The book written by Aitor Navarro, *Transactional Adjustments in Transfer Pricing*, is based on a doctoral thesis defended in 2016. It is well written, well documented, and reveals a mature researcher with deep knowledge in the area of transfer pricing. The book is about a central and controversial aspect of the application of the arm’s length principle: the question of whether or not, and if so to what extent and under what circumstances, a correct application of the arm’s length principle allows adjusting the conditions of controlled intercompany transactions, or even disregarding the very existence of such transactions. That possibility is described by the author as ‘transactional adjustments’, which are to be distinguished from comparability adjustments, or adjustments to the prices or margins of intercompany transactions. The terminology used in the 2017 OECD Transfer Pricing Guidelines is the (non)recognition of the accurately delineated transaction.

The topic has long been a controversial one, as illustrated by the *Altera* case in the United States (US). As emphasized by the author, and consistently with certain views expressed in the literature, the enforcement of transactional adjustments can easily be arbitrary and not supported by objective evidence. This is partly due to the difficulty of striking a balance between the conflicting interests of tax administrations (which are in need of tools to correct deviations from the arm’s length principle and compensate for information asymmetry); and taxpayers (which are normally free to organize their business activities and to enter into intercompany transactions that reduce their global tax burden, as long as these arrangements are supported by adequate substance). However, both parties need certainty and foreseeability.

The purpose of this work is to construct a theoretical framework for the notion of transactional adjustments under the arm’s length principle, to formulate certain recommendations as to how to correctly interpret it when transactional adjustments are being performed, and to test the OECD Transfer Pricing Guidelines in the light of this theoretical framework. The analyses contained in the book rely on several types of sources. The author delves into not only the OECD Transfer Pricing Guidelines, but also domestic laws, court cases, and academic literature. Suggestions are made both at a general level – mostly by critically examining the guidelines, and at a more practical level, by applying the theoretical framework to several issues. The result is a book that is addressed to both policymakers and academics, who will find in this study a thorough contribution devoted to an improved application of the arm’s length principle, and to practitioners who need to better understand the limits and possibilities under the arm’s length principle to perform transactional adjustments.

The book is divided in two parts. In the first part, the author analyses the framework for transactional adjustments, which starts with a general introduction to the arm’s length principle and to the concept of transactional adjustments (chapter 1). The author analyses certain of the characteristics, shortcomings, and assumptions of the arm’s length principle, and emphasizes that ‘given that total compliance with the standard is materially

Notes

1 The term ‘conditions’ refers to the elements of a transaction that the parties can control (e.g. which party assumes a risk), as opposed to the circumstances surrounding a transaction, which the parties cannot control.

2 See A. Navarro, *Transactional Adjustments in Transfer Pricing*, Doctoral Series vol. 40, 55 (IBFD 2018). The author finds a confusion in the doctrine between these concepts, which would be explained by the lack of attention that this distinction has attracted in academic literature.


6 The author chose to rely particularly on the domestic laws of Spain, the US, Australia, and Canada, these last two countries having an explicit possibility in their domestic laws to perform transactional adjustments.
impossible, the correct approach to the issue lies in considering the arm’s length principle as an optimization duty. This statement has important bearing for the rest of the study. Aitor Navarro also discusses the interesting distinction between a full or limited fiction enabled by the arm’s length principle; the suggestion being made is to adopt a limited fiction approach. This suggestion constitutes a fundamental assumption for the proposals made in the book. Since the author recommends a limited fiction approach, transactional adjustments should be kept to a minimum, and when applied they should be limited to the conditions of an intercompany transaction, thus excluding an adjustment to the circumstances surrounding a transaction and on which the parties have no control. The author then moves onto an analysis of the normative framework in which he finds transactional adjustments to be permitted by the arm’s length principle (chapter 2). After arguing that Article 9(1) of the OECD Model Tax Convention can only restrict domestic law without in itself constituting a legal basis to impose transactional adjustments, the author draws the logical conclusion that the enforcement of transactional adjustments should be subject to their prior acceptance in the domestic law. Once it has been established that a legal basis for transactional adjustments exists in the domestic law, a treaty may limit that domestic law but without preventing the enforcement of transactional adjustments: this is because such adjustments are viewed as intrinsic to the arm’s length principle, as long as they are consistent with the model proposed by the author.

The second part builds on the first one and contains the central contributions of the book, resulting in a proposal for what the author considers the correct interpretation of the arm’s length principle. To that end, the author starts by addressing the necessary step prior to any transactional adjustment, namely how to establish the facts that will constitute the basis for the proper delineation and the qualification of a transaction (chapter 3). The author argues that no transactional adjustments should be performed in the fact-finding stage: the facts should not be altered; it is the transfer pricing analysis that should be adapted to the existing reality. In this respect, Aitor Navarro considers that certain paragraphs of the OECD Transfer Pricing Guidelines suggest a possible alteration of the facts, something that would be incompatible with the arm’s length principle. An example concerns the reliance on the notion of options realistically available to the parties. Once the method to ascertain the facts has been established, the author proceeds to the search for a definition of the scope of transactional adjustments and of the consequences derived from the enforcement of such adjustments (chapter 4). The author emphasizes the evolution between the 2010 and 2017 guidelines as to the conditions for tax administrations to disregard a transaction (in particular the replacement of the two-pronged approach embedded in the 2010 guidelines by the reference to a comparison with independent enterprises behaving in a commercially rational manner in comparable circumstances).

However, the author considers that in both cases the guidelines adopt an incorrect approach as to how to replace a claimed arrangement by one deemed compatible with the arm’s length principle. The guidelines would be too far-reaching, uncertain in their scope, and too subjective. I would agree with this view, especially in the context of the inflation of anti-avoidance measures, most of which are vaguely drafted and ambiguous in their scope. Based on the shortcomings found in the guidelines, the author argues for a limitation to the scope of transactional adjustments. Accordingly, Aitor Navarro suggests that transactional adjustments be kept to a minimum, and be enforced only when different methods to conduct a transfer pricing analysis have been applied and have proved unsuccessful. In other words, transactional adjustments should be a technique of last resort when, as summarized by the author, ‘(i) no comparable transactions exist, (ii) comparability adjustments cannot be made; and (iii) the applicability of a hypothetical arm’s length test is not suitable’.

The border between cases where transactional adjustments should or should not be performed would nevertheless remain difficult to define, because of the subjective nature of the arm’s length principle, which to a great extent relies on judgment. The author then tests the validity and usefulness of the proposal developed in chapter 4 to five transfer pricing issues: the attribution of risks, the attribution of intangible-related returns, hard-to-value intangibles, business restructurings, and cost contribution arrangements (chapter 5). The result of the application of the model to these issues reveals several areas where the guidelines are deemed to be at tension with the arm’s length principle, such as the
requirements with respect to the notion of control-over-risk, or the possibility to perform ex-post adjustments for hard-to-value intangibles. The difficulty to reconcile this last rule with the arm’s length principle is consistent with certain views expressed in the doctrine, but is not a unanimous position: the Altera case in the US can be mentioned, where one of the questions at stake is whether it was congressional intent not to strictly rely on comparables when adding the commensurate-with-income provision in 1986. The US Court of Appeals for the Ninth Circuit found, before withdrawing its opinion, that Congress did not intend to strictly rely on comparables. The final opinion may, however, reverse the outcome of the first one. Finally, the conclusions of the research are summarized in chapter 6.

After reading the book, one might wonder how to improve the guidelines, given the critical arguments raised by the author. Aitor Navarro justifies the absence of de lege ferenda proposals by the argument that the arm’s length principle is already embedded in many domestic laws and tax treaties, and therefore it would be enough that the principle be correctly applied. It can be agreed with this reasoning, because in many cases countries have enacted a generally formulated arm’s length provision that can be interpreted consistently with the model developed in the book. However, suggestions of amendments to the paragraphs that are critically analysed by the author could contribute to the debate and help improve the guidelines, to the benefit of both tax administrations and taxpayers.

Of course, the author may suggest such amendments in a future article.

In conclusion, the book *Transactional Adjustments in Transfer Pricing* brings a welcome contribution to the analysis of a controversial and yet little explored topic, which has both theoretical and practical relevance, and will be useful for policymakers and academics as well as tax administrations, taxpayers, and judges. The book results in a plea for an approach whereby the adjustments to intercompany transactions are mainly limited to adjustments in the comparability analysis consistently with the facts of a case, as opposed to adjusting the conditions of a transaction or to even disregard it. Finally, it can be mentioned that this book incidentally contributes to the discussion on the suitability of the arm’s length principle as a method to allocate the cross-border income of multinational enterprises. The shortcomings of the guidelines evidenced in this book may not be easily corrected, given the ever more complex reality in which they are applied. If no correct balance can be found between the conflicting interests of tax administrations and taxpayers as to the recognition of transactions, the question is raised whether additional anti-avoidance rules, or alternative taxation principles, could help achieve the income allocation and anti-avoidance functions of an international tax system that the arm’s length principle alone may no longer be able to fulfil.

**Jérôme Monsenego**
Associate Professor of International Tax Law, Stockholm University

---

**Notes**

14 See Navarro, supra n. 2, at 225 for a general assessment of this criterion, and at 269 for an assessment of this criterion in the context of the guidance on cost contribution arrangements.

15 See Navarro, supra n. 2, at 256.

16 See e.g. Y. Brauner, *Values in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28(79) Virginia Tax Rev. 100–101 (2008) where it is considered with respect to the US commensurate with income rule that it is ‘a major deviation from the arm’s length standard’. Similarly, see J. Monsenego, *Utfallet av BEPS-Projektet*, 10(827) Svensk Skattetidning 840 (2015), where it is argued that independent parties might not necessarily include in an agreement a provision whereby the price of a transaction may be adjusted ex-post depending on the evolution of certain circumstances.

17 See Navarro, supra n. 2, at xxiv.