimately

85. 2010 PE Report, Part I, paragraph 72.
86. The controversy over the approach in the 2010 PE Report to the implementation of article 7 continues to be reflected in the poor take-up of the OECD proposals – *see* further R. Collier and J. Vella, "Five Core Problems in the Attribution of Profits to Permanent Establishments", *World Tax Journal* 11, no. 2 (2019), 163-168, https://doi.org/10.59403/vd7jxr.
87. This interpretation is to some extent supported by the detailed commentary in the report. For example, in the case of tangible assets, there are clearly different views on whether these should be sourced by reference to a place of use test or by reference to the significant people functions test, but the report concludes somewhat optimistically that either test should lead to the same or similar result (*see* 2010 PE Report, Part I, para. 75). The report also seems to downplay exceptions to the approach adopted, as in Part I, para. 194 where the possibility of "circumstances in a particular case that warrant a different view" is mentioned but not explained. Similarly, in the case of intangible assets, the difficulties – and potentially disagreements on the approach – do not seem to be faced head on and instead the comment made is that it would be "overly prescriptive to only allow one approach for dealing with the variety of ways in which IP can be exploited". *See* 2010 PE Report, Part I, para. 78.
88. For example, *see* 2010 PE Report, Part I, paras. 16,19, 20, 27 et seq.
89. *See* 2010 PE Report, Part I, para. 19.
90. The more detailed financial sector guidance in the 2010 PE Report facilitates the application of the AOA to financial sector business. Whilst Part I of the 2010 PE Report takes up 54 pages of the report, Parts II, III, and IV on banking, global trading and insurance business take up a further 154 pages.

lead to the pervasive reliance on conduct in the BEPS reforms. In an article 7 context, there is the first OECD report (in 1984) to advance an analysis of human functional activity as being what substantially generates income/profits, with the same report also identifying the negotiation and conclusion of contracts as the most critical of functional activities. These developments paved the way for the more pervasive reliance on functions/conduct delivered by the 2010 OECD PE Report and also by the conduct-based approach arising from the BEPS reforms of transfer pricing.

Although there is reflected in the OECD reports considered here some apparent progression in what is said on the relevance of conduct to testing and constructing the relevant transaction, the approach is piecemeal and disparate. There is in the OECD reports no clear and consistent pattern or development in what seems to be the thinking on this matter, nor even any express recognition that the reliance on conduct is increasingly supplanting the reliance on the legal position in determining the nature of the controlled transaction under consideration. This means that there is no recognition of the problems and issues in relying on conduct to construct transactions/contracts including the relevant "conditions" or "characteristics" of the relevant transaction or arrangement. There is no articulation of the uses and limitations of a conduct-based approach, nor indeed any real explanation of the working of the conduct-based approach at all. Given the nature and scale of what is involved in any reliance on conduct to construct transactions/contracts, the almost complete absence of any mention, let alone coherent analysis, of the issues arising seems very odd.[91]

Despite the lack of any discussion of the issues raised by the conduct-based approach, it is striking that what discussion there is seems to assume that the use of conduct to construct a transaction or "contract" will always be a straightforward matter, with any problems readily resolved by the factual and functional analysis.

As has been discussed in section 3.4.1., a conduct test can readily be used to validate certain purported contractual arrangements (as, for example, where a contract for services is verified by checking the service was in fact provided). In some cases, a conduct test can also be used to impute or construct a contract for transfer pricing purposes where none exists already (for example, as where a service is provided but there is no contract, and no consideration charged). In both these cases, it is possible to apply the transfer pricing rules by taking account of the absence or presence of conduct (as appropriate) rather than adhering to the strict legal/contractual position (or absence of any contract). However, this does not mean that it is *always* possible or straightforward to use conduct to construct a contract (or "conditions"/"characteristics"). Imputing or constructing a contract based on conduct is clearly much easier to do where the terms and consideration of any imputed contract can readily be deduced from the conduct concerned (as in the bookkeeping services example discussed in section 3.4.1. where legal capacity etc issues are not relevant). However, as the OECD guidance itself has recognized, the relevant value or price in respect of conduct may

91. The use of the notion of "economic substance" or "economic principles" may be mentioned by way of a further example of the vague and unarticulated discussion in the OECD reports. "Economic substance" is initially discussed as being something that is clearly different to what might be termed "factual" substance (as seen in the various examples of thin capitalisation as relevant to economic substance, such as for example in the 1979 OECD Report – and *see also* the 1998 OECD Report, para.123 where the phrase is used in a similar sense) but over time, and without any explanation, the notion of "economic" substance/principles comes to be used in the context of *conduct*. (It is noteworthy, however, that this has always been used in this context in the US transfer pricing regulations as detailed *infra* n. 211).

be affected by issues such as the capacity in which the conduct is carried on. There may also be inherent value in legal ownership or legal rights and the detailed terms and conditions of a contract will commonly also affect transfer pricing returns. There is no acknowledgement or recognition in the OECD reports that reliance on a conduct-based approach may present difficulties or need to be reconciled to what is said elsewhere in the guidance on the relevance (and value) of capacity, legal ownership, detailed terms and conditions of a contract, etc.

It seems hard to conclude that these difficulties were simply not foreseen by the OECD guidance given the warnings from the first transfer pricing report in 1979 of the problems that would arise from "rewriting" the legal arrangements.[92] As discussed in sections 3.2. and 3.4.2., it is possible that the intended "exceptional" approach to rewriting contracts was seen as largely accommodating the difficulties – perhaps because the issues would be expected to arise only in extreme cases (which could perhaps be managed pragmatically one way or another). Another possibility is that it was thought the difficulties might be materially diminished with the introduction of a conduct-based approach to risk (as reflected in the 1995 comments that "the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk"[93] which seem designed to override contracts). However, it is clear from the later OECD work on global trading in 1998 that thinking on risk was then still at a nascent stage and a long way from being developed on a consensus basis. A further possibility is that the more developed use of conduct in an article 7 context, where the approach was largely developed in a financial services context, might have been taken to indicate the practicability of the conduct-based approach more generally (i.e. outside the financial services context, where the problems are more significant). However, even here there is relatively little analysis of how an analysis of conduct can deliver the requisite "conditions" (which include legal entitlements, obligations, capacities, etc.)[94] and nothing that addresses the different issues that would be raised in an article 9, rather than article 7, context.

Overall, this consideration of the historical OECD material leaves the impression that, whilst reliance on the conduct-based approach has clearly been materially expanded over time, the implications and potential difficulties of that approach have been barely recognized or considered.[95]

92. As discussed earlier, there is a warning against attempting to rewrite the terms of the legal transaction in the OECD's 1979 transfer pricing report – and this is made even stronger in the 1995 Transfer Pricing Guidelines – yet the conduct-based approach where it is applied to override contractual terms is of course equivalent to such a rewriting of the contract – but apparently not seen as problematic.
93. 1995 OECD Transfer Pricing Guidelines, para. 1.26.
94. The guidance in Part I of the 2010 PE Report on attributing rights and obligations to the PE is very short. It recognizes that it is necessary to find a way to attribute to the PE the appropriate rights and obligations of the enterprise of which it is part but the guidance on exactly how this is to be done is a vague and generalised reliance on the output from the functional and factual analysis. *See* 2010 PE Report, Part I, para. 98.
95. It is hard to resist the conclusion that a false narrative or belief about the usefulness of the conduct-based approach developed over time – and that this was – and is – based on unexamined assumptions and the ready and uncritical acceptance of statements in earlier OECD reports. The situation seems to be an example of the disparity that can exist between claims and reality about international taxation due to the uncritical acceptance of what is said by the OECD and other international organisations – this tendency is explored in Wei Cui, "False Idols in the Early History of International Taxation", SSRN, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4986995.

4. Current Requirements of the OECD Transfer Pricing Guidelines

The guidance that was developed during the BEPS initiative placed a significant emphasis on the role of conduct, consistent with its project-wide emphasis on the need to interpret the international tax regime according to a "value creation" perspective.[96]

This new emphasis on value creation was reflected in the significant and detailed re-statement in Chapter I of the OECD Transfer Pricing Guidelines of the general principles concerning the determination – strictly, "delineation" – of the relevant controlled transaction.[97] In considering the contractual terms of a controlled transaction in the course of the required accurate delineation process, the OECD Transfer Pricing Guidelines emphasize that the written contracts alone are unlikely to provide all the information necessary to perform a transfer pricing analysis, or to provide information regarding the relevant contractual terms in sufficient detail. In that context, the OECD Guidelines require an investigation into the economically relevant characteristics of the commercial or financial relations between the parties which will include evidence of the actual conduct of the parties:

> It is, therefore, particularly important in considering the commercial or financial relations between associated enterprises to examine whether the arrangements reflected in the actual conduct of the parties substantially conform to the terms of any written contract, or whether the associated enterprises' actual conduct indicates that the contractual terms have not been followed, do not reflect a complete picture of the transactions, have been incorrectly characterised or labelled by the enterprises, or are a sham.[98]

Where conduct is found not to be consistent with the relevant economically significant contractual terms, the new BEPS guidance stipulates that transactions between connected parties should be "accurately delineated" by reference to the characteristics of the transaction as reflected in the conduct of the parties.[99]

The new guidance includes a significant emphasis on the assumption of risk and in particular "control of risk" decision-making which is made a precondition for the recognition of contractually assigned risks. In the rewritten guidance on intangibles, there was also a significant new focus on decisions concerning DEMPE.

This section explores how the current 2022 version of the OECD Transfer Pricing Guidelines explains the nature of the conduct-based approach. This point is pursued by addressing certain critical questions relating to that guidance. However, before turning to the guidance itself, it is helpful to summarize what the new approach, introduced by the BEPS Project and involving a significant overhaul of Chapter I of the OECD Guidelines, was trying to achieve.

96. The authors have previously addressed the notion of value creation – *see* Collier and Dykes, "On the Apparent Widespread Misapplication of the OECD Transfer Pricing Guidelines", 34-42.
97. The breadth of the new approach to the "delineation" of a controlled transaction is reflected in the OECD Transfer Pricing Guidelines, para. 1.36, which sets out the elements that that need to be considered in the accurate delineation process. This includes all the comparability factors (contractual terms; functional analysis; characteristics of the property/services concerned; economic circumstances and business strategies), meaning that the delineation process is by no means restricted to risks assumed. The process specifically includes also "responsibilities" (presumably "rights and obligations") and "outcomes" – *see* OECD Transfer Pricing Guidelines, para. 1.42.
98. Transfer Pricing Guidelines, paras. 1.43 - 1.50.
99. Transfer Pricing Guidelines, paras. 1.43, 1.45 and 1.46.

4.1. The purpose of the delineation approach

The basic goal of the major revisions to the guidance in Chapter I of the OECD Transfer Pricing Guidelines was to distinguish – and emphasize – the "delineation" question, namely the investigation into what transaction the controlled parties actually entered into.[100]

As outlined in section 3., pre-BEPS the OECD Transfer Pricing Guidelines contained a "two-pronged" test under which, by exception, a tax authority could recharacterize transactions entered into by the taxpayer. The first prong tested the transaction by reference to "economic substance", the second by reference to "commercial rationality".[101] The pre-BEPS guidance also contained a paragraph in the section outlining the standard approach to functional analysis, which noted that in instances where the parties' conduct diverged from the contractual terms then the "true terms" should be deduced based on the conduct. In this respect, the relationship between the "economic substance" test (applied by exception) and the "true terms" idea (applied as a routine matter) was not clear. The BEPS changes aimed to consolidate the "economic substance" and "true terms" tests into a single test of behaviour which is at the heart of the "accurate delineation" process.[102]

The intention was to present this "delineation" question as being, in the first instance at least, an entirely separate issue from any analysis of what third parties might or "would" do. It would only be necessary to undertake such a hypothetical analysis in the rare situations where the controlled transaction actually entered into is "de-recognised" (on the basis it is not commercially rational and its structure prevents a transfer price being established).[103] (The distinction between accurate delineation and non-recognition is explored more fully in section 4.2.)

The idea was therefore to develop in the guidance a much more searching response to the question of what transaction the parties had actually entered into than had hitherto been relevant given the (in practice at least) broad-based deferral to the contractual position.[104] The response developed in the BEPS Project sought to apply a decisively substance-based approach to identifying the "real" arrangements (including the real value-creating activities), not just the position reflected in the legal documentation. It was in this context that

100. The approach adopted was ultimately derived from the BEPS emphasis on the notion of "value creation", which included the requirement to align the location in which the profits concerned are taxed with the location in which the activities which generate those profits are carried on. The assumption in BEPS was that insufficient attention on the activities that generated the profits had hitherto enabled a significant diversion of profits through the use of contractual structures that parked those profits in low-substance, low-tax entities.

101. 2010 Transfer Pricing Guidelines, para. 1.64 et seq.

102. In a recent article, Michael McDonald, US delegate to and chair of WP6 during the BEPS process, noted that "one of the key structural improvements to Chapter I was separating the guidance on establishing the taxpayer transaction to be priced from the consideration of comparable uncontrolled transactions […] the structure of the revised Chapter I in delineating the actual transaction avoids esoteric and metaphysical questions like, 'what would parties at arm's length do?' (unrelated parties might conceivably do almost an infinite number of things) and, 'would a party at arm's length enter into this transaction?' (How can one ask this question in a vacuum, independent of potential pricing/remuneration?)". *See* McDonald, "Let's Not Overthink This", 1429-1435.

103. That was the intended approach, but as the authors explain below the intended separation of these issues was not achieved because *within the delineation process* itself it still appears to be necessary to apply the guidance on "options realistically available", and this inevitably requires some posing of the "would" question – i.e. asking what would unrelated parties have done given the options realistically available.

104. *See* McDonald, "Let's Not Overthink This", 1429-1435.

the significantly increased focus on the conduct of the parties in the control of risk was developed.[105]

HMRC, the UK tax authorities, have published guidance in their international tax manual which sheds interesting light on the motivation behind the significant conduct-based changes to the guidance on the fundamental principles of transfer pricing in Chapter I of the OECD Transfer Pricing Guidelines. HMRC state that:

> some OECD members consider that, in the absence of an explicit over-ride within the Guidelines, their domestic law binds them to transfer pricing of a transaction based upon its contractual form rather than economic substance. The 2017 amendments create greater internal consistency within the Guidelines by expanding upon the concept of establishment of the economic substance of a transaction – now termed "accurate delineation of the actual transaction" – to provide OECD members who have such concerns regarding their domestic law to use the substance of the transaction as the basis for transfer pricing analysis without this being considered to be a disregard of the actual transaction.[106]

What this makes clear is that the intention behind the relevant BEPS transfer pricing reforms was to emphasize that conduct-based changes to the transaction that overrode or supplemented the formal contractual arrangements should no longer be classified as an act of "recharacterization" or "disregarding" of the transaction.[107] The question of whether or not the OECD Guidelines are merely adopting a conduct-based approach to contract interpretation which is equivalent to approaches that are currently applied in domestic law is addressed in section 5.

4.2. The current guidance on the delineation approach

The authors now turn to explore the guidance on the conduct-based approach in the current 2022 version of the OECD Transfer Pricing Guidelines, by addressing four questions as follows:

1. What is the explicit objective of the accurate delineation exercise as explained in the OECD Transfer Pricing Guidelines?
2. How does the conduct-based approach to accurate delineation fit with other fundamental requirements of the OECD Guidelines, such as the requirement to consider "economically relevant characteristics" and "options realistically available"?
3. How is the accurate delineation process to be applied in practice?

105. As already noted, the detailed application of the control of risk rules is discussed in detail in Collier and Dykes, "The Virus in the ALP"; and Collier and Dykes, "On the Apparent Widespread Misapplication of the OECD Transfer Pricing Guidelines". In very broad terms, the control of risk rules provide a corroboration test for related-party contractual arrangements with regard to the assumption of risk. The effect of the rules is that intra-group legal allocations of risk are not respected for transfer pricing purposes, unless the entity that is legally assigned the risk both carries on certain control of risk functions (including decision-making about assuming and laying off and hedging risk), and has the financial capacity to absorb the risk should it crystallize. The rules are widely viewed as a BEPS "substance" requirement response to the booking of risk in low or no substance tax entities.
106. HMRC Internal Manual, www.gov.uk/hmrc-internal-manuals/international-manual/intm440201, p.57
107. As noted above, in previous versions of the OECD Transfer Pricing Guidelines, the possibility of conduct-based adjustments to contractual terms was, confusingly, featured both in the "exceptional circumstances" recognition paragraphs and in the standard approach to functional analysis. This issue is discussed further below in sec. 4.2.4.1.

4. What is the difference between accurate delineation of a transaction and non-recognition of a transaction?

4.2.1. What is the explicit objective of the accurate delineation exercise?

The first point to be addressed is perhaps the most critical, and this relates to what it means to "accurately delineate" a transaction. It is sometimes suggested that the exercise of accurate delineation is purely one of establishing a substance or conduct-based "underlying" reality, "beyond the legal form"[108] of the transaction, as though a description of the substance or conduct alone would be sufficient to enable a transfer pricing analysis to be performed. This, however, is not the case. Certain critical aspects of a transaction, in particular the *capacity* in which the parties are transacting and the associated *rights and obligations* must be known to enable the pricing of the transaction to be determined. (This point was recognized by the OECD's first transfer pricing report and was discussed in section 3.2.)[109]

It is not enough to simply describe the conduct of the parties and other factual circumstances; it is still necessary to take the critical next step and infer or deduce the price-sensitive *terms* of the actual transaction entered into. This is important, because it is often argued that the 2022 OECD Transfer Pricing Guidelines essentially diminish the role of contracts in transfer pricing, in favour of conduct. This is only half true. The OECD Guidelines require that contracts align with conduct, and where contracts do not align with conduct, it is necessary not to ignore contracts but to specify what the actual contract terms would include in order to align the contract with the relevant conduct.[110] The process of "accurately delineating a transaction" has at its heart the need to describe the true commercial relationship between the parties, including all price-sensitive rights and obligations, in a way that will enable step two of the pricing exercise (the comparison with third parties) to be undertaken.

Rights and obligations are not the only things that impact on price, and the functional analysis process requires that all other economically relevant characteristics and circumstances are also established. In this respect "accurate delineation" is not exclusively about recognizing the "true terms" of the transaction, but as we set out below, the specification of the basis on which the parties are transacting and their legal rights are an essential part of the exercise.[111]

The rights and obligations which comprise a commercial relationship are not necessarily obvious, and the role of a contract is to explicitly record them, which the OECD Guidelines recognize as providing the starting point for delineating the transaction:

> the controlled transactions may have been formalised in written contracts... including in typical cases the division of responsibilities, obligations and rights, assumptions of identified risks, and pricing arrangements...these agreements provide the starting point for delineating the transaction between them and how the responsibilities, risks, and anticipated outcomes were intended to be divided [112]

108. *See*, for example, the guidance of the UK tax authorities, HMRC, *International Manual*, at INTM485025 – Transfer pricing operational guidance: Accurate delineation of the actual transaction: Risk, para. 18.
109. *See* 1979 OECD Report, para. 17 in the previous sec. 3.2.
110. The OECD Transfer Pricing Guidelines state that "a transaction is the consequence or expression of the commercial relations between the parties" – OECD Transfer Pricing Guidelines, para. 1.42.
111. OECD Transfer Pricing Guidelines, para. 1.139.
112. OECD Transfer Pricing Guidelines, para. 1.42.

By definition, accurately delineating a transaction requires that all the economically significant aspects of the commercial relationship which might be captured in the terms of a contract (such as the division of responsibilities, respective obligations and rights and the assumption of risks) must be stipulated or understood for the purposes of the transfer pricing exercise. The OECD Guidelines clarify that "the first phase of a transfer pricing analysis 'relates to the process of accurately delineating the controlled transaction … *and involves establishing the characteristics of the transaction, including its terms*'" [113] [emphasis added]. Similarly, in cases where the nature of the transaction needs to be deduced from the conduct of the parties, the OECD Transfer Pricing Guidelines make it clear that the objective of the exercise is "*to determine the terms and conditions of the identified transaction*" [114] [emphasis added].

In keeping with this basic approach of identifying the terms of the transaction, the OECD Guidelines repeatedly emphasize that where economically relevant terms are missing from a contract, or inconsistent with conduct, they must be inferred or deduced. For example:

> If the contract neither explicitly nor implicitly (taking into account applicable principles of contract interpretation) addresses characteristics of the transaction that are economically relevant, then any information provided by the contract should be supplemented … by identifying those characteristics.[115]
>
> Where no written terms exist, the transaction would need to be deduced from the evidence of the actual conduct.[116]
>
> If the characteristics of the transaction that are economically relevant are inconsistent with the written contract between the associated enterprises, the actual transaction should generally be delineated … in accordance with the characteristics of the transaction reflected in the conduct of the parties.[117]
>
> Where conduct is not fully consistent with economically significant contractual terms, further analysis is required to identify the actual transaction.[118]

These references imply that it is only necessary to ascertain the "actual transaction" if the written contractual terms of the transaction fail to address matters that are economically significant, or if conduct is inconsistent with the written terms. If the contract is comprehensive and the conduct is consistent with those written terms, then the contract appropriately delineates the terms of the actual transaction. This means that the process of accurate delineation must include the specification of the nature of the relationship between the parties, in a way that is analogous to (or reflective of) the specification of the terms and conditions in a contract. This also means that, if there is a contradiction between the nature of the relationship and rights specified in the contract presented by the taxpayer and the "accurately delineated" relationship and rights proposed by a tax authority, the contradictory elements cannot plausibly sit side-by-side in the same analysis.[119]

113. OECD Transfer Pricing Guidelines, para. 1.37.
114. OECD Transfer Pricing Guidelines, para. 1.50. Given the clear legal connotation of the term, the choice here of the words "terms and conditions" (rather than, say, merely "conditions") seems evidently intended to refer to the various matters (terms) that would form part of a contract in a legal context.
115. OECD Transfer Pricing Guidelines, para. 1.43.
116. OECD Transfer Pricing Guidelines, para. 1.49.
117. OECD Transfer Pricing Guidelines, para. 1.45.
118. OECD Transfer Pricing Guidelines, para. 1.46.
119. OECD Transfer Pricing Guidelines, para. 1.88 makes this clear: "Where differences exist between contractual terms related to risk and the conduct of the parties which are economically significant and would be taken into account by third parties in pricing the transaction between them, the parties' conduct in

4.2.2. How does the conduct-based approach to accurate delineation fit with other core requirements of the OECD Guidelines, such as the need to consider economically relevant characteristics and options realistically available?

Whilst the OECD Guidelines clearly emphasize the fundamental importance of conduct as the basis for accurately delineating the terms of the transaction, they also frequently refer in the delineation guidance to the requirement to take account of the "economically relevant characteristics". For example:

> If the characteristics of the transaction that are economically relevant are inconsistent with the written contract between the associated enterprises, the actual transaction should generally be delineated … in accordance with the characteristics of the transaction reflected in the conduct of the parties.[120]

The key development in the BEPS-related guidance was the emphasis placed on a certain kind of conduct that is of particular importance for the purpose of accurately delineating the actual transaction in any case: when determining which party should be allocated the consequences of risk or the returns from developing IP, the risk control framework in Chapter I of the OECD Guidelines, and the DEMPE guidance in Chapter VI require that *actual control of risk decisions* are identified.[121] Notwithstanding the many problems with this guidance (several of which the authors have explored previously),[122] it does seem clear that the actual decision-making process in any case represents the factual base from which the process of allocating risk in accurately delineating the actual transaction is intended to proceed. However, it is also the case that, more broadly than conduct alone, the notion of "economically relevant characteristics" is accorded a central role in the process of accurately delineating the transaction. For example, the OECD Guidelines state that "the transfer pricing analysis will have … accurately delineated the transaction by analysing the economically relevant characteristics".[123] This inevitably raises the question of what is meant by the reference to economically relevant characteristics and how those characteristics fit in with the conduct-based approach.

As is made clear in the OECD Transfer Pricing Guidelines, the term "economically relevant characteristics" is in fact simply another name for the five comparability factors which are central to the transfer pricing comparability exercise, as explained in Chapter I of those Guidelines.[124] The intended reference to the five comparability factors is therefore specifically to the following factors:

the context of the consistent contractual terms should generally be taken as the best evidence concerning the intention of the parties in relation to the assumption of risk."

120. OECD Transfer Pricing Guidelines, para. 1.45.

121. It should be clarified that the focus in the delineation process on conduct is expressed in general terms and so is not limited to conduct comprising control of risk decisions, though control of risk decision-making is given especial emphasis in the guidance in Chapter I of the OECD Guidelines.

122. *See supra* n. 3.

123. OECD Transfer Pricing Guidelines, para. 1.139. There are also several other references to this notion in the OECD Transfer Pricing Guidelines – *see*, for example: "Where there is doubt as to what transaction was agreed between the associated enterprises, it is necessary to take into account the relevant evidence from the economically relevant characteristics of the transaction" (para.1.47); and "Economically relevant characteristics or comparability factors are used in two separate but related phases in a transfer pricing analysis. The first phase relates to the process of accurately delineating the controlled transaction for the purposes of this chapter, and involves establishing the characteristics of the transaction, including its terms, the functions performed, assets used and risks assumed by the associated enterprises, the nature of the products transferred, or services provided etc." (para. 1.37).

124. OECD Transfer Pricing Guidelines, paras. 1.36 and 1.37 clearly conflate the terms.

(i) contractual terms;
(ii) functions (taking into account assets used and risks assumed), circumstances and industry practices;
(iii) characteristics of the property of services;
(iv) economic circumstances of the parties; and
(v) business strategies.

The OECD Guidelines further subdivide the economically relevant characteristics into two categories: first, the "conditions of the transaction" (being chiefly the first comparability factor – (i) above, namely contractual terms); and, second, the "economically relevant circumstances in which the transaction takes place" (broadly, factors (ii) to (v)).[125] The conditions seem to be synonymous with the contractual terms in that the conditions are described as comprising what would have been agreed between the parties in comparable transactions.[126] The circumstances, captured in factors (ii) to (v), are highly relevant to the pricing analysis, but they do not, in and of themselves, explain or reveal the *basis on which* the parties have transacted, including the relevant capacities of the parties.

The inclusion of contractual terms in the list of comparability factors (and as one of a number of "economically relevant characteristics") suggests that it is in the same class of things as the other four factors, but there is clearly a distinct difference between contractual terms and the other comparability factors. The "conditions of the transaction" are the terms that are agreed between the parties, specifying the basis on which the parties are transacting, and the other four comparability factors are all important features (or context) that might influence the conditions (principally price) that would have been agreed at arm's length.

Notwithstanding the central importance of the conduct-driven control of risk analysis, the OECD Transfer Pricing Guidelines indicate that *all* of the comparability factors play an important role in the accurate delineation process.[127] However, unlike the role played by control of risk decisions, the way that factors (ii) to (v) play in to the delineation process is not explained in detail. It may simply be the case that the comparability factors other than the contractual terms (which are contingent on the conduct analysis) simply need to be enumerated in fully, describing (i.e. delineating) the transaction so that all of the aspects which will need to be taken account of in the second step of the transfer pricing process (the comparability analysis) are recognized.[128] This is an area where a clear statement to that effect would be helpful. As it stands, the guidance creates the impression that all of the

125. OECD Transfer Pricing Guidelines, para. 1.35.
126. OECD Transfer Pricing Guidelines, para. 1.35.
127. According to the OECD Transfer Pricing Guidelines, para. 1.38: "identifying the economically relevant characteristics of the transaction is essential in accurately delineating the controlled transaction and in revealing the range of characteristics taken into account by the parties to the transaction in reaching the conclusion that there is no clearly more attractive opportunity realistically available to meet their commercial objectives than the transaction adopted."
128. There are several well-known cases which suggest that establishing the economically relevant characteristics of the transaction forms part of "step one" of the transfer pricing exercise (establishing commercial or financial relations). Establishing a comprehensive account of the factors which are relevant to the pricing of the transaction may involve ascertaining price-sensitive features which are not specified in the terms of the contract. *See*, for example, *GE Capital* 2011 DTC 5011; *Chevron* [2017] FCAFC 62; and *BlackRock HoldCo 5, LLC v HMRC* [2024] EWCA Civ 330. In the *BlackRock* case the leading judgment (at para. 60) stated that "[i]n hypothesising a comparable transaction *the actual characteristics of the parties are not adjusted*" [emphasis added]. This is an exercise which is distinct from the consideration of whether contractual terms and legal rights are to be respected.

economically relevant characteristics, not just conduct, will play a role in determining the basis on which the parties are transacting, or what they have "agreed to".[129] This impression is compounded by the fact that in places the OECD Guidelines seem uncertain about the relationship between economically relevant characteristics and conduct.[130]

A further difficulty is that the OECD Guidelines also appear to allow for the possibility of delineating an alternative transaction based on what the parties "would" have agreed given their "realistically available options".[131] These options are not determined by conduct, but by economically relevant characteristics, and in particular by the options realistically available conferred by the respective "rights and other assets" of the parties.[132]

If the "options realistically available" concept includes a test of what third parties would have done in the first step of the transfer pricing analysis, then the user of the accurate delineation guidance in the OECD Transfer Pricing Guidelines is therefore concurrently applying two approaches:

> Approach 1: the basis upon which the parties are deemed to contract with each other (including the contractual allocation of risk) is ultimately determined by their actual conduct (in the case of risk assumed, principally by reference to the location of control of risk decisions made by the

129. OECD Transfer Pricing Guidelines, para. 1.47.
130. The OECD Guidelines convey a general sense that economically relevant characteristics and conduct are connected, as in the comment that "where no written terms exist, the actual transaction would need to be deduced from the evidence of actual conduct provided by identifying the economically relevant characteristics of the transaction" – OECD Transfer Pricing Guidelines, para. 1.49. In this formulation, the claim is that the economically relevant characteristics, or comparability factors, provide evidence of what the "actual conduct" is. It is not clear how this could be the case. The above comment from the OECD Guidelines may be compared to another statement in that guidance: "The contractual arrangements will generally determine the terms of the … transaction, as clarified or supplemented by the economic characteristics of the transaction as reflected in the conduct of the parties". (OECD Transfer Pricing Guidelines, para. 6.62). In this reverse formulation, the economic characteristics are reflected in the relevant conduct.
131. OECD Transfer Pricing Guidelines, 1.37, 1.38 and 1.35. The fact that the options realistically available are being taken into consideration in the first stage of the transfer pricing process (establishing the transaction to be priced) as part of the accurate delineation process, as well as in the second stage (performing a comparability analysis) is made perfectly clear in para. 1.38.
132. The OECD Transfer Pricing Guidelines, para. 9.41 specifies that the notion of "options realistically available" (or profit potential) is based on the rights and other assets of the parties concerned. Given that, as mentioned above, one of the key objectives of the BEPS rewrite of Chapter I of the OECD Guidelines was to separate the question what transaction the parties actually entered into from the question of what transaction third parties would have entered into, the approach here seems confusing. Paras. 1.37 to 1.39 of the OECD Guidelines make it clear that options realistically available are relevant to both stage one of the transfer pricing analysis (the accurate delineation of the transaction to be priced) and to stage two of the transaction (the pricing analysis, based on a comparison with third party transactions). It is possible to read para. 1.38 to mean that all that is happening in the first stage of the analysis is a stock-take of the economically relevant characteristics that will be relevant when the "options realistically available" analysis is applied in the pricing analysis in stage two. Tax authorities, however, regularly take a different meaning from para. 1.38, noting that it implies that the parties have "reach[ed] the conclusion that there is not clearly more attractive opportunity realistically available to meet their commercial objectives than the transaction adopted" and that this, effectively, represents the threshold which the transaction presented by the taxpayer must meet. This interpretation seems to have been shared by the drafters of subsequently developed sections of the OECD Guidelines. For example, para. 10.37 states that "the accurate delineation of the actual transaction may conclude that an unrelated borrower would not enter into a 10-year loan arrangement … and the transaction would be accurately delineated as a one year loan". *See also* para. 10.118, which requires that the *decision* to participate in a cash pool be tested by reference to whether it makes sense versus the next best option and para. 6.114 which, based on the realistically available options analysis, invites the user to consider whether the non-recognition provisions should apply, or whether "the conditions of the transaction should otherwise be adjusted".

> parties). In other words, what does the actual behaviour of the parties tell us about what they may be deemed to have agreed?[133]
>
> Approach 2: the basis upon which the parties are to be deemed to transact is to be determined by the hypothetical options realistically available to the parties, given the economically relevant characteristics, in particular their respective rights and other assets which are the main attributes that will create potential options. In other words, irrespective of the actual conduct of the parties, what kind of arrangement would their respective bargaining positions have enabled them to agree at arm's length?

The two approaches may yield markedly different answers given that the location of actual control of risk decisions within an MNE could obviously be very different from the location of the key rights and assets that confer bargaining power.[134] Therefore, on these fundamental points about how the accurate delineation exercise is to be applied, the guidance in the OECD Transfer Pricing Guidelines seems hard to follow, if not somewhat confusing, and this seems to be another matter on which further clarity is needed on what is intended by the guidance.[135]

This article proceeds on the basis that actual conduct (and in the case of risk assumption, specific decision-making behaviour) is intended to be the key determinant of any revision to contractual terms that is necessary in the process of accurate delineation. It should be noted, however, that whether contractual terms are being overridden because of conduct/decision-making behaviour or because an alternative option would have realistically been available, it is the overwriting of the contractual terms that is significant, and the consequences which the authors describe in section 4.2.3. would be similar in either case.

4.2.3. How is the accurate delineation process to be applied in practice?

This section is chiefly concerned with addressing the coherence of the directions in the OECD Transfer Pricing Guidelines on the process of accurately delineating a transaction.

4.2.3.1. The accurate delineation process

As already noted, the OECD Guidelines make it clear as a general matter that where there is an inconsistency between the contractual terms of the transaction and the economically relevant characteristics of the transaction, then the actual transaction should be determined (delineated) based on the conduct of the parties.[136] However, in relation to this general requirement concerning the contractual terms of the transaction, there is little in the guidance to explain how the process of construing the terms of the transaction based on the relevant conduct of the parties should be approached.[137] The guidance on the process to

133. OECD Transfer Pricing Guidelines, para. 1.42.
134. The UK tax authorities, HMRC, attempt to bridge this issue in their Guidance on risk control by asserting that where there is decision-making but no assets to provide the decision-maker with realistically available options then "it is reasonable to suppose that capital could move to exploit the opportunity". *See* HMRC *International Manual*, INTM485025 – Transfer pricing operational guidance: Accurate delineation of the actual transaction: Risk. This seems to assume a hypothetical reallocation of capital which would amount to a very significant adjustment to the assets of the parties, as well as to the contractual terms in any agreement between them.
135. The authors have previously identified several matters concerning the guidance on risk that require clarification – *see* Collier and Dykes, "The Virus in the ALP".
136. OECD Transfer Pricing Guidelines, paras. 1.45, 1.48 and 1.49.
137. The guidance includes three examples (*see* OECD Transfer Pricing Guidelines, paras. 1.44, 1.48 and 1.50). These illustrate disparities between the contractual arrangements and the facts/conduct but do not

be followed in the case of risk is more specific: the six-step control of risk framework set out in Chapter I of the OECD Guidelines explains how risk should be allocated between parties based on control of risk decision-making,[138] though the section of the guidance which deals with what is involved in the actual allocation of the risk comprises just two paragraphs and requires simply that "the risk should be allocated to the party exercising control".[139] The brevity of the guidance presumably reflects a view that the required risk allocation is so straightforward that there is little more to say in this section. However, as the discussion below indicates, the basis on which this allocation is done raises several difficult issues.

The intangibles guidance in Chapter VI applies the same principles and process as the risk control guidance in Chapter I, but with a narrower focus on "risks in relation to investment" in intangibles.[140] Specifically, the risk control process set out in Chapter I "should be followed in determining which party assumes risks relating to the development, enhancement, maintenance, protection and exploitation" of the intangibles in question.

The intangibles guidance differs from the general guidance on risk, because in addition to a requirement to allocate risk based on conduct, it also appears to require the conduct-based allocation of rights to income from intangibles. It may seem obvious that this must be the case given the relationship between the risks associated with investing in developing or acquiring intangibles and the expected return for taking the risk. However, the fact that, at arm's length, legal ownership (legal rights) would confer entitlement to income from intangibles poses particular problems for the accurate delineation process.

This may be why the intangibles chapter does not simply import the risk control process from Chapter I.[141] To accommodate legal rights, there is a separate, augmented framework for analysing transactions involving intangibles which is set out at paragraph 6.34. Where Chapter I specifies that "written contractual agreements" form the starting point for transfer pricing analysis,[142] Chapter VI states that "legal rights and contractual arrangements form the starting point for any transfer pricing analysis of transactions involving intangibles".[143] In the six-step process for intangibles, in addition to identifying how risk is borne contractually, it is also necessary for the purposes of the relevant guidance in Chapter VI of the OECD Guidelines to identify the legal owner of the intangibles. The test of control, in this case, the control of DEMPE decision-making and the test of whether this is consistent with the legal arrangements is basically the same as in Chapter I. However, where there is insufficient control relative to the legal arrangements, it is necessary to "delineate the actual controlled transactions" but in this instance "in light of legal ownership".[144]

It is not entirely clear what this statement is intended to mean, but what is clear, from subsequent paragraphs, is that "the actual transaction that must be deduced from the facts as

explain how a revised set of conditions or terms may be derived from the relevant conduct in each case. This may in part be explained by the point that the relevant guidance draws on the text in earlier versions of the OECD Transfer Pricing Guidelines concerning the role of conduct and it may have been assumed that the earlier text was established and widely accepted and so needed little further elucidation.

138. OECD Transfer Pricing Guidelines, paras. 1.60-1.106.
139. The OECD Transfer Pricing Guidelines also require the party that is being allocated the risk to have the financial capacity to bear the risk.
140. OECD Transfer Pricing Guidelines, para. 6.61.
141. OECD Transfer Pricing Guidelines, para. 6.35.
142. OECD Transfer Pricing Guidelines, para. 1.42.
143. OECD Transfer Pricing Guidelines, para. 6.35.
144. OECD Transfer Pricing Guidelines, para. 6.34.

established including the conduct of the parties" could involve "the allocation of significant rights in intangibles",[145] and that "legal ownership, by itself, does not confer any right ultimately to retain returns derived by the MNE group from exploiting the intangible".[146]

This means that the accurate delineation process, which, as described above, requires the terms and conditions of the actual transaction to be specified, would involve the specification of terms and conditions which confer rights in intangibles from one party to another. The OECD Guidelines do not specify how the rights would be determined based on conduct, only that they must be.

4.2.3.2. The reverse engineering approach

The discussion in the OECD Transfer Pricing Guidelines with respect to both risk and rights allocation seems to adopt an approach to the delineation of transactions that involves what may be referred to as a form of "reverse engineering". For example, in discussing one situation (i.e. where no associated enterprise exercises control over risk nor has the financial capacity to assume the risk), paragraph 1.99 of the OECD Guidelines refers to the need to determine "adjustments to the transaction that are needed for the transaction to result in an arm's length outcome". However, this seems to turn the conventional two-step approach on its head given that the arm's length principle is normally applied on the basis that it is the relevant transactional features that determine the pricing outcome.

The wording in the guidance seems to suggest that there is an outcome that is discernible *other than* as a direct consequence of the transactional features and that, once determined, such an outcome will enable those transactional features to be reverse engineered to align with that outcome. This sort of approach is now commonly seen in practice – for example, a tax authority might conclude that the "arm's length outcome" arising from DEMPE functions being carried out in their territory is that they should be allocated a share of the profit associated with an intangible. It might then be argued that the "adjustments to the transaction [that] are needed" require the imputation of contractual features necessary to deliver the predetermined profit outcome which follows from the assessment of the relevant conduct/functions. This presents a fait accompli, based on an apparent idea or assumption that significant value must be attributable to those functions. This is evidently a very different approach to asking what contractual features are implied by the behaviour/functions and then pricing them accordingly.

As noted in the introduction to this article (section 1.), the assumption that there is an arm's length outcome that can be determined without reference to contractual features is at the heart of the tendency of many tax administrations to short-circuit the accurate delineation process. Recent cases examined in section 5. also indicate that the idea that DEMPE functions create an entitlement to IP-related profit is beginning to gain currency in some courts.

This apparent "reverse engineering" in the delineation approach is pervasive in the examples of delineation that are included in the OECD Guidelines. These examples are significant in the current context as they provide the best illustration of how the OECD Transfer Pricing

145. OECD Transfer Pricing Guidelines, para. 6.36.
146. OECD Transfer Pricing Guidelines, para. 6.42.

Guidelines envisage that the process of accurate delineation should work, particularly given the paucity of the instructions in the main body of the OECD Transfer Pricing Guidelines.

4.2.3.3. Examples in the OECD guidance

There is some debate about how the examples included in the OECD guidance, which illustrate the accurate delineation process, should be interpreted. The structure of several of the examples features an IP owner on one side, and the provider of DEMPE services on the other. Where the circumstances are deemed to require a re-delineation, this is most often presented as though a different transaction to the one entered into by the taxpayer has occurred.[147] Typically, these examples do not specify that the actual transaction entered into by the taxpayer is retained in performing the accurate delineation exercise. Nevertheless, tax authorities will often assert that this is what is intended, and that the accurate delineation exercise includes an unstated assumption that the transaction entered into by the taxpayer is retained. It is argued that the examples of accurate delineation in the OECD Transfer Pricing Guidelines are merely illustrating what the pricing outcome should be and that there is no inference of any adjusted rights and obligations. The authors address these issues (and the intended operation of the accurate delineation process more generally) by reference to one specific example included in the guidance, namely Example 16 of Annex I to Chapter VI of the OECD Transfer Pricing Guidelines. The authors first explore how the accurate delineation process appears to operate based on the plain wording of the example, and then consider whether their conclusions would differ had the intent been to leave the taxpayer's contractual arrangements undisturbed.

The basic facts of Example 16 are as follows. A parent company sells rights to patents and other technology-related intangibles to a new subsidiary, Company T. Company T then contracts out the research and development (R&D) to the parent company on a cost-plus basis.[148] Company T has no personnel capable of conducting or supervising research activities. All such personnel are in the parent company, which supervises and controls the R&D.

A key assumption in this example is that Company T performs no activities in relation to the acquisition, development or exploitation of the intangibles. The example states: "A thorough examination of the transaction indicates that it should be accurately delineated as the provision of financing by Company T equating to the costs of the acquired intangibles and

147. The example in para. 9.122 is almost identical to Example 16, which we analyse in the main body of the article. It involves an R&D services transaction apparently being replaced by a loan. Similarly in Example 6 of Appendix I to Chapter IV the accurate delineation determines the legal owner of the intangibles in question to be the provider of funding. In Example 2 the "true nature" of a licensing arrangement is a "patent administration service contract". In Example 7 the "true transaction between the parties", based on "the *course of conduct* followed […] is that of a limited risk distribution agreement" [emphasis added] under the assumed terms of which certain costs would need to be reallocated – *see* OECD Transfer Pricing Guidelines: Annex I Chapter VI, para. 19. In Example 18 there is a more specific adjustment, whereby geographic rights granted in a licence are changed based on the behaviour of the parties – *see* Annex I Chapter VI, para. 66. In Example 19 "the conduct of the parties reveals that a transaction has taken place…*under comparable circumstances* independent parties *would have* concluded a licensing agreement" [emphasis added].

148. On a point of detail, the contracting out of R&D is also to another group company (Company S), though this is not particularly relevant to the discussion here.

the ongoing development" … "Company T is entitled to no more than a risk-free return for its funding activities".[149]

Whether there are any other important elements which have come to light in the "thorough examination" is not specified. Based on the facts presented, the accurate delineation of the transaction is determined not to be the provision of services from the parent company to Company T, but rather, the provision of financing from Company T to the parent company. That is where the example ends, but as with the other examples of accurate delineation, several important questions about the newly delineated contractual terms are left unanswered. Firstly, what has happened to the contractual arrangement that was in place? As noted above, tax authorities sometimes argue that the accurate delineation exercise is essentially concerned with deriving an appropriate pricing outcome, and that the intention is not to replace the existing transaction, but to price it correctly. However, that is not what has happened here, nor does it appear to happen in the other examples: The example states that the accurately delineated transaction is not a services transaction, but the provision of financing.

The ramifications are significant: the services contract appears to have been completely disregarded. While Company T paid for the intangibles, and remains the legal owner of those intangibles, it will only receive a risk-free return on the cash it has deployed. This means that the profit associated with the intangibles, over and above a risk-free return (or indeed, the losses if the intangibles lose value) will accrue to the parent company.

The OECD Guidelines state in paragraph 6.42 that:

> determining legal ownership and contractual arrangements is an important first step in the analysis, these determinations are separate and distinct from the question of remuneration under the arm's length principle. The return ultimately retained by or attributed to the legal owner depends on the functions it performs, the assets it owns and the risks it assumes … In the case of an internally developed intangible if the legal owner acts solely as a title-holding entity, the legal owner will not ultimately be entitled to any portion of the return derived from the exploitation of the intangible.[150]

This is the outcome delivered by the example. Legal ownership is framed here as being "separate from the question of remuneration", but based on the theory or logic of the OECD Guidelines themselves (as explained in section 4.2.3.1.), the pricing cannot be dealt with without specifying why the non-rights-holding entity (in this example, the parent company) would have any options realistically available to it given it owns no assets or other legal rights, etc. The functions of the parent alone may have negligible value from a bargaining-power perspective (this is not specified in the example). If it is concluded that the legal owner must effectively be holding the rights as a nominee, it is necessary to introduce a new set of contractual terms into the picture to deliver this outcome.

149. OECD Transfer Pricing Guidelines, Annex I to Chapter IV, para. 58. The salient features of the example are provided in paras. 54-57.

150. OECD Transfer Pricing Guidelines, para. 6.42. *See also* para. 6.46: "an important question is how to determine the appropriate arm's length remuneration … within the framework established by the taxpayer's contractual arrangements, the legal ownership of intangibles, and the conduct of the parties". This makes it sound as though there is no expectation that the contractual framework will be "trumped" by the conduct, but it is clear that this is exactly what the accurate delineation exercise is designed to do where there is a relevant inconsistency between contractual arrangements and conduct.

In any event, it will be necessary to infer or deduce terms which pass the entitlement to the profit from the intangibles from the legal owner (Company T) to the parent company. It is hard to imagine that the terms of a standard loan transaction would achieve that. The terms of the "actual" transaction that delivers the suggested profit outcome would have to be more like that of a licence (though to be consistent with Example 3 in the same set of examples, it would have to be a licence that also grants the licensee an entitlement to any capital proceeds on a disposal of the legal rights held by Company T).[151]

Further, there is no suggestion in this example that there is any "lending" behaviour or activity. It seems that the transaction needs to be interpreted in the example as a loan not because that is the transaction suggested by the conduct, but rather to account for the fact of the movement of cash. There is also an open question of what the loan is actually *for* and why the parent might want to borrow cash. In the re-delineated situation, the parent has continued to own the rights to the IP-related profit both before and after the movement of the acquisition cash.

The characterization advanced in the example raises a series of unresolved secondary issues. The capital transaction by which T acquired the asset is now characterized as a loan. T's asset is a loan, and the legally registered intangibles will now have nominal value only. In that case, what happens to any amortization on the intangible value originally paid by T? Would withholding tax be due on the inferred interest payment from the parent? If the accurate delineation results in a notional transfer of intangibles-related profit from T to the parent, is this treated as a loan or a dividend? And so on…

4.2.3.4. A pricing outcome approach

Consideration may also be given to the analysis if, instead of replacing the services transaction with a loan as implied by the plain wording of the example, the service transaction entered into by the taxpayer is preserved and the example is considered to "merely" specify what the pricing outcome should be. In that case, Company T would not have made a loan to the parent company, and the services transaction between them would be preserved. What would not change would be the pricing outcome, which would be consistent with that which would have arisen had Company T been deemed to have provided finance. Under this approach the "price" for the service will essentially be equal to any residual profit in excess of the financing return.

There are several problems with this proposition. The first, and most obvious, is that where the asset does not generate enough income to cover the cost of financing, the service provider will now have to make a payment to the IP owner. How would that payment be characterized? The user of the OECD guidance is now steered to a pricing exercise which ignores the rights and obligations of the parties as formally agreed, and which is based on an alternative, imagined set of rights and obligations. The newly delineated services transaction must be one in which the service provider has taken on the economic consequences which would typically attach to asset ownership, namely, the upside and downside outcomes which remain after paying the equivalent of a financing return to the asset owner. This is far more than simply a matter of determining a price. It would still be necessary to

151. In Example 3, the nominal intangibles owner is deemed to be the provider of registration functions and "should not otherwise share in the returns derived from the exploitation of intangibles, including the returns generated from the disposition of the intangibles". *See* Annex I to Chapter VI. Paras. 8 and 9.

specify how and why a services agreement with these particular (and unusual) terms had been inferred from the parties' conduct.

Whether the transaction is called a loan or a service is of far less consequence than its economic effect, and, assuming a profitable scenario, the actual legal owner would now be obliged to pay to the service provider all profits save for a financing return, presumably in perpetuity. It is unlikely that the original IP transfer from company T to the parent company was valued on this basis. The value of the IP will now be the net present value of the financing return (again, presumably in perpetuity). If amortization is being claimed this could be a significant issue in the jurisdiction in which Company T is based.

Irrespective of the name given to the transaction, the options realistically available to the parties will be dictated by their assets, including their capital. The parent company chose to sell its IP to Company T. As the IP owner, company T wields the associated bargaining power. If the capabilities of the parent company are not unique and valuable then their options will be limited, and a modest markup on costs is likely to be an appropriate pricing outcome. It may well be the case, however, that the IP cannot plausibly be developed, maintained and exploited without the specific capabilities of the parent company. In that case, the parent company would have retained a body of unique and valuable knowhow-based competences for which it might be able to charge a higher-than-average price.[152]

The need to pay a premium for these essential services would, of course, impact on the value of the asset to the owner, as noted above, but more importantly the fact that these services might be particularly valuable tells us nothing about the respective rights and responsibilities of the parties or the basis on which they have agreed to transact. In particular it would not mean that the service provider would take on the rights and obligations associated with ownership of the asset. Indeed, the IP owner could presumably terminate the services agreement. In that circumstance, what would give the service provider a continuing interest in the returns from the IP? This would seem to require a highly unusual set of rights attaching to the termination provisions, which would have to be inferred from the parties' behaviour.

Perhaps the most consequential impact of the various examples in the OECD Guidelines is that the value of the DEMPE activity seems to be derived based on the following formula: total income from intangibles equals risk-free financing return plus (or minus) DEMPE value. This is very far from what the drafters of the guidance seem to have intended,[153] but it has led to a widespread perception that the DEMPE guidance does not contain the same "threshold test" as that contained in the risk control guidance, and that rather than having to specify an alternative set of rights and obligations it is possible simply to reward all DEMPE functionality using this formula. This has led to valuation issues (i.e. what does it mean to "own" an intangible in the context of this kind of formula?) and to issues when senior decision-makers move location (if the formula results in a geographic reallocation of profits, should an exit charge apply?) and so on.

152. Richard S. Collier and Ian F. Dykes, "Competencies, Competence and the Arm's Length Principle", *Bulletin for International Taxation* 77, no. 12 (2023), https://doi.org/10.59403/3gx38hx.
153. Andrew Hickman, "Arm's length principle mutations: control of risk in the OECD guidelines and variations in practice", *MNE Tax*, 13 January 2021; and Eyal Gonen, Leonid Karasik and Michael McDonald, "Control Over Risk and DEMPE Functions".

Irrespective of whether the transaction is called a loan or a service, if the control test is failed the "actual" rights and obligations should reflect the agreement implied by the conduct of the parties. In most of the examples in the OECD Guidelines, the location of control is already decided and presented as cut-and-dried, not complicated or subject to the kinds of control-threshold debates that are ubiquitous in the real world (and on which the authors have written previously). In several examples, the accurately delineated transaction is described as, essentially, an archetype; "a licence", "a patent administration service", "a limited-risk distributor", "a loan", all of which, it is inferred, may be readily amenable to benchmarking. There is little discussion about the specific features/terms of these imputed agreements which would impact on pricing, such as the duration of the loans or licences and the terms in general (other than Example 18, in which the geographic terms of a licence are changed).

In particular, the examples tend to start with a description of the contractual situation and the control behaviour and proceed to the accurate delineation of the "true transaction" without really explaining how one gets from one to the other. This is obviously highly unsatisfactory given that it sheds little or no light on the application of a core assumption of the delineation approach, namely that where it is necessary to diverge from the transacted contract then the terms of the actual transaction can be divined from the relevant conduct or behaviour.

There is a suggestion in the OECD Transfer Pricing Guidelines that the goal is to identify a readily understood transaction of a type that the behaviour concerned might resemble "in substance".[154] However, many of the examples in the OECD Guidelines use a formulation along the lines of "a thorough examination of the transaction indicates that it should be accurately delineated as…"[155] or "a thorough examination of the transaction may show…",[156] implying that the appropriate delineation will become clearer as the examination becomes more thorough. In the experience of the authors, the reverse is often true (because commonly a detailed examination will throw up conflicting factors, such as multiple and constantly varying contributions to the control of risk from different legal entities). Further, the OECD Guidelines recognize that transactions entered into by MNEs may be unlike those commonly (or ever) seen between unrelated parties.[157]

Based on the discussion above, and notwithstanding the many examples in the guidance, it is not clear how the process of accurately delineating the rights and obligations implicit in a hard-to-benchmark transaction would proceed, nor what would be the reference points needed to determine what the transaction looks like "in substance". This means that the detailed process by which the conduct or behaviour of the parties modifies the terms and conditions of the taxpayer's contractual arrangements to arrive at the accurately delineated "true transaction" remains elusive.

154. OECD Transfer Pricing Guidelines: Annex I Chapter VI, para. 4.
155. OECD Transfer Pricing Guidelines: Annex I Chapter VI, para. 58.
156. OECD Transfer Pricing Guidelines: Annex I Chapter VI, para. 63.
157. As indicated in the OECD Transfer Pricing Guidelines, para. 1.142: "Associated enterprises may have the ability to enter into a much greater variety of arrangements than can independent enterprises and may conclude transactions that are not encountered ... between independent parties ... for sound business reasons."

4.2.4. What is the difference between accurate delineation of a transaction and non-recognition of a transaction?

The OECD Guidelines describe the process of accurate delineation as one of "supplementing and clarifying" existing contractual terms,[158] but, as has been discussed in section 4.3., where risk is reallocated from the party bearing contractual risk to the party controlling the risk, it is difficult to argue that this does not amount to "changing" those contractual terms. The discussion in section 4.2.3.3. of the examples in the OECD Transfer Pricing Guidelines reinforces this point. It is difficult to see how the accurate delineation of a service arrangement as a loan (or indeed as anything else which grants to the service provider rights and obligations which would otherwise accrue to the asset owner) could reasonably be deemed to be merely a clarification of existing contractual terms. Therefore, given the very significant pricing ramifications which potentially follow such a material modification of the transacted arrangements, it is relevant to understand how the OECD Guidelines differentiate between the accurate delineation of a transaction (which is now a routine part of the standard transfer pricing process) and a determination that a transaction falls within the scope of the "recognition" guidance[159] and so should only be recharacterized in the exceptional circumstances described for the purposes of that guidance.

4.2.4.1. Background

Before proceeding with that analysis, it is useful to address some relevant background to the issue. In section 2. of this article, the authors noted an apparent conflict in the 1995 OECD Transfer Pricing Guidelines between the implied broad scope of the guidance on conduct and contractual terms on the one hand and the guidance on the "recognition" of transactions on the other.[160] In the first case, the guidance suggests that contractual terms may be construed, supplemented or overridden where the behaviour of the parties suggests that the "real" transaction and its "true terms" differ from or in some way augment the contractual terms presented by the taxpayer. The guidance seems to be a general stipulation, not subject to any particular limitations. In contrast, the guidance on the "recognition of the actual transactions undertaken" contemplates that contractual terms may be overridden only in the exceptional circumstances specified in that guidance. The same guidance also places limitations on a tax authority's ability to ignore or adjust the legal form of a taxpayer's transactions, supported by stark warnings about what would otherwise be "a wholly arbitrary exercise the inequity of which would be compounded by double taxation", etc. The 1995 OECD Guidelines offer no perspective on why the first approach to inferring the "true terms" in the analysis of the contract terms should be any less arbitrary, consequential or controversial than the second, exceptional, approach to recognizing the "actual transactions".[161]

158. *See*, for example, OECD Transfer Pricing Guidelines, paras. 1.43, 1.44, 6.4, 6.36, 6.62, 8.9, and 9.17.
159. More correctly, the guidance entitled "Recognition of the accurately delineated transaction" comprising OECD Transfer Pricing Guidelines, paras. 1.139-1.148.
160. The earlier discussion notes the apparent conflict arising in the 1979 OECD Report, and being later accentuated in the 1995 Transfer Pricing Guidelines.
161. Whilst a tax authority's ability (or otherwise) to apply the recognition provisions in the OECD Transfer Pricing Guidelines has been the subject of several court cases, and academic dispute (*see*, for example, Bullen, *Arm's Length Transaction Structures*), the idea that there is a general licence under the OECD Transfer Pricing Guidelines for the "true terms" in a contract to be inferred from conduct has not been developed through litigation, and in practice seems, at least until the OECD BEPS Project, to have been largely ignored.

This background is important in explaining the approach adopted by the OECD in the transfer pricing response to the BEPS initiative. For some tax authorities it was important to stress that the "control of risk" revisions to Chapter I and the "DEMPE" revisions to Chapter VI of the OECD Guidelines were, essentially, *clarifications* of the existing guidance. This may have been in part to boost the legitimacy of the BEPS work, but it is also the case that some tax authorities were already deploying this kind of conduct-centric approach in live cases as the transfer pricing work in the BEPS Project progressed.[162]

In the development of the risk control framework and the related DEMPE framework, this extant, general requirement to identify the "true terms" of a transaction by reference to the conduct of the parties was extensively elaborated upon, ultimately becoming the "accurate delineation of the actual transaction".[163] The "actual transaction" of the 2022 OECD Guidelines is therefore a development of what may be termed the "real" or "true" transaction" of the 1995 OECD Guidelines.[164] All these terms have in common the clear connotation that the transaction presented by the taxpayer may not be the "actual" or "real" transaction, and that the transaction presented by the taxpayer is therefore contingent upon verification.

The idea that there is a second, different "recharacterization"[165] (or "non-recognition") standard which will apply only in specified, exceptional cases was retained in the BEPS transfer pricing revisions, but, as described at the beginning of this section (section 4.1.), in the revised guidance the "economic substance" prong was removed (as it had been subsumed into the "accurate delineation" approach), and in the post-BEPS guidance a transaction will only be "de-recognised" if it is commercially irrational.[166]

This elaboration of the existing general licence for tax authorities to override contractual relationships was fundamental to the operation of the risk control and DEMPE guidance and became the centrepiece of the BEPS transfer pricing work.

4.2.4.2. The recognition guidance

Following the 2015 BEPS revisions, the section of the OECD Transfer Pricing Guidelines which, exceptionally, limits a tax authority's ability to substitute the transaction presented

162. In the experience of the authors, this was not an isolated occurrence. In the period from 2012, approaches that were being developed by the tax authorities in the course of the BEPS work (and as it evolved toward the Final Reports in October 2015) were commonly being deployed by tax authorities in ongoing disputes. Similarly, elements of the revised approach to the attribution of profits to PEs that would later be developed in the 2008 and 2010 OECD reports on that topic could be seen in tax authority arguments in tax disputes from 2001.
163. The transmogrification referred to also drew on the "recognition" guidance. Specifically, what was formerly the first specific circumstance in which a transaction might be "non-recognized" (i.e. broadly where there is a difference between the legal form and the "economic substance" of a transaction – as discussed in sec. 2.) was assimilated into the accurate delineation guidance, leaving the second circumstance as the subject of the post-BEPS recognition guidance.
164. As the discussion indicates, there is some evolution in the way the test has developed but nonetheless the BEPS changes, with their mandatory control of risk anchor points for the transfer pricing exercise, etc. represent a significant shift in the required transfer pricing approach.
165. "Recharacterization" is a term used widely in practice to refer to the "recognition" guidance, but it does not feature in the 2022 OECD Guidelines.
166. Michael McDonald, "Let's Not Overthink This", 1429-1435.

by the taxpayer with an alternative transaction was entitled “recognition of the accurately delineated transaction”.[167] The section starts by stating :

> Following the guidance in the previous section [which sets out the risk control framework] the transfer pricing analysis will have identified the substance of the of the commercial and financial relations between the parties and will have accurately delineated the transaction by analysing the economically relevant characteristics.[168]

The paragraphs that follow summarize the accurate delineation process, taking care to avoid stating explicitly that the process may sometimes involve a conduct-based override of the rights and obligations in the agreements transacted by the taxpayer.[169] The OECD Guidelines seem to imply that a reallocation of risk or entitlement to IP-related profit does not amount to “non-recognition” of the transaction presented by the taxpayer, or “the substitution of one transaction with another”, because the guidance goes on to state that

> Every effort should be made to determine pricing for the actual transaction as accurately delineated… a tax administration should not disregard the actual transaction or substitute other transactions for it unless the exceptional circumstances described in the following paragraphs apply.[170]

On this basis a tax authority is presumably free to accurately delineate the transaction based, as relevant, on conduct, but once the accurate delineation process is complete (including any reallocation of risks) it is this newly delineated transaction to which the “exceptional” commercial rationality restriction would apply.

The commercial rationality restriction is spelled out in the OECD Guidelines[171] and then expressed in simpler terms as follows: “the key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances … thereby preventing determination of a price that would be acceptable to both of the parties”.[172]

This means that in deciding whether or not the transaction presented by the taxpayer should be recognized, the test is whether the transaction would have been entered into, under any terms and conditions, by independent parties acting in a commercially rational

167. OECD Transfer Pricing Guidelines, Section D.2: para. 1.139 et seq.
168. OECD Transfer Pricing Guidelines, para. 1.139.
169. OECD Transfer Pricing Guidelines, para. 1.140: Formal conditions “will have been clarified and supplemented”. “Contractual risk assumption will have been examined … and … risks assumed under the contract may have been allocated in accordance with the conduct of the parties and other facts … Therefore, the analysis will have set out the factual substance of the commercial or financial relations between the parties and accurately delineated the transaction”.
170. OECD Transfer Pricing Guidelines, para. 1.141.
171. OECD Transfer Pricing Guidelines, para. 1.142: The full text of the test is: “where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to each of them at the time of entering the transaction”. This paragraph features undefined phrases which are different from those generally used in the accurate delineation requirements. For example, here the authors are considering “the arrangements made in relation to the transaction, viewed in their totality” as distinct from simply “the transaction” the authors are also considering the “respective perspectives” of the parties in addition to the options realistically available to them. It seems important that features exist which “prevent the determination of a price that would be acceptable to both of the parties”, but it also seems to be the case that if the transaction is deemed to be commercially irrational, then this will inevitably result in such a finding. This seems to be borne out in Example 1 at paras. 1.146 and 1.147.
172. OECD Transfer Pricing Guidelines, para. 1.143.

manner, based on the options realistically available to them. If the test is triggered, the resulting exercise is then one of "narrowing the range of potential replacement structures to the structure most consistent with the facts of the case".[173] The discussion in the OECD Guidelines gives an example of what this might mean, in the process revealing the breadth of possible outcomes: an R&D services structure could, depending upon the facts, potentially be "recast" as the provision of financing, or as a service agreement but with the service provided by the IP owning party, or as a licence with contingent payment terms.

Notwithstanding the fact that the rationale for change in the re-delineation cases (covered in section 4.2.3.3.) is centred mainly on differences between control behaviour and contractual terms, and in the non-recognition cases the rationale is solely commercial irrationality, the process of inferring what an appropriate alternative transaction might be (and the outcome) seems to be identical. However, the non-recognition guidance states that "because non- recognition can be contentious and a source of double taxation, every effort should be made to determine the actual nature of the transaction".[174] This seems intended to imply that the "accurate delineation" exercise is different from the non-recognition exercise and so presumably should be less contentious. Yet it is very hard to understand how the accurate delineation process described earlier does not also amount to the "substitution" of one transaction with another in the same way as may apply in a non-recognition context. This is particularly true given that, as described above, the accurate delineation process does not appear to be limited to actual conduct but is often deemed by tax authorities (in some cases, with apparent justification) to involve a consideration of the alternative options realistically available to parties.

4.2.5. Conclusions on the current guidance in the OECD Transfer Pricing Guidelines

The primary objective of the conduct-based approach to accurate delineation is clear. Where the contractual terms in intercompany agreements are contradicted by the conduct of the parties or where those terms do not deal with characteristics of the transaction that are economically relevant, then it is necessary to infer alternative terms which are consistent with the actual conduct of the parties.

The actual process of determining rights and obligations involved in the accurate delineation exercise, according to which the terms and conditions of a contractual relationship are inferred by reference to the conduct of the parties is, by contrast, entirely opaque, a point that is reflected in the discussion above of the detailed examples in the OECD Transfer Pricing Guidance.

Accurate delineation is differentiated from non-recognition in the OECD Transfer Pricing Guidelines. Accurate delineation is core to the transfer pricing process, and a required routine exercise, whereas a finding of non-recognition is intended to be exceptional. Any transaction which is subject to an evaluation for non-recognition purposes will already have been accurately delineated. The OECD Guidelines specify that that non-recognition involves replacing one transaction with another and warn against the bilateral challenges posed by the "wholly arbitrary" restructuring of legitimate business transactions. However, most of the examples of accurate delineation provided in the OECD Guidelines either involve

173. OECD Transfer Pricing Guidelines, para. 1.148.
174. OECD Transfer Pricing Guidelines, para. 1.142.

replacing one transaction with another (just as is done by the non-recognition guidance) or substituting critical rights and obligations whilst at the same time preserving the nominal transactional structure, in both cases giving rise to the identical bilateral challenges of non-recognition cases.

The OECD Guidelines specify that non-recognition is, in essence, about whether the transaction undertaken by the taxpayer possesses commercial rationality (in other words, would the parties have transacted this way at arm's length given their respective assets and attributes?). The accurate delineation guidance differs insofar as it appears to be centred on the actual behaviour or conduct of the parties as distinct from their bargaining power. Nonetheless, the guidance states in several places that economically relevant characteristics are also pertinent to the accurate delineation process, and that in particular the accurate delineation of the transaction may be influenced by the options realistically available to the parties.

Overall, given the intended operation of the accurate delineation process (and specifically its reliance on the conduct or behaviour of the parties in determining the terms of the relevant "true transaction") the current guidance in the OECD Transfer Pricing Guidelines seems to be incomplete, confusing and inconsistent. The next section surveys the experience from attempts to apply it in practice.

5. What Is the Experience of Applying the Conduct-Based Approach in Practice?

5.1. Tax authority practice

As a general matter, the emphasis on the relevance of conduct in the accurate delineation process, including the "control of risk" and "DEMPE" changes to the OECD Transfer Pricing Guidelines that were made in the course of the BEPS Project have led to some very significant changes in the practice of tax authorities: there has been a very significant increase in the extent to which, following the BEPS Project, tax audits have focused on conduct, particularly decision-making behaviour. There has not, however, been a corresponding increased focus on translating that decision-making behaviour into an alternative set of terms and conditions of the relevant "accurately delineated" transactions.

Typical audit requests will focus on gathering an understanding of the decisions made by the most senior individuals in the jurisdiction in question with particular emphasis on global and regional roles, roles with strategic aspects, and on sales and marketing and DEMPE functions relating to intangibles. Where senior decision-makers are identified, the most common approach adopted by tax authorities is to assert that entities, or functions within entities, have been wrongly characterized as limited risk or risk free, and/or that DEMPE-related decision-making confers an entitlement to IP-related returns. Normally a tax authority will assert that cost-plus or managed-margin transfer pricing methods are not appropriate for a risk-taking entity or DEMPE-related function and will seek to apply methodologies which delink the return of the entity or function in question from the costs of the entity.[175]

175. This is the opposite of the approach which is normally adopted where taxpayers have utilized an approach which allocates any material profit to overseas senior decision-makers, in which case tax authorities in paying jurisdictions will often argue for a cost-plus approach.

In most cases, the experience of the authors is that tax authorities will, if challenged on the point, assert that there is no need to go through the process of specifying what the alternative contract would look like because they are merely selecting an appropriate transfer pricing method, and that this does not amount to adjusting the contract between the parties.[176] In cases involving senior decision-makers, tax authorities will commonly argue that the profit split transfer pricing method should be used (though on occasion, where a tax authority is investigating a loss-making company, it may assert that the significant decisions about risk are taken elsewhere, and that a TNMM-based margin should be applied). The closest tax authorities normally get to specifying the relevant contractual relationship in these cases is to identify individuals who they deem to be senior decision-makers and to assert that in their judgement the employing entity "looks like" an entrepreneur, or a full risk distributor or, in cases where they believe the control of risk lies outside the jurisdiction, that the entity "looks like" a limited-risk distributor. In an assessment of this type, there is a broad, implicit assertion that the capacity in which the parties have engaged with one another is different from what is in their contract,[177] but a detailed analysis in support of that conclusion and dealing with how behaviour translates into the relevant terms of the arrangement is avoided.

Finally, rather than saying "this particular conduct translates into this kind of contractual term", it is common for the tax authorities' analysis of conduct to morph into an assertion of the kind of contractual relationship the party "would have been able to agree", which is not a test based on conduct but on options realistically available. In this way, much as in the OECD Transfer Pricing Guidelines themselves, the actual behaviour (what contract is implied by what the parties did) and the hypothetical behaviour (what contract is implied by what the parties would or could have done) is conflated.[178]

176. This is perhaps why HMRC's international tax manual guidance on the risk control framework included an extended defence of using the profit split method in cases involving risk control decisions and DEMPE functions. The manual states that "the transactional profit split method is not a method of delineation"; rather, its application stems from "a recognition of the imperfect nature of allocating … risk to one party where functions span both parties" – *see* HMRC *International Tax Manual* INTM485025 – Transfer pricing operational guidance: Accurate delineation of the actual transaction: Risk at para. 82. If this were true, it would mechanically spread risk between the profit-splitting parties, thereby undermining what appears to be the objective of the control of risk framework. Notably, in the section on intangible assets at para. 125 of the same guidance, the approach put forward by HMRC which, essentially, endorses a profit split based on decision makers does not mention accurate delineation at all.

177. This kind of "fiscal classification" resembles the approach adopted by the OECD Transfer Pricing Guidelines in the examples to Chapter VI. As Bullen notes "fiscal classification requires features necessary for such a classification". Bullen, *Arm's Length Transaction Structures*, 165. Such features could provide a "fiscal definition", but there are no internationally recognized contractual features which define, for example, a "limited-risk distributor", and it is noteworthy that the OECD's Working Party 6 (which deals with transfer pricing matters) recently reached an impasse when attempting to use this definition as part of its work on the guidance on "Amount B".

178. In cases where a party is deemed to have control of risk, but they do not have the capital to provide the realistic option of taking on the risk, HMRC are of the view that "it is reasonable to suppose that capital could move to exploit the opportunity". This presupposes a hypothetical reallocation of capital which would amount to a very significant recharacterization. HMRC, *International Tax Manual*, INTM 485025 – Transfer Pricing operational guidance: Accurate delineation of the actual transaction: Risk, para. 56. www.gov.uk/hmrc-internal-manuals/international-manual/intm485025.

5.2. Decided cases

In practice relatively few of these cases have, to date, been litigated. It is more common for settlements to be reached which in turn are giving rise to difficult MAP cases. Many of the court cases that do exist in which tax authorities have sought to adjust aspects of the taxpayer's contractual arrangements other than the price have, essentially, been about "commercial rationality" or the "would" test, rather than about an analysis of the conduct of the parties under the risk control framework.[179]

There are, however, several cases from Sweden which illustrate how courts are beginning to interpret the risk-control and DEMPE guidance. These cases all address the idea that risk control functions may give rise to an entitlement to IP-related profit. Taken together, these cases illustrate some of the problems that arise where alternative contractual terms are not specified.[180] There are several cases in which similar issues arise, but for the purpose of this article the authors will touch briefly on four: *Pandox*, *Meda*, *Twilio* and *Datawatch*.[181]

The *Pandox* case[182] related to the acquisition of hotel-owning subsidiaries by a Swedish-parented group. As is the industry standard, hotels in each territory would normally be owned by a company in the same territory. The hotel-owning subsidiaries had few (but not zero) employees. The hotels generated rental income from third-party operating companies, and the Swedish parent charged the hotel companies for its services. The Swedish tax authorities, *Skatteverket*, argued that, because the senior employees of the Swedish parent company were heavily involved in the decision-making surrounding the acquisitions, and because there were few employees in the hotel-owning subsidiaries, the critical decisions about economically-significant risks were taken in Sweden, and an accurate delineation of the relevant arrangements would result in the hotel-owning subsidiaries receiving a risk free return, with the balance to be paid to the Swedish decision-makers.

Whilst describing their approach as "accurate delineation", *Skatteverket* did not specify what the rights and obligations under the accurately delineated arrangement would be. Having deemed the decision-making in the local subsidiaries to be insufficient to pass the control test, they seem to have simply taken the "formula" referred to in section 4. of this article (total income from assets equals risk free return on investment plus DEMPE return) and applied that by reference to the location of the decision-makers. In consequence, the company argued that the Swedish tax authorities had not established that the transaction was mispriced and further, by not specifying what the alternative "accurately delineated" contractual arrangements would be, they were in breach of the principle of legality: essentially, they had not applied the required transactional approach. It was also argued that, when the acquisitions were made, the acquired companies already owned long-term rental

179. Given that the OECD guidance discussed in this article is relatively recent, there are only limited court cases in which it is discussed. Similarly, with some notable exceptions (like the United Kingdom) tax authorities have generally not issued detailed guidance on the matters discussed in this article. However, the comments that follow below highlight some notable developments that are known to the authors. (For the avoidance of doubt, the authors have not attempted to conduct a comprehensive global assessment of relevant developments.)
180. The cases are complex with differing fact patterns, and the discussion here is inevitably a simplified overview of some of the features which are relevant to this article.
181. These cases are typically referred to by reference to the principal taxpayer involved for ease of understanding and comparison because the formal case references are numeric. The authors have included the formal case references in footnotes.
182. Administrative Court, Stockholm, case 12512-20, 12520-12523-20 and 13265-20. 25 Feb 2022.

agreements with associated operating rights and responsibilities, and that further, each hotel-owning affiliate had its own legal personality with the associated ability to make its own decisions.

The Administrative Court ruled in favour of the taxpayer, with these latter points proving decisive. The Administrative Court stated that *Skatteverket* had not done enough to show that the control threshold test established by the OECD Transfer Pricing Guidelines had not been met (i.e. on the basis that there was insufficient decision-making in the hotel-acquiring entities to "anchor" the assets there), nor had they been able to demonstrate that the Swedish parent was materially involved in post-acquisition decision-making. Another important factor in the decision was the fact that the acquired entities already owned long-term rental agreements (presumably because the critical decision to enter into those agreements had been taken elsewhere, and before the subsidiaries were acquired).[183]

The *Twilio* case involved an acquisition of a Swedish company by a US parent, after which the US parent made significant control decisions on behalf of the Swedish company, though the IP remained registered in Sweden for legal purposes. The United States entered into a five-year licence with the Swedish IP owner. *Skatteverket* asserted that the entitlement to IP-related profit had moved to the United States, and that an exit charge should be due. The appeal court judgment states that "the right of return accrues to the party or parties that perform and control the more important functions linked to intangible assets (paragraphs 6.42 and 6.54 of the OECD Guidelines)"[184] and "according to the OECD Guidelines, the right of return belongs to the party that performs and controls essential functions and risks associated with intangible assets". Based on the fact that the current DEMPE functions were performed in the United States, the transaction was deemed, for the purposes of the Swedish transfer pricing rules, to be "a transfer of the … IP business". *Skatteverket* were therefore successful in their assertion that the exit charge should (broadly) be based on the original acquisition price for the entire company.

The *Datawatch* case[185] applied similar reasoning, with essentially the same outcome. Again, the current DEMPE functions were deemed to be determinative of the location of entitlement to IP-related profits. In neither case is this proposition considered by the court to be particularly problematic – it is presented as a straightforward interpretation of the OECD Transfer Pricing Guidelines.

The *Meda* case[186] did not involve a change of facts post-acquisition as was the case in the Twilio and Datawatch cases. In *Meda*, a Luxembourg subsidiary of a Swedish-parented group acquired IP from unconnected parties. The company in Luxembourg employed between two and five individuals across the period in question and was not heavily capitalized. Acquisition financing was provided through intercompany loans. The income from the acquired IP accrued to the legal owner, in Luxembourg. *Skatteverket* argued that the

183. The decision therefore made it unnecessary to consider what the ramifications would have been had Sweden been entitled to a significant share of the rental income, and how this would have been viewed by the counterparty territories, who would have treated the rental receipts as being property-related income and therefore within the ambit of article 6 of the OECD Model. Nor was it necessary to consider the question of whether *Skatteverket* were entitled to override the relevant contractual arrangements based on the Swedish domestic tax law.
184. Court of Appeal, Gothenburg, case no. 17-22, 22 Feb 2024.
185. Court of Appeal, Stockholm, case no. 4775-4777-19, 22 February 2024.
186. Court of Appeal, Stockholm, case no 6754-6759-22, 10 April 2024.

risk control functions with respect to the acquisition of IP were performed by the Swedish parent and other entities, and not by the Luxembourg-based subsidiary. In consequence, it was argued that a profit split should be applied. The profit split mechanism was one in which the IP owner first received a risk-free return on investment, with the Swedish parent then retaining 60% of the residual profit (presumably in perpetuity) based on the fact that the most important decision-maker was based in Sweden, with the remaining 40% being allocated to other individuals who contributed to control decisions.

The taxpayer argued that the board of the Luxembourg affiliate did, in fact, control acquisition decisions and also that, because the Swedish tax authorities had not claimed that the contracts legally differed from their civil law form, they were precluded from making a substance over form assessment under domestic law.

The latter argument was accepted by the first-tier court, which stated that the control of risk provisions in the OECD Transfer Pricing Guidelines did not create a licence to disregard civil law agreements. However, the Court of Appeal sidestepped this issue by asserting that the basic transfer pricing adjustment mechanism was not limited to adjustments to price, and did, in fact, extend to adjustments to contractual terms based on what third parties would agree.[187] This meant it was not necessary to consider whether an adjustment to the contract was allowed under civil law "substance over form" provisions, because the process for applying the correction rule is governed by the OECD Transfer Pricing Guidelines. Further, the Court of Appeal explicitly addressed the question of whether they were obliged to specify what form of transaction third parties would have agreed to. The Court concluded that, because groups can enter into unique arrangements that have no counterpart in arrangements between unrelated parties, it was not reasonable to expect *Skatteverket* to provide evidence of market-based conditions, and that it was appropriate in the circumstances to simply apply the profit split approach described above.

The implications of these cases are significant. The *Datawatch*, *Twilio* and *Meda* cases all skip the need to specify the rights and obligations which the parties are deemed to have agreed to in the controlled transaction, and proceed directly to a fairly simplistic application of the "DEMPE formula" to the effect that entitlement to IP-related returns (and presumably liability for losses) follows decision-making as it moves, and triggers exit charges. While the Swedish court seems to have deemed some decisions to have lasting ramifications which create an enduring entitlement to profits, there is no consideration of how that entitlement might attach to historic (as well as current) decisions, nor any recognition that these decisions interpret the OECD Transfer Pricing Guidelines as having introduced a formulary approach to profit allocation. It is unsurprising that Swedish commentators are disappointed that none of the issues raised in these cases have found their way to the Swedish Supreme Court of Appeal.

187. The question of whether the basic transfer pricing comparison in article 9 and in most domestic transfer pricing legislation allows for changes to terms other than price is a critical feature of several well-known cases (including, for example; *McKesson Canada Corporation and Her Majesty The Queen*, 13 December 2013, Docket:2008-2949(IT)G; *Canada v. General Electric Capital Canada Inc.* (2010 FCA 344) 15 December 2010; *Chevron Australia Holdings Pty Ltd v. Commissioner of Taxation* (No 4) [2015] FCA 1092 23 October 2015; and *Commissioner of Taxation v. Glencore Investment Pty Ltd* [2020] FCAFC 187, 6 November 2020. It is notable that where such changes are ruled to be possible, as in the *Meda* case, the test is deemed to be one of commercial rationality and is not based on behaviour. This adds an extra layer of complication to an already complicated issue.

Beyond Sweden, the picture is more varied. In one noteworthy case in Denmark, the Danish tax authorities, SKAT, argued that a persistently loss-making Danish company was, by continuing to maintain a presence in the Danish market, providing a service to the group, and that this service had not been charged-for. The National Tax Tribunal ruled that "SKAT has thus made an estimate [which would have left the Danish affiliate with a TNMM-based profit] which implies that there is a lack of a controlled transaction … [and that] … a lack of a controlled transaction should only be established in exceptional circumstances" and that this was not such an exceptional case. SKAT withdrew the case but issued a memorandum disagreeing with the judgment, stating that "[i]n the opinion of the Ministry of Taxation, whether there is a controlled transaction depends on a specific assessment. This assessment must be made on the basis of the facts at hand, including the basis of the agreement and the parties' actual conduct. See [the OECD Guidance] on 'accurate delineation of the actual transaction'".[188] In other words, in the opinion of SKAT, the Tribunal had erred in applying the "recharacterization by exception only" standard to the "implied missing transaction", when they should have been applying the "accurate delineation as a matter of routine" standard.[189] The case therefore exemplifies the difficulties of distinguishing between the application of the (routine) accurate delineation approach and the (exceptional) recognition doctrine.

5.3. Cases concerned with what is "commercially rational"

Even though there are few cases which focus solely on how actual behaviour translates into contractual terms, there are some noteworthy aspects to the "commercial rationality" line of cases which are potentially relevant to cases in which a tax authority seeks to amend the terms and conditions of a contract entered into by a taxpayer.[190] In particular, in the "commercial rationality" cases which involve tax authority challenges based on the notion that unrelated taxpayers would not have entered into the transaction concerned, the tax authorities rarely specify what the alternative unrelated party contract would be. This further underscores the practical difficulties in the construction of contracts based on conduct or on what third parties "would" or "might" do.[191] As described above, the Swedish Court of Appeal in *Meda* essentially dispensed with the need for the tax authority to specify what transaction had been entered into, saying it was unreasonable to ask them to do so, but that has not been the position of the courts in other cases.

For example, in the Canadian *Cameco* case,[192] the judge noted that the Canadian transfer pricing legislation "contemplates replacing the existing transaction with some other

188. SKM Announcement, SKM number: SKM 2021.166.DEP, 25 March 2021.
189. The basis for one of the taxpayer's rebuttals of the findings in the *Coca Cola* case in the United States bears certain similarities to the National Tax Tribunal's argument in the case above. There the taxpayer argues that in selecting the comparable profits method to test the profits of licensees (the result of which would be a fixed but relatively routine margin earned by the licensees), the inherent contractual character of the licence has been overridden and that this amounts to an impermissible recharacterization – *see* Appellant brief for 11th Circuit, 25 Feb 2025, with respect to *Coca-Cola Co. v. Commissioner*, 155 T.C. 145 (2020), 4.
190. It is important to stress that these cases are decided based on the domestic legislation of the jurisdictions concerned.
191. By way of observation, the practical difficulties of all these issues in mutual agreement procedures (MAP), (and the potential scale of those difficulties in the event these issues are widely disputed) is a further acute concern, and it is hard to imagine that existing resources for dealing with such MAP disputes will be sufficient.
192. *Canada v. Cameco Corp*, Feb 2021, Supreme Court, case no. 39368.

transaction. It does not contemplate replacing the existing transaction with nothing" and further, that the legislation requires the tax authority to specify the "terms and conditions" of that alternative transaction.[193] The *Cameco* case can be viewed as the latest in a line of cases which test the extent of the transactional changes permitted by the domestic transfer pricing provisions. The debate about where the boundary lies between a permissible contractual change and a change that would amount to a recharacterization is articulated most clearly in the *McKesson* case,[194] but one thing that seems to emerge from these cases is that where a change is permissible, it is necessary to specify what the changed terms would be.[195] Similarly, in the case of *Watsons Personal Care Stores,* the original assessment was set aside because the Malaysian tax authority, whilst being empowered to disregard the structure, was also obliged to specify "the structure that would have been adopted" in its place, and their failure to do so amounted to "a base denial, lacking any evidence".[196]

These cases deal with obligations on the tax authority to specify the characteristics of alternative transactions in the context of arguments about what is, or is not, "commercially rational". There are, as noted above, relatively few cases to date which explicitly address conduct-based contractual adjustments. As noted above, the appeal court in the *Meda* case stated that it was unreasonable to expect the Swedish tax authorities to make such a determination, but this case can be compared with the recent *Costa Crociere* case in Italy. The judgment in that case is somewhat confusing as (perhaps not surprisingly given the analysis in section 4.) it seems to conflate the "accurate delineation" process and the "non-recognition" process.[197] The Italian tax authority "was not precluded in the abstract from re-qualifying the contract"; however, the case was dismissed "because the tax authority did not "examine in the least the content of the contract, its economic substance, the risks actually assumed [etc.]". In essence, the tax authority in *Costa Crociere (*as in the *Cameco* and *Watsons Personal Care Stores* cases), did not complete the process and specify what they considered the alternative transaction would have been.[198] Under the OECD Transfer Pricing Guidelines, this is a required step, irrespective of whether the alternative contract

193. *Canada v. Cameco Corp*, Feb 2021, Supreme Court, case no. 39368, paras. 53 and 55.
194. *McKesson Canada Corporation and Her Majesty The Queen*, 13 December 2013, Docket:2008-2949(IT)G, para 125 et seq.
195. This view is expressed by Justice Boyle in *McKesson Canada Corporation and Her Majesty The Queen*, 13 December 2013, Docket:2008-2949(IT)G, paras. 283-351. The specification of the revised terms was not required by Justice Middleton in the *Glencore* case because the contractual terms agreed by the taxpayer were deemed to be within the range of contracts which a third party might have agreed. *See Commissioner of Taxation v. Glencore Investment Pty Ltd* [2020] FCAFC 187, 6 November 2020, para. 166 et seq.
196. *Malaysia v. Watsons Personal Care Stores Holding Limited*, April 2023, High Court, Case no. WA-14-20-06/2020, paras. 20 and 36.
197. The judge said: "[The 2017 Guidelines] envisage the possibility of disallowing or substituting the transaction between the parties, but under very strict conditions, and, above all after all the necessary steps have been taken to accurately delineate the actual transaction between the parties which is a preliminary operation in any transfer pricing analysis: to this end, it is necessary to start from the context of the contract, examine the actual economic substance of the transaction, its commercial rationality and always with reference to the need to compare it with similar transactions between independent enterprises." *Italy v. Costa Crociere SpA*, July 2024, Supreme Court Case no. 20228/2024, para. 7.5
198. There is also some similarity here to *Glencore*, where the Commissioner "submitted that there was no range of possible outcomes.., but just one outcome, namely retention of the pre-existing terms as they were". This is clearly not quite the same, but what the commissioner had not done was set out what the "range of hypothetical contracts" "might reasonably be expected" to have been entered into by third parties to see whether the transaction selected by the taxpayer actually fell within that range. There are clearly substantial challenges involved in laying out what this range of hypothetical contracts would look like. *See Commissioner of Taxation v. Glencore Investment Pty Ltd* 2020, para. 166.

is to be determined based on actual conduct or on the basis of what third parties would or might do.[199] The cases discussed above, though relatively limited in number, seem to indicate the difficulty of that exercise.[200]

5.4. Conduct in the construction of contracts

An additional, important area of emerging focus relates to the extent to which the contractual changes permitted by the OECD Guidelines as part of the "accurate delineation" process are already licensed in contract law, thereby avoiding the need for specific enabling legislation. In making the significant changes to Chapter I of the OECD Guidelines outlined in this article, there seems to have been a general presumption made by some members of WP6 that the kind of (conduct-driven) contractual changes licensed by the accurate delineation rules would not require specific enabling legislation under the domestic law of states applying this new approach.

This assumption may have been based on the fact that contract law in both common and civil law jurisdictions permits terms to be implied into agreements between third parties. Such an implication may be based on a determination of the intent of the parties, which will in turn be based on the detailed "matrix of facts" surrounding the transaction. In this respect, there appear to be superficial similarities between the way that terms are implied under contract law and the "accurate delineation" approach set out in the OECD Guidelines.

It seems highly unlikely, however, that courts will ultimately deem contract law to provide a licence to imply terms into contracts based on the approach set out in the OECD Transfer Pricing Guidelines. This is because, in contract law, account is taken of such implied terms of a contract in only a relatively limited set of circumstances, namely, where there are gaps which the parties did not contemplate, or where the implied term is necessary to give the contract efficacy.[201] In particular, "it is a cardinal rule that no term can be implied into a

199. An interesting case currently going through the courts in the United Kingdom may ultimately require the UK tax authorities, HMRC, to undertake such an exercise. Whilst the UK *Refinitiv* case (*see R (on the application of Refinitiv Limited and others) v. HMRC*, case UKSC/2025/0018) is ostensibly about the extent to which HMRC must continue to respect the ramifications of a contractual relationship which they had hitherto accepted in an APA, HMRC's assessment involves an implied re-delineation of the contractual rights of the parties based on an analysis of DEMPE activities. It is possible that HMRC do not consider this to be a re-delineation, but merely the application of a profit-split methodology as described in *supra* n. 177. It seems clear, however, that if method selection changes the way that risk is shared in a contract, then this would represent an implicit contractual override.

200. A further noteworthy aspect of these "commercial rationality" cases is that tax authorities seem rarely to prevail in them. As a result, some jurisdictions have introduced, or are contemplating the introduction of, domestic transfer pricing rules which specifically grant the tax authorities greater freedom to adjust contractual terms. *See*, for example, certain new Polish rules, which now define the controlled transaction as "economic activities identified on the basis of the actual behaviour of the parties". This is noteworthy because here a transaction is not defined as an agreement between parties but as "economic activities" which appears to be a license for the "fiscal classification" approach, in which the tax authority may assert that the entity "looks like" a certain kind of operation (described in *supra* n. 176). The revised Polish provisions also remove the "exceptional" proviso from the recharacterization rules. Transfer Pricing Ward 1, General Provisions, Chapter 1A.

201. Lord Neuberger, "Express and Implied Terms in Contracts", School of Law, Singapore management University, 19 Aug 2016, para. 26. In any event, as emphasized by Pichadze, the tasks of ascertaining the terms of a contract and determining their meaning must be carried out in accordance with the settled rules and/or principles that actually govern the contract(s) in question. These are the rules and/or principles which are actually binding on the courts with respect to the analysis of the contract under review and it is these rules which would determine the degree to which the conduct of the parties may displace or supplement the terms of the contract – *see* Amir Pichadze, "Exposing Unaddressed Issues in the

contract if it contradicts an express term".[202] This therefore means "the court's first recourse is to the objective meaning of the terms of any written agreement, only going beyond them to the background 'matrix of facts' if competing meanings present themselves".[203]

This means that if what is written in a contract is internally consistent, and without gaps which hinder its interpretation then, as a matter of law, the contract will be respected, irrespective of the parties' intentions[204] or their conduct.

This is important given that article 9 and the guidance in the OECD Transfer Pricing Guidelines are no more than "soft law", which means they are not "self-executing" as to their domestic application and so require detailed domestic legislation to implement transfer pricing rules:

> Accordingly, while the TPG utilize a mix of legal and non-legal principles and concepts, derived from sources such as domestic tax laws as well as generally accepted accounting principles, care must be taken to recognize that some aspects of the transfer pricing analysis must be carried out in accordance with the applicable law rather than based on some other inapplicable principles; notwithstanding that those other principles may be conceptually relevant. This is exemplified by the tasks of identifying and construing the contractual terms. There is only one correct way to determine what the contractual terms of the controlled transaction are and what those terms actually mean: it is in accordance with the law that actually governs the contract in question.[205]

The basic principles of contract interpretation may in some cases be overridden, such as by laws protecting consumers and employees,[206] and of course they may also be overridden by domestic transfer pricing rules. However, it does seem clear that enabling legislation is necessary to give effect to the OECD's conduct-based approach to the delineation of transactions, and that without it general contract law will not allow for a conduct-based override of a contract that is otherwise capable of interpretation based solely on its written content.

OECD's BEPS Project: What About the Roles and Implications of Contract Interpretation Law and Private International Law in the Transfer Pricing Arm's Length Comparability Analysis?" *World Tax Journal*, 7, no. 1 (2015): 99, https://doi.org/10.59403/2s4cqmw.

202. Lord Neuberger, "Express and Implied Terms in Contracts", School of Law, Singapore management University, 19 August 2016, para. 28.
203. Sarah Worthington, "Common law values: The Role of Party Autonomy in Private Law", *Legal Studies Research Paper Series*, June 2015, 33.
204. The OECD Guidelines refer to the intent of the parties (as distinct from their conduct) in only a handful of places (*see* OECD Guidelines, paras. 1.42, 1.47, 1.88, 2.161, 6.36 and 8.21), but there does seem to be a suggestion that the ultimate objective in examining the conduct of the parties is to ascertain what their intent was. For example, para 1.42 states that delineating the transaction involves ascertaining "how the responsibilities, risks and anticipated outcomes were intended to be divided at the time of entering the contract" and para. 1.88 states that "the conduct of the parties … should generally be taken as the best evidence concerning the intention of the parties in relation to the assumption of risk". Para. 6.36 also includes the inference that the conduct that matters in deducing the actual transaction is the "decisions and intentions" of the associated enterprises. This apparent focus on the intentions of the parties reflects an important legal theme as a common thread in the law of contracts, in both civil law and common law jurisdictions, is that the true nature of a contract is based on the parties' common intentions and thus in determining the legal nature of a contract; it is a search for the common intention of the parties that is the object of the exercise. *See* Amir Pichadze, "The Role of Contract Interpretation in Transfer Pricing Law", *Canadian Tax Journal* 65, no. 4 (2017): 851.
205. Amir Pichadze, "Exposing Unaddressed Issues in the OECD's BEPS Project", 126.
206. Sarah Worthington, "Common Law Values: The role of Party Autonomy in Private Law", *Legal Studies Research Paper Series*, paper 33, June 2015, 4 and 5: "Most democracies accept paternalistic intervention by the legislature in contexts where consent is perhaps not truly 'free'". Such legislation typically regulates contract terms where there is a perceived imbalance of power" Worthington here cites laws protecting consumers and employees. Unlike transfer pricing rules, these legal protections typically operate to strike out a contract, rather than replace it with an alternative contract.

This general conclusion has also been reached by others. In the context of German tax authority arguments that civil law does indeed create a licence for the kind of substance-based adjustments outlined in the OECD Transfer Pricing Guidelines, Oliver Busch notes that:

> the judgements cited by the tax authorities [in support of the contention that circumstances are to be assessed according to their "economic content" as opposed to contractual terms] are all limited to an internal interpretation of the contract itself, namely whether the civil law contract designation is compatible with what the parties intended, i.e. the specific agreements in the contract. The OECD goes far beyond this by allowing for a complete abstraction from the contract, in which the treatment should be based solely on the behaviour of the parties involved.[207]

Van der Ham et al. concur: "a reclassification of facts in existing formal contracts, with reference to the new wording of the OECD TPG is, in the opinion of the authors outside of the applicable abuse provisions and therefore not covered by the applicable law".[208]

The discussion above suggests that importing the conduct-based approach reflected in the "accurate delineation" exercise into domestic law may be more problematic than has been assumed by the OECD, though jurisdictions, such as the United Kingdom, which import the OECD Transfer Pricing Guidelines directly into their domestic legislation[209] will argue that they do have an explicit override of contract law in their legislation. Other jurisdictions, such as the United States, have had domestic rules allowing for a conduct-based contractual override for many years.[210] Unsurprisingly, yet more jurisdictions have implemented, or are considering the implementation of, domestic transfer pricing legislation which features such rules.[211]

Overall, the extent to which domestic transfer pricing legislation permits changes to contractual terms continues to be contested. Several cases have dealt with contractual changes in the context of the "commercial rationality" issue, whilst few have dealt with risk-control and DEMPE decision-making (with the Swedish cases, *Pandox*, *Twilio*, *Datawatch* and *Meda* being notable exceptions). To date, in most of the cases where contractual changes have been deemed to be permissible, courts have generally required tax authorities to specify the nature of the alternative terms and conditions, though, as discussed, in the *Meda* case this was not deemed necessary, and the court accepted a formulary-style headcount-based profit split based on the location of the significant decision making functions.

207. Oliver Busch, "The New Administration Principles on Transfer Pricing", *Der Betrieb* (2021): 1908.
208. A. Vogele, T. Borstell and S. van der Ham, *Verechnungspreise: Betriebswirtschaft, Steurrecht*, 6th Ed. (C.H. Beck, 2023): 1945.
209. For accounting periods beginning on or after 1 April 2023, UK transfer pricing legislation operates by reference to the *OECD 2022 Guidelines* – see *s164 TIOPA 2010*.
210. *See*, for example, US regs S1.482 1(d)(3)(iii)(B) "the allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction […] in considering the economic substance of the transaction the following facts are relevant – (1) whether the pattern if the controlled taxpayer's conduct over time is consistent with the purported allocation of risk…. (2) whether the controlled taxpayer has financial capacity … [etc.]". Notably, in S1.482 1 (d)(3)(ii)(B) the rules license the IRS to "disregard" contractual terms that are inconsistent with behaviour, but also require them to "impute terms that are consistent with the economic substance".
211. *See*, for example the Polish rules referred to in *supra* n. 201, and the recent Malaysian guidance at https://www.hasil.gov.my/media/c55fiwyk/malaysia-transfer-pricing-guidelines-2024.pdf, (para. 5.14).

6. Conclusions

It should be emphasized that this article is not intended as an argument in favour of deferring to the relevant legal documentation as the sole determinant of the facts or "reality" on which any transfer pricing analysis is to be based: the authors recognize such an approach would obviously be open to abuse. Further, they commend OECD efforts to protect the tax base against the effect of artificial or unreal arrangements, and support work to ensure the transfer pricing regime is conceptually sound and practically administrable. However, the article does seek to make the case that: (i) the conduct-based response to the problem of abuse has been adopted with too little analysis of some obvious difficulties; (ii) that approach is causing a whole range of problems and is difficult to apply in practice; and (iii) that approach is producing results which are in some cases hard to reconcile with the ALP (but which look more like a formulary approach to the allocation of profits).

As section 3. demonstrates, the formative guidance on the conduct-based approach appeared in the very first OECD report on transfer pricing in 1979. Subsequent versions of the OECD Transfer Pricing Guidelines have inherited and increasingly developed that approach, most notably as part of the transfer pricing reforms in the BEPS Project. It should not be a surprise that the significant shift over the last 10-15 years to this pervasive reliance on conduct is proving particularly difficult. The process of identifying the transaction to be priced is of the most fundamental importance in applying the transfer pricing approach based on transactional comparability. This is because a careful understanding of the transaction entered into is always required to enable a proper comparison of that transaction with a third-party analogue. Nonetheless, the relevant guidance in the OECD Transfer Pricing Guidelines on determining the transaction in any case has gone through an arc of almost never deviating from the relevant legal analysis to apparently deviating routinely, yet apparently with too little thought as to what this means or requires.

The result of this materially increased reliance on conduct is that the OECD has taken one of the biggest set of technical and practical difficulties relating to the ALP (namely the degree to which conduct or behaviour can be used to construct actual transactions) and exported those difficulties into the routine transfer pricing exercise concerning all transactions, reversing the previous approach where the conduct-based approach is applied on a more exceptional basis (where, arguably, the difficulties might be more manageably accommodated). What makes this shift remarkable is that it has been effected with almost no consideration of what the process of relying on conduct to construct transactions involves and what difficulties might arise.

What may well account (at least in part) for the current position is that statements made about the role of conduct which originated in earlier OECD papers (for example, the historical material discussed earlier which deals with contractual terms) have possibly been taken up and developed in the BEPS Project but with a false confidence in what has already been established relating to the role of conduct in the transfer pricing exercise. At the same time, the specific concentration on risks assumed – and the major shift to determine the location of risks ultimately by conduct – has perhaps underestimated the difficulties created by the apparent separation of "risks" from (legal) "rights" and so not clearly delivered the decisive reallocation of profits based on risks assumed that was sought. (Both of these difficulties are in consequence inherent in the DEMPE approach.)

As the authors have sought to explain in this article, they do accept that the conduct-based approach can be used reliably in several ways. For example, an assessment of conduct may corroborate or verify whether a legally contracted service has actually been provided. There may also be cases where the presence of certain conduct (and the absence of any corresponding legal arrangements) can readily allow the creation or deeming for transfer pricing purposes of arrangements that raise transfer pricing implications (as in the example given earlier in this article of a bookkeeping service which can be imputed solely on the basis of conduct alone). There are also certain other ways the presence or absence of relevant conduct can be reliably used in the transfer pricing process.[212] All of these instances suggest that conduct or behaviour tests may clearly have a role to play in the transfer pricing system.

However, as the above discussion seeks to show (and as the OECD Transfer Pricing Guidelines themselves have historically acknowledged) there are limits to the degree to which conduct can be relied upon to create or deem transactions for transfer pricing purposes. The difficulties are especially acute in cases where it is argued conduct or behaviour tests can be used to identify value (or assets) which stem from what are "merely" legal rights or legal capacities or the detailed terms of legal agreements. The short point is that, as the very first OECD transfer pricing report recognized, legal rights *in themselves* are a source of value and determine prices. That obviously remains equally true today. It is also true that no plausible comprehensive approach based on conduct or behaviour has been developed by the OECD to allow an exclusively conduct-based approach to determining the nature of the "true" transaction in any case. Thus, contrary to the assumptions made in the current OECD guidance, in the view of the authors it seems highly doubtful that, as a general matter, all the important features of a transaction are capable of being inferred from the conduct of related parties.

If the current heavy reliance on the conduct-based approach is to be maintained in its current form, some further material clarifications and revisions of the OECD guidance seem to be required. Perhaps of most immediate assistance in cases involving a "re-delineation" of a transaction or arrangement would be for tax authorities to identify the assumed core terms that stem from applying the conduct-based approach. Such a practice would seem better aligned with the requirements of the OECD Transfer Pricing Guidelines and make it easier practically to analyse and test the different perspectives on the impact of the relevant conduct in disputed cases. Certain other detailed improvements might also be made. For example, if it was not the intention for DEMPE decision-making to give rise to a transfer of rights in intangibles, then it is very important that this is made clear. This could be combined with further work to set out the circumstances in which organizational know-how-based competences might represent sources of competitive advantage. The objective might be to limit the problems associated with delineating rights based on conduct and to focus instead on the issue of the appropriate valuation of DEMPE services. (This work might be combined with a more comprehensive set of principles around the valuation of intangibles, and in particular, the relationship between the capital value of IP and any essential ongoing DEMPE activities.) If, however, it was the intention for DEMPE decisions to potentially give rise to a transfer of rights in intangibles, then much more explicit guidance on how the rights are to be inferred from conduct is necessary, in particular when that relevant conduct

212. For example, as the authors indicate in Collier and Dykes, "Competencies, Competence and the Arm's Length Principle", p.15, a functional control test can readily be used to identify the location of ownership of intellectual property which constitutes some form of "competency" asset.

is fragmented, and where decision-makers move jurisdiction. A related point is that some guidance on exactly what role “acquisition” decisions play in a DEMPE analysis would also be helpful (the earlier discussion might be taken to suggest there should also be an “A” in the “DEMPE” analysis).[213]

Various other points are also important (such as the desirability of a clear statement that the comparison with third parties inherent in the pricing exercise cannot proceed without an understanding of the rights and obligations of the respective parties, and that establishing these is a critical component of the accurate delineation exercise; and a clear statement that it was not the intention of the guidance to introduce a formula whereby the total returns from intangibles should be deemed to equal a risk-free return on capital plus the returns to DEMPE activity). These are a few examples of the many potential areas for attention in what has now emerged as an extraordinarily complex conduct-based regime. It is evident that the various difficult conceptual, technical and practical issues that are inherent in these rules present taxpayers with a set of compliance challenges that are unparalleled across the transfer pricing spectrum.

213. The discussion earlier in this article of Example 16 implies that “acquisition” decisions may be important. A similar implication seems to follow from the OECD Transfer Pricing Guidelines, para. 6.49.