Arm’s length transaction structures:
Recognising and restructuring controlled transactions in transfer pricing

— Summary —

Andreas Bullen
1. PART I: INTRODUCTION .............................................................................................................. 4
   1.1 THE ISSUES EXAMINED BY THE THESIS; TERMINOLOGY ............................................. 4
   1.2 METHODOLOGY .................................................................................................................. 5
   1.3 OUTLINE OF THE THESIS ................................................................................................ 7
2. PART IIA: THE AS-STRUCTURED PRINCIPLE’S LEGAL FOUNDATION ............................. 7
   2.1 INTRODUCTION ..................................................................................................................... 7
   2.2 HISTORICAL DEVELOPMENT ............................................................................................ 8
   2.3 CONTEMPORARY EXPRESSION .......................................................................................... 9
   2.3.1 The wording of Art. 9(1) OECD MTC ......................................................................... 9
   2.3.2 Other OECD material and domestic law ...................................................................... 11
3. PART IIB: THE ADJUSTMENTS RESTRICTED BY THE AS-STRUCTURED PRINCIPLE ...... 11
   3.1 ADJUSTMENTS NOT BASED ON THE ARM’S LENGTH PRINCIPLE ................................. 11
   3.2 ADJUSTMENTS UNDER ART. 9(1) OECD MTC’S ARM’S LENGTH TEST ..................... 12
   3.3 COMPARABILITY ADJUSTMENTS ....................................................................................... 13
4. PART IIC: EXAMINATION OF THE AS-STRUCTURED PRINCIPLE AND COMPLEMENTING
   PRINCIPLES .................................................................................................................................. 13
   4.1 THE AS-STRUCTURED PRINCIPLE’S RATIONALES ........................................................ 13
   4.2 THE SUBJECT MATTER OF THE AS-STRUCTURED PRINCIPLE ..................................... 15
   4.3 PRINCIPLES COMPLEMENTING THE AS-STRUCTURED PRINCIPLE .............................. 16
5. PART IIIA: ISSUES COMMON TO BOTH EXCEPTIONS FROM THE AS-STRUCTURED
   PRINCIPLE ....................................................................................................................................... 18
   5.1 PRELIMINARY ISSUES COMMON TO BOTH EXCEPTIONS FROM THE AS-STRUCTURED
      PRINCIPLE ............................................................................................................................ 18
   5.2 COMMON ISSUES PERTAINING TO CONCRETE ANALYSES UNDER THE EXCEPTIONS .... 19
      5.2.1 Threshold for structural adjustments ........................................................................ 19
      5.2.2 Relevance of a tax-avoidance motive ....................................................................... 19
      5.2.3 The concrete arm’s length test in the area of structural adjustments ....................... 20
      5.2.4 Unique transaction structures .................................................................................... 21
      5.2.5 Consequences of a structural adjustment ................................................................ 22
6. PART IIIB: THE ECONOMIC SUBSTANCE EXCEPTION .................................................................. 22
   6.1 GENERAL SCOPE .................................................................................................................. 22
      6.1.1 The notion of economic substance ............................................................................ 22
      6.1.2 Further qualification of the exception’s scope ............................................................ 23
      6.1.3 The authorised structural adjustment ...................................................................... 23
   6.2 CATEGORIES OF ARRANGEMENTS POTENTIALLY LACKING ECONOMIC SUBSTANCE .... 24
7. PART IIIC: THE COMMERCIAL RATIONALITY EXCEPTION ......................................................... 25
   7.1 GENERAL SCOPE .................................................................................................................. 25
      7.1.1 In general ..................................................................................................................... 25
      7.1.2 The notion of commercial irrationality: the realistically available options standard (RAO
          standard). ......................................................................................................................... 25
      7.1.3 Search for realistically available options .................................................................... 26
      7.1.4 The clearly-more-attractive test ............................................................................... 27
      7.1.5 The practical impediment requirement ...................................................................... 28
      7.1.6 The authorised structural adjustment ...................................................................... 29
   7.2 CATEGORIES OF POTENTIALLY IRRATIONAL ARRANGEMENTS .................................... 30
      7.2.1 In general ..................................................................................................................... 30
      7.2.2 Irrational transfers of profit generators ..................................................................... 30
      7.2.3 Irrational approaches to valuation uncertainty at the time of controlled transactions .... 32
      7.2.4 Irrational cost incurrence: qualitative irrationality ..................................................... 33
1. PART I: INTRODUCTION

1.1 The issues examined by the thesis; terminology

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

Traditionally, the Organisation for Economic Co-operation and Development (the “OECD”) has nevertheless recommended its Member countries, in other than exceptional cases, to adjust only price conditions and other valuation elements of controlled transactions based on the arm’s length principle. As artificial pricing is presumably the most obvious means available to associated enterprises to shift profits between themselves it is understandable that examinations under the arm’s length principle have primarily focused on the prices agreed between associated enterprises. In contrast, the marginal focus traditionally devoted to transaction structures adopted by associated enterprises is perhaps less understandable.

The thesis “Arm’s length transaction structures: Recognising and restructuring controlled transactions in transfer pricing”, addresses two primary issues, as its subtitle indicates. The issues are discussed and answered in light of the arm’s length principle as authoritatively stated in Art. 9(1) of the OECD Model Convention with respect to Taxes on Income and on Capital (the “OECD MTC”), as interpreted, in particular, by the accompanying Commentaries (the “OECD Commentaries”) and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the “OECD Guidelines”).

The first issue examined is the extent to which domestic tax administrations, in applying the arm’s length principle, must recognise the controlled transaction actually undertaken by the associated enterprises. In discussing this, OECD Guidelines Para. 1.64, which recommends domestic tax administrations ordinarily to examine controlled transactions “based on the transaction actually undertaken by the associated enterprises as it has been structured by them”, plays a prominent role. The principle established by this paragraph is referred to as the “as-structured principle” throughout the thesis.

1 E.g., parent–subsidiary companies and sister-companies.
2 See e.g. OECD, Transfer Pricing and Multinational Enterprises (Paris 1979) (the “OECD 1979 Transfer Pricing Report”), Paras. 15, 23; Working Document CCCTB\WP\041\doc\en (European Commission): Common Consolidated Corporate Tax Base Working Group (CCCTB WG): Related parties in CCCTB: Meeting to be held on 13 December 2006 (Dated Brussels, 5 December 2006), Para. 21.
3 This summary of the thesis refers to the OECD Guidelines as they read, and with the paragraph numbering they have, after the revision 22 July 2010.
4 OECD Guidelines Para. 1.64.
The second issue concerns the extent to which the arm’s length principle authorises domestic 
tax administrations to restructure the controlled transaction actually undertaken. In discussing 
this, OECD Guidelines Para. 1.65 is key insofar as it refers to

\[(...) \text{ two particular circumstances in which it may, exceptionally, be both appropriate} \]
\[\text{and legitimate } (\ldots) \text{ to disregard the structure adopted by a taxpayer in entering into} \]
\[\text{a controlled transaction.} \]  
(Bold added)

In the thesis, the type of adjustment restricted by the as-structured principle, but exceptionally 
authorised under Art. 9(1) OECD MTC as interpreted by OECD Guidelines Para. 1.65 is 
referring to as a “structural adjustment”. The language reflects that this type of adjustment 
involves an adjustment of the controlled transaction’s “structure”. Structural adjustments are 
to be contrasted with “valuation adjustments”, the latter of which “merely” involves the 
adjustment of the price and other valuation elements agreed in the controlled transaction, see 
also infra section 3.2. The first circumstance in which a structural adjustment is authorised 
under Art. 9(1) OECD MTC arises “where the economic substance of a [controlled] 
transaction differs from its form”. The thesis refers to this circumstance as the “economic 
substance exception”. The second circumstance in which a structural adjustment is so 
authorised arises where, in brief, the arrangements made in relation to the controlled 
transaction are not commercially rational and practically impedes the domestic tax 
administration from determining an appropriate transfer price. The thesis refers to this 
circumstance as the “commercial rationality exception”.

The thesis’ two primary issues are highly interrelated. Thus, the extent to which the arm’s 
length principle authorises domestic tax administrations to restructure controlled transactions 
depends on the extent to which they are required to recognise the controlled transaction 
actually undertaken, and vice versa. Their common theme can be formulated as an issue of 
how broad authority the arm’s length principle grants to domestic tax administrations. The 
thesis, thus, examines the outer limits of the authority granted by the arm’s length principle. 
By contrast, the thesis does not examine the arm’s length principle’s core area of application, 
i.e. adjustment of price conditions and other valuation elements examined under the transfer 
pricing methods established by the OECD Guidelines.

Normally both/all parties to a controlled transaction are “taxpayers”. In order to distinguish 
the parties from each other the thesis refers to the taxpayer examined under Art. 9(1) OECD 
MTC, i.e. the taxpayer whose profits might have been reduced because of non-arm’s length 
conditions, as the “examined taxpayer”. By contrast, the other party to the controlled 
transaction, i.e. taxpayer whose profits might have been increased because of non-arm’s 
length conditions and which might be granted a downward corresponding profit adjustment 
under Art. 9(2) OECD MTC, is referred to as the “related party”.

1.2 Methodology

As already indicated, the thesis discusses and answers its two main issues and all secondary 
issues derived from these in the light of the arm’s length principle as authoritatively stated in
Art. 9(1) OECD MTC, as interpreted, in particular, by the OECD Commentaries and the OECD Guidelines. In concrete terms, the thesis examines said issues from the perspective of how Art. 9 would operate if actually incorporated in a double taxation convention ("DTC") entered into by two (or more) OECD Member countries. DTCs qualify as treaties between states and are therefore to be interpreted according to the canons of interpretation set out in Arts. 31–33 of the Vienna Convention on the Law of Treaties (the “VCLT”), which codify international customary law. In line with, this the thesis interprets Art. 9(1) OECD MTC in accordance with the VCLT’s canons of interpretation, the general rule of which provides as follows:

*A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.*

Chapter 2 of the thesis concludes that the OECD Commentaries and the OECD Guidelines are primary means of interpretation relevant under the VCLT’s general rule of interpretation and therefore must be attributed significant weight in the process of interpreting Art. 9 OECD MTC. Said Chapter also concludes that those of the VCLT’s canons of interpretation governing the interpretation of the actual text of the treaty, i.e. primarily Art. 31(1) excluding extrinsic parts of the context, Art. 31(4) and Art. 33, shall be applied by analogy to interpret the text of the OECD Commentaries and the OECD Guidelines themselves.

The methodological approach delimits the thesis’ scope in four directions. First, the thesis does not examine its issues from the perspective of model tax conventions other than the OECD MTC, such as the United Nations Model Double Taxation Convention between Developed and Developing Countries or national model tax conventions. Second, the issues are not examined from the perspective of any one concrete DTC entered into between two or more countries. Third, the issues are not examined in light of the domestic law of any one particular OECD Member (or non-Member) country. Fourth, the thesis does not examine arm’s length provisions governing other than income taxation.

Although the thesis does not examine its issues from the perspective of the domestic law of anyone particular country, the thesis *does* rely on relevant domestic sources of law. The approach of giving emphasis to domestic sources of law in the process of interpreting Art. 9 OECD MTC (as well as other articles of the OECD MTC) is supported, in particular, by the absence of an international tax court or tax tribunal deciding DTC disputes and publishing their interpretations. The primary interpreters of Art. 9 OECD MTC, its DTC parallels and other parts of the OECD material, which also publish their interpretations in some form or another, are therefore domestic courts, tax administrations and legislators. The so-called “principle of common interpretation” justifies the approach. In its purest form, under this principle the tax administration and courts of one DTC contracting state should look to decisions made by the tax administration and courts of the other contracting state when interpreting and applying the DTC, and vice versa. The thesis, however, draws upon the entire spectre of domestic sources of law, i.e. sources of law originating from domestic legislators,

---

8 By contrast, the issues are not examined from the perspective of the arm’s length principle as it governs the allocation of profits to permanent establishments (“PEs”), see Art. 7(2) OECD MTC, nor from the perspective of the special arm’s length provisions in Arts. 11(6) and 12(4) OECD MTC.

9 Art. 31(1) VCLT.

10 Art. 31(1) VCLT.
domestic courts as well as from domestic tax administrations. Under the principle of common interpretation the thesis uses domestic sources of law primarily to assist the interpretation of Art. 9(1) OECD MTC. The approach is properly characterised as a comparison with an assisting purpose, the purpose of which is to use sources of law from one or more tax systems in order to clarify rules of another tax system. This approach must be distinguished from comparisons with a prevailing purpose, under which the comparison serves a purpose as such and is performed in order to identify differences and similarities between the rules of two or more jurisdictions in a specific area. The thesis does not adopt that approach.

Due to reasons of scope the thesis primarily examines domestic law material from three selected countries, i.e. Canada, Norway and the United States. Although the thesis concentrates on three main countries, domestic sources of law originating from other countries have not been ignored. On the contrary, the thesis takes into account domestic sources of law capable of assisting its examinations, regardless of national origin, including sources originating from Australia, Denmark, Germany, the Netherlands, Sweden and the United Kingdom.

1.3 Outline of the thesis

The thesis is divided into four main Parts, I–IV. Part I contains an introductory Chapter 1, Chapter 2, addressing methodological issues, and Chapter 3, providing a brief outline of arm’s length provisions as a platform for Parts II and III.

Part II examines the as-structured principle and is subdivided into three Parts, A–C. Part II.A examines the as-structured principle’s legal foundation, whereas Part II.B examines which adjustments are restricted by the principle. Part II.C examines the principle’s rationales (Chapter 12), its subject matter (Chapter 13) as well as certain other principles complementing the as-structured principle (Chapter 14).

Part III examines the authority to restructure controlled transactions and is also subdivided into three Parts, A–C. Part III.A examines issues common to both exceptions from the as-structured principle. Parts III.B and III.C, respectively, examine the economic substance exception and the commercial rationality exception, both the exceptions’ general scope and categories of arrangements potentially falling under their scope.

The examination of the two primary issues does not result in one (or more) main conclusion(s), but rather in a number of conclusions on the various secondary issues created by the primary issues. Summaries and conclusions concerning secondary issues are provided in the context in which the relevant issue is examined rather than in a final Chapter containing all summaries and conclusions. Part IV does, however, contain a Chapter offering some final remarks.

2. PART II.A: THE AS-STRUCTURED PRINCIPLE’S LEGAL FOUNDATION

2.1 Introduction

As a general rule, the allocation of taxing rights under DTCs and the assessment of tax liabilities under domestic tax law are likely to be governed by what a taxpayer has actually done, not by what it could, might or – in the tax authorities’ view – should have done. An issue, however, is whether the arm’s length principle as authoritatively stated by Art. 9(1) OECD MTC allows for exceptions to be made from this general rule in the form of allowing domestic tax administrations to restructure controlled transactions. In principle, the authority
to restructure controlled transactions based on the arm’s length principle could be restricted to a smaller or greater extent. In particular, the degree of constraint could take one of the three main forms:

i) An absolute as-structured principle: The arm’s length principle would not under any circumstances authorise tax administrations to restructure controlled transactions regardless of how detrimental or irrational the transaction structure appears from the perspective of the examined taxpayer.

ii) A restrictive as-structured principle: The arm’s length principle would in principle authorise a tax administration to restructure controlled transactions, but only in narrowly defined circumstances.

iii) A carte-blanche regime: The arm’s length principle would not impose any constraints on a tax administration’s authority to restructure controlled transactions. Under such a regime a tax administration would be authorised to restructure controlled transactions for whatever reason and in whatever manner it desires.

Chapter 4 of the thesis concludes that, as articulated in Art. 9(1) OECD MTC, the arm’s length principle clearly does not create a carte-blanche regime; an adjustment under the paragraph is only authorised if the conditions made or imposed in the controlled transaction “differ from those which would be made between independent enterprises”. The same will be true for any domestic arm’s length provision replicating this essential feature of Art. 9(1). The real issue is therefore whether the authority to restructure controlled transactions based on the arm’s length principle is limited by an absolute or “merely” by a restrictive as-structured principle.

2.2 Historical development

Chapter 5 of the thesis examines the as-structured principle’s historical development. The examination reveals that the genesis of Art. 9(1) OECD MTC, i.e. Art. IV of the 1932 DTC between France and the United States, was written with price adjustments in mind (as opposed to structural adjustments restricted by the as-structured principle). Textual similarities suggest Art. IV of the 1932 DTC between France and the United States was the genesis of Art. 5 of the League of Nations 1933 Draft Convention, which in turn served as the ultimate model tax convention progenitor of Art. 9(1) OECD MTC. Examinations of the League of Nation’s material reveals that Art. 5 of the League of Nations 1933 Draft Convention as well as its League of Nations successors were primarily aimed at price adjustments. This is particularly clear from Volume IV of the League of Nations study entitled “Taxation of Foreign and National Enterprises”, written by Dr. Mitchell B. Carroll. In sum, whereas the League of Nations’ material did not contain a statement explicitly discouraging the restructuring of controlled transactions, the examinations nevertheless reveals that the material regarded the arm’s length principle (referred to as the “separate accounting method”) as primarily aimed at examining and adjusting insufficient or excessive remunerations.

The first explicit statements identified, suggesting that the arm’s length principle does not authorise domestic tax administrations to restructure controlled transactions, are contained in

early US case law, decided in the 1940s under the predecessor of section 482 of the US Internal Revenue Code (the “IRC”). By contrast, neither the 1963 version nor the 1977 version of the Commentaries on Art. 9 OECD MTC touched upon the issue of whether Art. 9(1) authorises domestic tax administrations to restructure controlled transactions. Rather, the first explicit statements of the as-structured principle identified within the OECD material are contained in the OECD 1979 Transfer Pricing Report. For reasons that remain unclear, the principle was expressed twice by the Report. First, the pertinent part of Para. 15 – not so informatively entitled “[m]inor adjustments and substitution of methods” – provided that

\[
(\ldots) \text{as a general principle, tax authorities should base their search for an arm's length price on actual transactions and should not substitute hypothetical transactions for them} (\ldots).^{12}
\]

Second, Para. 23 of the Report – more aptly entitled “[r]ecognition of actual payments and transactions” – similarly provided:

\[
\text{In general, the approach which is adopted in this report to the adjustment of transfer prices for tax purposes is to recognise the actual transactions as the starting point for the tax assessment and not, in other than exceptional cases, to disregard them or substitute other transactions for them.}^{13}
\]

The wording of the quoted paragraphs strongly resembles statements in US case law under IRC section 482 establishing the as-structured principle. This indicates that the OECD’s adoption of the as-structured principle was inspired by the relevant developments in US case law.

In sum, the examined historical material clearly supports the as-structured principle’s existence. However, the OECD 1979 Transfer Pricing Report “merely” referred to the as-structured principle as “a general principle” and did acknowledge that Art. 9(1) OECD MTC could authorise structural adjustments in “exceptional cases”. It, thus, interpreted Art. 9(1) so as to establish a restrictive – rather than an absolute – as-structured principle.

### 2.3 Contemporary expression

#### 2.3.1 The wording of Art. 9(1) OECD MTC

Chapter 6 of the thesis examines the as-structured principle’s contemporary expression in the OECD material and selected domestic laws. A fundamental issue in this regard is whether the wording of Art. 9(1) OECD MTC itself prevents domestic tax administrations from restructuring controlled transactions. The wording of Art. 9(1) provides that

\[
\text{[w]here (\ldots) conditions are made or imposed between (\ldots) two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. (Bold added)}
\]

---

In its first part Chapter 6 examines five propositions which, if verified, would imply that the wording has such a barring effect. The first proposition states that the term “conditions” used in Art. 9(1) OECD MTC, according to its ordinary meaning, only includes certain types of conditions, primarily those establishing the price. As the restructuring of transactions may involve the adjustment of other types of conditions, Art. 9(1) does not therefore authorise the restructuring of controlled transactions. The thesis rejects this proposition. The the term “conditions” is not, according to its ordinary meaning, restricted to certain types of conditions such as price conditions, but rather includes all types of conditions made or imposed by associated enterprises in their commercial or financial relations, whatever the nature of the rights and obligations governed by the conditions.

The second proposition states that the wording of Art. 9(1) does not authorise the restructuring of controlled transactions because this line of action may involve the adjustment of several conditions of the examined controlled transaction, whereas Art. 9(1) only authorises adjustment of a single condition at a time. This proposition is clearly meritless, as Art. 9(1) refers to “conditions” in the plural, not in the singular.

The third proposition states that Art. 9(1) only authorises adjustment of “conditions”, not the adjustment of the “commercial or financial relations” they form part of. As the restructuring of a controlled transaction would involve an adjustment of the “relations”, such adjustments are therefore prevented by the wording of Art. 9(1). The thesis also rejects this proposition, because the proposition fails to acknowledge the close relationship existing between the “relations” and their “conditions”, i.e. that the “relations” are the sum of their “conditions”. Adjusting the “conditions” would also therefore involve adjusting the “relations”. If Art. 9(1) was to be interpreted in accordance with the proposition this would imply that domestic tax administrations would be unable to do what they are authorised to do (i.e. adjust “conditions”) without simultaneously doing what they are not authorised to do (i.e. adjust “relations”). This would be rather absurd and the proposition must therefore be rejected.

The fourth proposition states that Art. 9(1) prevents the “two-stage operation” characterising the process of restructuring controlled transactions: in the first stage the controlled transaction will be restructured, whereas in the second stage an arm’s length consideration will be determined based on the restructured transaction. The thesis also rejects this proposition, as there is nothing in the wording of Art. 9(1) preventing this two-stage operation.

The fifth and final proposition is that the wording of Art. 9(1) prevents the restructuring of controlled transactions because such restructuring would lead to the creation of income. Income will be “created” if the associated enterprises’ combined profits are higher after than before the adjustment under Art. 9(1). The thesis also rejects this proposition. First, a corresponding adjustment under Art. 9(2) will normally prevent the creation of income. Second, the wording of Art. 9(1) does not prevent the creation of income in the first place. Thus, under the wording a profit adjustment is authorised if some profits “have not (...) accrued” to the examined taxpayer because of non-arm’s length conditions being made or imposed. The wording does not require the non-accrued profits to have accrued to the related party or any other group company. Hence, the wording therefore authorises the allocation of non-accrued profits to the examined taxpayer, which will result in the creation of income.

In sum, the thesis concludes that the wording of Art. 9(1) OECD MTC itself cannot be interpreted so as to prevent domestic tax administrations from restructuring controlled transactions.
2.3.2 Other OECD material and domestic law

Rather than by the wording of Art. 9(1) OECD MTC, the as-structured principle is established by the OECD Guidelines, which states as follows in their paragraph 1.64:

A tax administration’s examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them (...). In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them.

The as-structured principle is also emphasised elsewhere in the Guidelines, in other OECD material and various examined domestic laws, including that of Australia, Canada, Germany, Norway, Sweden, the United Kingdom, and the United States.

Even though the as-structured principle does not follow explicitly from the wording of Art. 9(1) itself, this does not necessarily mean that OECD Guidelines Para. 1.64 amounts to a restrictive interpretation of the wording. Hence, Para. 1.64 must be read in conjunction with Para. 1.65, which, in brief, produces a recommendation that the actual transaction should not be restructured unless it – “exceptionally” – lacks economic substance or commercial rationality. The Guidelines establish a restrictive rather than an absolute as-structured principle and consequently do not suggest that controlled transactions can never be restructured under Art. 9(1). A restrictive as-structured principle may be entirely consistent with the wording of Art. 9(1), as the wording provides little guidance on how broad authority it grants to restructure controlled transactions.

3. PART II.B: THE ADJUSTMENTS RESTRICTED BY THE AS-STRUCTURED PRINCIPLE

3.1 Adjustments not based on the arm’s length principle

Part II.B of the thesis examines which adjustments are restricted by the as-structured principle. Chapter 8 examines whether the principle restricts three categories of adjustments not based on the arm’s length principle. This issue arises because these adjustments prima facie may seem to involve a disregard or substitution of “the transaction actually undertaken by the associated enterprises”\(^\text{14}\) based on the economic substance exception.

The first category of adjustment includes three sub-categories of adjustments involved in the process of establishing the controlled transaction actually undertaken. The Chapter concludes that the as-structured principle does not restrict this category of adjustment. The reason for this is that this category of adjustment is a step in the process of establishing which controlled transaction is “actually” – as opposed to purportedly – undertaken, not a matter of disregarding or restructuring the controlled transaction actually undertaken. The three sub-categories of adjustments are as follows:

- Factual substance adjustments: Such adjustments are undertaken if the associated enterprises’ actual conduct differs from their written agreement (or from the transaction they otherwise purport to have undertaken). If such discrepancy exists, the transaction “actually” undertaken is that evidenced by the associated enterprises actual conduct.
- Interpretative adjustments: Such adjustments are undertaken if the domestic tax administration and the examined taxpayer disagree on how the associated enterprises’

\(^{14}\) OECD Guidelines Para. 1.64.
written agreement shall be interpreted based on applicable rules on contractual interpretation. If such disagreement exists, the tax administration may substitute the taxpayer’s contractual interpretation with its own.

- Gap-filling adjustments: Such adjustments are undertaken to fill in gaps (non-regulated issues) in the associated enterprises’ written agreement. The gap-filling adjustment is undertaken by filling in the gaps in the contract based on background rules of law (contract law, commercial law, etc.) and industry customs.

The second category of adjustment includes fiscal classification adjustments. Such adjustments are undertaken if the domestic tax administration disagrees with the examined taxpayer’s fiscal classification of a phenomenon, e.g. a transaction (sale or lease?) or the subject matter of a transaction (service or intangible property?). The fiscal classification of a phenomenon is determined by its features. The examined taxpayer’s fiscal classification of a phenomenon (e.g. of a capital contribution as “debt”) may be disregarded if the phenomenon does not possess the features necessary for it to fall under the applicable fiscal definition of the phenomenon. Fiscal classification adjustments involve the application of fiscal definitions to to-be-classified phenomena, not the application of the arm’s length principle. The Chapter therefore concludes that the as-structured principle, which is derived from an interpretation of the arm’s length principle, does not restrict fiscal classification adjustments.

The third category of adjustment includes adjustments under domestic general anti-avoidance rules (“GAARs”). Domestic GAARs typically apply to transactions which (i) are exclusively or primarily tax motivated and (ii) seek to achieve a tax advantage under a tax rule contrary to the object and purpose of this tax rule. If the GAAR is applicable, the examined transaction may be restructured and the taxpayer may be denied the relevant tax advantage. Adjustments under domestic GAARs do not involve an application of the arm’s length principle; both the requirements for undertaking an adjustment and the directive for the adjustment will normally be different under the two types of legal norms. The Chapter therefore concludes that the as-structured principle, which is derived from an interpretation of the arm’s length principle, does not restrict adjustments under domestic GAARs.

3.2 Adjustments under Art. 9(1) OECD MTC’s arm’s length test

The as-structured principle dictates that domestic tax administrations shall not disregard actual controlled transactions or substitute other transactions for them in other than “exceptional cases”. The principle, thus, draws a distinction between two main types of adjustments under Art. 9(1) OECD MTC’s arm’s length test, i.e. those involving a disregard or substitution of the actual transaction (“exceptional adjustments”) and those not involving such disregard or substitution (“non-exceptional adjustments”). Chapter 9 of the thesis establishes the precise distinction between exceptional adjustments and non-exceptional adjustments.

The Chapter concludes that exceptional adjustments are distinguished from non-exceptional adjustments by a qualitative criterion pertaining to the nature of the contractual condition which is adjusted based on the arm’s length principle. Under this qualitative criterion there are two main types of contractual conditions, i.e. valuation conditions and structural conditions. The notion of “valuation conditions” is positively defined so as to include conditions estimating the value of the property or service transferred in the controlled transaction or some element of the transaction structure. The conditions examined under the transfer pricing
methods established by the OECD Guidelines, i.e. prices, gross profit margins, net profit margins and profit splits, are core examples of valuation conditions. By contrast, “structural conditions” is a negatively defined, diverse residual category of all contractual conditions not qualifying as valuation conditions, and having the common feature that they add or subtract from the values established by the valuation conditions. Core examples of structural conditions are conditions (i) establishing the transferred property’s or service’s nature, volume and quality, (ii) allocating functions and risks between the associated enterprises and (iii) establishing the term (duration) of the contractual relationship. As already indicated, adjustments of valuation conditions are referred to as “valuation adjustments” by the thesis, whereas adjustments of structural conditions are referred to as “structural adjustments”.

The Chapter also examines whether exceptional adjustments are distinguished from non-exceptional adjustments by a quantitative criterion pertaining to the extensiveness of the structural adjustment. Under this criterion not all structural adjustment would be restricted by the as-structured principle, but only those leading to fundamental changes in the controlled transaction structure. Possible examples of extensive structural adjustments would be adjustments changing the nature of the transferred property or service and changing the form of the transaction (e.g. from a sale to a license), whereas possible examples of non-extensive structural adjustments would be adjustments of conditions establishing less fundamental parts of the transaction structure such as the time of payment and the scope of warranties offered by the seller. After a thorough analysis of the parts of the OECD Guidelines dealing with structural adjustments, and also based on relevant policy considerations, the Chapter concludes that exceptional adjustments are not distinguished from non-exceptional adjustments by a quantitative criterion. The conclusion means that the as-structured principle restricts all structural adjustments, whether extensive or not.

3.3 Comparability adjustments

Even if there are differences between an examined controlled transaction and an identified uncontrolled transaction which could materially affect the (valuation) condition examined under the chosen transfer pricing method, the uncontrolled transaction can serve as a comparable under the arm’s length principle if “reasonably accurate adjustments can be made to eliminate the effect of (...) such differences”. Such adjustments are generally referred to as “comparability adjustments”. Chapter 10 concludes that comparability adjustments must be strictly distinguished from structural adjustments, as the two types of adjustments have entirely different purposes and entirely different effects. Comparability adjustments do not involve a disregard of substitution of the controlled transaction actually undertaken and are therefore not restricted by the as-structured principle.

4. PART II.C: EXAMINATION OF THE AS-STRUCTURED PRINCIPLE AND COMPLEMENTING PRINCIPLES

4.1 The as-structured principle’s rationales

Chapter 12 examines the as-structured principle’s rationales and, thus, precisely why domestic tax administrations ordinarily should base their transfer pricing examinations on “the transaction actually undertaken by the associated enterprises as it has been structured by

---

15 See OECD Guidelines Chapter II.
16 OECD Guidelines Paras. 1.33, 3.47.
them”. The as-structured principle’s stated rationales are found in the last sentence of OECD Guidelines Para. 1.64, which states as follows:

Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could 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.

From this statement two rationales can be identified. The first is to avoid wholly arbitrary structural adjustments. A structural adjustment may turn into a wholly arbitrary exercise because it might be very difficult for a tax administration to determine both whether the structure of the controlled transaction differs from that which would have been adopted by comparably placed independent parties and precisely which transaction structure independent enterprises would have adopted. Under the freedom of contract and the freedom of business judgment independent enterprises can, and frequently do, adopt a large variety of transaction structures. Further, different independent enterprises may have different views on which transaction structure is preferable.

The second rationale which can be derived from the statement is to avoid economic double taxation, which may arise if the tax administration competent to tax the examined taxpayer and that competent to tax the related party disagree either on whether or on how the controlled transaction should be restructured.

The Chapter also examines a number of other rationales which potentially can be advanced in support of the as-structured principle. Such rationales include:

- **Ability to pay considerations.** If the controlled transaction is restructured, fictitious income, which have not accrued to any of the group companies, may be created. The group will not have the ability to pay tax on such income.

- **Equal treatment of controlled and uncontrolled transactions.** Uncontrolled transactions undertaken by independent enterprises are normally recognised for tax purposes (unless e.g. they are restructured under a domestic GAAR). It may therefore amount to discrimination if domestic tax administrations are granted a broad authority to restructure controlled transactions.

- **Freedom of contract.** Under this freedom taxpayers are generally free to determine the content of the contractual relationships without government interference.

- **Freedom of business judgment.** This freedom is attributed weight in Para. 9.163 of the OECD Guidelines, which states that “MNEs are free to organise their business operations as they see fit. Tax administrations do not have the right to dictate to an MNE how to design its structure or where to locate its business operations”.

- **Tax administrations lack the associated enterprises’ business knowledge.** In order to determine whether a controlled transaction structure lacks economic substance or commercial rationality domestic tax administrations must develop qualified opinions on complex commercial issues. However, tax administrations are, presumably, first and foremost experts in interpreting and applying the tax law and they may often not possess

---

17 OECD Guidelines Para. 1.64.
18 See OECD Guidelines Para. 9.163.
the necessary business knowledge or experience to develop qualified opinions on complex commercial issues. This suggests they should generally not interfere with the structure of controlled transactions.

- **The commercial interest of individual group members may conflict with that of the MNE group as such.** Domestic tax administrations are primarily inclined to challenge a controlled transaction structure under the arm’s length principle if the actual structure is perceived to be commercially unfavourable to the examined taxpayer (even though the actual structure is commercially favourable for the group as such). If so, the tax administration will typically seek to replace the actual transaction structure with a hypothetical, alternative transaction structure which is more commercially favourable to the examined taxpayer, but which may be commercially unfavourable to the group. Arguably, domestic tax administrations should not have the authority to insist that MNE group members adopt transaction structures which are commercially – as opposed to fiscally – unattractive for their group.

- **Pacta sunt servanda.** This principle dictates that a contract is binding upon its parties. That contracts concluded between related as well as unrelated parties are governed by the principle of *pacta sunt servanda* is a legal reality which must be taken into account when applying the arm’s length principle.

The Chapter concludes that none of the examined rationales support an *absolute* as-structured principle, i.e. a regime under which the arm’s length principle as authoritatively stated by Art. 9(1) OECD MTC would not authorise structural adjustments under any circumstances. The Chapter does, however, conclude that a *restrictive* as-structured principle, i.e. a regime under which the arm’s length principle in principle authorises structural adjustments, but only in narrowly defined circumstances, is supported by several of the examined rationales.

**4.2 The subject matter of the as-structured principle**

Chapter 13 examines the subject matter of the as-structured principle, which is stated to be “the transaction actually undertaken by the associated enterprises as it has been structured by them”. The principle’s primary subject matter is the concrete rights and obligations created by the associated enterprises. This means that, in other than exceptional cases, domestic tax administrations should recognise, inter alia, that the associated enterprises have

- transferred the (tangible or intangible) property or services they have actually transferred, in terms of nature, quality, quantity and other features;
- undertaken the controlled transaction in the form it has actually been undertaken, whether as an outright sale against monetary consideration, a contribution in kind, a lease, a license, a rental or in another form;
- allocated functions as they have actually been allocated;
- used the assets which they have actually used;
- allocated risks as they have actually been allocated; and
- undertaken the controlled transaction in the geographic market in which it has actually been undertaken.

---

19 OECD Guidelines Para. 1.64.
Prima facie, the requirement to recognise the controlled transaction structure may be understood primarily as a requirement to recognise that the examined taxpayer has done what it actually has done, i.e. performed the functions it has actually performed, assumed the risks it has actually assumed and used the assets it has actually used. But the structure of the controlled transaction must be recognised from the perspective of both – or, if more than two parties (e.g. to a cost contribution arrangement), all – of the associated enterprises which are parties to the transaction. Hence, the domestic tax administration must also recognise that the examined taxpayer has not done what the related party has done, i.e. that it has not performed the functions actually performed by the related party, has not assumed the risks actually assumed by the related party, and so on.

The Chapter concludes that the subject matter of the as-structured principle, by implication and as corollaries, also covers a number of other factors. In concrete terms, under the principle the domestic tax administration must ordinarily also recognised the following:

- The associated enterprises’ implementation of the controlled transaction.
- The examined taxpayer’s decision whether or not to terminate/renegotiate a controlled contractual relationship.
- The examined taxpayer’s choice not to undertake a – potentially favourable – controlled transaction
- The examined taxpayer’s role in the MNE’s business structure (its business model).

Finally, the Chapter also concludes that the as-structured principle requires recognition of the examined taxpayer’s group-company status. When transacting with each other – and potentially also when transacting with unrelated enterprises – MNE group members face certain special commercial circumstances (“MNE-specific commercial circumstances”) different from those unrelated enterprises face when transacting with each other. These include reduced transaction costs, increased visibility and information sharing, reduced risks, increased trust and increased bargaining power. When examining a controlled transaction under the arm’s length principle, such MNE-specific commercial circumstances cannot be disregarded, but must be recognised as circumstances potentially affecting the analysis of whether the conditions made or imposed by the associated enterprises conform to the arm’s length principle. Consequently, the “independent enterprises” referred to in Art. 9(1) OECD MTC are semi-independent enterprises facing MNE-specific commercial circumstances when transacting with each other, not truly independent enterprises facing the normal commercial circumstances facing entirely unrelated enterprises. The arm’s length principle, thus, only requires imputation of a hypothetical divergence of interest between the parties to controlled transactions, providing each party with a hypothetical incentive to act in its own self-interest.

4.3 Principles complementing the as-structured principle

The pertinent issue under the arm’s length principle is which conditions unrelated enterprises would have made in “comparable transactions and comparable circumstances” (bold added) to those of the associated enterprises. Further, the Guidelines state, a comparison of conditions made in controlled and uncontrolled transactions is only useful if “the economically relevant characteristics of the situations being compared (…) [are] sufficiently

20 OECD Guidelines Para. 1.6.
**comparable**”\(^{21}\) (bold added). Hence, the comparison should not only take into account the structure and valuation of the controlled transaction, but also the “facts and circumstances surrounding [it]”\(^{22}\). Chapter 14 of the thesis examines four important economically relevant characteristics of the associated enterprises’ situation, qualifying as such surrounding facts and circumstances. The Chapter concludes that said characteristics must also be recognised in analyses under the arm’s length principle. The examined characteristics are as follows:

- **The time of controlled transactions.** The international norm is that domestic tax administrations must recognise the time of controlled transactions. The “time” of a controlled transaction is the time it is entered into (as opposed, e.g., to the time it is implemented). When the contract is concluded, its binding effect occurs under the principle of *pacta sunt servanda*. After this point in time a party will normally not – unless e.g. the contract itself provides otherwise – have the right to make changes to its contractual rights and obligations, whether because of subsequent developments, subsequent discoveries or other circumstances. The requirement to recognise the time of the controlled transaction implies that the examination under the arm’s length principle can only be based on information “known”\(^{23}\) or “reasonably foreseeable”\(^{24}\) at the time of the transaction. The Chapter examines certain domestic departures from this international norm, the most important of which is the US commensurate with income standard, providing that “[i]n the case of any transfer (or license) of intangible property (...) the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible”\(^{25}\). The commensurate with income standard does not recognise the time of the controlled transaction since it requires the transferor’s income from transferred or licensed intangible property to be commensurate with the income actually generated by the intangible property, even if the amount of the actual income is higher than that foreseeable at the time of the transaction. The Chapter concludes that the examined domestic departures from the international norm run contrary to Art. 9(1) OECD MTC.

- **The associated enterprises’ level of knowledge.** A taxpayer’s level of knowledge will affect its bargaining position. The Chapter concludes that domestic tax administrations must recognise the associated enterprises’ actual level of knowledge; tax administrations are not authorised to impute to them a higher than actual level of knowledge.

- **The associated enterprises’ level of experience.** A taxpayer’s level of experience will affect its bargaining position and also its ability to run its business satisfactorily. The Chapter concludes that domestic tax administrations must recognise the associated enterprises’ actual level of experience; tax administrations are not authorised to impute to them a higher than actual level of experience.

- **Uncontrolled circumstances.** Many of the “economically relevant characteristics” surrounding a controlled transaction cannot be influenced and are, thus, not controlled by the associated enterprises. Examples of such uncontrolled circumstances are conditions in

---

\(^{21}\) OECD Guidelines Para. 1.33. See also OECD Guidelines Para. 1.35.  
\(^{22}\) OECD Guidelines Para. 3.76.  
\(^{23}\) See OECD Guidelines Para. 2.130.  
\(^{24}\) See OECD Guidelines Paras. 2.130, 6.32, 6.33, 7.23, 8.20.  
\(^{25}\) US Internal Revenue Code section 482, second sentence.
the market in which the controlled transaction is undertaken in terms of size, level of
competition, production costs and nature and extent of government regulations. The
Chapter concludes that uncontrolled circumstances must be recognised in examinations
under the arm’s length principle, as associated enterprises have no more influence over
uncontrolled circumstances than independent enterprises do.

5. **PART III.A: ISSUES COMMON TO BOTH EXCEPTIONS FROM THE AS-
STRUCTURED PRINCIPLE**

5.1 **Preliminary issues common to both exceptions from the as-structured principle**

Part III of the thesis examines the two exceptions from the as-structured principle, i.e. the
economic substance exception and the commercial rationality exception. Whereas Part III.A
examines issues common to both exceptions, Parts III.B and III.C examines the exceptions
individually.

Chapter 15 examines preliminary issues common to both exceptions from the as-structured
principle. First, the Chapter examines the historical development of the authority to
restructure controlled transactions under Art. 9(1) OECD MTC. The examination reveals that
the authority is broader under the OECD Guidelines (adopted in 1995) than under the OECD
1979 Transfer Pricing Report. Whereas the 1979 Report did contain a parallel to the economic
substance exception, the commercial rationality exception was introduced by the OECD
Guidelines.

Second, the Chapter examines whether structural adjustments are only authorised subject to
explicit legal authority. The Chapter concludes that DTC provisions replicating Art. 9(1)
OECD MTC authorise structural adjustments in the circumstances referred to in OECD
Guidelines Para. 1.65. Therefore, a more explicit DTC provision is not required to provide
such an authority. Since Art. 9(1) OECD MTC – like other provisions contained in double
taxation conventions – can generally only restrict and, thus, not create domestic law, a
domestic tax administration will only be authorised to restructure a controlled transaction
based on the arm’s length provision if also authorised under the relevant domestic arm’s
length provision. Whether such a domestic provision authorises a structural adjustment
depends on whether it is drafted broadly, e.g. so as to authorise adjustments of “conditions”,
“terms” and/or “arrangements”, or narrowly, e.g. so as only to authorise adjustments of
“prices” or “remunerations”. However, other relevant sources of law, e.g. case law, travaux préparatoires
and administrative statements and practice, may provide for a different
interpretation than that suggested by the wording. Further, if the OECD Guidelines are
relevant to the interpretation of the domestic arm’s length provision, the exceptions from the
as-structured principle established by the Guidelines may be implemented into domestic law
on an interpretative basis.

Third, the Chapter examines whether the authority to undertake profit-increasing or profit-
decreasing structural adjustments is mandatory or discretionary. A structural adjustment is
profit-increasing if the examined taxpayer’s profits will be higher and profit-decreasing if its
profits will be lower if assessed based on a restructured rather than based on the actual
transaction. The Chapter concludes that profit-increasing structural adjustments are not
required under Art. 9(1) OECD MTC, but that they might be required under a domestic arm’s
length provision (e.g. to prevent domestic tax administrations from arbitrarily choosing to use
their competence to restructure in some cases, but not in others). By contrast, the Chapter
concludes that profit-decreasing structural adjustments are required under Art. 9(1) OECD
MTC in cases where the actual transaction contains two non-arm’s length conditions, of
which one has reduced the examined taxpayer’s profits, whereas the other has increased its profits. In such cases the domestic tax administration cannot confine itself only to adjust the non-arm’s length condition having an unfavourable effect on the examined taxpayer’s profits; it must also adjust the non-arm’s length condition having a favourable effect on the taxpayer’s profits. Only insofar as the non-arm’s length conditions have a negative net effect on the examined taxpayer’s profits does Art. 9(1) authorise an upward profit adjustment.

Finally, the Chapter examines certain (other) basic features of the exceptions from the as-structured principle. In this examination the Chapter concludes e.g.:

- that the exceptions are derived from an interpretation of Art. 9(1) OECD MTC and therefore must be interpreted subject to the paragraph’s wording;
- that the exceptions are exhaustive, implying that Art. 9(1) OECD MTC does not authorise structural adjustments in other circumstance than those referred to in OECD Guidelines Para. 1.65;
- that the basic example accompanying each of the exceptions are not exhaustive; and that
- the exceptions does not only apply to situations belonging to the same class as the situations addressed in the basic accompanying examples (the exceptions and the examples are, thus, not to be interpreted according to the *ejusdem generis* canon of interpretation).

### 5.2 Common issues pertaining to concrete analyses under the exceptions

#### 5.2.1 Threshold for structural adjustments

Chapter 16 examines common issues pertaining to concrete analyses under the exceptions from the as-structured principle. First the Chapter examines the threshold for undertaking structural adjustments. OECD Guidelines Para. 1.64 provides that tax administrations should not restructure controlled transactions “[i]n other than exceptional cases” (*bold* added). Similarly, their Para. 1.65 describes the exceptions from the as-structured principle as circumstances in which it may “exceptionally” be appropriate and legitimate to restructure controlled transactions. The authority to restructure controlled transactions under Art. 9(1) OECD MTC can, thus, be said to be subject to an exceptionality standard. The Chapter concludes that the exceptionality standard does not establish additional requirements for restructuring controlled transactions to those otherwise established by OECD Guidelines Para. 1.65. Rather, the standard is implicit in the strict requirements for undertaking structural adjustments under the two exceptions established by the paragraph. The Chapter also rejects that the threshold is lower for restructuring some categories of controlled transactions than others and that the threshold differ depending on the extensiveness of the adjustment.

#### 5.2.2 Relevance of a tax-avoidance motive

The arm’s length principle is generally understood as an objective norm, which may authorise an income adjustment irrespective of any intention of the associated enterprises to minimise

---

OECD Guidelines Para. 1.66 may, however, be read so as to provide otherwise in the area of structural adjustments. This paragraph observes that:

\[ \text{in both sets of circumstances described} \ldots \text{[in Para. 1.65] the transaction} \ldots \text{may have been structured by the taxpayer to avoid or minimise tax.} \]

(Bold added)

The Chapter, however, concludes that the presence of a tax-avoidance motive is not a requirement for undertaking a structural adjustment under Art. 9(1) OECD MTC as interpreted by the OECD Guidelines. The existence of such a requirement is neither supported by the wording of Art. 9(1) nor by the wording of OECD Guidelines Para. 1.65. Consequently, Art. 9(1) may authorise a structural adjustment regardless of whether the associated enterprises have adopted the examined transaction structure in order to avoid or minimise tax, to achieve non-tax benefits or out of inadvertence.

The Chapter further concludes that the presence of a tax-avoidance motive is not sufficient for a structural adjustment to be authorised under Art. 9(1) OECD MTC. Only if the requirements established by OECD Guidelines Para. 1.65 are fulfilled will the paragraph authorise a structural adjustment. Consequently, Art. 9(1) OECD MTC does not authorise a structural adjustment solely because the examined taxpayer could have adopted an alternative transaction structure triggering a higher tax burden than the structure actually adopted.

5.2.3 The concrete arm’s length test in the area of structural adjustments

If the examined controlled transaction structure can also be identified between unrelated enterprises it cannot be argued that the controlled transaction lacks economic substance or commercial rationality within the meaning of OECD Guidelines Para. 1.65. That this is so follows from the wording of Art. 9(1) OECD MTC itself: if the examined structural conditions made or imposed in the controlled transaction are also made between independent enterprises they do not “differ from those which would be made between independent enterprises”. This interpretation is also confirmed by the OECD Guidelines.

Chapter 16 concludes that the examined controlled transaction structure therefore cannot be restructured if it is comparable to the structure adopted in a concrete uncontrolled transaction, to transaction structures conforming to a relevant industry custom or to a transaction structure proposed in a bona fide uncontrolled offer. The critical part of the analysis – which can be referred to as the “concrete arm’s length test” – is whether the controlled transaction structure is in fact “comparable” to the identified uncontrolled transaction structure. The Chapter concludes that the general comparability standard established in OECD Guidelines Para. 1.33 is also controlling in the area of structural adjustments. Under this standard,

\[ \text{to be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.} \]

---

27 OECD Guidelines Para. 1.2.
28 OECD Guidelines Para. 1.66.
However, differences between a controlled and an uncontrolled transaction affecting an independent party’s willingness to agree on a particular valuation condition (price, margin, profit split) may not affect its willingness to agree on a particular structural condition. E.g., whereas differences in geographical market will normally affect an independent party’s willingness to agree on a particular price, such differences may not affect its willingness to enter into a long-term contract (e.g., a long-term contract may be equally attractive to a German enterprise as to a Japanese enterprise). This means that the comparability standard in the area of structural adjustments is broader than that in the areas of valuation adjustments; differences rendering two transactions non-comparable for valuation purposes may not render them non-comparable for structural-adjustment purposes. The Chapter concludes that the controlled transaction structure will be “comparable” to an identified uncontrolled transaction structure if the following requirements are fulfilled:

- The disputed structural condition agreed in the controlled transaction (e.g., a particular risk allocation) is also in the uncontrolled transaction.

- There are no differences between the controlled and uncontrolled transaction which renders the disputed structural condition less attractive in the controlled transaction than in the uncontrolled transaction.

5.2.4 Unique transaction structures

The outcome of the concrete arm’s length test may be that no comparable uncontrolled transaction structures are identified. If so, the controlled transaction structure can be said to be “unique”. The fact that a controlled transaction structure is unique does not, however, necessarily mean it is not “structured in accordance with the economic and commercial reality of parties transacting at arm's length”30. First, in practice it may be very difficult to determine whether a seemingly unique transaction structure is actually unique. A first challenge is created by the fact that a large body of material evidencing the conditions made in uncontrolled transactions must be examined in order to conclude that the controlled transaction structure is actually unique. A second challenge is created by the difficulties of obtaining information about the transaction structures adopted by independent enterprises. Second, a truly unique controlled transaction structure is not necessarily detrimental to the examined taxpayer; it may also be more favourable than, or have a similar level of attractiveness as, the structures adopted by independent enterprises. Rather than reflecting that alternative transaction structures would not be acceptable to them, independent enterprises’ preference for particular structures over others may have other reasons, e.g. it may be historically motivated as conforming to traditional industry customs. As a result, a uniqueness criterion may lead to absurd results, i.e. the disregard of controlled transaction structures which are favourable to the examined taxpayer. The Chapter therefore concludes that a controlled transaction cannot be restructured merely because it is unique, whether the unique transaction is an unorthodox outcome of the freedoms of contract and business judgment or is a result of MNE-specific commercial circumstances.

The fact that a controlled transaction structure is unique therefore merely implies that it is necessary to examine it further in order to determine whether it lacks economic substance or commercial rationality within the meaning of OECD Guidelines Para. 1.65. This means that the analysis under the exceptions from the as-structured principle must be undertaken in a two-step process:

---

30 OECD Guidelines Para. 1.66.
• The first step is the *concrete* arm’s length test described in the previous subsection. If one or more comparable uncontrolled transactions are identified, Art. 9(1) OECD MTC will not authorise a structural adjustment. If such comparables are not identified, it is necessary to proceed with the second step.

• The second step is a *hypothetical* arm’s length test. This test must be undertaken in accordance with the principles described infra section 6.1 (economic substance exception) and infra section 7.1 (commercial rationality exception).

5.2.5 Consequences of a structural adjustment

In a final section Chapter 16 examines the consequences of a structural adjustment. The primary consequence is that valuation adjustments shall be undertaken based on the restructured controlled transaction. It is therefore the restructured – not the actual – controlled transaction which enters the comparability analysis in the context of valuation adjustments. What is to be examined in the comparability analysis in the context of valuation adjustments is, thus, whether one or more identified uncontrolled transactions are sufficiently comparable to the restructured controlled transaction. Further, a valuation adjustment will be authorised insofar as the actually agreed, examined valuation condition (price, margin, etc.) differs from the valuation condition which would have been agreed in an uncontrolled transaction which is comparable to the restructured controlled transaction.

The Chapter further concludes that the tax administration competent to tax the related party, under Art. 9(2) OECD MTC, will be committed to undertake a downward corresponding adjustment of the related party’s profits based on the restructured transaction, even if this means that the corresponding adjustment will be higher than if had been based on the actual transaction. Such a commitment will, of course, only exist if the controlled transaction is restructured in accordance with Art. 9(1) OECD MTC as interpreted by OECD Guidelines Para. 1.65.

6. PART III.B: THE ECONOMIC SUBSTANCE EXCEPTION

6.1 General scope

6.1.1 The notion of economic substance

Part III.B of the thesis is devoted to a more detailed examination of the economic substance exception. Chapter 17 examines the exception’s general scope. From the OECD Guidelines it is highly unclear when a controlled transaction will lack “economic substance” within the meaning of the economic substance exception. The examinations done as part of the project has revealed that the notion of “economic substance” has three sub-prongs:

• The anti-avoidance prong. If the examined controlled transaction does not alter the examined taxpayer’s economic situation in a meaningful manner, absent a reduction in its tax liability, the transaction lacks economic substance within the meaning of the anti-avoidance prong. An example would be a so-called “wash sale” in which a taxpayer transfers its shares to another taxpayer in order to incur a capital loss, but agrees to repurchase the shares immediately after the transfer. This transaction does not alter the transferor’s economic situation in a meaningful manner.

---

31 This must be distinguished from the comparability analysis in the context of structural adjustments described supra subsection 5.2.3.
• The factual substance prong. Under this prong a transaction lacks economic substance if the associated enterprises’ actual conduct differs from the terms of their written agreement (or the transaction they otherwise purport to have undertaken).

• The arm’s length prong. Under this prong the form of a controlled transaction lacks economic substance if it differs from the form independent enterprises would be expected to adopt.

The Chapter concludes that the economic substance exception is only concerned with the arm’s length prong of the notion of economic substance. This is confirmed e.g. by OECD Guidelines Para. 1.66, which provides that in situations where the economic substance exception (or the commercial rationality exception) applies “the totality of (...) [the controlled transaction’s] terms would be the result of a condition that would not have been made if the parties had been engaged in arm’s length transactions” (bold added). Hence, the phrase “economic substance” has a special meaning as used in OECD Guidelines Para. 1.65.

6.1.2 Further qualification of the exception’s scope

After having established that the economic substance exception is only concerned with the arm’s length prong of the notion of “economic substance” the Chapter makes the following further qualifications of the exception’s scope:

• The exception only applies if the discrepancy between the form and economic substance is caused by the community of interest existing between the associated enterprises. If the discrepancy could also have existed between unrelated parties – which may very well be the case – the exception will not authorise a structural adjustment.

• According to the wording of OECD Guidelines Para. 1.65, the economic substance exception applies if the economic substance of the “transaction” differs from its form. The Chapter nevertheless concludes that also individual contractual conditions can be tested and adjusted under the exception.

• For an adjustment to be authorised under the exception it suffices that the economic substance of the controlled transaction “differs” from its form. Hence, the transaction needs to be totally devoid of economic substance.

• Unlike the commercial rationality exception, the economic substance exception may apply even if the actual transaction structure does not practically impede the tax administration from determining an appropriate transfer price. However, the strong preference for pricing solutions inherent in the as-structured principle and the exceptionality standard established by it is also relevant under the economic substance exception.

6.1.3 The authorised structural adjustment

According to OECD Guidelines Para. 1.65, if the economic substance exception applies “the tax administration may disregard the parties’ characterisation of the transaction and re-characterise it in accordance with its substance.” In line with the above conclusion that the economic substance exception is only concerned with the arm’s length prong of the notion of economic substance, the Chapter concludes that under the exception the “economic substance” of the examined transaction or conditions, in accordance with which it/they are to be re-characterised, is expressed by the expected behaviour of independent enterprises. This expected behaviour is, therefore, of significant importance when determining how the examined transaction/conditions is/are to be restructured under the exception. The Chapter
further concludes that the adjustment is governed by a proportionality requirement, i.e. the controlled transaction can only be restructured to the extent it lacks economic substance. Structural conditions that do not lack “economic substance” within the meaning of the exception cannot be restructured.

6.2 Categories of arrangements potentially lacking economic substance

Chapter 18 goes on to examine four categories of concrete arrangements potentially lacking economic substance within the meaning of the economic substance exception.

The first arrangement examined is thin capitalisation. This is the arrangement addressed in the basic example accompanying the economic substance exception. A company is thinly capitalised if its amount of controlled loans exceeds its so-called “borrowing capacity” in that an independent lender would not have been willing to lend such substantial funds to it. The Chapter concludes that a taxpayer’s borrowing capacity must be distinguished from its borrowing willingness. Hence, even if the examined taxpayer’s controlled loans do not exceed its borrowing capacity, it might not have been willing to lend such substantial amounts had it been independent. E.g., the controlled loans might exceed its capital needs. If the examined taxpayer “merely” has exceeded its borrowing willingness, the form of the capital contribution (as a loan) will not differ from its “economic substance” within the meaning of the economic substance exception. However, if the examined taxpayer has exceeded its borrowing willingness this might trigger a structural adjustment under the commercial rationality exception. The Chapter further concludes that if the controlled loans do exceed the examined taxpayer’s borrowing capacity, the part of the loans exceeding its borrowing capacity – but only this part – can be recharacterised as an equity contribution.

The second arrangement examined is situations where the associated enterprises have reallocated a risk after the outcome of the risk had become known or reasonably knowable. The Chapter concludes that if it is known or reasonably knowable that the risk will not materialise, the party originally assuming the risk would not have agreed to reallocate the risk had the parties been unrelated. By contrast, if it is known or reasonably knowable that the risk will materialise, the party originally not assuming the risk would not have agreed to reallocate the risk had the parties been unrelated. Hence, in both situations the risk reallocation would appear to be non-arm’s length. The Chapter further concludes that the risk reallocation can be disregarded if it takes place after the outcome of the risk had become known or reasonably knowable, provided that a comparable risk reallocation cannot be identified between unrelated parties. If the risk reallocation is disregarded, the transfer pricing consequences shall be determined based on the original risk allocation.

The third arrangement examined is situations where the risk-assuming party in a controlled transaction is financially incapable of bearing the risk. Such a risk-allocation might be unattractive for both parties to the transaction. If the risk materialises the risk-assuming party will risk going out of business. An independent enterprise would therefore be reluctant to assume such a high risk exposure. Moreover, if the risk materialises the non-risk assuming party might ultimately suffer the economic consequences of the risk materialising. It would therefore be more attractive for it to assume the risk itself, as such risk-assumption will have a favourable effect on its price terms and as this would put it in a better position to manage the risk with the aim of preventing the risk from materialising. The Chapter thoroughly examines the process of determining whether the risk-assuming party is financially incapable of

---

32 See OECD Guidelines Para. 1.65.
assuming the risk and concludes that risk allocations contrary to the financial capacity criterion can be disregarded under Art. 9(1) OECD MTC if a comparable risk allocation cannot be identified between unrelated parties.

The fourth arrangement examined is situations where a risk over which one of the contracting parties have relatively more control has been allocated to the other contracting party (having relatively less control over the risk). This risk allocation will put the risk-assuming party in a vulnerable position because the non-risk assuming party will control whether the risk actually materialises into costs and losses. The non-risk assuming party may not have strong incentives to prevent the risk from materialising (as it will not suffer the consequences should the risk materialise). This risk allocation will therefore be unattractive for the risk-assuming party. Moreover, as the risk-assuming party puts itself in a vulnerable position it would be likely, at arm’s length, to request a particularly high financial award for assuming the risk. The non-risk assuming party might not have strong incentives to prevent the risk from materialising (as it will not suffer the consequences should the risk materialise). Therefore, this risk allocation will also be unattractive for the risk-assuming party. The Chapter thoroughly examines the control criterion and concludes that that risk allocations contrary to the control criterion can be disregarded under Art. 9(1) OECD MTC if a comparable risk allocation cannot be identified between unrelated parties.

7. PART III.C: THE COMMERCIAL RATIONALITY EXCEPTION

7.1 General scope

7.1.1 In general

Part III.C of the thesis is devoted to a more detailed examination of the commercial rationality exception. Chapter 19 examines the exception’s general scope. A structural adjustment is authorised under the commercial rationality exception if the following two requirements are fulfilled:

- The commercial irrationality requirement: “[t]he arrangements made in relation to the transaction, viewed in their totality, [must] differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner”.

- The practical impediment requirement: “[t]he actual structure [must] practically impede[] the tax administration from determining an appropriate transfer price”.

The two requirements are cumulative.

7.1.2 The notion of commercial irrationality: the realistically available options standard (RAO standard)

An important part of Chapter 19 is its examination of the notion of commercial irrationality. The Chapter concludes that the so-called “realistically available alternatives standard” (the “RAO standard”) shall be applied to determine whether the commercial irrationality requirement is fulfilled. The RAO standard is expressed as such in Para. 1.34 of the OECD Guidelines:

Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they

33 See OECD Guidelines Para. 1.65.
will only enter into the transaction if they see no alternative that is clearly more attractive.

The RAO standard involves a two-step analysis. First, the tax examiner must identify the relevant associated enterprise’s realistically available options, if any. Second, it must determine whether one or more of the identified options, if any, were clearly more attractive for this enterprise than the transaction actually undertaken.

If, in the first step, it is determined that the relevant enterprise had no realistically available options, the analysis ends and the second step shall not be undertaken. In this case, the commercial irrationality requirement will not be satisfied and Art. 9(1) OECD MTC will not authorise a structural adjustment of the transaction actually undertaken, regardless of how detrimental it may be to the relevant enterprise. If, on the other hand, the enterprise had realistically available options the commercial irrationality requirement will be satisfied if one or more of the options were clearly more attractive than the actual transaction, but not if none of the options was clearly more attractive than it.

7.1.3 Search for realistically available options

The Chapter then goes on to examine which options can be considered to have been “realistically available” to the examined taxpayer. The Chapter identifies a number of circumstances which suggest that the option shall either not be considered to have been “realistically available” at all or to have had a reduced level of availability:

- **The option does not respect the business of the MNE group as such.** The purpose of an analysis under the commercial rationality exception is only to assess whether transactions actually undertaken between the group members are irrational, not to assess whether the business of the group as such is irrational. If an identified option disrespects the business of the MNE group as such, the option should not be considered realistically available to the examined taxpayer. Structural adjustments involving addition of activities to, detraction of activities from and/or qualitative changes to the group’s overall business may be considered to disrespect the MNE group’s business as such.

- **The option is commercially unattractive for the MNE group.** As pointed out supra section 4.1, the commercial interest of individual group members may conflict with that of the MNE group as such. Therefore, whereas the actual transaction may be commercially attractive for the MNE group as such but not for the examined taxpayer, the identified option may be commercially attractive for the examined taxpayer but not for the MNE group as such. Arguably, domestic tax administrations should not have the authority to insist that MNE group members adopt transaction structures which are commercially unattractive for their group. Therefore, options which are commercially unattractive for the group should not be considered realistically available to the examined taxpayer.

- **The option is strongly counterfactual.** An option can be said to be strongly counterfactual if it ignores indisputable, physical expressions of the group’s business, such as the location in which the group’s personnel (directors, employees, etc.) perform their functions, the location of its business assets, the location of its real estates (manufacturing plants, warehouses, research labs, offices, etc.) and the location of any natural resources extracted by it. The Chapter concludes that strongly counterfactual options do not per se qualify as not realistically available. However, the more counterfactual a particular option appears at the stage of the tax examination, the stronger the reason for considering this option not to be realistically available.
• *The option was not readily available at the time of the controlled transaction.* An option will not be readily available to the examined taxpayer if it could not have adopted it as it existed at the time of the controlled transaction, but only if the taxpayer had made certain changes to its existing business, e.g. through building new manufacturing plants, investing in new assets, hiring new personnel and/or borrowing more capital. The Chapter concludes that a not readily available option cannot always be considered not realistically available. However, the fact that an option is not readily available will reduce its level of attractiveness. Further, options which will only be possible if additional equity capital is contributed to the taxpayer and options which are not readily available at the time of the transaction due to external factors outside of the associated enterprises’ control cannot be considered realistically available.

• *The option is not acceptable to the other party to the transaction.* The Chapter concludes that an option which, at arm’s length, would not have been acceptable to the related party cannot be considered realistically available to the examined taxpayer.

• *The taxpayer did not have knowledge of the option.* If it is established that the examined taxpayer did not actually have knowledge of the option at the time of the transaction the option cannot be regarded as realistically available to it.

• *The option is illegal.* Potentially, an identified option may be illegal under the domestic law of a relevant jurisdiction, typically under that of the examined taxpayer’s or the related party’s home state. The Chapter concludes that illegal options cannot be considered realistically available to the examined taxpayer.

7.1.4 The clearly-more-attractive test

For the commercial irrationality requirement to be satisfied it is not sufficient that the examined taxpayer had other realistically available options than to enter into the controlled transaction actually undertaken. Additionally, it must also be established that one or more of the realistically available options were “clearly more attractive” to the taxpayer than the transaction actually undertaken.

This “clearly-more-attractive test” is performed in a two-step process. First, the tax examiner must establish both the actual transaction’s and the options’ level of attractiveness. In this regard “attractiveness” refers to commercial – as opposed e.g. to environmental, scientific, publicity-related or religious – attractiveness. An option’s commercial attractiveness to an enterprise is determined by its ability to contribute to the enterprise’s profits, by increasing its gross income and/or reducing its costs, i.e. its “profit-maximizing capacity”. The actual transaction’s and the realistically available options’ attractiveness must be assessed from the perspective of the time of the controlled transaction and, thus, only based on information known or reasonably foreseeable at this point in time. Further, the assessment must take into account that attractiveness is subjective. Therefore, the assessment must take into account the perspective of both pessimistic and optimistic enterprises, both the perspective of risk averse and risk willing enterprises, and so on.

Second, the tax examiner must compare the actual transaction’s level of attractiveness with each of the option’s level of attractiveness. The OECD Guidelines suggest that an independent enterprise would only have rejected the actual transaction if one or more of the realistically available options were “clearly more attractive”\(^34\) (bold added) to it than the

\(^34\) OECD Guidelines Para. 1.34.
actual transaction. This “clarity criterion” has several implications. First, the criterion must reasonably imply that the commercial irrationality requirement will not be satisfied if one or more of the options are only considered to have a modestly higher level of attractiveness than the actual transaction. Second, the criterion suggests that subjectivity must be emphasised. In specific, if, taking into account the fact that different independent enterprises may assess an option’s level of attractiveness to be different due e.g. to differences in risk appetite, it is a realistic possibility that a rational independent enterprise would not consider any of the options to be clearly more attractive than the actual transaction, it cannot be considered clear that any of the options are in fact more attractive. Third, the clarity criterion suggests uncertainty must be emphasised. Hence, if, after a thorough and careful analysis of the actual transaction’s and the options’ levels of attractiveness, it still remains uncertain whether one or more of the options are clearly more attractive than the actual transaction, it cannot be considered clear that one or more of the options are in fact more attractive.

7.1.5 The practical impediment requirement

Chapter 19 also examines the second cumulative requirement for applying the commercial rationality exception, i.e. the practical impediment requirement, which is satisfied if “the actual structure [of the controlled transaction] practically impedes the tax administration from determining an appropriate transfer price”. The Chapter qualifies the requirement as follows:

- The requirement is only satisfied if it cannot reliably be determined that the controlled transaction’s valuation conditions (price, margins, profit splits, etc.) are arm’s length either under the transfer pricing methods explicitly outlined by the OECD Guidelines or by an unspecified – i.e. “other” – method (as referred to in Para. 2.9 of the Guidelines).

- An “appropriate” transfer price is a price arrived at through correct interpretation and application of the arm’s length principle as authoritatively stated by Art. 9(1) OECD MTC, based on the guidance provided by the OECD Guidelines.

- The practical impediment requirement is only satisfied if the irrational part of the “actual structure” practically impedes the price determination. Practical impediments caused by other – rational – parts of the transaction structure or by external factors, such as e.g. difficulties in obtaining information, do not qualify. The practical impediment requirement is, thus, not aimed at valuation difficulties in general, but only at those created by commercially irrational arrangements.

- The reasons why a commercially irrational arrangement may practically impede the price determination are (i) that the irrational arrangement will not be matched by concrete comparable uncontrolled transactions and (ii) that the tax administration will face significant difficulties in addressing the lack of concrete comparables through performing comparability adjustments to differently structured uncontrolled transactions.

- The Chapter discusses the issue of whether it is necessary that the irrational arrangement makes it impossible to determine an appropriate arm’s length price or if it is sufficient that the arrangement make the determination difficult. The Chapter concludes that in practice it will be difficult, if not impossible, to distinguish irrational arrangements making the price determination difficult from those making the price determination impossible. Therefore, in practice, assessing whether a qualifying impediment exists would have to be based on the degree of the valuation difficulties; the more severe valuation difficulties that arise
from the irrational arrangement, the more defensible is the position that a qualifying practical impediment exists.

### 7.1.6 The authorised structural adjustment

If the commercial irrationality requirement and the practical impediment requirement are both fulfilled, Art. 9(1) OECD MTC as interpreted by the commercial rationality exception will authorise the domestic tax administration to restructure the examined controlled transaction. In such cases, the OECD Guidelines provide, the domestic tax administration may

(...) conform the terms of that transfer in their entirety (and not simply by reference to pricing) to those that might reasonably have been expected had the transfer of property been the subject of a transaction involving independent enterprises.  

The adjustment directive essentially provides that the commercially irrational arrangements actually adopted by the associated enterprises may be substituted with the – commercially rational – arrangements which independent enterprises behaving in a commercially rational manner might reasonably be expected to adopt. In concrete terms, the latter (commercially rational) arrangements are the, or one of the, realistically available option(s) identified in the analysis under the RAO standard.

The structural adjustment must stand in proportion to the controlled transaction’s commercially irrational feature, i.e. the commercial rationality exception only authorises a structural adjustment of this feature. As other – commercially rational – features would also have been adopted by independent enterprises behaving in a commercially rational manner these features do not qualify as commercially irrational under the commercial irrationality requirement and cannot therefore be restructured.

If the examined taxpayer only had one realistically available option to entering into the actual transaction, Art. 9(1) OECD MTC will authorise the domestic tax administration to restructure the actual transaction in accordance with this option. Often, the taxpayer will, however, have had more than one, potentially many, realistically available options. If so, it becomes incumbent to determine which of the options the actual transaction shall be restructured in accordance with. The Chapter identifies three alternative standards on the basis of which one of the following options can be chosen:

i) The most attractive option, i.e. the option which is most attractive to the examined taxpayer.

ii) The market norm option, i.e. the option most commonly adopted by independent enterprises.

iii) The least-extensive-adjustment option, i.e. the option which is structurally most similar to the actual transaction, but which is nevertheless not overshadowed by a clearly more attractive option (otherwise this option too would be commercially irrational).

As a commercially rational independent enterprise, acting in its own self-interest, would be expected to choose the most attractive one among the realistically available options, the

---

35 OECD Guidelines Para. 1.65.

36 See OECD Guidelines Para. 9.184.
Chapter concludes that the most attractive option shall normally be chosen. In practice, however, several of the (most) attractive options may be considered essentially as having the same level of attractiveness. If so, a choice cannot be made by choosing the most attractive option. In such cases, it therefore seems appropriate, the Chapter concludes, to resort to the least-extensive-adjustment option.

7.2 Categories of potentially irrational arrangements

7.2.1 In general

The thesis’ final four Chapters examine four concrete categories of arrangements which could potentially fall within the purview of the commercial rationality exception.

7.2.2 Irrational transfers of profit generators

An enterprise’s profit potential is strongly dependent upon the extensiveness of its business operations as primarily reflected by the functions it performs, its business assets and the risks assumed by it, hereinafter referred to as its “profit generators”. The more functions it performs, the more valuable assets it uses and the more risk it assumes, the higher the profits it will be expected to earn, albeit e.g. the assumption of risk may actually result in losses. Independent enterprises seeking to maximise their profits may therefore be reluctant to transfer their profit generators to unrelated parties as this will reduce their expected profits.

Chapter 21 examines whether Art. 9(1) OECD MTC as interpreted by the commercial rationality exception authorises the disregard of controlled profit-generator transfers. The Chapter’s focus is on whether the transfer is commercially irrational for the profit-generator transferor, not for the transferee. The Chapter primarily focuses on the clearly-more-attractive test, i.e. the issue of whether the examined taxpayer’s option of not transferring its profit generators to the related party (if any) was “clearly more attractive” to it than to undertake the transfer (as it has actually done). In an initial part the Chapter concludes that controlled profit-generator transfers do not qualify as commercially irrational per se. In order to conclude that such a transfer is commercially irrational it is necessary to establish that one or more qualifying circumstances are present. The Chapter examines a number of such qualifying circumstances. The most significant circumstances are the following two:

- **The consideration paid by the transferee.** The Chapter concludes that the pertinent issue is whether the amount of the arm’s length consideration is high enough for the transferor to have been willing to transfer the relevant profit generator to an unrelated party, also taking into account other factors affecting the transfer’s attractiveness. If the actual consideration is below arm’s length this must be dealt with by adjusting the consideration to the arm’s length amount; a below-arm’s length consideration will therefore not be a factor supporting the disregard of the profit-generator transfer. The Chapter further observes that, in principle, it is conceivable that the potential transferor, at arm’s length, would not have been willing to sell for the highest price the potential transferee would have been willing to pay. If this is the case, there would be no basis for the transfer had the parties been unrelated.

- **The anticipated drop in the transferor’s post-transfer profits.** The Chapter finds it reasonable to assume that the greater the anticipated drop in the transferor’s post-transfer profits the less willing the enterprise would be to transfer its profit generators. The

37 See e.g. OECD Guidelines Para. 1.42.
anticipated profit decline will equal the transferor’s anticipated profits if the transfer is not undertaken less its anticipated profits if the transfer is undertaken. The relevant figure is the transferor’s anticipated arm’s length profits, not any below-arm’s length profits actually earned by transferor and resulting from non-arm’s length conditions being made or imposed in its post-transfer controlled transactions. The appropriate response would be to adjust the consideration charged in the post-transfer transactions rather than to emphasise the non-arm’s length consideration as a factor supporting a disregard of the transfer as such. Further, the level of the transferor’s anticipated post-transfer profits must be viewed together with any consideration paid by the transferee for the transferred profit generator. Thus, even if a significant anticipated drop in its post-transfer profits would, if viewed in isolation, have discouraged the transferor from undertaking the transfer, the consideration received in the transfer itself may re-establish its willingness to undertake the transfer. Finally, the examined material does not suggest that any, relatively minor anticipated decrease in the transferor’s profits would discourage it from undertaking the transfer. Thus, the examined material suggests that what may be suspect from the point of view of the arm’s length principle are transfers of significant, high-profit potential functions, risks and assets and, thus, not (normally) transfers of routine, low-profit potential functions, risks and assets.

The Chapter further concludes that a number of other examined circumstances – contrary to what have sometimes been alleged – do not support a conclusion that the controlled profit-generator transfer is commercially irrational. These circumstances include:

- that the transferor’s and transferee’s post-transfer division of business activities allegedly is not “natural”;
- that the transferor’s and transferee’s post-transfer division of business activities is highly integrated or interdependent;
- that the transferor and transferee share input factors (officers, employees, premises, business assets, etc.) after the transfer;
- that the profit-generator transfer is circular, e.g. a sale- and license back of intangible property;
- that the transferor provided assistance to the transferee, e.g. financial assistance to fund the transfer;
- that the profit-generator transfer does not serve a group-level business purpose; and
- that the profit-generator transfer is tax motivated.

If the profit-generator transfer qualifies as commercially irrational and the practical impediment requirement is also fulfilled Art. 9(1) OECD MTC will authorise the domestic tax administration to disregard the transfer. The disregard implies that the transferor is deemed not to have transferred the relevant profit generators. As a result, the transferor cannot be deemed to have realised capital gains (or losses) through the transfer. Further, if the transfer is disregarded the transferor will be treated for tax purposes as if it had continued to perform the functions, assume the risks and/or own/use the assets it has actually transferred. Therefore, the tax administration must hypothesise the profits (or losses) which the transferred profit generator(s) would have generated had they actually continued to be handled by the transferor.
7.2.3 Irrational approaches to valuation uncertainty at the time of controlled transactions

If unrelated enterprises enter into a contract despite of significant valuation uncertainty, they might be expected to agree on a *dynamic*, rather than a *static*, pricing mechanism, allowing for the consideration to be adjusted e.g. if the actual profits generated by the transferred property differ significantly from what the parties projected at the time of the transaction. If associated enterprises fail to address valuation uncertainty in the manner independent enterprises are expected to do, domestic tax administrations might challenge the structure of the controlled transaction. In particular, the tax administration competent to tax the transferor may question why it settled for a modest static consideration instead of a dynamic, potentially higher consideration. Chapter 21 of the thesis examines the extent to which, and how, such static pricing structures can be restructured under Art. 9(1) OECD MTC.

The Chapter first examines the deemed-to-be irrational arrangement addressed in the basic example accompanying the commercial rationality exception, which is

(...*) a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract.*

38

The reason why this lump-sum, early-stage intangible transfer might be commercially irrational is the combination of two factors, i.e. valuation difficulties existing at the time of the transaction (the to-be-transferred intellectual property rights do not even exist at the time of the transaction) and the choice of a static pricing mechanism (i.e. the lump sum). The lump-sum structure will be unattractive to the transferor if the enterprises agree on a low lump sum, whereas it will be unattractive to the transferee if they agree on a high lump sum. In practice, however, associated enterprises undertaking lump-sum intangibles transfers commonly agree on a low lump sum. The Chapter concludes that the lump-sum transfer cannot be disregarded in its entirety, but that Art. 9(1) OECD MTC allows the domestic tax administration to restructure the actually adopted static lump-sum pricing mechanism into a dynamic pricing mechanism. The Chapter finds that the predominant view appears to be that the lump-sum transfer should be restructured into a combined research and license agreement, under which the transferor (researcher) obliges itself to perform research and to license the fruits of its research to the transferee against remuneration in the form of annual royalty payments.

The Chapter also examines the fact patterns addressed in the OECD Guidelines’ subsection on “[a]rm’s length pricing when valuation is highly uncertain at the time of the [intangibles] transaction”.39 This subsection is primarily aimed at license agreements, in which the associated enterprises have agreed on a static royalty clause. A royalty clause will qualify as static e.g. if the royalty is stipulated as a fixed lump-sum amount per year. The OECD Guidelines suggest the static royalty clause can be restructured either by introducing a hypothetical price adjustment clause into the license agreement or by reducing the term of the license (i.e. to impute a shorter-term license agreement). The Chapter concludes that the static royalty clause can only be so restructured if significant valuation uncertainty existed at the time the associated enterprises entered into the license agreement. Significant valuation uncertainty will exist if future developments were not predictable at the time of the

38 OECD Guidelines Para. 1.65.
transaction, e.g. because the licensed intangible was newly developed at the time of the
transaction and had not yet proven to be commercially viable.

7.2.4 Irrational cost incurrence: qualitative irrationality

In order to maximise profits independent enterprises have a strong incentive to minimise costs
(in addition to increasing gross income). Independent enterprises will therefore not be inclined
to spend money on property or services for which they do not have a business need. By
contrast, an MNE group member may choose to acquire property or services from, and also to
develop property together with, an affiliate even if it does not have a need for the
property/services in its own business, provided the acquisition has favourable group-level
effects, e.g. a reduction of the group’s overall tax burden.

The thesis’ Chapter 23 examines whether an examined taxpayer’s purchase of property or
services from, or development of property together with, an affiliate can be disregarded under
Art. 9(1) OECD MTC as interpreted by the commercial rationality exception on the ground
that the taxpayer does not have a business need for the property or services. The reason why
such a purchase or co-development would qualify as commercially irrational would be the
property’s or services’ qualities as seen in relation to the examined taxpayer’s business. This
is reflected in the Chapter’s heading, i.e. “qualitative” irrationality.

The Chapter concludes that the examined taxpayer’s purchase of property or services from, or
development of property together with, an affiliate will qualify as commercially irrational if
the taxpayer does not have a reasonable expectation of being able to exploit the purchased
property or services either directly or indirectly. In order to assess the examined taxpayer’s
ability to exploit or use the acquired property or services directly, e.g. through physical use or
consumption, the property or services must be viewed in light of the examined taxpayer’s
business. If the property or services cannot meaningfully be exploited or used in the examined
taxpayer’s own business, i.e. they cannot serve a meaningful function, direct exploitation
cannot be considered possible. If indirect exploitation (e.g. through resale, license, hiring out
or leasing out) is also not possible, the examined taxpayer cannot and will not benefit
economically from the acquired property or service either by direct or indirect exploitation.
Therefore, its realistically available option of not acquiring the property or services will be
clearly more attractive than the actual acquisition, with the consequence that the acquisition
qualifies as commercially irrational. If so, and provided that the practical impediment
requirement is also fulfilled, Art. 9(1) OECD MTC, as interpreted by the commercial
rationality exception, will authorise the domestic tax administration to disregard the purchase.

7.2.5 Irrational cost incurrence: quantitative irrationality

At arm’s length, an independent enterprise will be able to purchase almost any property or
service which it is technically, physically and legally possible to provide, provided that it is
willing (and able) to pay the price requested by potential transferors. However, even if a
particular property or particular services can be purchased at arm’s length, it does not follow
that they are. It is not unconceivable that the lowest price for which independent transferors
would be willing to transfer particular property or services, i.e. the “minimum arm’s length
supply price”, is higher than the highest price independent transferees would be willing to
pay, i.e. the “maximum arm’s length demand price”. If so, there will be a negative area of
agreement and therefore no basis for the transaction at arm’s length, with the effect that the
property or services will not be traded on the market.
In order e.g. to obtain tax savings, associated enterprises may, however, effectuate controlled transfers of property and, particularly, services for which there would be a negative area of agreement at arm’s length. From the transferee’s perspective such a transfer will qualify as a quantitatively irrational cost incurrence. The thesis’ Chapter 24 examines the authority to restructure such quantitatively irrational purchases under Art. 9(1) OECD MTC as interpreted by the commercial rationality exception. The Chapter finds that a purchase may qualify as quantitatively irrational even if the transferee clearly has a business need for the acquired property or services. Hence, the basis for restructuring a quantitatively irrational purchase would be the mere fact that the maximum arm’s length demand price for the property or services is lower than the minimum arm’s length supply price. The Chapter identifies controlled insurance agreements with extremely low deductibles as core examples of potentially quantitatively irrational transactions. Such extremely low deductibles may, at arm’s length, increase the insurance premiums to such a high level that an independent insuree would not be willing to pay the insurance premiums (but rather settle for higher deductibles triggering lower insurance premiums).

The Chapter thoroughly examines how to determine whether there is a negative area of agreement for the property or services transferred in a controlled transaction. As mentioned above, a negative area agreement exists if the maximum arm’s length demand price is lower than the minimum arm’s length supply price. The Chapter finds that the maximum arm’s length demand price will be lower than the minimum arm’s length supply price if a comparably placed independent transferee would have considered the expected benefits of adopting the high-cost transaction structure not to exceed the cost of adopting the structure (i.e. the minimum arm’s length supply price). The benefits resulting from the high-cost transaction structure must be assessed ex ante based on information known or reasonably foreseeable at the time of the transaction. Hence, it is the expected benefits at the time of the transaction which are relevant to the analysis, not the – possibly lower or higher – benefits actually realised by the transferee.

The Chapter concludes that Art. 9(1) OECD MTC as interpreted by the commercial rationality exception will authorise domestic tax administrations to restructure the quantitatively irrational transaction, provided that practical impediment requirement is also fulfilled. In concrete terms, the domestic tax administration will be authorised to substitute the actual transaction, for which there is a negative area of agreement, with an alternative transaction for which there is a positive area of agreement. For example, in a controlled insurance transaction the tax administration may substitute an extremely low deductible which is more costly than an independent insuree would be willing to accept with a higher, less expensive deductible which an independent insuree would be willing to pay for.

****