II. 2. t

TRANSFER PRICING AND MULTINATIONAL ENTERPRISES

Report
of the OECD Committee
on Fiscal Affairs

1979

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT
PARIS

TRANSFER PRICING AND MULTINATIONAL ENTERPRISES

Report
of the OECD Committee
on Fiscal Affairs

1979

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT
PARIS

The Organisation for Economic Co-operation and Development (OECD) was set up under a Convention signed in Paris on 14th December 1960, which provides that the OECD shall promote policies designed:

— to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
— to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development;
— to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

The Members of OECD are Australia, Austria, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

***

© OECD, 1979
Queries concerning permissions or translation rights should be addressed to:
Director of Information, OECD
2, rue André-Pascal, 75775 PARIS CEDEX 16, France.

CONTENTS

PREFACE 7

Chapter I : SUMMARY OF PROBLEMS 13

Chapter II : GOODS 25

Chapter III : TECHNOLOGY AND TRADEMARKS 45

Chapter IV : CERTAIN INTRA-GROUP SERVICES 71

Chapter V : LOANS 85

Annex : RECOMMENDATION OF THE OECD COUNCIL 95

DETAILED TABLE OF CONTENTS 97

FOREWORD

This report was adopted by the Committee on Fiscal Affairs in January, 1979. The Council of the OECD approved the report for publication and adopted the Recommendation annexed to it on 16th May, 1979.

PREFACE

The problem stated

1. While taxation problems arising from international investment are not new, they have become more important in recent years as a consequence of the growing internationalisation of economic activities. One characteristic of this process is the development of so-called " multinational enterprises " (by which is usually meant groups of associated enterprises operating across national frontiers) which have increasingly become powerful economic entities each with a large degree of common strategy. However, such an international economic entity generally operates in a legal framework which has remained national; it has therefore to conform with the varied and sometimes conflicting national laws of the countries in which it operates. This increasingly common phenomenon of related companies operating in a group with some degree of centralised management, yet with the individual members of the group operating under different national laws, has given rise to important problems regarding the taxation of corporate profits.

2. In a multinational enterprise (MNE) many transactions normally take place between members of the group — sales of goods, the provision of services, the licensing of patents and know-how, the granting of loans and so on. The prices charged for such transfers do not necessarily represent a result of the free play of market forces, but may, for a number of reasons and because the MNE is in a position to adopt whatever principle is convenient to it as a group, diverge considerably from the prices which would have been agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions in the open market (hereafter referred to as " arm's length prices "). Tax factors may affect the nature and the amount of the payments since it is likely that MNEs will be more concerned with the total of their net earnings after tax than with the forms which these earnings take — whether for example they are received as royalties, cost charges, service fees, profits from intra-group

sales, or dividends from their affiliates etc. On the other hand it has to be recognised that in many instances tax considerations are unlikely to be paramount where, for example, enterprises are subject to conflicting pressures from various government departments — in the home as well as the host countries — including customs authorities, exchange or price control offices and others, or where the different entities of a group face the scrutiny of minority shareholders. Divergences from arm's length prices will not necessarily always occur: in some MNEs the members have a considerable amount of autonomy so that they can and often indeed do bargain with each other in a manner similar to that of independent entities — local managers wanting to show a good profit record for their subsidiaries may resist fixing excessive transfer prices for goods, services, rights etc. if their local subsidiaries' profits would thereby be reduced. There may be other factors tending to cause their prices to approximate to arm's length prices.

Interest of the tax authorities

3. Multinational enterprises may adopt transfer prices which are not arm's length prices in order to minimise tax (for example, by selling goods to a subsidiary in a tax haven country at less than arm's length prices) or they may adopt them for other reasons but, whatever the reason, whenever intra-group transfers are not carried out at arm's length prices, the result is likely to be that profits are shifted from one company to another company in the group and the tax liability of the relevant companies distorted in consequence. Since national tax authorities need to determine the proper level of taxable profits of the affiliated enterprises operating within their respective jurisdictions, the transfer pricing policies of MNEs are of great importance to them, and, particularly where there are grounds for believing that the taxable profits reported by a member of such a group are unduly low, the relevant national tax authority may have to examine the possibility that this is due to the transfer pricing policy applied by the group. It is generally acknowledged that, in taxing the profits of an enterprise which engages in transactions with associated enterprises outside the jurisdiction of the relevant taxing authority, the profits should be calculated on the assumption that the prices charged in these transactions are arm's length prices. This is the underlying assumption in Article 9 (1) of the OECD Model Double Taxation Convention on Income and Capital (1977) on transactions between associated enterprises. In this context, it may be noted that the arm's length approach, which underlies this report, has also been endorsed by the United Nations Group of Experts on Tax Treaties between Developed and Developing

Countries[1], and that there is a broad consensus among governments of developed and developing countries and MNEs that arm's length pricing is the appropriate approach to adopt in arriving at profits for tax purposes. Modern bilateral double taxation conventions between OECD Member States and between OECD Members and other States have accordingly adopted this principle. It is important to bear in mind, moreover, that the need to adjust the actual price to an arm's length price, in order to arrive at a proper level of taxable profits, arises irrespective of any contractual obligation undertaken by the parties to pay a particular price or of any intention of the parties to minimise tax. Hence, the consideration of transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes.

Interest of multinational enterprises

4. In the organisation of their intra-group relations MNEs are necessarily confronted with transfer pricing problems — essentially a price has to be charged for every transaction. Even in seeking, itself, to fix its transfer prices on the arm's length basis, a multinational enterprise will face problems and the process will be all the more difficult if, as may happen, it is confronted with differing, perhaps conflicting requirements by different administrations (perhaps even within the same country). One of these problems could be the danger of double taxation, if national tax authorities differ in their approach for tax purposes. It is therefore of importance to multinational enterprises also that common approaches to the resolution of transfer pricing problems should be developed.

Objectives of the report

5. The main objectives of the report are to set out as far as possible the considerations to be taken into account and to describe, where possible, generally agreed practices in determining transfer prices for tax purposes. It is hoped that, by doing so, the report will not only help tax officials to approach more effectively the problems presented to them

1. See, inter alia, page 62 of the seventh report on " Tax Treaties between Developed and Developing Countries " (United Nations 1978) which states that " the Group of Experts had unanimously recognised the validity of the arm's length principle and that governments should apply arm's length pricing wherever appropriate ".

by the transfer prices of multinational enterprises but will also help the enterprises themselves by indicating ways in which mutually satisfactory solutions may be found to those tax problems. The basic point of reference in all the various chapters of this report is the arm's length price. The report can be seen in fact as an attempt to set out the considerations to be taken into account, and the means available, for determining an arm's length price in the widely varying circumstances which arise in practice in connection with transactions between associated enterprises. What is set out in the main body of the report must necessarily be regarded, however, as only a general guide setting out principles that may be relevant and appropriate to apply in most cases to the different circumstances arising. The report does not and cannot lay down rules that are appropriate to every aspect of every case: it is an essential feature of the problem that it is always necessary to have regard to the particular facts of each case.

6. The process of establishing an arm's length price is often complex and difficult and the difficulties are likely to be greater for both taxpayers and tax authorities if there is a lack of a common approach to the matter. The 1963 OECD Draft Double Taxation Convention on Income and Capital[1] laid a foundation for such a common approach in providing a common concept and a common language but the need now is to develop practical means for applying one. It is another purpose of this report therefore to establish as far as possible such an approach with the objective not only of enabling the interests of the national tax authorities involved to be protected but also of enabling the double taxation of the enterprises involved to be prevented. The aim is also to provide guidance of universal validity and it is considered that the conclusions in the report are equally applicable, for example, whether the relevant transactions are between entities in developed countries or entities in developed and developing countries.

Scope of the report

7. This report discusses the determination of acceptable prices for the purposes of establishing taxable profits when transfers of goods, services or technology etc., take place or loans are made between associated enterprises situated in different countries. The report covers not only transfers between parent and subsidiary companies but also those

1. See the end of Chapter I for the text of Article 9 of the 1977 OECD Model Double Taxation Convention, which reproducted without change the 1963 version of Article 9.

between other enterprises under common control[1] though the problems arising specifically from transactions between companies under common control have not been dealt with and indeed some countries would regard such transactions as passing through the common parent insofar as the price deviates from arm's length. It was not thought necessary for the purpose of the report to define such expressions as " associated enterprise " or " under common control ". A broad basis of common understanding of what is meant is assumed. Nor was it thought necessary to define precisely the expression " multinational enterprise " (MNE) which is frequently used[2].

8. The report covers in some detail some of the more important types of transfer which, in practice, take place between associated enterprises. It should be said at the outset that some subjects have been treated in a way which may seem to be comparatively superficial and others have not been discussed at all. The reason for this is either that the report concentrates on the more pressing problems or that the topics are so case-oriented that satisfactory generalisation is not possible. Among topics omitted altogether from the report are certain types of transfers which seemed of lesser or less general importance — for example sales as distinct from transfers of the right to use patents and know-how, transfers of literary and artistic copyrights, transactions in real estate and transactions in securities such as shares and bonds. Also outside the scope of the present report, since the aim has been as far as possible to set out general principles, is any attempt to deal with special transfer pricing problems relating to particular industries or special types of enterprise. Finally no mention is made of the treatment of corresponding adjustments (as referred to in Article 9 (2) of the OECD Model Double Taxation Convention), which is a related

1. Whereas the principle of arm's length pricing is valid also for the taxation of permanent establishments, the considerations set out in this report need to be applied with care to the taxation of permanent establishments because of the special factors involved (for example, because of the limitations normally recognised on the acceptability for tax purposes of loan or royalty contracts between permanent establishments and the remainder of the enterprise of which they form part — see Commentary on Article 7 of the OECD Model Double Taxation Convention).

2. In this connection, reference is made to the OECD Guidelines for Multinational Enterprises, paragraph (8), which says :
" A precise legal definition of multinational enterprises is not required for the purposes of the guidelines. These usually comprise companies or other entities whose ownership is private, State or mixed, established in different countries and so linked that one or more of them may be able to exercise a significant influence over the activities of others and, in particular, to share knowledge and resources with the others. The degree of autonomy of each entity in relation to the others varies widely from one multinational enterprise to another, depending on the nature of the links between such entities and the fields of activity concerned. "

problem but outside the scope of this report. However a common approach based on the considerations set out in this report should help to reduce the need for any such corresponding adjustment.

Experience on which the report is based

9. A special working group of experts under the aegis of the Committee on Fiscal Affairs of the OECD has studied this problem over a number of years. In addition the group has held technical discussions with representatives of multinational enterprises under the aegis of the Business and Industrial Advisory Committee to the OECD and also with representatives of the Trade Union Advisory Committee to the OECD. Consultations have also taken place with the Secretariat of the Customs Co-operation Council. The report was unanimously adopted by the Committee on Fiscal Affairs in January 1979 and was the subject of a Recommendation of the Council on 16th May, 1979 — see the Annex on page 95.

Structure and layout of the report

10. Chapter I of the report summarises some of the problems, Chapter II deals with transfers of goods, Chapter III with transfers of patents, know-how and trademarks, Chapter IV with transfers of certain services and Chapter V with intra-group loans. Most of the considerations and methods discussed in Chapter I apply to all of the types of transfers. Although the general considerations are set out in Chapter I, more explicit details of what is meant by the arm's length principle and what methods can be employed to arrive at arm's length prices are given in Chapter II in relation to transfers of goods. They are therefore taken up in a less detailed manner in the later Chapters, which therefore should be read in conjunction with Chapters I and II.

CHAPTER I

SUMMARY OF PROBLEMS

THE ARM'S LENGTH PRINCIPLE

Comparable uncontrolled prices

11. Making a judgement whether a particular transfer price conforms to the arm's length principle would ideally require direct reference to prices in comparable transactions between enterprises independent of each other or between the group and unrelated parties. This method is frequently referred to as the " comparable uncontrolled price " method and in principle it is the most appropriate to use and in theory the easiest. In practice, however, it often happens that such evidence is not available or it is impracticable to collect it together or there is argument about whether the prices quoted are comparable or not. Other methods may therefore need to be used to obtain an arm's length price.

Cost plus and resale methods

12. There will be many cases where no useful evidence of uncontrolled transactions will be available because, for example, the goods or services etc. which are supplied are so special to the group that there is no open market in them and they are not supplied to independent enterprises. This may be particularly the case for example for semi-finished products or in relation to transfers of technology. In other cases the transactions within the group may not be satisfactorily comparable with those between the group and independent third parties, for example because they take place at a different stage in the chain of production or distribution or because the independent third party is too small a customer to claim the discounts for volume which an entity within the group might be big enough to achieve if it were independent. In such circumstances it will often be necessary, in order

to establish an arm's length price, to use either the cost plus method or the resale method, the cost plus method starting from the cost of providing the goods or services etc. and adding whatever cost and profit mark-up is appropriate and the resale price method starting from the final selling price and subtracting the cost and an appropriate profit mark-up.

Other methods

13. The complexities of real life business situations may put many conceptual and practical difficulties in the way of the application of the methods referred to above. A mixture of these methods, or other methods still, may sometimes therefore have to be used. Any method which is used will involve problems of judgement and the evaluation of evidence and it has to be recognised that the object of using it is to produce a figure which is acceptable for practical purposes. Experience shows that the difficulties can in general be satisfactorily dealt with and acceptable prices agreed.

The so-called " global " methods

14. Proposals for radical reformulations of the approach to intra-group transfer pricing which would move away from the arm's length approach towards so-called global or direct methods of profit allocation, or towards fixing transfer prices by reference to predetermined formulae for allocating profits between affiliates, are not endorsed in this report. The use of such alternatives to the arm's length principle is incompatible in fact with Articles 7 and 9 of the OECD Model Double Taxation Convention. Such methods would necessarily be arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises and tending to ignore the management's own allocation of resources, thus producing an allocation of profits which may bear no sound relationship to the economic facts and inherently running the risk of allocating profits to an entity which is in truth making losses (or possibly the contrary). A number of such methods are sometimes advocated, allocating profits in some cases in proportion to the respective costs of the associated enterprises, sometimes in proportion to their respective turnovers or to their respective labour forces, or by some formula taking account of several such criteria. They are all however to some degree arbitrary. For example, it does not follow that profit is uniformly related to cost at all stages in an integrated production and marketing process. Indeed the problem of allocating costs could well be no easier than in using the cost plus method to arrive at an arm's length price. Nor does it follow that labour costs are the same for the same labour in different

countries, or that profits are necessarily related to any simple combination of such factors. To allocate profits by such methods in a way which reduced the arbitrariness of the results to a negligible degree would necessitate a complex analysis of the different functions of the various associated enterprises and a sophisticated weighing up of the different risks and profit opportunities in the various different stages of manufacturing, transportation, marketing and so on. Nor would the information necessary for such an assessment be readily available or, in many cases, available at all. The need would be for full information about the total activities of the whole MNE. While the widest range of such information may be available to the tax authorities in the country of the parent company in a group even those tax authorities will be limited to some extent in the information which they can compile. The tax authorities of the country in which a subsidiary is situated will on the other hand be in no position to acquire even this amount of information without imposing on the MNE itself a possibly intolerable administrative burden, or a similar burden on the tax authorities of the parent company's country if they seek to get the information by way of exchange of information provisions under double taxation agreements. Nor can it be generally assumed that the tax authorities of the country of the subsidiary should in any case be entitled to quite such a wide range of information about the group's worldwide activities. In practice moreover the information may simply not be available to those authorities. Even if the information were available, however, the varied activities of any MNE and the varied circumstances and situations in which they are carried on must make it impracticable for the tax authorities of the country in which one subsidiary is situated to judge in any satisfactory manner the profitability of any of the other parts of the group situated elsewhere. Moreover, problems would still arise in the comparison of figures produced in different countries by different accounting methods and different legal requirements. Another major disadvantage of any attempt to use such global methods of profit allocation as an alternative to the arm's length principle is that their unco-ordinated use by the tax authorities of several countries would involve the danger that, overall, the MNE affected would suffer double taxation of its profits. This is not to say, however, that in seeking to arrive at the arm's length price in a range of transactions, some regard to the total profits of the relevant MNE may not be helpful, as a check on the assessment of the arm's length price or in specific bilateral situations where other methods give rise to serious difficulties and the two countries concerned are able to adopt a common approach and the necessary information can be made available.

Minor adjustments and substitution of methods

15. The starting point for scrutinising transfer prices would frequently be the appearance of a discrepancy between the profits returned by an associated enterprise and those which might be expected to be made by comparable enterprises in the uncontrolled situation. Since the assessment of an arm's length price depends very often on careful judgement and the resolution of many, perhaps conflicting, considerations by negotiation between the tax authorities and the enterprise concerned, it follows that if the prices actually paid can be substantiated by acceptable evidence as being arm's length prices there would be no justification for seeking to make merely minor or marginal adjustments to them for tax purposes. Similary a tax authority should hesitate to disturb without good reason a pricing arrangement reasonably and consistently operated between associated enterprises if it is also reasonably and consistently operated in comparable dealings with independent parties. Moreover, 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, thus seeming to substitute their own commercial judgement for that of the enterprise at the time when the transactions were concluded (though there may be some circumstances where the form of transaction has effectively to be ignored — see paragraphs 23 and 24).

Safe havens

16. At this point it may be helpful to consider whether limits of tolerance could be formulated in advance by tax authorities and made known to enterprises by what are sometimes known as safe haven rules, indicating that prices falling within certain ranges would be accepted without question. The report makes no recommendation on this topic. Whilst such an approach may be useful to both taxpayers and tax authorities within a particular country in minimising disputes over the determination of a proper arm's length price, such safe havens are likely to be arbitrary since they will rarely fit exactly the varying circumstances even of enterprises in the same trade or business. The minimisation of this arbitrariness would be difficult and would involve a considerable expenditure of skilled labour in collecting, collating and continuously revising a pool of information about prices and pricing developments. Another point is that safe havens in one country may create difficulties in other countries and further problems would arise if it were a question of seeking to fix a safe haven range of prices acceptable to a number of countries. In any event, it would be necessary to revise periodically the range of prices or rates of interest to reflect changes in market conditions. Moreover, the general

use of safe haven ranges for tax purposes could affect the prices charged in the open market. More important perhaps in practice they could open an undesirable scope for tax avoidance.

GENERAL CONSIDERATIONS

Functional analysis

17. When examining the transfer prices adopted within a multinational enterprise, it is always useful to begin by analysing the functions of the various entities which are comprised in the relevant MNE. Some familiarity with the structure and organisation of the group and some knowledge of which entities undertake the risks and responsibilities for the various activities are essential for tax authorities to help them in assessing when a profit is likely to arise and roughly what sort of profit it is likely to be. It may be important not only to find out which entities perform the different functions of manufacturing, assembling, research and development, servicing, distribution, marketing and selling, transportation, advertising, etc., and which entities own the trademarks and other intangible property, but also to ascertain in what capacity they perform these functions — whether for example with regard to selling activities as principal (accepting all the risks and entitled to all the profits of the activity) or as agent (with limited risks and for a limited return).

Charging the appropriate beneficiary

18. It is clearly easier for tax authorities and MNEs to agree tax liabilities if charges for goods, services, etc., are made direct to the appropriate customer. MNEs may, however, arrange some transactions in a less direct manner (particularly intra-group services and transfers of technology, through interposed affiliates). This may be done for purely business reasons, but such a strategy could also be part of a tax avoidance scheme. Such practices may raise the question how far a real benefit has in fact been conferred on the related party which is ostensibly paying for it and how far such a transaction affects other entities. Problems of this kind are likely to arise where a variety of alleged benefits are charged for in one package deal.

Package deals

19. The report gives separate consideration to four main types of intra-group transactions for the convenience of the analysis of the problems presented by intra-group transfer pricing. But it must be

borne in mind that, in practice, MNEs quite frequently make package deals in which a single charge is made for a variety of benefits. In theory at least a parent company might licence patents, know-how and trademarks to a subsidiary, undertake to provide it with various technical and administrative services, and even sell or lease production facilities to it, all for an undifferentiated payment. Such comprehensive packages would be unlikely to include sales of goods, however, although the price charged for sales of goods may cover some accompanying services. While it may, in some circumstances, be convenient to treat the package deal as in effect one transaction with its own arm's length price, this will often not be feasible. It has to be borne in mind that package deals even between unrelated parties may create intricate problems for the tax authorities concerned. For example, the tax treatment of the separate ingredients may differ either under domestic law or under a double taxation agreement; payments for services for instance are generally not required to be made under deduction of tax in the country of source whereas royalties or interest may be subject to a withholding tax and so on. It may be necessary therefore for the tax authorities, for one reason or another, to insist on appraising the different items of the deal separately. Tax authorities will need to examine a package deal between associated enterprises and its elements in the same way as they would analyse similar deals between unrelated parties. The report aims to provide the foundation for such an analysis insofar as it is necessary to make one.

Set-offs

20. Another situation which it may be necessary to consider arises when a benefit provided to one enterprise within a group is balanced to some degree by different benefits provided by that enterprise in return, with the consequence that the enterprises claim that the benefit received should be set off against the benefits provided as full or part payment for those benefits so that only the net gain or loss (if any) on the transaction needs to be taken into account in assessing the tax liabilities of the enterprises. An enterprise may, for example, license another enterprise to use a patent in return for the provision of know-how in another connection and claim that the transaction results in no profit, no loss. This kind of arrangement is encountered sometimes between unrelated parties and it could not be argued therefore in principle that it is unacceptable between associated enterprises.

21. Set-offs may vary in size and complexity from a simple balance of two specific transactions (such as a favourable selling price for manufactured goods in return for a favourable purchase price for the raw material used in producing the goods) to an arrangement for a

general settlement balancing all benefits accruing to both parties over a period. Unrelated parties would be very unlikely to consider such set-off arrangements unless the benefits could be accurately quantified in advance, the likelihood of an adequate balance ascertained and the contract made in advance. In any other circumstances, independent parties would normally prefer to allow their receipts and disbursements to flow independently of each other in the ordinary way taking any profit or loss which resulted as part of normal trading, hoping actually to benefit if, for example, market conditions change in their favour.

22. Even if such an arrangement is in principle acceptable, the question which has to be asked in all cases, however, is whether the benefits do in fact balance each other over an appropriate period to the extent claimed. It may well be necessary for the tax authority to analyse the arrangement and the transactions in order to satisfy itself of this and the final judgement will then depend on a reasonably acceptable assessment of what would be an arm's length price for all the relevant transactions. It should also be remembered that provisions regarding set-off between related parties in international transactions may not be fully comparable with those regarding set-offs between domestic enterprises because of the differences in the tax treatment of the set-off under different national tax systems or differences in the treatment of the payment under double taxation agreements. For example, withholding tax would complicate a set-off of royalties against sales receipts.

Recognition of actual payments and transactions

23. 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. The aim in short is, for tax purposes, to adjust the price for the actual transaction to an arm's length price. Similarly, it is considered that transactions between associated enterprises should not be treated differently for tax purposes from similar transactions between independent parties simply because the parties to the transaction are related. The report does, however, recognise that it may be important in considering, for example, what is ostensibly interest on a loan to decide whether it is an interest payment or, in reality, a dividend or other distribution of profit.

Intra-group contracts and arrangements

24. Associated enterprises are, however, able to make a much greater variety of contracts and arrangements than can unrelated enterprises because the normal conflict of interest which would exist between independent parties is often absent. Associated enterprises may and frequently do conclude arrangements of a specific nature that are not or are very rarely encountered between unrelated parties (cost contribution arrangements for research and development expenditure as discussed in Chapter III of the report would be one example). This may be done for various economic, legal or fiscal reasons dependent on the circumstances in a particular case. Moreover, contracts within an MNE could be quite easily altered, suspended, extended or terminated according to the overall strategies of the MNE as a whole and such alterations may even be made retroactively. In such instances tax authorities would have to determine what is the underlying reality behind an arrangement in considering what the appropriate arm's length price would be.

Necessary documentation and evidence

25. The flexibility of arrangements available to MNEs may, however, create a problem for them as well as for tax authorities. If the transactions are not adequately evidenced by contemporary documents it is clearly more difficult for the MNE to convince the tax authorities that they took place in the form and manner claimed or that the transactions compare properly with particular transactions between unrelated parties. Retroactive agreements would justifiably be rejected moreover as inadequate to explain transactions taking place before the agreements. This is not to say that evidence can consist only of written contracts or agreements or that documentary evidence should be required in relation to every transaction. It is clearly desirable to avoid burdening MNEs with unnecessary documentation requirements. It would be reasonable, however, to require MNEs to provide in support of any important contention either the relevant legal documents and explanatory material or at any rate sufficient information to allow the tax authorities to arrive at an informed judgement in the matter.

External effects on the pricing practices of MNEs

26. The prices charged for goods, services, etc. transferred between associated enterprises in different countries may be affected by, for example, Government interventions in the form of price control, or subsidies to particular sectors, or by exchange control or exchange

rate policies. It should be observed that the same considerations would apply to transactions between unrelated enterprises and that they would usually influence the prices in such transactions.

27. Of these constraints, exchange controls have given cause for more particular comment. Problems may arise for example because exchange controls effectively prevent an associated enterprise which has received a loan from transferring abroad the interest payments as they fall due, thus possibly throwing doubt on the treatment of the interest for tax purposes. While there may be room for more than one solution in both the country of the borrower (which may or may not regard the untransferred interest as having been paid) and the country of the lender (which may or may not be deemed to have received interest not transferred) it is considered that there is no justification for treating blocked payments differently for tax purposes when they occur between associated enterprises from the way in which they would be treated if they occurred between unrelated enterprises. It is however considered that exchange control regulations in a country should not preclude the deduction for tax purposes, for either associated or unrelated enterprises, of payments due to persons outside that country, although it is recognised that the tax authorities of the other country may have to take the effects of these regulations into account.

Sustained losses

28. It cannot be envisaged that over a long period an independent enterprise can continue to remain in business and make losses and this has to be taken into account in the attitude of the tax authorities towards associated enterprises which make losses over long periods. It may be recognised that in an arm's length situation start up losses may occur, or that, due to a weak market, a profitless situation may last for a relatively long period of time in the anticipation of future compensating profits. Nevertheless, if losses are consistently made over a period in an associated enterprise, the tax authorities will have to address themselves to the question whether these losses are not being made with a view to transferring taxable profits to an associate in another country, or in the financial interest of the group as a whole rather than the associated enterprise in question. This will normally require a closer examination of the whole operations of the group. This examination may well show that the decision to keep going a loss making business has been dictated by constraining political or social reasons; when evidence of such reasons is given, a profit adjustment may or may not be justified.

Transfer prices for taxation and customs purposes

29. Customs administrations, broadly speaking, also apply the principle of arm's length pricing and use it also to provide a neutral standard of comparison between values attributable to goods imported by associated enterprises and values for similar goods imported by third parties[1]. Since customs and income tax administrations are not always looking at the same sort of transfers (customs being concerned with transfers across borders, with or without change of ownership, and income tax administrations being concerned with transfers between entities), and since customs administrations have traditionally examined goods at the time of importation while income tax officials consider the price at the transfer of ownership some time after the transaction has taken place, and for other reasons, the approaches of the two administrations have sometimes differed. In more recent years, however, a number of customs administrations have found it increasingly impracticable to consider imports by MNEs on a consignment by consignment basis and have begun to apply methods analogous to those described in this report to reach an acceptable price for a range of imported goods. Co-operation between income tax and customs administrations in reaching such a price is becoming more common and this should help to diminish the number of cases where customs values are found unacceptable for income tax purposes or vice versa.

OECD Guidelines for MNEs

30. It happens frequently when transactions with an associated enterprise take place over frontiers that the tax authorities need information concerning the associate in the other country or possibly some other associate in order to be able to determine the appropriate taxable profit in their own country. Often the tax authorities will not have possession of this information. In this context it is appropriate and may be helpful to refer to the OECD Guidelines for Multinational Enterprises which have been promulgated by Member Governments and, in particular, to the first Guideline on taxation and the Guideline on disclosure of information which are reproduced below.

RELEVANT TEXTS ALREADY PUBLISHED BY OECD

31. As indicated above, in addition to paragraph 8 of the introduc-

1. See Article VII of the General Agreement on Tariffs and Trade and the Convention on the Valuation of Goods for Customs Purposes signed in Brussels on 15th December, 1950 which is based on that article.

tion to the OECD Guidelines for Multinational Enterprises quoted in footnote (2) to paragraph 7 above, other parts of the OECD Guidelines, as well as Article 9(1) of the OECD Model Double Taxation Convention, are of relevance to the subjects dealt with in this report. The relevant texts are as follows :

a) Article 9(1) of OECD Model Double Taxation Convention on Income and Capital

ASSOCIATED ENTERPRISES

1. "Where

   a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

   b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two 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 ".

b) OECD Guidelines on taxation

"Enterprises should

1. upon request of the taxation authorities of the countries in which they operate, provide, in accordance with the safeguards and relevant procedures of the national laws of these countries, the information necessary to determine correctly the taxes to be assessed in connection with their operations, including relevant information concerning their operations in other countries ;
2. refrain from making use of the particular facilities available to them, such as transfer pricing which does not conform to an arm's length standard, for modifying in ways contrary to national laws the tax base on which members of the group are assessed. "

c) OECD Guidelines on disclosure of information

" Enterprises should, having due regard to their nature and relative size in the economic context of their operations and to requirements of business confidentiality and to cost, publish in a form suited to improve public understanding a sufficient body of factual information on the structure, activities and policies of the enterprise as a whole, as a supplement, insofar as necessary for this purpose, to information to be disclosed under the national law of the individual countries in which they operate. To this end, they should publish within reasonable time limits, on a regular basis, but at least annually, financial statements and other pertinent information relating to the enterprise as a whole, comprising in particular :

i) the structure of the enterprise, showing the name and location of the parent company, its main affiliates, its percentage ownership, direct and indirect, in these affiliates, including shareholdings between them ;
ii) the geographical areas[1] where operations are carried out and the principal activities carried on therein by the parent company and the main affiliates ;
iii) the operating results and sales by geographical area and the sales in the major lines of business for the enterprise as a whole ;
iv) significant new capital investment by geographical area and, as far as practicable, by major lines of business for the enterprise as a whole ;
v) a statement of the sources and uses of funds by the enterprise as a whole ;
vi) the average number of employees in each geographical area ;
vii) research and development expenditure for the enterprise as a whole ;
viii) the policies followed in respect of intra-group pricing ;
ix) the accounting policies, including those on consolidation, observed in compiling the published information. "

1. For the purposes of the guideline on disclosure of information the term " geographical area " means groups of countries or individual countries as each enterprise determines is appropriate in its particular circumstances. While no single method of grouping is appropriate for all enterprises or for all purposes, the factors to be considered by an enterprise would include the significance of operations carried out in individual countries or areas as well as the effects on its competitiveness, geographic proximity, economic affinity, similarities in business environments and the nature, scale and degree of inter-relationship of the enterprises' operations in the various countries.

CHAPTER II

GOODS

INTRODUCTION

Preliminary remarks

32. It is not easy to estimate accurately the percentage of total international trade in goods relating to transactions within MNE's. Difficulties arise because of variations in the definitions of multinational enterprises which are used and because of deficiencies in data collection etc. A United Nations publication[1] gives some indications of the proportion of particular countries' intra-group trade. It states that " approximately 40 % of imports to the United States in 1974 were intra-firm transactions... Roughly 50 % of United States exports in 1970 were within transnational corporate systems. " The United Nations document notes that " there are also data to indicate that 29 % of Swedish exports in 1975, 30 % of United Kingdom exports in 1973 (a rise from 26 % in 1970) and 59 per cent of Canadian exports in 1971 were on an intra-firm basis. " The document continues that " these figures are based on sampling procedures and are, therefore, prone to error, but the errors are likely to be small in comparison to the magnitude of the base figures. " Amounts of the kind indicated above are clearly sufficient to render the proper assessment of the profits arising from transnational intra-group trade a matter of considerable importance. Special problems arise for tax authorities from the fact that the terms and conditions of sales of goods between members of an MNE are not necessarily governed by economic factors alone but may, among other things, be used as a means of profit shifting to alleviate the overall tax burden of the group. The proper assessment of these profits is also important, however, to the MNEs themselves because they may suffer unrelieved double taxation if different tax authorities take different views of the adjustments which ought to be made for the

1. Transnational Corporations in World Development : A re-examination, United Nations, 1978, page 43.

purposes of computing tax liability. Problems may also arise for MNEs as a result of conflicting requirements and evaluations made by customs authorities, price control officers and anti-trust authorities etc., and these problems may have an influence on the transfer pricing policies which they adopt.

Scope of the Chapter

33. This Chapter seeks to elucidate some of the problems facing tax authorities in relation to transfer prices for goods. It concentrates on sales of raw and processed materials, semi-manufactured products and finished manufactured products including mass-produced goods and custom-made products, but does not deal with problems relating to certain items of tangible property, such as immovable property and shares and bonds. Nor does it deal with the special problems which may arise in relation to ores and minerals. Leasing contracts and similar arrangements are not dealt with either though there may be cases where long-term leasing contracts are very similar to sales.

34. Another feature of the transfer of goods which is not dealt with in this report except incidentally is the provision, which is not unusual in some branches of industry, of entire production facilities and their plant and equipment. Such transactions may present special problems because the provision of such facilities may be linked with the transfer of intangible property such as patents and know-how and with general service contracts as well as engineering contracts and long-term supply agreements. Also the value of the provision to both contracting parties may be primarily related to the benefits expected to arise from the long-term economic exploitation of the plant rather than to the original price and installation costs, so that the transaction has some analogy with investment in real estate or perhaps shares or bonds.

35. It may happen that a transaction which is in law a sale of goods may on close examination appear to be more akin to the provision of services. For example the functions of some distributors may be so minimal and the risks and responsibilities which they undertake so small that their profit is more akin to an agency fee or commission than the profit on a sale. Similarly the production and sale of a turnkey factory may have involved the seller in fact in no more than the organisation of the project, the risks and responsibilities being carried elsewhere. In such circumstances too it may be more appropriate to measure the profit on the transaction on the basis of treating the payment as if it were a payment for services.

36. Section I deals with the arm's length principle in general and with its application in special situations. Problems such as supply of goods for less than normal payment, sustained losses, pricing for market penetration and Government interventions in the market are discussed in this context. The different methods of estimating the arm's length price are discussed in Section II.

Section I

THE GENERAL PRINCIPLE OF ARM'S LENGTH AND ITS APPLICATION IN SPECIAL SITUATIONS

General considerations

37. As in other areas of transfer pricing the arm's length principle as expressed in the OECD Model Double Taxation Convention has to be followed in the evaluation for tax purposes of transfer prices for goods. Following this principle, prices paid for goods transferred between associated enterprises should be, for tax purposes, those which would have been paid between unrelated parties for the same or similar goods under the same or similar circumstances.

38. In applying this rule, however, there are a number of general points which have to be borne in mind. One is that it should not be assumed that the prices actually charged within an MNE will never be arm's length prices. The transfer pricing policies of multinational enterprises may in fact be market-oriented and, where the different entities within such groups have their own profit responsibility, they may be free to contract either with an associated enterprise or with a third party with the result that there is a degree of bargaining within the group which produces a price effectively indistinguishable from an arm's length price. (The full implementation of such a policy may, however, be difficult when, for example, components or semi-finished products are sold within the group which are not available on the market). Another point which it is necessary to bear in mind is that the transactions within MNEs may not be directly comparable with those which take place between independent enterprises so that allowances have to be made in comparing their transfer prices with the prices payable between independent enterprises. For example, entities within MNEs tend to render a wide range of additional technical and management and other services to their associates in connection with the sale of goods — a feature which is less common in transactions between independent enterprises. Similarly, the production facilities of a group may be largely integrated with the consequence that the produc-

tion arrangements are divided up among different group members in a way which would not be paralleled by independent enterprises. For example, these arrangements may involve long-term buy and supply agreements or agreements to use combined production plants under an obligation to buy from them (" joint facility arrangements ").

39. The application of the arm's length principle to the prices charged within MNEs is based on the assumption that prices are determined on the markets in the different countries by ordinary market forces. There may, however, be factors of various kinds, as discussed in the rest of this Section and, more generally, in Chapter I, which modify the operation of the normal rules of a market economy. Each of these factors is considered separately, but it can be expected generally that they would all have a similar effect on sales between unrelated enterprises in similar conditions and tax authorities should take this into account when considering adjustment of transfer prices.

Supply of certain goods for no payment or less than normal payment

40. The question has to be considered whether, in an arm's length situation, goods might be supplied for no payment or an unusually low payment, or might be supplied at a price producing less than the usual profit, or even a loss. It would not be unusual for an independent enterprise to do this if the goods were samples or advertising offers, but associated enterprises are not likely to be in a parallel situation. The question is more likely to arise in connection with goods sold to an associate in financial difficulties when some or all of the payment might be waived. It would be very exceptional for this to occur in transactions between independent enterprises, though the possibility cannot be wholly discounted (for example a supplier might to some extent be prepared to waive payment by an independent customer in temporary difficulties in order to preserve a potentially valuable outlet for his goods). But tax authorities could properly require very convincing proof that this situation would arise before accepting a nil or reduced payment between associated enterprises as equivalent to the arm's length price. Payment might be deferred in such circumstances in the arm's length situation but this would normally affect the price or be compensated for under a credit arrangement of some sort.

41. It may be reasonable in some circumstances to analyse the transfer prices for product lines or other groupings rather than to ascertain an arm's length price for each individual product or sale. An enterprise may find it necessary to sell some products at less than the market price or even supply them free in order to make a higher profit on its sales of products overall to the same buyer. A clothing enterprise may, for example, make a loss on its small and large garments in

order to be able to sell a complete range and make its profits from the medium sizes. An electric appliance enterprise may sell light bulbs at a loss in order to sell electric fittings, lampshades, etc. and make its profits in that way. Likewise, a producer may sell new products at a comparably low price and make his profits on the replacement market or through the repair of the products, or through the sale of auxiliary material, for example film for cameras. In such cases, an unusually low or high price would, however, have to be examined closely and substantiated by cogent evidence, and the prices realised on resale by the buyer could be relevant.

Losses

42. (*a*) It has to be recognised that a member of an MNE may, like any independent enterprise, sustain genuine losses whether from mismanagement, from unfavourable economic conditions either in its particular market, or more generally, etc. It follows therefore that if losses are made by a member of an MNE it is not necessarily because the transfer prices of the relevant goods are artificially fixed to produce that result.

(*b*) There are other circumstances too in which tax authorities could find losses acceptable — particularly what may be called " start up " losses or " market penetration " losses which would, of their nature, be expected to be sustained only during a short period — see paragraph 43 below.

(*c*) Where it is claimed that losses have been sustained over a comparatively short period in such circumstances, tax authorities should not therefore have much difficulty in accepting that they are genuine.

(*d*) Where, however, a multinational enterprise consistently makes losses over a period of several years in a particular country it might seem appropriate to regard the losses as artificial since an independent enterprise which consistently made losses would eventually go out of business. However, it is necessary to bear in mind that an MNE may legitimately hesitate for a long time to wind up the operations of a loss-making member of the group in a particular country if there are strong political or social pressures in that country to persuade them to continue these operations, or even if the capital which the MNE had invested in that enterprise was considerable in amount and there was some prospect of eventually making the enterprise profitable again. It is not to be assumed therefore that sustained losses are necessarily artificial. But they could certainly be a feature which deserved close examination.

(*e*) A rather special case of the loss-making enterprise within an MNE would be exemplified by the situation (mentioned in para-

graph 41) in which a group of companies produces a range of products, some of which would be profitable to produce on an arm's length basis and some not but all of which are needed in order that the group should make a profit overall and a member of the group in one country produces only the loss-making products in the range while the profit-making products are made elsewhere. An independent enterprise could not operate if it could only make losses by selling at an arm's length price and it would be appropriate in these circumstances to regard the loss-making member of the MNE as producing not for its own benefit but for the benefit of other members of the group and thus as performing a service for which it should be paid an adequate fee.

(*f*) In all the above cases, satisfactory evidence needs to be received from the enterprise.

" Start up " or " market penetration " prices

43. Another type of specially low prices which may nevertheless be claimed to be arm's length prices may be met with where the seller's object is market penetration. Producers may lower the prices of their goods, even to the extent of temporarily making losses, in order to enter new markets, to increase their share of an existing market, to introduce new products into the market, or to fend off increasing competition etc. One result of this may be to produce a lasting reduction in the normal market price of the relevant goods but in general specially low prices may be expected to be charged for a limited period only, with the specific object of improving the profits of the producer in the long term. Producers may not, however, be alone in this kind of activity; both producing and marketing entities may combine in such an operation, splitting the risk and sharing the profitable outcome, if any, in some way between them. Tax authorities could in principle therefore accept such low prices charged between associated enterprises as arm's length prices but only if independent enterprises could be expected to have fixed the prices in the same manner in comparable circumstances.

Government intervention

44. Governments may exert control on prices in a wide variety of ways ranging from simple exhortation through wages control, production subsidies, etc. to direct statutory control of prices. These controls have, in general, to be seen however as conditions of the market in that particular country. Normally it appears to be the final price to the consumer which is the subject of any direct control but the control may operate on prices earlier in the chain of transactions bringing the

goods to the consumer's market. But at whatever stage the control is imposed it will present a problem for tax authorities in deciding what effect the control can be regarded as exerting on the prices paid at the prior stages in the supply of the goods to the market. MNEs may in practice make no adjustments in their transfer prices to take account of such controls, leaving the final seller to suffer any limitation of profit which results, or they may charge prices which share the burden in some way between the final seller and the production organisation. The question which tax authorities have to ask in examining the transfer prices charged in such cases is whether independent parties could be expected to have fixed the prices in the same manner in such circumstances. While the natural assumption might be that, in the arm's length situation, a seller subject to price controls would not be able to persuade his supplier to moderate his prices, there could be circumstances in which an independent supplier would be ready to do this rather than lose some or all of the business, so that the possibility cannot be ignored. On the other hand, when it is established for example that the products concerned are actually sold on comparable free markets (and under comparable conditions) at significantly higher prices leading to corresponding higher profits, the lower profits of the enterprise in the country with price control will most probably be due to that price control, and to that extent no profit adjustment for tax purposes would be justified. Quite obviously a country with price control cannot easily expect that enterprises selling goods under control would make profits comparable to those which could be realised if no price control existed.

Section II

METHODS OF ASCERTAINING AN ARM'S LENGTH PRICE

General considerations

45. There are a variety of ways of ascertaining arm's length prices. The main broad methods are as follows :

a) adopting with any necessary modification the uncontrolled market price for the same or similar goods, or adopting or adapting similarly the prices of the same or similar goods to independent third parties — the comparable uncontrolled price method ;

b) taking the price at which the goods are sold by the connected purchaser (the reseller) to independent customers and subtracting a mark-up to arrive at the arm's length price for the sale by the original vendor — the resale price method ;

c) taking the vendor's cost and adding an appropriate mark-up to arrive at the arm's length price for the sale by the original vendor and thus for the purchase by the reseller — the cost plus method ;

d) any other method which is found to be acceptable.

46. The main methods of ascertaining an arm's length price in relation to sales of goods are discussed in more detail in the following paragraphs. The question arises whether it is possible to lay down any order of priority in using these methods. Clearly the comparable uncontrolled price method is basically preferable to other methods since it uses evidence most closely related to an arm's length price, but there may be cases where the evidence of resale profit mark-ups, production costs or other data may be more complete, more conclusive and more easily obtained than undisputable evidence of open market prices. There should always be the possibility, therefore, of selecting the method which provides the most cogent evidence in a particular case. It has to be recognised that an arm's length price will in many cases not be precisely ascertainable and that in such circumstances it will be necessary to seek for a reasonable approximation to it. Fre-

quently, it may be useful to take account of more than one method of reaching a satisfactory approximation to an arm's length price in the light of the evidence available.

47. In considering any one of the methods described, the tax authorities need a substantial amount of reliable information about the activities of the MNE in different countries. Sometimes, fiscal authorities may lack certain information when examining intra-group sales. The tax authority assessing the buyer may have more information about transactions and conditions regarding market prices and mark-ups in its own country than in another and consequently may find it easier to rely on these data rather than trying to calculate the cost and profit mark-up of the related seller abroad. The country in which the original vendor is situated may have access to open market prices in the country and to the costs and profit ratios of the producer, but may be ignorant of the resale prices and mark-ups obtained by the foreign subsidiary. But it should always be possible for the taxpayer to introduce evidence from the other country. Equally tax authorities will find it useful to develop their own sources of such evidence. This is an area where there could be more frequent, and more effective, exchanges of information between tax administrations, it being understood that due regard should be paid to the requirements of business confidentiality. It is perhaps worth emphasizing too that the co-operative production of information by the enterprise and the MNE of which it is a member may be helpful in achieving a mutually satisfactory result both to the taxpayer and to the tax authorities.

The comparable uncontrolled price method

Definition

48. The comparable uncontrolled price method offers the most direct way of determining an arm's length price. The transfer price is set by reference to comparable transactions between a buyer and a seller who are not associated enterprises. Uncontrolled sales may include sales by a member of an MNE to an unrelated party and sales to a member of an MNE by an unrelated party as well as sales in which the parties are not related to each other or to the MNE (though they may themselves be members of other MNEs). Uncontrolled sales are, in short, sales in which at least one party to the transaction is not a member of the taxpayer's affiliated group, but they would include only bona fide transactions and not sales unrepresentative of the market, for example made in a limited quantity at unrealistic prices to an unrelated buyer, for the purpose of establishing an arm's length price on a larger transaction. The method requires the uncontrolled transactions

to be carefully reviewed for comparability with controlled transactions. A number of factors can affect the price; these are discussed in more detail in the following paragraphs.

Economic comparability

49. For the prices of goods to be comparable, it is necessary to look at prices of goods sold on markets which are economically comparable. The progressive liberalisation of international trade which has taken place during the last decades has certainly facilitated access to new markets, but is has not led, even in the countries where this liberalisation is the most extensive, to the constitution of one single market where transactions would be made always and everywhere under the same conditions. Only in very few cases is it possible to determine directly an arm's length price in one country on the basis of market prices in another country. Geographically different markets therefore can be satisfactorily compared only if the economic conditions are the same or differences in conditions can be easily eliminated. The variety of economic and social structures, of geographical situations and of consumers' habits means that supply and demand of the same product may vary considerably from one country to another. In practice, market prices do vary from one country to another or even within one country and in addition different country policies in many spheres (for example, value of currency, taxes, competition policy, price or exchange control, size and efficiency of market and degree of concentration) are likely to influence price levels. On the other hand, an enterprise enjoying a monopoly or other dominant position in the market can, and often will, charge uniform prices to all its unrelated customers or to all of them in particular areas, or uniform prices modified only by identifiable market specific factors such as import duties. This situation may be found for example in the provision of certain refill goods or spare parts.

Comparable market levels

50. For prices to be readily comparable it is, among other things, necessary to compare goods sold at the same point in the chain from producer to consumer or to be able to quantify easily the different points in the chain. To take perhaps the simplest example, there will be a difference between the wholesale and retail price of a commodity but if the retailer's mark-up is readily ascertainable, it should not be difficult to make the necessary adjustment.

Comparable goods

51. Direct comparison of controlled sales with sales in the uncontrolled situation will be more readily acceptable if the goods concerned are as nearly as possible physically identical but if the differences are important a useful comparison may still be possible so long as appropriate adjustments can be reasonably made to the uncontrolled price to take account of the differences. Similarly it may be possible to derive some help from sales of substitute goods though much will depend on the circumstances — see paragraph 52. It is likely to be easier to find comparable uncontrolled prices where the goods are natural products or mass manufactured goods in common production but even so in many seemingly homogeneous products, such as steel for example, quality differences are an important determinant of price and this has to be taken into account. Nevertheless, in general it is fair to say that the less standardized the goods the less easy it will be to find comparable uncontrolled prices. To find comparable open market prices for semi-finished goods or components may sometimes be extremely difficult and sometimes impossible, since to the extent that they are specialised they are less likely to be traded on the open market.

52. Consumer acceptance of products may also significantly affect their price. Product differentiation by buyers may be based upon certain characteristics of the product such as exclusive patented features, trademarks, trade names, peculiarities of the package or container, or singularity in quality, design, colour or style, and such a basis may be real or fancied, but as long as it leads to a preference for one variety of the product over another it will affect the prices. Thus physically and chemically identical products may be exchanged at different prices if some are branded products and the others are not. A direct comparison with the prices of identical goods may similarly be misleading if identical guarantees do not form part of the conditions of sale. Thus goods which are otherwise identical with patented products but are counterfeit, illegally copied or smuggled in (so that they sell at low prices) will often for this reason not be directly comparable to the patented products and the prices at which they sell will generally not be helpful in seeking to estimate an arm's length price for those patented products. Depending, however, on the effectiveness of the protection provided by the patent in the relevant market and the volume of " pirate " sales etc. the price at which these goods are sold may force down the price of the patented goods to some extent and they may, therefore, have some relevance. Although the prices at which they are sold may give an indication of the mere cost of production of the patented goods they could hardly be relevant for any other

purpose as they do not take into account research and development, technical assistance and other connected services.

53. In comparing controlled sales with uncontrolled sales the following factors also have to be considered: the volume of sales must be comparable (if the volume has an effect on price); the uncontrolled sales must have been realised at a time reasonably close to the period during which the transactions under consideration were made, because market prices may vary over time due to seasonal fluctuations or to changes in the general economic situation; the terms of sale may also justify price variations; costs of transport, packaging, advertising, marketing, guaranteeing may or may not be included in the deal; the terms of payment are also relevant factors; foreseeable or expected fluctuations in exchange rates or in rates of inflation may be expected to have been taken into account (for example by invoicing in a hard currency or by indexing or by advance payments).

54. When intra-group sales are compared with uncontrolled sales it is necessary to consider whether the seller has rendered auxiliary services to the buyer and whether any intangible property such as patents, know-how, goodwill or trademarks have also been transferred in connection with the sale of goods. It is characteristic of transactions within MNEs that services or transfers of intangibles are frequently connected with a sale, and this is particularly true in some high-technology industries. In such cases, remuneration for the use of intangibles or for the rendering of services may form an element of the price of goods or may be separately invoiced.

Other considerations

55. It may not be possible to use the comparable uncontrolled price method, because of some of the special difficulties referred to in Section I or because no comparable uncontrolled prices are available or because the prices available are not truly comparable, for example because they relate to purely marginal uncontrolled sales. In such cases, recourse must be had to one or more of the methods described below. Here it might be mentioned that in determining a reasonable profit margin for the various associates concerned it is important to take into account the nature of the product. If the product represents an important innovation it may be reasonable to attribute the greater portion of the profit to the enterprise concerned with production and research and development (where expenditure on research and development has been incurred) which would have to bear the losses if the product were rejected by the market, whereas with more standardized products the profit element may be due more to the marketing than to the production or research and development activities of the MNE.

Tax administrations will, in such circumstances, have to take account of market conditions, the custom of the trade and all other relevant facts and circumstances of each individual case in determining what is an appropriate price. It is particularly important in such a context to analyse how the MNE is organised, what are the economic functions of the different associates and, particularly, which members contribute to the research and development undertaken by the MNE. Attention should also be paid to consistency of pricing. A consistent pricing policy would be normal both for sales to associates and for uncontrolled sales. If pricing practices vary over a period the possibility cannot be ruled out that tax minimisation is the motive for such variations which may therefore need to be satisfactory explained.

The resale price method

56. The resale price method begins with the price at which a product which has been purchased from a related seller is resold to an independent purchaser. This price is then reduced by an appropriate mark-up representing the amount out of which the reseller would seek to cover his costs and make a profit. What is left after subtracting the mark-up can be regarded as an arm's length price of the original sale. This method is probably most useful where it is applied to marketing operations.

57. Appraising the appropriate mark-up presents difficulties. There would be least difficulty where the buyer and reseller does not add substantially to the value of the product (though even in such a case the matter may not be simple). It is therefore in cases where there is no usable evidence of comparable uncontrolled sales and the associated seller contributes the greater part of the value of the goods, that this method is likely to be most useful. It will be less helpful where, before resale, the goods are further processed or incorporated into a more complicated product so that their identity is lost or transformed (for example, where components are joined together in finished or semi-finished goods) with the result that the contribution of the goods to the value of the final product cannot be simply distinguished. Whereas the comparable uncontrolled price method calls for the use of comparable prices the resale price method calls in effect for the use of comparable mark-ups. But these are not easily found. The determination of the costs of the buyer and reseller should not cause too many problems, but deciding on the size of any profit which should be included in the mark-up may well provide cause for argument. The considerations outlined in paragraphs 59-62 may, however, be helpful in this context.

58. A resale price would be most useful as a starting point if reali-

sed within a short time before or after the time of the controlled sale. The more time that intervenes between the two the more likely it is that other factors — changes in the market, in rates of exchange, in costs, etc. — will need to be taken into account in any comparison. Tax authorities have also to consider that where the value of the product is affected at the resale stage by the use of the trademark or other intangible property, the value of the product may be so changed as to make application of the resale price method difficult, if not impossible.

59. The profit mark-up can be expected to be related predominantly to the value of the functions performed and the risks taken by the person reselling the product. This can clearly range widely from the case where the reseller effectively performs minimal services as a forwarding agent to the case where he takes on the full risk of ownership together with the full responsibility for and the risks involved in advertising, marketing or distributing and guaranteeing the goods, financing stocks and other connected services. If the reseller does no more than sell the goods on again, in circumstances where it is clear that he has had to make little or no effort, it would be reasonable to argue that his profit would be a small one. This would particularly be the case for example where he did not take delivery of the goods and he was operating in a low tax or no tax country in which his customers for the most part did not reside. But even in that situation it could be argued that his intervention merited more than a minimal profit if it could be shown that he had some special expertise in the marketing of such goods or bore, in effect, specific risks. Such a claim in these circumstances would, however, need to be well supported if it were to be accepted. It would be more easily acceptable if the reseller was carrying on a general brokerage business — though this is unlikely to be a genuine situation in the context of associated enterprises — in which case, however, the profit mark-up could be related to a brokerage fee. On the other hand, where the reseller is clearly carrying on a substantial commercial activity involving such operations as the breaking of bulk, packaging, advertising, marketing, storage, transport, distribution and servicing of the goods and bears the related economic risks then a reasonably substantial mark-up might be expected.

60. In cases where the chain of distribution of goods incorporates a company in a no tax or very low tax country, it would be relevant for tax authorities to look not only at the resale price of goods which have been purchased from this company but also at the price paid by this company to its own supplier. There could well be practical difficulties in the way of getting this information and the true function of the intermediate company might be difficult to ascertain for the same reason. But if it could not be demonstrated that the company either bore

a real risk or performed a function which increased the value of the goods then any element in the price which was claimed to be attributable to its activities could reasonably be attributed elsewhere.

61. The profit mark-up may be expected to vary also with regard to whether or not the reseller has the exclusive right to resell the goods. Arrangements of this kind are found in transactions between unrelated parties and may influence the price so that the use of the arm's length concept does not therefore require an exclusive right of this sort to be ignored. The value to be attributed to such an exclusive right will depend to some extent on its geographical scope and the existence and relative competitivity of possible substitute goods. The arrangement may be valuable to both vendor and reseller in the arm's length situation. It may stimulate the reseller to greater efforts to sell the vendor's particular line of goods or on the other hand, in providing the reseller with a kind of monopoly, may have the result that he makes little effort to sell the goods. In consequence, the effect of this factor on the reseller's profit margin, though it may be important in some cases, will need to be examined with care.

62. The profit mark-up of a distributor associate may be estimated by reference to the profit mark-up which he earns on items purchased and sold in uncontrolled transactions. Failing that, the profit mark-up earned by a totally uncontrolled party may serve as a guide, though this should be applied only with considerable caution.

The cost plus method

63. This method of estimating an arm's length price is based on the supplier's cost to which an appropriate profit mark-up is added. It is a method that raises problems both as regards assessing costs (paragraphs 66-68) and the appropriate mark-up for profit (paragraph 69) and is likely to be appropriate as a determining criterion mostly in specific situations (see paragraph 65), though it may also be useful as a means of verifying provisionally acceptable prices after other methods have been applied. Whilst it is true that an enterprise has to cover its costs over a period of time to remain in business, its costs do not usually help much in forming an opinion of the appropriate profit in specific cases.

64. The cost plus method may over-emphasize historical costs, ignore demand, fail to reflect competitive conditions adequately, and it assumes a profit whereas, in real life, business profits are not always guaranteed. It is, moreover, difficult to allocate costs to particular products in a satisfactory manner. Also some costs may be abnormal (due to mismanagement, for example).

65. Nevertheless, the cost plus method may be helpful in estimating an arm's length price, when semi-finished products are sold between related parties or when different entities of an MNE have concluded joint facility agreements or long-term buy-and-supply arrangements or when the subsidiary essentially performs a role of subcontractor. Also prices fixed on a cost plus basis are in fact a feature of some arm's length transactions particularly where the contract is for a specialised product tailored to suit the individual customer alone and the costs of production are heavy and unpredictable. (Some Government contracts for the supply of military equipment, and some turnkey factory projects, provide examples of this).

66. It may be difficult to determine the relevant cost, because cost accounting concepts are not universal and vary from country to country and from business to business and this could provide scope for argument. Tax authorities will need to discover what costing methods have in fact been used. If these are suitable and appropriate and used consistently by the enterprise (for example used in calculating prices charged to independent third parties as well as in calculating prices charged to associated enterprises) tax authorities might reasonably find it satisfactory and convenient to use them. However, whatever the costing methods applied the selling prices thus derived for intra-group transactions would have to recover not only the direct cost of purchasing raw materials, components and goods, the cost of salaries and other expenses of processing, but also relevant overhead or indirect costs (including normally a proper share of research and development costs) in order to make, under normal conditions, an appropriate profit on these transactions. Prima facie the costs to be attributed to individual units of production are the relevant historical costs but the costs of the input of materials and labour for example will vary over a period and it may often be necessary to accept some averaging of the costs incurred over a period of time, over a group of products, or over a particular line of production. The allocation of the cost of fixed assets will also present a problem and, particularly where the production or processing of different products is carried on simultaneously and the volume of activity fluctuates, again some reasonable averaging will need to be accepted.

67. The costs which can be considered are limited to those of the vendor, and this may raise the problem of how to allocate some costs between vendors and purchasers. For this it is necessary to consider the functions performed and the risks undertaken by the parties to the transaction.

68. Also to be taken into consideration is the way in which exceptionally heavy costs such as expenditure on capital equipment,

research projects and advertising campaigns should be attributed to the different units involved. A related problem is how overhead costs should be apportioned; whether, for example, they should be apportioned by reference to turnover or to number or cost of employees or to some other criterion. A manufacturer faced with the contention of a tax authority that revenue from associates should be uplifted on a cost plus basis may argue that certain of his sales into foreign markets represent a disposal of marginal production so that he need only take variable or incremental costs into account. Such a claim could only be justified if it could be shown that the goods could not be sold at a higher price (see also paragraph 43). No general rule can be set out which will deal with all cases and the various methods used should be consistent as between controlled and uncontrolled sales and should also be consistent over time in relation to particular enterprises.

69. In addition to identifying appropriate costs, there is the problem of determining an appropriate profit mark-up. Ideally the seller's mark-up should be determined by reference to the seller's mark-up on similar items purchased and sold in uncontrolled transactions. If the seller makes no uncontrolled sales, its gross profit will have to be estimated from that earned by uncontrolled sellers performing similar activities. Here again, as in applying the resale price method, it is important to analyse the actual economic functions of the associated enterprise.

Other approaches

70. Cases will often occur where there is no satisfactory evidence of comparable uncontrolled prices and where it may also be difficult to apply either the resale price method or the cost plus method. In such instances, it may be necessary to adopt other reasonable approaches for arriving at an arm's length price. It may also be necessary to have recourse to additional calculations and computations to cross-check a price derived according to one or other of the methods previously described. Some other such methods used in practice are discussed in the following paragraphs, though the list is by no means exhaustive. They all need to be used with care.

Comparable profits

71. Tax authorities may find some help in a comparison of an enterprise's overall performance with that of other similar enterprises in the same or similar circumstances. Levels of profit in an industry may for example conform to a pattern and an exception to the pattern might indicate that profits were being shifted by artificial transfer prices.

But comparisons of this sort would need to be made with care. It does not necessarily follow that exceptional profits or losses are artificial. Moreover there are many ways of looking at the profit situation of an enterprise — analysing for example what relation the profit bears to total receipts from sales, or to the operating expenses incurred, and a method which is appropriate for one company may not be appropriate for another. It may be helpful nevertheless to make comparisons of this sort in relation to the gross profits from sales of particular products or groups of products but even so the results of the comparison could normally be regarded only as pointers to further investigation.

72. Another approach which is sometimes suggested either as a method of arriving at the arm's length profit or as a method of achieving a similarly equitable allocation of profits between associated enterprises would be to attempt to allocate some proportion of the combined net income arising from a sales transaction to the various associated enterprises concerned in it on the basis of their proportionate contribution to the final profit. This is considered in paragraph 14, in which the problems of this approach are set out in some detail.

73. By a somewhat similar process the reasonableness of transfer prices may perhaps be assessed by comparing the yield or return on the capital invested in the relevant associated enterprises with the yield or return on the capital invested in enterprises carrying on similar activities and requiring the same kind of capital investment. This too presents difficulties. One problem is that the financial structuring of the relevant entities would need to be essentially similar if this comparison was to be useful and if the structure was not essentially similar (because for example of the different impact of obligations to pay interest) then difficult adjustments would have to be made to the calculations in order to ensure comparability.

Net yield expectations

74. A further approach might be to look at the yield on the capital involved, for example to assume in the case of transactions between a parent and a subsidiary company that the subsidiary's arm's length profit would be related in some way to the return which would be expected from investing the relevant capital in other ways. But this too is an arbitrary assumption: the profit made by a comparable independent concern would not necessarily bear any particular relationship to the return on investment in other ways. Although therefore such an approach might have some value in indicating a reasonable range of possible profit margins the concept of a " normal " return on capital invested is too imprecise to be likely to be useful in isolation.

Sales of goods — summing up

75. The methods described do not by any means exhaust the possible techniques, and it does not follow that if an approach has not been mentioned it ought not to be followed. The preceding analysis should, however, help to indicate how tax authorities and multinational enterprises may come in an informed way to the discussion of whether, and if so what, adjustments are appropriate to the transfer prices involved in the transactions in which they are interested in the context of sales of goods.

CHAPTER III

TRANSFERS OF TECHNOLOGY AND TRADEMARKS

Scope of the Chapter

76. The term " intangible property " covers industrial property rights (such as patents, know-how, trademarks, trade names, designs or models) as well as literary and artistic property rights (copyrights). This Chapter concentrates on problems involving patents and know-how and trademarks as these are of most concern to tax authorities in connection with the taxation of MNEs. A transfer of intangible property can be made in various ways. Only the use, and not the sale, of rights is discussed, though there may be cases where it is difficult to determine whether a right is sold outright or merely made available to another person for a limited period of time. Section I deals with transfers of technology. Payments for rights to use patents and know-how developed by one member of an MNE for other members are discussed in Sub-section A. Cost contribution arrangements among associated enterprises for research and development expenditure are treated in Sub-section B. The transfer of the right to use trademarks and trade names is dealt with in Section II.

Section I

TRANSFERS OF TECHNOLOGY (USE OF PATENTS AND KNOW-HOW)

General considerations

77. In considering payments for research and development (R & D) in this Chapter, a distinction is made between individual transfers of particular patents and know-how and more general arrangements for making the benefits of R & D available to members of an MNE, and this Chapter considers how far different methods of payment for these benefits are appropriate. The question of whether a payment can be allowed as a deduction in arriving at profits for tax purposes is related to the reality of the benefit which the payer has received or may be expected to receive from the rights, know-how, research activity, etc. for which the payment was stated to be made. It is explained that the amount of any payment has to be calculated for tax purposes on the arm's length basis and a number of ways in which this may be attempted are reviewed, setting out what seem to be the main factors to be taken into account in the process and attempting to provide some guidance as to the effect which these factors may be expected to have in the calculation.

78. Transfers of technology raise problems of particular importance as the relative items of intangible property, such as patents and know-how, may be the result of longlasting and expensive R & D undertaken by the parent company alone or by some, or all, of the associated enterprises in an MNE. To remain competitive, industrial groups have to devote considerable resources to research — whether fundamental or applied — and development. Basic research is of great importance. There have been many instances where private groups have helped to advance the limits of scientific knowledge as a result of basic research sometimes undertaken with only the broadest commercial objective in view. As to applied research, such activities will be oriented to the solution of fairly immediate, and well-defined, problems whose commercial potential is perceived by the enterprise which

undertakes it. In the development phase of research, specific commercial objectives are clearly uppermost and will concern such activities as the building of prototypes and pilot plants or the design of new equipment, or the redesigning of already existing models.

79. In most sectors of industry, it appears that it is the larger enterprises, though not necessarily the largest, that spend proportionately more money on R & D activities and, in particular, R & D is a sine qua non for the MNE for which the penetration of new markets and competition in already-established markets depend very much on success in product renewal and innovation. It does not appear that there are any considerations of general validity which explain the level or the growth of R & D expenditure in an industrial group. This reflects the diversity of products which MNEs manufacture and sell and of the industries they are engaged in, some being technology-intensive (for example, computers and aerospace) some not (for example, distribution of food and clothing); also the degree and pattern of integration and the autonomy allowed to the various members of the group may vary. But in all cases, a successful R & D activity is a prerequisite for the growth and profitability, and even for the continued existence, of the industrial group. The actual size of R & D budgets depends on a variety of factors, including the policy of competitors or potential competitors, the expected profitability of the research activity, and the trend of profits (the research activity possibly rising if profits shrink); or considerations based on some relation to turnover, or an assessment of the yield from R & D activity in the past as a basis for fixing future expenditure levels.

80. At each stage in the R & D process, the final commercial benefits to be derived remain uncertain, though no doubt more so at the research than at the development level, and the degree of risk involved makes it difficult to estimate benefits from the outlays made which, in the event that some R & D projects prove successful commercially, will only materialise in the future. Moreover, MNEs will understandably seek to recoup the cost of financing unsuccessful research from the results of successful research.

81. The manner in which expenditures on R & D (including the cost of unsuccessful projects) are recovered varies according to the circumstances. Part will be obtained from the sales of the goods which benefit from the results of successful R & D expenditure; part will come from sale and licensing of successful items of intangible property to related, or unrelated, parties. In both cases, taxable profits accrue to the entities using the results of their R & D against which the costs involved can be offset. R & D activities within multinational enterprises are organised and financed in various ways. In some multi-

national enterprises R & D is undertaken by one or more members, the results being made available to the other members mainly by way of licensing contracts; in such a case, R & D expenditures will not be recouped until such time as any intangible property is developed. Other MNEs find it convenient to adopt varying forms of cost contribution arrangements (such as those considered in Sub-section B below) for allocating R & D expenses (and sometimes other expenses like services and overheads)[1] among the different members participating in the agreement; in such a way, R & D expenditures can be recouped before any item of intangible property is developed. It may occur also that R & D is undertaken at the specific request of one member.

82. The pricing policies adopted by MNEs in relation to intra-group transfers of intangible property present a number of difficulties for national tax authorities since the terms and conditions of such transfers may not correspond to the economic realities but may be used — partly because of the differences of national tax systems — as a means of shifting profits between members in order to alleviate the overall tax burden of the MNE. Tax considerations may themselves determine the way in which R & D expenditures are recovered as well as the form and amount of a transfer price or of a cost allocation — particularly, for example, where the tax laws of a particular country treat one kind of payment differently from another by allowing or refusing a deduction or by requiring, or not requiring, certain kinds of payment to be made under deduction of withholding tax and also where one of the associated enterprises operates in a country with a lower tax rate than that in which the other operates or in a country with no tax at all. On the other hand, as pointed out in paragraph 2, tax considerations may be outweighed by other factors.

83. MNEs therefore recoup their costs of R & D and allocate their profits in various ways for various reasons. In doing so, they may create problems for national tax authorities. The transfer pricing system or the cost allocation method agreed upon within an MNE need not necessarily provide an acceptable basis for the determination of profits for tax purposes in each of the countries concerned. The respective tax authorities have to consider if, and to what extent, such payments need to be adjusted for tax purposes.

1. In practice, MNEs quite frequently make what is called a " package deal ". (See paragraph 19.)

Patents and know-how

84. A patent gives a legally protected monopoly right to an invention. The term know-how is perhaps a less precise concept. The Commentary on Article 12 of the OECD Model Double Taxation Convention — paragraph 12 — gives the following definition : " Know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; in as much as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique ". Know-how thus may include secret processes or formulae or other secret information concerning industrial, commercial or scientific experience which is not covered by patent.

85. It may be important for tax purposes to distinguish clearly a transfer making available the use of know-how to another party, from technical assistance or similar activities which constitute personal services. Again, the Commentary on Article 12 gives some indications that may be helpful in this respect : " In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognised that the grantor is not required to play any part himself in the application of the formulae granted to the licensee and that he does not guarantee the result thereof. This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party ". Examples of personal services would be pure technical assistance, an opinion given by an engineer, a lawyer or an accountant and services in connection with the sale of goods, such as after-sales services or services rendered by a seller to the purchaser under a guarantee. However, in practice, it is often very difficult to determine where the exact borderline lies as most know-how contracts include a service element.

86. A know-how contract and a service contract may be dealt with differently in a particular country according to its internal tax legislation or to the tax treaties it has concluded with other countries. Thus, in the United States the regulations for the allocation of income differ fundamentally in the two cases. A charge reflecting fair market value would be required for transfers of intangible property (unless a cost sharing arrangement was concluded), whereas only cost has to be charged for the rendering of services (except if the services are an integral part of the business activity of one of the contracting parties or if they are rendered in connection with the transfer of property other

than under a cost sharing agreement). In several countries, whether or not a withholding tax is levied on payments made to non-residents depends on the way an agreement is viewed. If the payment is seen as service fees, it is usually not taxed in the country of origin unless the receiving enterprise carries on business in that country through a permanent establishment situated therein. On the other hand, royalties paid for the use of intangible property are subject to a withholding tax in some countries.

Methods of making available a patent or know-how to another party

87. As already noted, there are numerous ways of making intangible property available, but three main methods may be distinguished for tax purposes. A developer may recoup costs for R & D activities by requiring payments from another party for the latter's use of patents and know-how once they are developed. This is discussed in Sub-section A. Another entirely different concept consists of contributing to the cost of R & D. Various forms of cost contribution arrangements are dealt with in Sub-section B. If research is performed by an enterprise at the specific request of another enterprise to which that property then developed is assigned, this may often be regarded simply as a service rendered by that developing enterprise and, if so, the payments made for the research may be more appropriately treated as fees for services (see Chapter IV).

A. PAYMENTS FOR PATENTS AND KNOW-HOW DEVELOPED BY ONE MEMBER FOR OTHER MEMBERS OF THE SAME MNE

88. Intra-group contracts licensing patents or know-how are frequently concluded between a parent company, as the developer who has borne the entire costs of the development, and one or several of its subsidiaries. Where MNEs have formed research units in different countries, members may also license the intangible property they have developed to the parent or to other members, although R & D would normally be undertaken on behalf of the parent company. Reciprocal licensing (cross-licensing) is not uncommon, and there may be other, more complicated arrangements as well. For tax purposes, the arrangements made between members of MNEs should correspond to those that would be made between parties unrelated to each other.

Justification of benefits

89. Payments under licensing agreements would be allowed as a deduction for tax purposes only if a real benefit had been conferred, or could be reasonably expected at the time of the conclusion of the contract to be conferred, on the licensee. It would normally be expec-

ted that a licensing agreement should be concluded in writing defining as closely as possible the nature of the intangible property which is involved, and hence providing a basis for assessing the benefit conferred. In addition, the taxpayer would have to produce all the evidence needed by the tax authorities to check if a benefit had in fact been conferred on him as licensee in the particular case. It is clearly important to determine what is the underlying reality behind an arrangement irrespective of the latter's formal aspect.

90. Whilst it has to be demonstrated that the patent, or know-how, in question is in fact useful for the particular needs of the enterprise paying for them and that a real benefit is thereby conferred, this point should not be confused with the separate matter of the calculation of what is the appropriate rate of the payment to be made for that benefit.

The general principle of arm's length pricing

91. The general principle to be taken as the basis for the evaluation for tax purposes of transfer prices between associated enterprises under contracts for licensing patents or know-how is that the prices should be those which would be paid between independent enterprises acting at arm's length. It follows from this that such transactions should not be treated differently for tax purposes from similar transactions between independent parties solely by virtue of the fact that the enterprises are associated. Thus, if payments for the use of intangible property are deductible for tax purposes when made between unrelated parties, similar payments made in similar circumstances between associated enterprises ought to be treated similarly. Also, in conformity with Article 24 of the OECD Model Double Taxation Convention a deduction should not be refused on the grounds that the payment is made to a non-resident. On the other hand, it seems hardly likely in an arm's length situation that a licensor would waive or defer payment of royalties due to financial difficulties of the licensee. The licensor would usually be entitled to withdraw the right to use the relevant property.

Form and amount of the consideration

92. Where payments are made in respect of the use of intangible property in intra-group situations, they should be in a form which is compatible with the form which would be adopted in transactions between unrelated parties under the same circumstances, though it has to be taken into account that there are a number of forms which might be adopted in an arm's length situation. Usually, a royalty or a know-how fee would be paid, that is, a recurrent payment based on the

user's output, sales or, in some circumstances, profits. When such royalty payments are based on the licensee's output or sales a degressive payment would be acceptable to tax authorities if this would be usual between independent parties. The consideration may also take the form of a lump-sum payment, sometimes combined with a recurrent payment. Enterprises may also agree on reciprocal licensing rights.

93. The compensation for the use of intangible property may be included in the price charged for the sale of goods when, for example, one enterprise sells unfinished products to another and, at the same time, makes available its experience for further processing of these products. Whether it could be assumed that the transfer price for the goods includes a licence charge and that, consequently, any additional payment for royalties would ordinarily have to be disallowed by the country of the buyer, would depend very much upon the circumstances of each deal and there would appear to be no general principle which can be applied except that there should be no double deduction or double charge for the provision of the technology.

94. In determining the amount of an arm's length consideration, the standard to be applied is the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances. An arm's length consideration may sometimes be determined by looking to licence contracts that the same developer has concluded with unrelated parties involving the same or similar intangible property under the same or similar market conditions. Likewise, the offers to unrelated parties or the genuine bids of competing licensees, could be considered when the data exist. Where the user sublicenses the property to third parties, the price paid by the latter may be relevant. The amount of the consideration for similar transactions between unrelated enterprises in the same industry may also be a guide to the arm's length rate, but appears to be infrequently used. In many cases, it will be difficult to find satisfactory comparable open market transactions since the owner of intangible property (and particularly the owner of a patent) is essentially the owner of a monopoly right which he may not make available to unrelated enterprises. It is considered that it is unlikely to be possible to construct any standard rates, such as a certain percentage of sales, as even within a given sector of industry it is extremely difficult to discern any typical rate or range of rates.

95. In using evidence provided by comparable transactions in seeking to arrive at an acceptable price for tax purposes in relation to an intra-group licence contract, it is necessary to take all the circumstances into account. This is as much the case where the evidence is provided by transactions between completely unrelated parties as in other

circumstances. It is necessary for example to take account of the following factors. The expected profits and conditions in the relevant market can affect the amount, and account needs to be taken for example of the possibility that the fee paid in one market may not reflect the arm's length price in another. The terms on which the transfer of the intangible property is made need to be considered; limitations on the geographic area in which rights may be exercised, export restrictions on goods produced by virtue of any rights transferred, and the exclusive or non-exclusive character of any rights granted may affect the amounts payable (the amount of the consideration to be paid by the licensee may be expected to be higher, for example, if an exclusive right is conferred than if there are restrictions or limitations on its use). The value of services such as technical assistance, training of employees and so on, rendered by the developer in connection with the transfer have to be allowed for, as may the capital investment (to construct new plants or to buy special machines), the starting-up expenses and the development work required of the transferee, if any.

96. The nature of a patent can also be important: it is likely that an entirely new and distinctive " breakthrough " patent will command a higher price than one either designed to improve a process already governed by an existing patent or one for which substitutes are readily available (but a breakthrough patent may also, because of its novelty, be hard to evaluate). The length of the period during which patents and know-how etc. are likely to maintain their value will also affect the amount of the payments which would be asked for the right to use them, and this period may vary widely since in some branches of industry techniques are superseded more quickly than in others. The degree and duration of protection afforded under the patent laws of the relevant countries is variable but this factor must be evaluated, bearing in mind that new patents may speedily be developed on the basis of old ones, so that the effective protection of the intangible property is prolonged correspondingly. The process of production for which the property is used and the value it contributes to the final product have to be taken into account and it would not be appropriate, for example, if the royalty for a patented invention which only covered one component of a device was calculated by reference to the selling price of the complete product. In a case where an invention covers only one part of a complicated machine, a royalty of a small proportion of the selling price of that machine may seem reasonable at first sight but may well be exorbitant if this component is measured by reference to the value of other components and if its impact on the final product is compared to the impact of other parts. If the licensee has the right to participate in further developments by the licensor or if, on the contrary, the licensee is under the obligation to impart fur-

ther improvements of an invention, or other intangible, to the licensor, these circumstances will influence the level of the payment made for the original patent or know-how.

97. In arm's length situations cases arise where the payment made to the licensor varies according to the turnover of the licensee, being perhaps at a lower rate if sales exceed a certain figure. Variations in rates may be justified also according to the extent to which the intangible property concerned has already been used by the licensee in production.

98. Where a sufficiently similar transaction involving an unrelated party cannot be found, or does not provide satisfactory evidence, other methods have to be used as a means of testing whether the price actually paid by the licensee is acceptable to the tax authorities. There will be many cases of this kind and this illustrates the difficulty of the subject. In general, reliance cannot be recommended on one particular method rather than another and usually it will be necessary to take account of more than one method in reaching a satisfactory approximation to an arm's length price.

99. It appears that one of the common approaches employed in practice is to make a pragmatic appraisal of the trend of an enterprise's profits over a long period in comparison with those of other unrelated parties engaged in the same or similar activities and operating in the same area. There could, of course, be many reasons for an unusual profit situation and it may be possible for the taxpayers to give satisfactory explanations for particular cases. The profit comparison approach thus remains more in the nature of an indication that the consideration charged for the use of intangible property may or may not be reasonable. Recourse to a comparison of the proportionate profits of the licensor and the licensee achieved thanks to the development and the use of the intangible property would not be a promising method. It would be very difficult to isolate the respective profits of the licensor and the licensee since a number of rights may be under licence at the same time for the manufacturing of different products and since the accounting methods in the countries concerned may differ fundamentally. In addition there is the difficulty of knowing how to apportion the overall profit between the licensor and the licensee.

100. It may be useful to look at the costs incurred by the licensor in developing the property. However, the actual open market price of intangible property is not related in a consistent manner to the costs involved in developing it. This is because the price will exceed cost for successful research, but the price will be less than cost for less successful or unsuccessful research. Moreover, cost for successful research

may often include the cost of unsuccessful research. The uncertainties attendant on the eventual return on expenditure on R & D and the length of time during which technology will prove to be commercially usable together with the monopoly element present in patent licensing make reference to cost hazardous. Moreover, it may not be easy to determine what the costs connected with the development of a particular item of intangible property were when research is performed in a group on a large scale and for various purposes. Despite these difficulties, there may be cases where the cost-oriented method gives some guidance, at least as regards the lower limit for the licensor's profit in normal circumstances. Looking at the costs may also be appropriate to verify a provisionally acceptable price after other methods have been applied.

101. In considering any one of the methods described, the tax authorities need a substantial amount of reliable information about the activities of the MNE in different countries. Sometimes, fiscal authorities may lack certain information in examining transactions of intangible property within MNEs. Tax authorities in the country of the licensee may, for example, be unaware of the terms under which the licensor has concluded similar agreements with other associated or unrelated enterprises. Tax authorities in the developer's country may, for example, need to know the volume of sales realised by the licensee using the property and the conditions of sub-licensing contracts, if any, and the general conditions in the licensee's market.

B. COST CONTRIBUTION ARRANGEMENTS AMONG ASSOCIATED ENTERPRISES FOR R & D EXPENDITURE

The practice of MNEs

102. Some MNEs use cost contribution arrangements to finance R & D expenditure as or before it is incurred instead of selling or licensing patents or know-how after they have been successfully developed. This method of recouping R & D costs is not very common but it has been used over recent years by several large MNEs with extensive and costly research activities undertaken on a worldwide basis. Some of these arrangements also cover the costs of various services (mainly costs of technical assistance but often including also the cost of management and administrative services). In the following paragraphs the main characteristics of cost contribution arrangements are briefly described and the attitudes of national tax administrations towards them are then considered.

103. Although not numerous, cost contribution arrangements in practice take a variety of forms. They fall however into two main cate-

gories. There is, first, the cost sharing arrangement under which members of the group agree to share the actual costs and the risks of R & D undertaken for the benefit or expected benefit of each of them. In such cases, each participant would bear its fair share of the costs and risks and would in return be entitled to its fair share of any usable results of the R & D. The arrangements resemble in some respects a joint venture or partnership. Secondly, there is what may be described as the cost funding arrangement (which would be very unusual among unrelated enterprises) under which members contribute in a more general way to the cost of the R & D programme of the group. Usually this contribution would take the form of a generalised fee and would not be related to the actual cost of any specific R & D activity. Such arrangements resemble a mandate given by the members to the enterprise which is responsible for the R & D programme (which may often be, but will not always be, the parent company) to engage in or procure R & D for the benefit of the group. In such cases, the actual results of the R & D may well be owned by a single enterprise — frequently the parent company — which will have the primary responsibility for the patent, although the results, if any, of the R & D would usually be available to all the contributing members.

104. The MNEs who adopt it see several advantages in a cost contribution approach. Some feel that each affiliate has a better chance to get access to the benefits from research programmes of a large magnitude in return for reimbursing only a relatively small share of the costs. They may also feel that cost contribution arrangements provide a simpler and more equitable method than intra-group licensing. Finance through cost funding or cost sharing has the advantage that costs are either financed in advance or reimbursed rapidly. Co-operation between the research enterprise and the participants is considered by the MNEs to have been encouraged by use of cost contribution agreements. Due to the different accounting methods and tax legislation in the countries involved the MNEs point out however that difficulties may arise when cost contribution arrangements are operated among enterprises in different countries.

105. In principle, only the net costs of R & D are allocated to the participants of a cost sharing arrangement. Cost of research performed at the specific request, whether of an associated or an unrelated enterprise, would not therefore be included in the total costs incurred and would be billed directly to the enterprise that requested the work to be done. Receipts from licensing to third parties would similarly be deducted. The remaining net costs are shared by the participants according to an agreed formula and if there is an excess of royalties over gross costs in any year, such excess would be distributed or credited. This net cost concept seems to be widely followed, particularly in arrangements between separately incorporated companies.

106. Cost funding arrangements vary in the methods used for raising funds for development. According to some arrangements, the participating enterprises contribute in proportion to their envisaged use of the property developed. In many MNEs, however, contributions will be related to the turnover or sales of the participating members and other (more sophisticated) formulae are also found. The calculation of contributions would ordinarily take account only of the net costs likely to be incurred. But the practice of MNEs may vary in defining net costs in that they may adopt different methods of dealing with costs recouped and profits made by the research company from transactions with third parties.

107. There is evidence that co-operation in R & D is not confined to associated enterprises, but that it also occurs between unrelated enterprises. Jointly-owned research companies have been established between private partners and between private firms and the State. Such companies have taken the form of joint stock companies or partnerships. Usually, they will carry out specific research projects, but in some cases, there is a more general co-operation between several participants in R & D. The general shape of such arrangements appears to be that participants would agree to share the costs incurred by the research company but that research specifically requested would be charged to the enterprise which asked for it. Otherwise, it appears, the costs may be allocated in proportion to the envisaged use of any developments, in proportion to the respective shares or according to any other formula agreed upon. In return, the normal arrangement seems to be that participants may use any property developed free of charge. The patents will usually be owned either by the research company itself or jointly by the participants. However, it seems clear that arrangements of this kind would usually remain more limited in their objectives and in the extent of actual pooling of R & D activities than in some examples of intra-group arrangements discussed above.

The attitude of the tax authorities

108. The United States have special rules for cost sharing arrangements. Under certain conditions enterprises taking part in such arrangements are allowed for tax purposes to charge or to deduct as expenses the actual costs involved without the addition of a profit mark-up. In Regulation 1 482-2(d)4, a cost sharing arrangement is defined as an agreement between two or more members of a group for the sharing of costs and risks of developing intangible property in return for a specified interest in the property that may be produced. The term " specified interest " means that the participants would acquire a specific right to use a specific result of the research performed. The con-

tribution to the costs must be reasonably related to the property conferred. It would be expected to be smaller, for example, if there is a geographical limitation to the rights that may be transferred. Such an agreement, if entered into by members of a group, has to be concluded in advance and in writing. It has to reflect an effort in good faith by the participating members to bear their respective shares of all the costs and risks of the development on an arm's length basis, that is, the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated. If these conditions are met, and if the research project is successful, rights to the property can then be transferred free of charge to the participating member. On the other hand, the participating member is not excused from contributing its share of the costs of the research if the latter is not successful, or if the research is successful but has a fair market value less than the share of the costs that were borne by that member under the agreement.

109. The United States tax authorities were led to adopt these rules mainly because various forms of cost sharing arrangements existed in practice and because a need was felt to accommodate there existence in the regulations. Experience with such intra-group cost sharing arrangements is said to be positive and they do not appear to have opened up avenues for tax avoidance. No greater danger of tax avoidance is seen through cost sharing arrangements than through any other type of intra-group transaction. The tax authorities apply a hard " facts and circumstances " test in each case. No particular problems have been raised by the use of cost sharing contracts. The United States tax authorities appear to have been mainly concerned with MNEs with headquarters in the United States and recovering R & D costs incurred in United States research centres from associated enterprises. However, in the reverse situation, payments would be accepted as deductible expenses if the cost sharing arrangement met the requirements set out in the regulations.

110. Other countries contributing to the preparation of this report had little experience of cost sharing arrangements on the lines of those approved by the United States regulations. Therefore they have not felt the need to draft special rules regarding the deductibility of such payments as expenses or their treatment as receipts of a research centre located in their countries, though they may be increasingly obliged to deal with such cases.

Questions for taxation policy

111. The conceptual and practical difficulties in computing the costs of the research and development efforts involved in bringing to the stage of commercial exploitation an invention or new process, together with the uncertainty surrounding its eventual profitability, have already been

noted. R & D expenditures could be recouped through individual transfers of the right to use property developed in the way described in Subsection A above but cost contribution arrangements may be seen as another possible method. Both cost sharing and cost funding arrangements present tax authorities with numerous difficulties and for tax purposes adjustments may often have to be made to the payments passing between the parties. However, in reaching a decision on this point, much would depend upon the precise conditions of such an arrangement in an MNE and the justification provided in terms of benefits received and costs incurred.

Justification of benefits

112. The terms and conditions of cost contribution arrangements must be carefully examined in each particular case to determine whether the research is actually performed in the interest and for the real benefit of the respective parties; in this sense a potential benefit would be a real benefit only if the relevant party had a genuine and substantial interest in the results which the research might produce. As in the case of licence contracts, looking at the benefits conferred or conferable is a key consideration. Thus, inter alia, the research carried out would have to be closely related to the specific needs of the participants. The terms and conditions of an arrangement must be comparable to those which would have been adopted by unrelated parties under similar circumstances. Cost contribution arrangements between independent parties are uncommon except for special projects, so that it would have to be established that the respective participants are really in a position to benefit from the various research projects. Normally, only manufacturing enterprises would be expected to be found as participants in a cost contribution arrangement since trading enterprises would expect to recover their cost in the price of the goods sold, but there may be exceptions. The contributions by participants must be made for research projects in which they are in fact interested and should not lead to an excessive build-up of funds in the hands of the research enterprise.

113. In most countries, it would normally be expected that the terms of a cost contribution arrangement would have been laid down in a written contract concluded in advance. The terms and conditions would have to be precisely defined. A vague formula would not be sufficient. In addition, the participants to the cost contribution arrangement would be expected to be able to demonstrate that the R & D they are paying for is in conformity with the written agreement and has been or will be carried out in practice. All the evidence needed to prove that the research has been performed in the interest and for the expected real benefit of a particular entity would have to be produced at the request of the tax authorities concerned. Here again, it will be

important to look at the substance rather than the form of an arrangement.

114. Whilst it cannot be expected that all, or even most, research projects will be successful, if a member of an MNE participating in a cost contribution arrangement has not benefited from substantial developments over a long period of time, this may be an indication, since the R & D budgets of independent enterprises are naturally profit oriented, that the research was not carried out in the interest, and for the benefit, of that particular company. In such circumstances an independent enterprise would not be likely to participate in the arrangement.

The amount of the contribution

115. Calculation of the permissible amount of deductible costs in approved cases of cost contribution arrangements presents a number of difficulties, including the possibility that such arrangements might open up opportunities for profit transfers disguised as deductions for costs. This consideration reinforces the need for a strict interpretation of the notion of real benefit as it has to be established that only expenditure which is in fact related to R & D carried out in the interest of the participants is charged to them.

116. It is considered that not only direct costs but also some indirect costs of R & D could be shared by the participating enterprises in approved cases. Indirect costs are those which are not specifically identified with a particular research or development activity but which relate to the direct costs. They would thus include costs with respect to supervisory, clerical, administrative and other overhead activities in accordance with generally accepted accountancy practice. It may, however, be very difficult in practice to determine such costs precisely.

117. Costs of a capital nature, like expenditure for buildings, machines and other assets necessary for the research, may be allocated on the basis of the allowances for depreciation. Recognition may have to be given to special allowances for R & D capital costs. Problems may arise as the tax laws and the depreciation practices may vary considerably in the different countries concerned.

118. In a genuine cost sharing arrangement, only net costs may be subject to allocation, the costs of research at request being charged directly to the requesting party and any licence receipts or receipts from the sale of research assets being deducted from the amount to be allocated among participants. Any subsidies granted to the developer by a government would also be deducted. Any excess of receipts over

gross costs in any year would normally be distributed, or credited, to the participants in the arrangement. In a cost funding arrangement, the question whether, and to what extent, the remuneration received by the research company from third parties or government subsidies have to be taken into account in calculating the contribution, may depend upon the formula adopted by the group for the calculation of contributions (see paragraph 106). It would not, however, be essential to take account of marginal remuneration from third parties. As in the case of licence and royalty arrangements, it will be important for tax authorities to watch closely that costs of R & D are not, once again, included in the price of goods that have been sold to one of the participants of the arrangement; otherwise there would be double counting of costs.

119. The question arises whether the contributions of the participants in a cost contribution arrangement should include a profit element. In cases where R & D were carried out to order, the enterprise carrying out the research should be expected to carry it out for a profit and thus to charge, in addition to costs, a profit mark-up. It would follow that the profit mark-up would then form part of the expenses incurred by the contributing participants. It was noted that the United States rules in the case of certain cost sharing arrangements (see paragraph 108) treat the participants as incurring only the net costs of the R & D which is carried out under the arrangement and it is necessary to decide how cost sharing arrangements should be regarded in which the enterprise carrying out the research charged the beneficiaries of the research only the net costs which it incurred, without any profit mark-up. It is considered that, to the extent that the enterprise carrying out the research is relieved of risk because it could rely on its costs being met by the participating members of the group, then any profit mark-up should not take account of such risk and ought to be limited to a reward for its activities in organising and managing the relevant research project or projects. But it seems difficult to accept that there would often be cases of genuine cost sharing arrangements in the arm's length situation. Accordingly, it would usually be right to look for a profit mark-up in cases of cost contribution arrangements.

120. The treatment for tax purposes of contributions paid to a separately incorporated research entity by associated enterprises is also a matter to be considered. It would carry out research in the interest of other members and would not use the results of the R & D for its own purposes. It seems, therefore, that such research enterprises would ordinarily be required and allowed to charge costs plus a profit mark-up to reflect their efforts at organising and managing the research.

The allocation to the participants

121. The costs of R & D have to be allocated in a fair and equitable way to the participants of a cost contribution arrangement. There is no formula that could be universally applied as the circumstances may vary considerably. Some MNEs allocate costs in proportion to the expected benefits of the parties involved and this seems a reasonable approach. Others allocate costs according to the proportionate turnover of the participants. This rule of thumb may provide a reasonable measure of eventual benefits conferred, but it may also lead to distortions and this type of allocation formula would have to be scrutinised closely by the tax authorities in the countries concerned.

Other considerations

122. The tax treatment of any contributions to R & D carried out by another enterprise abroad will depend upon the laws of the countries concerned. Under such laws the payments may be deductible as an expense or, in some circumstances, may be charged to capital account according to the choice of accounting procedures, where a choice is permitted as to the most advantageous or prudent course of action in the opinion of the MNE. Special rules may apply when an enterprise makes payments to a separately set up research entity which it has established in co-operation with other companies. (See the Appendix to this Chapter).

123. A withholding tax, which in some countries applies to royalties, is unlikely to be levied by such tax authorities when the parties have concluded a cost contribution arrangement and this may have been an important aspect as regards the preferences of MNEs for such arrangements. In the context of the problem of profit mark-up on cost contributions (discussed in paragraphs 119 and 120) the question was raised whether when such contributions include a profit element, like royalties, they should not also be subject to a withholding tax. It is considered that these payments are ingredients in the calculation of business profits and differ in character from royalties. Therefore they ought not to be treated in the same way with respect to the taxation at source (see also paragraph 174).

124. The need to obtain adequate information from MNEs noted earlier applies, a fortiori, in the case of cost contribution arrangements and calls for the co-operation of the members of the group.

Section II

TRANSFER PRICING ASPECTS OF USE OF TRADEMARKS

125. Transfer pricing problems concerning trademarks and trade names are discussed in the following paragraphs. Many of the considerations below would also be relevant in looking at transfer prices for similar items like models and designs. Franchising operations are not treated here.

Some legal and economic aspects of the trademark

126. There are fundamental differences between trademarks and patents. The essential difference is that trademarks are marketing instruments whereas patents are basically concerned with the right to produce goods. A patent gives an exclusive right to use a given invention for a necessarily limited period of time. Trademarks confer on their owners the right to use them as distinctive signs to identify specific products or services of a particular manufacturer or dealer and, as a corollary, to prohibit their use by other parties for similar purposes. However, they do not necessarily create an economic monopoly, because competitors are not prevented from selling the same or similar products so long as they use different distinctive signs. A trademark may continue indefinitely; its protection will disappear only under special circumstances (voluntary renunciation, no renewal in due time, cancellation or annulment following a judicial decision, etc.). Patents are usually the result of risky and costly research and development and the developer will try to recover his costs through sales or licence agreements. The legal creation of a trademark is not an expensive matter though it will very often be an expensive business to give it a value and to ensure that that value is maintained or increased - intensive and costly advertising campaigns will ordinarily be necessary and so will expenditure, which may well be considerable, on the control of the quality of the trademarked product. The expenditure may have to be incurred not only by the owner of the trademark but also by the licensee. On the other hand, in some cases, patents, because of their

outstanding quality may also have a very strong marketing effect similar to that of a pure trademark and payments for the right to use such patents may have to be looked at in much the same light as payments for the right to use a trademark.

127. A trademark is the protection (usually capable of indefinite renewal) under the law of the country concerned of a unique name, symbol or picture so that it can be used only with the owner's permission for the relevant products or services. It may help in the commercial exploitation of a patented product but it may also serve as a kind of hallmark conferring a valuable market status on the goods or services denoted even though they enjoy no patent protection (either because patent rights have expired or because they have never existed). The value of the trademark in a particular country depends upon the nature of the legal right created under that country's law, upon the extent and success of the promotional expenditure incurred in order to implant the goods or services in the minds of potential customers (the image of the trademark in that country, upon who incurred that expenditure — the owner or a licensee — and upon the value of the market to which it will provide access.

128. Trademarks may fulfil various functions :

a) A trademark traditionally points to the origin of a product or of a service indicating that the relevant goods or services come from the proprietor of the mark by virtue of his manufacture or provision of them, or his selection, certification, dealing with or offering them for sale.

b) A trademark is, normally, considered by the consumer as a guarantee of the quality of a specific product or service. Nowadays, consumers seem to be much more concerned with this guarantee of quality than with the origin of goods or services. It is, therefore, recognised in modern trademark law that it is not a necessary element of a trademark to indicate the origin of a product or service.

c) Trademarks may have an important advertising value for the goods or services concerned. In modern trade, a business is frequently built up around a trademark and the goodwill of an enterprise may be inherent in the trademark itself. Trademarks may confer a considerable value and " force of penetration " on certain products or services and may become a commercial vehicle of great effectiveness. The force of penetration of a specific trademark may be such that it transfers to other goods, whether produced by the same enterprise or not, the goodwill of the original trademarked goods. A similar situation may arise with services.

129. Trademarks may be acquired for goods, either for specific products or for a line of products. They would mostly be used at the consumer market level, but may be encountered at other market levels. Trademarks may also be acquired for services. The ownership of a trademark would normally be vested in one person, for example, a legally independent company. A trademark is registered and protected in a given country, but the same signs could be registered as trademarks in other countries, or internationally.

130. A trade name (often the name of an enterprise) may have the same force of penetration as a trademark and may indeed be registered in some specific form as a trademark. The names of certain multinational enterprises in pharmaceutical or electronic industries, for example, have an excellent sales promotion value, and they may be used for the marketing of a variety of goods or services. The names of well-known persons, designers, sportsmen, actors, people working in show business, etc., may also be used as trade names and trademarks, and they have often been very successful marketing instruments.

The trademark licence contract

131. It seems to be generally recognised nowadays that a trademark may be sold or otherwise transferred by one person to another. It is also admitted, in principle, that the owner of a trademark may allow another person to use his trademark under certain conditions. Trademark licensing has become a common practice, particularly in international trade.

132. Various kinds of licence contracts are concluded in practice. There are two main categories: first, the licensee could be a dealer who is allowed to use the trademark in selling products manufactured by the licensor and owner of the trademark; secondly, the owner of a trademark could license a trademark to an enterprise which will use the sign for goods that it produces itself or buys from other sources. The terms and conditions of licence agreements may vary to a considerable extent.

133. What is provided by the owner of a trademark is not limited to measures to ensure the legal validity of the mark which is licensed, and to taking care that it is properly used and protecting it against infringements by other parties. The licensing of a trademark is nearly always coupled with efforts by the licensor to keep the image of the product up-to-date and with a strict control of the quality of the product or its components or of the processing, manufacturing and storage conditions of the products to be sold under the trademark licensed. If a licensor wants to secure that the products made and sold or

the services rendered under the licensed trademark meet his quality standards, this will lead almost automatically to a certain degree of technical guidance. On the other hand, the licensee would often be expected to co-operate in promoting the trademark for the common benefit and to take account of trends in consumer attitudes. Because co-operation between licensee and licensor is a feature of trademark licensing, it will therefore affect the nature and amount of payments made under the relevant contracts.

134. Technical assistance provided by the licensor would be one example where trademark licensing is closely linked to other transactions between the same parties. In other cases, the owner of the trademark may sell finished or semi-finished products to the licensee. Also, a manufacturing enterprise may be allowed to use a patent for the production and a trademark for the marketing of certain goods. All-embracing licensing contracts and similar arrangements are quite often found in practice.

135. Between associated enterprises more complicated contracts and wide-ranging arrangements are common. There may be different forms of cross-licensing agreements and affiliates may agree on joining a licence pool. " Package deals " seem to be widely used by MNEs. The arrangement in a multinational enterprise may be that all members are entitled to use, normally for a consideration, the trademarks, trade names, patents and other intangible property developed by any member of the group.

Considerations affecting the value of a trademark

136. It is possible that a new trademark or one newly introduced into a given market may have no value or little value and its value may change over the years as it makes an impression on the market (or perhaps loses its impact). The value and any changes will depend to an extent on how effectively the trademark is promoted in a market. In certain cases, the value for the licensor may increase as the result of efforts and expenditure by the licensee (zero royalties or lump-sum payments which recognise this possibility are not uncommon), and the licensor may also subsidise special efforts by the licensee. It follows that in such cases the share of the obligations and expenditure necessary for the effective use of a trademark between licensor and licensee in an arm's length situation will mainly be influenced by the relative benefit expected by the parties (especially if the trademark licensing is linked with transfers of the trademarked goods or services: in such cases these transfer prices may have to be taken into account for the assessment of an appropriate trademark royalty).

137. Because of the considerations set out above, it is necessary, in seeking to arrive at the arm's length price for the right to use a trademark or trade name, to approach this matter rather differently in some respects from the way in which the problem would be approached in the case of a patent royalty or other similar intangible. However, as with transfers of technology, the essential question here is what benefit is transferred. In answering this question, it is necessary to assess all the obligations implied by the licensing agreement and the likely costs to be incurred or saved by both parties. The costs incurred by the licensee under the licence contract will affect the amount of any trademark royalty which he is required to pay. In arriving at the arm's length price, it may be possible to use the comparable uncontrolled price method if a trademark or trademarks with similar effects are licensed to unrelated enterprises, though as with patent royalties there may be little useful evidence available for this kind of comparison (moreover the impact and the value of a trademark in one market will not necessarily be the same as in another): it will not be very useful to refer to the costs of developing the trademark as a foundation for this calculation since these will not normally be relevant, whereas it may well be relevant to have regard to the costs of maintaining the value of the trademark, including the costs of advertising and quality control; some help may be found, if adequate evidence is available, by comparing the volume of sales and the prices chargeable and profits realised for trademarked goods with those for similar goods which do not carry the trademark.

Appendix to Chapter III

SOME ASPECTS OF THE TAX TREATMENT OF RESEARCH AND DEVELOPMENT[1]

138. *Deductibility of R & D expenditures*

a) R & D expenditures could be either treated as current expenses or charged to capital account. The general rule seems to be that R & D expenditure incurred during the taxable year in connection with a trade or business is treated as an expense and allowed as a deduction in computing profits for tax purposes. The expenditure may be related to a general research programme or to a particular project and the taxpayer may or may not have obtained a patent protecting his development. A tax loss may be carried forward.

b) In the United States, the taxpayer may choose the method which is most advantageous to him and may deduct his R & D expenditures as expenses or may charge them to capital account to be written-off in later years. In France, Germany and Switzerland, R & D expenditures which are deductible as expenses have to be treated as such; the taxpayer has no choice. In the United Kingdom R & D expenditure may be deducted as an expense but if as a matter of accountancy practice the taxpayer preferred to capitalise such expenditure and then write it off over a period of years, no objection would be offered.

c) The United States rules on deferred expenses are that, in computing taxable income, such deferred expenses are allowed as a deduction rateable over a period of not less than 60 months as may be selected by the taxpayer. The period begins with the month in which the taxpayer first realises benefits from his expenditure.

d) However, different rules apply when the R & D expenditure is clearly of a capital nature. Any expenditures for buildings, machines

1. These notes relate to the situation at 1st January, 1979.

and other assets have to be charged to a capital account, and a reasonable allowance for depreciation is allowed. In some countries, special allowances are granted with regard to research assets. In France, a special allowance of 50 per cent for buildings used for research is available. A similar allowance, limited to 30 per cent for buildings and 50 per cent for other assets, was granted in Germany if the assets had been bought or produced prior to 31st December, 1974. In the United Kingdom, the whole cost of capital expenditure incurred on scientific research is deducted in a single amount as it is incurred. No such special allowance is granted in the United States, but the allowances for depreciation of property may be considered as R & D expenditures and such expenses may be deferred in the way described in paragraph (c). Moreover in some countries subsidies for research assets bought or produced by a taxpayer are available. A subsidy of 7.5 or 20 per cent — depending on the amount of costs incurred — may be obtained in Germany under certain conditions.

Companies for joint research

e) Frequently, enterprises group together and create a special enterprise to do research for their common benefit. If this enterprise is established as a partnership, any losses incurred by its research activities may normally be set off against profits realised by the partners themselves in the same country. However, a set-off of profits and losses would often not be possible between enterprises operating in different countries. In France, a new legal form of a company, the " groupement d'intérêt économique " (GIE), is particularly suited to joint research operations[1]. If a research entity is formed as a joint stock company, its losses could not normally be set off against profits realised by the individual shareholders.

f) Contributions to the capital of a research company would not ordinarily be deductible by the participating enterprises. In the case of a joint stock company, a depreciation of the shares would normally not be allowed. In France, however, the contributions to the capital of research companies which have been approved by the government may exceptionally be depreciated up to 50 per cent by the participants if certain conditions are met.

1. The GIE is a legal entity itself. As there are few binding rules, it can be adapted to various situations by the participants. If a loss is realised, it can be set off against profits incurred by the partners [as in the case of a partnership (" société ")].

CHAPTER IV

CERTAIN INTRA-GROUP SERVICES

INTRODUCTION

Preliminary remarks

139. In nearly every MNE arrangements have to be made for providing within the group a wide range of services, in particular administrative, technical and commercial services for the constituent parts of the enterprise; such services may include the important control function needed to implement the overall strategy of the group comprising the parent companies and its associates. The cost of providing such services may be borne initially by the parent or by a specific associate or by a number of associates and may be recovered in a variety of ways from the other enterprises in the group. The practice of MNEs in charging for such services differs widely, inter alia, according to the type of service, the specific circumstances of each case and also to traditions within each MNE and the countries in which the MNE operates. National tax authorities are of necessity much concerned with the ways MNEs charge for services, since the solution adopted can have a significant impact on the allocation of profits between the parent company and its associates. Futhermore, unless there is some broad convergence of the approaches adopted by different tax administrations to such problems, conflicting claims to tax may arise, with the consequent possibility of double or multiple taxation of profits.

Scope of the Chapter

140. This Chapter is confined to the treatment of services which are typically and distinctly provided within a highly integrated group of enterprises and therefore normally are not rendered in the same quantity and form between independent enterprises, although such services may nevertheless be encountered in third party contracts, especially those with specialised service enterprises. This report,

however, does not, except incidentally, deal with service industries where the rendering of services is part of the regular business. The activities of MNEs and their component members engaged in insurance, banking, tourism, communication, transportation, management consultancy, advertising and so on raise special questions that are not fully dealt with here.

141. As already noted, intra-group arrangements for making available the use of intangibles share some common features with those for rendering services. In some cases, indeed, such as know-how contracts, it may be very difficult to determine where the exact borderline lies between the two (see paragraph 85). Again, auxiliary services are frequently associated with the transfer of technology. In this report, however, payments for services are dealt with as a separate matter, as a convenient way of analysing the particular problems which may be presented by them in the ascertainment of the profits of the various members of MNEs.

142. Section I contains some brief comments on the nature of intra-group services in MNEs and the ways in which the provision of such services are organised. Section II sets out an approach to the tax treatment of intra-group services. Section III summarises the main conclusions reached.

Section I

SERVICES IN A GROUP OF ASSOCIATED ENTERPRISES

143. Some of the services provided within a multinational enterprise form part of a range of services provided on a continuous basis (for example, technical assistance); others are more tailored to specific occasions, for example, trouble-shooting services. Some of the services provided are clearly the same as those which could be provided for other companies by specialised independent service companies, such as legal or accountancy services; other services (such as central auditing or foreign financing advice, or training of personnel) may be on the face of them specific to the MNE as a whole, though even these are services which to a large extent may be provided by unrelated enterprises for themselves; others again relate to the parent company's stewardship activities. Individual MNEs differ quite widely in the services which are provided and in the manner of providing them, and only a functional analysis of each case can reveal the role of any particular unit — whether parent company, regional or divisional centre or other associated enterprises. Nevertheless, the parent company will normally have special functions of co-ordination and control which it may sometimes delegate in part to other control centres. The parent company also, it needs to be remembered, is the ultimate shareholder of the subsidiaries in the group although there will often be other shareholders in particular associated companies.

144. Technical services may be linked quite often with transfers of technology (patents and know-how) and with sales, and, in such cases, they may or may not be remunerated separately. In other cases, technical services may be provided in connection with new production plans, rationalisation, quality control and other improvements. Services of an administrative and commercial nature would include services provided in connection with financing, such as capital increases, loan contracts, supervision of cash flows and solvency, services in connection with employment and social questions, investment and production assistance, intra-group co-ordination, marketing and auditing,

including, for example, production and sales control and other more general budgetary matters.

145. For the purposes of analysis this report treats activities of a servicing nature provided within a group of associated enterprises as falling into the following three categories. The first comprises activities of the parent company acting in its capacity as a shareholder. A second group of activities would comprise those unequivocally performed for the benefit of one or more associates. Thirdly, there are servicing activities which may benefit to varying degrees the parent, the group as a whole and one or more of the associated enterprises in particular. In the real world, classification of particular servicing activities under these three headings is not always self-evident. This problem is discussed further in paragraphs 154 to 156 below.

146. A notable feature of service activities in MNEs is the availability of certain services " on call " (that is, to be used as and where needed). The parent company, or possibly a separately constituted service company, may thus be ready to provide, for example, financial, managerial, technical, legal or tax advice and assistance to members of the group at any time in return for payment which will commonly take the form of an annual flat rate fee or contribution from each of the relevant members based possibly on that member's total sales or turnover, etc. Such " on call " services may also, however, be paid for individually when provided.

147. Practice in charging for intra-group services or, as the case may be, in allocating central expenditures, differs according to the circumstances and organisational structure of each MNE. There does not appear to be any fixed pattern either industry-wise or country-wise. Some MNEs consider that certain costs of central staff activities are incurred with a view to benefit the parent company. In such cases, no charge would be made for what are sometimes called " administrative ", " managerial " or " parental " services. However, it seems that these are not well-defined categories and that their composition varies from one MNE to another.

148. Other MNEs tend more to follow a global allocation concept, mainly based on costs, arguing that it would not correspond to economic realities to take out the costs of some services, since all the activities of the parent are performed in the interest, and for the benefit, of the entire group. According to this view, it would be artificial to separate out some types of services, since what counts is the long-term performance of the MNE and its members, taking account of the whole of their continuous stream of activities. Consequently, all the parent company's or service company's costs are allocated to the associates in proportion perhaps to their sales, or to their turno-

ver. Cost allocation systems are sometimes limited to services, but in other cases associated enterprises pay a flat fee as a remuneration for the right to use patents and know-how and trademarks as well as to receive diverse services (the so-called " package deal "). Costs for central group activities may also be passed on as part of the price of goods delivered to associates. A profit mark-up may or may not be added to the costs included under a cost allocation system.

Section II

TREATMENT FOR TAX PURPOSES OF INTRA-GROUP SERVICES

149. The successive steps involved for tax authorities are identifying the type of service, determining whether a benefit has effectively been conferred on one or more of the associated enterprises (with which is bound up the question whether such enterprises should be expected to pay for them) and then evaluating the amount of the remuneration appropriate in each individual case. For MNEs the need is to produce satisfactory evidence to prove that services have in fact been performed, costs incurred, and that a real benefit has been conferred on an enterprise.

150. Determining whether a benefit has effectively been conferred on an associated enterprise may raise a number of questions, including mainly the following :

- if services are provided on an " on call " basis, should an enterprise be expected to pay irrespective of whether it uses the service over a given period ?
- can expenses incurred by a parent company in managing and protecting its investments be properly charged to the members of the group ?
- if services are performed or made available neither in the exclusive interest of the parent company nor in the specific interests of one or several subsidiaries, how should the various members of the group pay for such services ?

These questions are dealt with in paragraphs 151-159 below. The question of what should be the form and amount of the payment is dealt with in paragraphs 160-169 below. The question of what evidence needs to be produced by MNEs is taken up in paragraphs 170-173.

Justification of benefits

151. Any payment for services rendered between associated enterprises would be required or allowed for tax purposes only if a real benefit has accrued to the enterprise that has been charged for such services. In such cases it may be accepted that a real benefit has been conferred when the assistance was intended to serve the other enterprise, according to reasonable expectations at the time the service was rendered, even if the potential benefits anticipated are not realised in practice.

152. When a parent company, or another company in a group maintains staff or equipment available to render specific " on call " services, of the kind described in paragraph 146, costs are incurred in the interest of associated enterprises and they could normally be charged for such services. However, the tax authorities in the country where a subsidiary is established may properly take account of the actual use made of the services that are available. In doing so it would be appropriate to look at the continuous stream of activities and the benefits received over a period of more than one year, as it may well happen that even if the services are not used in a given year they may be used intensively in another year.

153. It is comparatively easy to ascertain whether or not a benefit has been conferred by a service when the service meets the specific needs of a particular enterprise. Where costs are incurred by the central organisation on behalf of the group as a whole it will often be very difficult to determine whether a real benefit has accrued to the different members of the group. Generally speaking, an indirect or remote benefit to an associated enterprise would not justify a deduction for tax purposes. This, ordinarily, would also apply if a service merely duplicated a service being performed by the associated enterprise, or if the service is already being performed by a third party.

154. Expenses incurred by a parent company in managing and protecting its investments are incurred by the parent company as shareholder and would not be properly chargeable therefore to the other members of the group. Other expenses incurred by the parent company may also be distinguished as prima facie incurred solely for its benefit and similarly not properly chargeable to the other members of the group. These latter would include, for example, the cost of the parent's audit of its subsidiaries, expenses incurred by a parent company in arranging meetings of its own shareholders and for consolidating the results of the members of the group, including the necessary auditing, and in providing finance for the extension of the group itself.

155. There may be cases, however, where such expenditure is incurred in the provision of services which benefit a subsidiary. For example, the audit of a subsidiary might on rare occasions prevent duplication by fulfilling to some extent the audit requirements of the relevant national law in regard to that subsidiary. However, a claim that there was a benefit for a subsidiary in such circumstances as these would need to be well supported by evidence.

156. The central co-ordination and control of the group is a service which the parent company provides at least partly for itself and to some extent as shareholder of the subsidiaries, but this service will normally in fact benefit the individual members of the group, though it will not necessarily benefit them all equally, and may even provide a positive disadvantage to some in particular instances.

157. Where the services comprise, for example, the decision-making activities of the top management of the parent company, it may be argued that they fall into the category of services provided by the parent company for its own benefit as shareholder and not for the benefit of the individual members of the group, although they may provide a benefit for one or other of these members. The indirectness or remoteness of the benefit will be a relevant factor in deciding whether or not this kind of service could properly be chargeable to members: the answer to the question whether the member would have bought the service had it been on offer from an independent third party may also be a relevant factor.

158. The question of what part of the central co-ordination and control of the group carried out by the parent company is a service for which the other members should be expected to pay is a difficult one. Many elements of this activity might, however, be bought by an enterprise from an independent third party — for example detailed planning services for particular operations, emergency management or technical advice (trouble shooting), even in some cases assistance in day-to-day management, and in principle there need be no difficulty about allowing or requiring such services to be charged for.

159. To discern what benefit a particular member of the group may derive from such services it will often be necessary to analyse in some degree the responsibilities and functions of the various members of the group as well as their performances and profits (perhaps over several years) so as to establish the relationship between the relevant services and the member's activities and performance, and it may be necessary to consider not only the immediate impact of a management decision, but also its long-term effect. For example expenditure on preparations for a marketing operation might prima facie be too heavy to be borne by a member in the light of its current resources,

but, taking into account the profit expectations from the operation, it may nevertheless be regarded as an arm's length expense.

Form and amount of the consideration

160. As in other areas of intra-group transfers, the general principle to be followed is that prices for services performed between associated enterprises should be those which would be paid between unrelated enterprises. Consequently such transactions should not be treated differently for tax purposes from similar transactions between unrelated enterprises, simply because the enterprises happen to be associated.

161. Special situations which could be argued to justify waiver or deferral of payment (for example, start-up losses, financial difficulties) would appear to occur very exceptionally in transactions between unrelated enterprises but the possibility of them occurring cannot be wholly discounted.

162. In transactions between independent enterprises specific services are normally charged individually to the recipient of the services whereas, when an assortment of services is provided for the members of an MNE, the payment is often made by way of a flat rate fee. In principle, this would be acceptable to tax authorities to the extent that independent enterprises making comparable arrangements could be expected to fix the price in a similar manner. It is not unknown, for example, for an independent enterprise to pay an annual " retainer " fee to a firm of lawyers to ensure entitlement to legal advice and representation if litigation is brought against the concern. These services may be available " on call " and they may vary in amount and importance from year to year.

163. The compensation for services rendered to an associated enterprise may be included in the price for other transfers. Thus, the price for licensing a patent or know-how may include a payment for technical assistance services performed for the licensee or for managerial advice on the marketing of the goods produced under the licence. In such cases, tax authorities would have to check that there is no additional service fee charged and that there is no double deduction.

164. Normally, to determine the amount of the consideration under the arm's length principle, the open market value of the services rendered would have to be established. Information about the prices paid in other transactions of a similar kind, between unrelated parties, would naturally be looked for, but in the absence of such information, it may be necessary to look at prices charged by the providing enterprise for similar services to unrelated enterprises. In applying

either of these methods of arriving at the arm's length price, account has to be taken of the possibility that the arm's length price in one market may differ from the arm's length price in another.

165. Where it is not possible to compare the service fee charged by an associated enterprise with the price charged in a sufficiently similar open market transaction, a cost-oriented method may be helpful in providing an approximation to arm's length prices. The general rule should be that the charge, in these cases, ought to reflect all the relevant costs, both direct and indirect, since an independent supplier of services in an arm's length situation would seek to recover all relevant costs incurred. It may often be very difficult in practice, however, to determine the indirect costs actually related to a particular service and an apportionment of the total relevant costs of the supplier on some reasonable basis may have to be accepted. The supplier of the service would normally be expected to charge the full cost (as opposed to the incremental or marginal cost).

166. Direct costs are those identifiable with a particular service including, for example, costs attributable to employees directly engaged in performing such services, and expenses for material and supplies directly consumed in rendering such services. Indirect costs are those which cannot be identified as incurred in relation to a particular activity but which, nevertheless, are related to the direct costs; these include costs incurred to provide heating, lighting, telephone, etc., to defray the expenses of occupancy (rents and maintenance of buildings, etc.) and those of supervisory and clerical activities as well as other overhead burdens of the department incurring the direct costs. They include also an appropriate share of the costs relating to supporting departments and other applicable general and administrative expenses, to the extent reasonably allocable to a particular service.

167. As with research and development, an important question to be answered is whether, if a cost-oriented method is used, a profit mark-up should be required and allowed by the relevant tax authorities. In the arm's length situation an independent enterprise would normally charge for the services it provided in such a way as to recover not only its costs but also an element of profit, and in the case of associated enterprises the general rule would therefore be to expect the charge to be based on costs with an appropriate profit mark-up.

168. Clearly if a main activity of an enterprise is the business of providing such services then in the arm's length situation it must seek to make a profit and in the case of associated enterprises a charge including a profit element would be appropriate. It is also unlikely that an enterprise in the arm's length situation would provide services merely for cost, even if the provision of such services were not a main

part of its business, if it were particularly capable of supplying the relevant services and the value of the services to the recipient were considerably greater than the cost, or if the cost of the services represented a substantial proportion of the expenses of the recipent's business. Tax authorities might expect therefore that the charge for services provided by an associated enterprise in this sort of situation would also include a profit element some tax authorities would not in practice expect a profit mark-up to be included in a charge for services provided by an associated enterprise in other circumstances but exclusion of a profit mark-up in such cases cannot be generally recommended as a matter of principle, though, unless significant amounts of money are involved, there may often be little to be gained in seeking to adjust a charge based on direct and indirect costs alone.

169. If a cost-oriented method is used, the question has to be asked whether the cost could in fact be met by the recipient of the services, and, if it could not, the cost-oriented method will prima facie not be appropriate for use in arriving at the arm's length price. In addition the real value of services concerning very specialised assistance may not be related in a consistent manner to the costs involved. If a comparable open market price cannot be found and if the cost-oriented method does not seem appropriate, other methods may have to be used by tax authorities, based for example on the examination of the overall performance of the relevant associated enterprise or on any other useful indicator. It may also be helpful to take account of more than one method in reaching a satisfactory approximation to an arm's length price.

The evidence to be produced

170. A taxpayer has to produce satisfactory evidence to prove that a service has been performed, a cost incurred and a real benefit, whether actual or potential, received. To determine what is the underlying reality behind an intra-group service agreement or cost allocation arrangement is often therefore the crucial question for tax authorities when deciding whether or not to admit the deduction of a payment.

171. What would be regarded as satisfactory evidence on these questions depends largely on the type of service rendered and on the circumstances of each individual case. Where a service payment is based on costs, adequate books and records must be maintained by taxpayers to permit verification of such costs. In the case of cost-related allocation schemes, the enterprise could be expected to provide written service or cost allocation agreements defining as closely as possible the nature of the activities and costs included, as well as the method of remuneration. Where this seems necessary after the event, supporting evidence could, for example, include invoicing, individual

evidence of cost incurred, records of time consumed, travel documentation and written evidence of the cost allocation agreement and evidence of the service flow over an appropriate period.

172. Especially in cases where an MNE's central expenditure is allocated to the members on a broad basis it would be necessary for the taxpayer, in co-operation with other associated enterprises, to be prepared to submit information to the tax authorities about the structure and organisation fo the MNE and about the functions and responsibilities of its respective members.

173. As has been said, the evidence to be produced will depend largely on the facts and circumstances of each particular case, and on the amounts of services rendered or costs allocated. In cases of minor importance, it may not be reasonable to require taxpayers to keep elaborate records and costly documentation, and tax authorities may find it sufficient to make an assessment of the appropriate charge as best as they can in the light of the available evidence.

Withholding taxes

174. It seems that some countries levy withholding taxes on service fees and contributions to central management costs when they are paid to an associated enterprise in another country. The view taken in this report is that, in accordance with the OECD Model Double Taxation Convention, such payments should not be taxed in the country of source unless they enter into the computation of the profits of a permanent establishment of the providing enterprise (see also paragraph 123).

Section III

SUMMARY OF CONCLUSIONS

175. It appears that there are two fairly clear-cut situations; one where services are provided exclusively for the benefit of the parent company and another where they are provided for the specific benefit of one or more associates. Apart from these, most of the likely situations present some uncertainty about which associated enterprise has derived the benefit from the services or in what proportion its benefits have been shared. The appropriate amount chargeable for the service presents a further question in all these situations.

176. Costs clearly belonging to the sphere of the parent company as shareholder cannot properly be chargeable to its subsidiaries since they are incurred by definition in the interest of the parent company alone, though it might not be easy to decide that expenses fall unequivocally into this category. Expenses incurred by a parent company in arranging meetings of its own shareholders, or for consolidating the results of the members of the group, or by way of administrative expenses in providing finance for the extension of the group itself, ought not, to the extent that they have to be regarded as shareholder's expenses, to be chargeable to the members of the group.

177. Charges for specific services provided by one associated enterprise to another should in principle be allowed, though here again, the receipt of a real benefit would have to be established. This would be so whether the services were provided on a specific basis or " on call " as described in paragraph 146. In the case of flat fee remuneration of services, including " on call " services, it would be proper for the tax authorities to consider, inter alia, from an examination of the use made of the services in fact over a period, whether it would be appropriate to regard the entity concerned as deriving any benefit from them.

178. As regards the wide range of activities which may be performed by a parent company or possibly by specialised subsidiaries,

which to some extent are performed in the interests of the MNE as a whole and to some extent in the interests of particular members, difficulties will often be experienced in discerning precisely in the interests of which member they are performed. This grey area would include activities commonly described as " trouble-shooting " services, general managerial advice, control and supervision and advertising. Where the charges were important in ascertaining the tax liability of the relevant member (whether this was the parent company or an associate), it would be especially necessary to look closely at the question of what benefit was derived by the relevant member and to be guided by the size and degree of that benefit, accepting the principle of chargeability if the receipt of a benefit could be established, and if it would normally be paid for between unrelated enterprises.

179. Here too, a real benefit would include a genuine potential benefit even if in the upshot it did not materialise and it would be proper in considering whether or not a benefit was received to look at the circumstances over a period longer than the particular year of account in question.

CHAPTER V

LOANS

Preliminary remarks

180. It appears that MNEs tend increasingly to devise overall financing policies for their associated enterprises, in which policies intra-group loans play an important role. Taxation considerations form part of an MNE's financial strategy where loans are concerned because the tax cost of debt financing is usually less for the group than that of equity finance, and this also is a problem which concerns the delimitation of two national jurisdictions. Other considerations are the extent to which an associated enterprise with an MNE can itself borrow, the policies of governments from the point of view of exchange control and the balance of payments, relative costs of borrowing in the various financial centres and the risk of exchange losses.

Scope of the Chapter

181. In most cases of loans within multinational enterprises, money would be lent by the parent company to its subsidiaries; but it often occurs that parent companies borrow from their foreign subsidiaries. Debt servicing can provide opportunities for profit shifting, for example, either from the subsidiary to the parent or vice versa depending on whether the lender charges an excessive rate of interest or the borrower pays less than normal interest. This Chapter of the report attempts to deal with the situations which are met in practice. It is assumed in what follows that the associated enterprises involved are not engaged in banking or financing activities as part of their regular business.

Section I

DEFINITION OF LOANS

182. The term " loan " is used in a broad sense and applies to all forms of indebtedness. This includes loans or advances of money or other consideration, whether or not evidenced by a written instrument. The contracting parties would normally agree that a fixed amount of principal has to be paid back and this would usually be reflected in the books of both the lender and the borrower. Any form of indebtedness arising in the course of business out of sales, leases, the rendering of services or any other extension of credit is also included.

Loans versus equity contributions

183. Since for tax and other reasons equity contributions may be disguised as loans, a distinction has to be made between the two. Where it is determined that a financial transaction is a contribution to the equity of an enterprise, it follows that no interest is due. Thus such cases do not constitute an exception to the general principle that loans should bear interest. As a practical matter, some countries may be less concerned than others with this question, but the principle does not seem disputable.

184. Financial contributions from a parent company to its subsidiary abroad would be the case in point. Tax authorities in the parent's country will not require the parent to receive interest if the alleged loan is in fact an equity contribution and will ordinarily consider any interest which has been paid as being, in fact, a receipt of a dividend. Making a distinction between an equity contribution and a loan is, in practice, more important for the country of the subsidiary. It is clear why this should be so. Thus, if it is decided that the financial transaction is, in fact, a disguised equity contribution, the country of the borrower will ordinarily disallow for tax purposes the deduction of interest and will treat it as a dividend payment in which case it may also attract a different rate of withholding tax.

185. Countries approach differently the question of how to distinguish an equity contribution from a loan. In some states, specific reallocation provisions apply when one of the companies involved is a non-resident. In others, transactions between domestic entities and transactions with non-residents generally follow the same rules. Three main types of solution may be mentioned.

186. A number of countries adopt a fairly flexible approach, examining the circumstances of each individual case. Thus one country lists several factors, each of which is assumed to be evidence of either a stock or a debt instrument. The courts in that country have weighed these criteria in numerous cases they have had to deal with; but it is reported that each has been decided on the basis of the particular facts. The most important factors[1] that have been taken into consideration by the courts are: whether there is an unconditional written promise to pay a fixed amount of principal at a fixed maturity date; whether the loan is subordinated to the rights of other creditors; the ratio of debt to equity of the company[2]; whether the debt is convertible into stock or shares of the issuing company; whether the shareholders of the company hold the alleged debt instruments pro rata in relation to their shareholdings; the rights of the holders in the event of a default in the payment of interest[3]; whether the parties " intented " to create a debtor-creditor relationship or not. In the past, the debt-equity ratio was considered to be the single most important factor. But in recent years, the debt-equity ratio has been given greater weight than other factors and the courts now recognise that a very high debt-equity ratio may be normal for some industries and attempt to weigh all of the above factors.

187. In another country which also would adopt a somewhat flexible approach and, as a rule, would look at the circumstances of each individual case, the general criterion is that of " unusual financing ". This is applied in a different way to real estate, financing, trading or manufacturing companies, because financing practices are known to differ greatly as between categories of enterprises. For income tax purposes, for example, debts of real estate companies may not exceed 70-80 per cent of the fair market value of the real estate; a different debt-equity ratio is applied to " sociétés financières ", where the debt may not exceed six time the nominal capital plus the reserves. For the other categories of enterprises, debt-equity ratio is not held to be more important than other criteria which, whilst not being spelt out fully in the manner described in the proceeding paragraph, could, in particular cases, be similar. No distinction is made between resident and non-resident companies.

1. They apply whether the company in question is the borrower or the lender.

2. A very high ratio of debt to equity could be evidence of a stock instrument, depending on the industry involved.

3. The right to sue the company for the principal amount would be evidence of a debt instrument, but the right to take over the management of the company or acquire voting rights upon default would be evidence of a stock instrument.

188. A third country also takes a pragmatic approach in distinguishing loans from equity contributions. All circumstances of a particular case would be considered to determine whether an alleged loan is to be regarded as " hidden capital " contribution. No hard and fast debt-equity rule is applied. In practice, it seems to happen rarely that a financial transaction, which is treated as a loan under civil law, would be considered as capital for taxation purposes. No distinction is made between resident and non-resident companies.

189. In a fourth country, the law treats certain payments of interest as distributions of profit in specific circumstances where it is thought desirable to combat possible avoidance devices designed to disguise such distributions as interest. Interest on certain securities which can be converted into shares, and interest which depends to any extent on the results of a company's business, are therefore treated as distributions. In addition, as a broad anti-avoidance measure, interest paid to a non-resident company by a resident 75 per cent subsidiary or, in certain circumstances, by a 75 per cent subsidiary of a common parent, is also treated as a distribution. In double taxation agreements that country, however, sometimes provides that this special treatment of interest paid to non-resident companies shall not apply except where more than 50 per cent of the share capital of the recipient of the interest is controlled by a resident of that country.

190. As things stand today, there is a distinct possibility that the same financial transaction could be treated as a loan by one country and as an equity contribution by another, either because the country of the lender takes a different view from the country of the borrower or because borrowers of the same MNE in different countries who are involved in what, to the MNE, seem to be similar transactions are treated differently by different national tax authorities. This is an unsatisfactory situation which it would be desirable to improve. It may be asked therefore, whether it would be possible to envisage that with time, more and more tax authorities would move towards what could be called the " multiple criteria test ". Or whether, on the contrary, it would be preferable to move towards a simpler, single criterion test, such as the debt-equity ratio, if some agreed range for such a ratio could be found. Finally, the question is sometimes raised whether it would be preferable, and conceivable, to adopt a rule-of-thumb for deciding on cases involving payments to non-residents which would be based upon a threshold level of non-resident ownership whilst leaving other cases which did not reach that critical level to be decided in accordance with company law.

191. It is generally recommended that a flexible approach should be adopted in which the special conditions of each individual case

would be considered, although it is realised that such an approach would call for sufficient qualified staff to carry out a somewhat sophisticated analysis and could, if cases were numerous, thus raise problems for some tax administrations. A hard and fast debt-equity rule would, however, not be appropriate for the solution of problems raised by the determination of the nature of a financial transaction. Financing practices differ too widely from one country to another, and, within a given country, between different categories of enterprises. Most of the countries whose practices are described in the previous paragraphs, therefore, refer to a number of factors which are of significance in distinguishing a loan from an equity contribution. On the same reasoning, it is considered that a rule based on the fact that the owner of the shares was non-resident would not be appropriate for general adoption either.

Section II

THE GENERAL PRINCIPLE OF ARM'S LENGTH PRICING AND ITS APPLICATION IN SPECIAL SITUATIONS

The general principle

192. Once it has been established that an intra-group loan exists the general principle to be followed is that the loan should bear interest if interest would have been charged in similar circumstances in a transaction between unrelated parties.

193. The parent company will usually be the lender, but it may also happen that it has borrowed money from a subsidiary abroad. In both cases interest would normally have to be charged. The following paragraphs discuss the application of the arm's length principle in some special situations. As regards such circumstances, the burden of proof would ordinarily lie with the taxpayer.

SPECIAL SITUATIONS

Trade credits

194. In most countries, and in most trades, there are likely to be established norms of practice with regard to interest charges on trade credits. The existence of such norms provides in each case a point of reference for trade credits between associated enterprises. Where the tax authorities do have more precise rules, it is desirable that these rules should approximately represent a codification of business practices.

195. It is suggested that the concept of normal trade practice could be generally adopted as regards delays in making settlements. If under given circumstances, an unrelated party would not have charged interest on balances outstanding, an associated enterprise need not be required to charge interest either. Similarly, an associated borrower would not be regarded as paying interest if, in regular trade

practice, no interest would have been paid. In looking at particular transactions it has to be borne in mind, however, that prices for goods or services may contain an implicit interest element. If an implicit element of interest is recognised and this is at an arm's length rate, there would be no grounds for requiring additional interest. Due to different trade practices in the countries concerned, the possibility cannot be overlooked that two tax administrations may reach different conclusions when looking at the same transaction from two different angles although acceptance of the general arm's length approach should make it possible to avoid extreme cases of divergent interpretation.

Loans to an enterprise in financial difficulties

Initial financial difficulties

196. During its start-up years, an enterprise will frequently be in need of financial support, for example, from a parent company. Nevertheless, applying the arm's length principle, most countries would not accept that an intra-group loan could be interest-free simply because the enterprise was in its start-up phase. It was concluded that, for tax purposes, interest should always be regarded as charged (even though eventually deferred) unless an unrelated lender would have waived the payment of the interest in the same circumstances.

Other financial difficulties

197. Cases may arise where one enterprise within a group, usually the parent company, makes a loan to another in order to help in overcoming financial difficulties and where from the start the lender waives, or defers, interest. Similarly, a parent company may agree to waive or defer interest on an outstanding loan in cases where a subsidiary has fallen into financial difficulties. If, in such circumstances, an unrelated lender would have been led to act in the same manner and such cases can arise — it could be generally accepted that interest on loans made in similar circumstances between associated enterprises could be waived or deferred.

Section III

THE RATE OF INTEREST

General considerations

198. The arm's length interest rate is the rate of interest which is charged, or would have been charged at the time the indebtedness arose, in transactions with, or between, unrelated parties under similar circumstances. The concern of tax authorities in this area of transfer prices is to prevent profit shifting through lenders and borrowers agreeing on interest rates which do not correspond to arm's length rates in similar transactions between unrelated parties. As to the level of the rate of interest, it can be expected that tax authorities will insist on adjustment only if this rate significantly deviates from the market rate, or if the amounts concerned are substantial. It should be recalled that, as was stated in paragraph 181, loans by banks or financial institutions are not being considered here.

Relevant factors

199. Ideally, in each case, the interest rate to be determined for tax purposes should be set according to the conditions in financial markets for similar loans. In deciding what is a comparable or similar loan, it is necessary to take into account: amounts and maturities; the nature or purpose of the loan (trade credit, general purpose loan, real estate credit, etc.); the currency or currencies involved (strong or weak currencies); the exchange risks of the taxpayer lending or borrowing in a particular currency; the security involved and the credit-standing of the borrower. The Central Bank rate, or the prime rate, may offer a starting point, but a mechanical rule based on either of these rates is not recommended, since it would not necessarily take into account the factors referred to above, and is therefore unlikely in many cases to reflect the arm's length rate of interest.

200. Further complications arise from the difference which may exist between conditions in financial markets in the country of the

lender and those in the country of the borrower. It may be clear that in a specific arm's length situation, the rate of interest would be governed by conditions on either one or the other market. There may, for example, be effectively no market for a particular type of loan in one or other of the countries. There is also the case where the country of the borrower may insist, for balance of payments reasons, on capital being raised abroad. MNEs, like other large borrowers, frequently have the option of borrowing funds on the international capital market at rates which may be more favourable than at home. In most cases such as these, there may be no real difficulty in finding an arm's length rate for similar loans. Sometimes it is not clear which market rate should prevail, and the question arises whether the rate of interest in the lender's or the borrower's country should be accepted as the appropriate rate. However, no straightforward principle presents itself which would win general acceptance, and it would depend on the facts of the particular case.

201. Special difficulties may arise when money is lent for long periods. Capital market conditions change, and it may be necessary for independent parties, either at the outset or later, to agree that the interest rate may be varied. If an unrelated lender (or borrower) were allowed to revise the rate of interest, then it would be reasonable to require, or to allow, such a revision in intra-group loans.

Section IV

FINAL REMARKS

202. To sum up briefly, before the appropriate level for interest rates charged on intra-group loans is considered, there are two points to be cleared: first whether or not a particular transaction should be treated as a loan, and second whether interest should be paid. On the first point, the main problem is to distinguish between, on the one hand, what may properly be described as loans and, on the other, contributions to equity capital. Whilst there are a variety of possible methods of doing this, general preference is expressed for a flexible approach related to the particular circumstances of each individual case. On the second point, it is considered that in general it would be right to expect interest to be paid on any loan but it may be accepted that if it could be shown that a lender who was at arm's length from the borrower might agree to waive or defer the payment of interest, then it would be reasonable to agree that associated enterprises might act in this same way. Finally, the main factors which, it seems, need to be taken into account in arriving at an arm's length rate of interest, have been listed above, and some of the difficulties in giving these factors their proper weight are noted.

Annex

RECOMMENDATION OF THE COUNCIL
on the determination of transfer prices between associated enterprises
(Adopted by the Council on 16th May, 1979)

The Council,

Having regard to Article 5(*b*) of the Convention on the Organisation for Economic Co-operation and Development of 14th December, 1960;

Having regard to the Declaration of 21st June, 1976 adopted by the Governments of OECD Member Countries on International Investment and Multinational Enterprises and the Guidelines annexed thereto;

Having regard to the Report of the Committee on Fiscal Affairs of 12th March, 1979 on the determination of transfer prices between associated enterprises;

Considering that transactions between associated enterprises (i.e. between parent and subsidiary enterprises or enterprises under common control) may take place under conditions differing from those taking place between independent enterprises;

Considering that the prices charged in such transactions between associated enterprises (usually referred to as transfer prices) should, nevertheless, for tax purposes be in conformity with those which would be charged between independent enterprises (usually referred to as arm's length prices) as provided in Article 9(1) of the OECD Model Double Taxation Convention on Income and on Capital;

Considering that problems with regard to transfer prices in international transactions arise mostly between the various entities of multinational enterprises and assume special importance in view of the substantial volume of such transactions;

Having regard to the considerations in the Report referred to above regarding the methods to be followed for the correct determination of transfer prices for goods, technology, trademarks and services and of interest rates on loans between associated enterprises;

Having regard to the need to achieve consistency in the approaches of tax authorities, on the one hand, and of associated enterprises, on the other hand, in the determination of transfer prices for the purposes of ensuring correct taxation of profits and avoidance of double taxation;

I. RECOMMENDS to the Governments of Member countries:

1. that their tax administrations take into account, when reviewing, and if necessary, adjusting transfer prices between associated enterprises for the purposes of determining taxable profits, the considerations and methods set out in the Report referred to above for arriving at arm's length prices when goods, technology, trademarks and services are provided or supplied or loans granted between associated enterprises;

2. that they give the Report referred to above publicity in their country and have it translated, where appropriate, into their national language(s);

3. that they develop further co-operation between their tax administrations, on a bilateral or multilateral basis, in matters pertaining to transfer pricing;

II. INSTRUCTS the Committee on Fiscal Affairs:

1. to pursue its work on issues pertinent to transfer pricing and to the assessment of taxable profits of associated enterprises in general;

2. to report periodically to the Council on the results of its work in these matters together with any relevant proposals for improved international co-operation.

DETAILED TABLE OF CONTENTS

PREFACE

Paragraph

The problem stated 1
Interest of the tax authorities 3
Interest of multinational enterprises 4
Objectives of the report 5
Scope of the report 7
Experience on which the report is based 9
Structure and layout of the report 10

CHAPTER I
SUMMARY OF PROBLEMS

THE ARM'S LENGTH PRINCIPLE

Comparable uncontrolled prices 11
Cost plus and resale methods 12
Other methods 13
The so-called " global " methods 14
Minor adjustments and substitution of methods 15
Safe havens 16

GENERAL CONSIDERATIONS

Functional analysis 17
Charging the appropriate beneficiary 18
Package deals 19
Set-offs 20
Recognition of actual payments and transactions 23
Intra-group contracts and arrangements 24
Necessary documentation and evidence 25
External effects on the pricing practices of MNEs 26
Sustained losses 28
Transfer prices for taxation and customs purposes 29
OECD Guidelines for MNEs 30

RELEVANT TEXTS ALREADY PUBLISHED BY OECD 31

Article 9(1) of OECD Model Double Taxation Convention on Income and Capital
OECD Guidelines on taxation
OECD Guidelines on disclosure of information

CHAPTER II
GOODS

INTRODUCTION

Preliminary remarks 32
Scope of the chapter 33

Paragraph

Section I

THE GENERAL PRINCIPLE OF ARM'S LENGTH AND ITS APPLICATION IN SPECIAL SITUATIONS

General considerations 37
Supply of certain goods for no payment or less than normal payment 40
Losses 42
" Start up " or " market penetration " prices 43
Government intervention 44

Section II

METHODS OF ASCERTAINING AN ARM'S LENGTH PRICE

General considerations 45
The comparable uncontrolled price method
Definition 48
Economic comparability 49
Comparable market levels 50
Comparable goods 51
Other considerations 55
The resale price method 56
The cost plus method 63
Other approaches 70
Comparable profits 71
Net yield expectations 74
Sales of goods — summing up 75

CHAPTER III

TRANSFERS OF TECHNOLOGY AND TRADEMARKS

Scope of the chapter 76

Section I

TRANSFERS OF TECHNOLOGY (USE OF PATENTS AND KNOW-HOW)

General considerations 77
Patents and know-how 84
Methods of making available a patent or know-how to another party 87
A. Payments for patents and know-how developed by one member for other members of the same MNE
Justification of benefits 89
The general principle of arm's length pricing 91
Form and amount of the consideration 92
B. Cost contribution arrangements among associated enterprises for R & D expenditure
The practice of MNEs 102
The attitude of the tax authorities 108
Questions for taxation policy 111
Justification of benefits 112

Paragraph

The amount of the contribution 115
The allocation to the participants 121
Other considerations 122

Section II

TRANSFER PRICING ASPECTS OF USE OF TRADEMARKS

Some legal and economic aspects of the trademark 126
The trademark licence contract 131
Considerations affecting the value of a trademark 136

Appendix to Chapter III

Some aspects of the tax treatment of research and development 138

CHAPTER IV

CERTAIN INTRA-GROUP SERVICES

INTRODUCTION

Preliminary remarks 139
Scope of the chapter 140

Section I

SERVICES IN A GROUP OF ASSOCIATED ENTERPRISES ... 143

Section II

TREATMENT FOR TAX PURPOSES OF INTRA-GROUP SERVICES .. 149

Justification of benefits 151
Form and amount of the consideration 160
The evidence to be produced 170
Withholding taxes 174

Section III

SUMMARY OF CONCLUSIONS 175

CHAPTER V

LOANS

Preliminary remarks 180
Scope of the chapter 181

Section I

DEFINITION OF LOANS 182

Loans versus equity contributions 183

Paragraph

Section II

THE GENERAL PRINCIPLE OF ARM'S LENGTH PRICING AND ITS APPLICATION IN SPECIAL SITUATIONS

The general principle 192
Special situation
Trade credits 194
Loans to an enterprise in financial difficulties 196

Section III

THE RATE OF INTEREST

General considerations 198
Relevant factors 199

Section IV

FINAL REMARKS 202

Annex

RECOMMENDATION OF THE OECD COUNCIL

REVENUE STATISTICS OF OECD MEMBER COUNTRIES, 1965-1978. Will present comparable data on tax revenues and social security contributions for the years 1965 to 1978 under a standardized classification, as well as an analysis of these data. An annex to the publication gives a breakdown of tax receipts by levels of government for the years 1973 to 1976. (To be published)

THE TAXATION OF NET WEALTH, CAPITAL TRANSFERS AND CAPITAL GAINS OF INDIVIDUALS (1979). Analyses capital gains taxes as well as traditional taxes on capital, such as net wealth taxes and taxes on gifts, estates and inheritances both from the point of view of the policy questions and practical aspects. 196 pages £10.80 US$22.00 F88,00

THE TAX/BENEFIT POSITION OF SELECTED INCOME GROUPS IN OECD MEMBER COUNTRIES 1972-1976 (May 1978). Describes the impact of the payment of direct taxes and receipt of certain cash transfers upon the disposable income of typical family units at different levels. 132 pages £4.30 US$8.75 F24,00

TAXATION OF COLLECTIVE INVESTMENT INSTITUTIONS, 1977 (February 1978) 64 pages £3.00 US$6.00 F24,00

MODEL DOUBLE TAXATION CONVENTION ON INCOME AND OF CAPITAL (September 1977). The new OECD Model Convention for the avoidance of double taxation with respect to taxes on income and on capital is a revision of the 1963 Draft Convention. The new Articles and the Commentaries thereto take account of the experience gained by OECD countries since 1963 in negotiating and implementing bilateral conventions between them. 216 pages £6.00 US$12.50 F50,00

THE TREATMENT OF FAMILY UNITS IN OECD MEMBER COUNTRIES UNDER TAX AND TRANSFER SYSTEMS (April 1977). Discusses the different ways in which household units fare under income tax and social security systems in OECD countries. Special emphasis is placed upon the tax position of two-earner families in view of the importance of this aspect of the taxation of the family when questions of tax equity and the effect of taxation on working wives are under discussion. 140 pages £3.40 US$7.00 F28,00

THE ADJUSTMENT OF PERSONAL INCOME TAX SYSTEMS FOR INFLATION (January 1976). Describes the effects of the interaction of inflation and the personal income tax system, and sets out the methods that governments use to offset these effects and describes the policy implications of indexation for the personal income tax system. Annexes to the report present some OECD Member countries' experiences in adjusting for inflation. 78 pages £1.70 US$3.75 F15,00

INTERNATIONAL COMPARISON OF TAX DEPRECIATION PRACTICES, by G. Kopits (June 1975). Presents a detailed comparison of tax depreciation practices operative in OECD countries. It also gives a quantitative estimate of the effect of such practices on the cost of capital in the different countries. 346 pages, bilingual £4.20 US$10.50 F42,00

THEORETICAL AND EMPIRICAL ASPECTS OF THE EFFECTS OF TAXATION ON THE SUPPLY OF LABOUR, by L. Godfrey (April 1975). Summarises the surveys and econometric studies on the question of the incentive and disincentive effects of taxation on labour supply. 142 pages £2.20 US$5.50 F22,00

THEORETICAL AND EMPIRICAL ASPECTS OF CORPORATE TAXATION, by J. Wiseman and M. Davenport (September 1974). Presents a survey of the economic analysis of the impact of different company tax systems upon the financing of firms and, notably, as regards the volume, structure and the "quality" of their investment. 80 pages £1.50 US$3.75 F15,00

NEGATIVE INCOME TAX: An approach to the co-ordination of taxation and social welfare policies (June 1974). Describes the features characterising negative income tax proposals and the difficulties that attach to their implementation. It also considers under what circumstances a negative income tax may or may not be an appropriate method of rationalising the tax and welfare systems of a country. 56 pages £1.00 US$2.50 F10,00

COMPANY TAX SYSTEMS IN OECD MEMBER COUNTRIES (October 1973). Describes the systems of company taxation operative in OECD Member countries, analysing the reasons for governments' choice and the effects of the system both at the domestic and international levels. 142 pages £2.00 US$5.00 F20,00

DRAFT DOUBLE TAXATION CONVENTION ON ESTATES AND INHERITANCES (August 1966) 128 pages £0.75 US$2.50 F10,00

The OECD CATALOGUE OF PUBLICATIONS and Supplements will be sent free of charge on request addressed to OECD Publications Office, 2 rue André-Pascal, 75775 PARIS CEDEX 16, or to the OECD Sales Agent in your country.

OECD SALES AGENTS
DÉPOSITAIRES DES PUBLICATIONS DE L'OCDE

ARGENTINA – ARGENTINE
Carlos Hirsch S.R.L., Florida 165, 4° Piso (Galería Guemes)
1333 BUENOS-AIRES. Tel. 33-1787-2391 Y 30-7122

AUSTRALIA – AUSTRALIE
Australia & New Zealand Book Company Pty Ltd.,
23 Cross Street, (P.O.B. 459)
BROOKVALE NSW 2100 Tel. 938-2244

AUSTRIA – AUTRICHE
Gerold and Co., Graben 31, WIEN 1. Tel. 52.22.35

BELGIUM – BELGIQUE
LCLS
44 rue Otlet, B1070 BRUXELLES. Tel. 02-521 28 13

BRAZIL – BRÉSIL
Mestre Jou S.A., Rua Guaipà 518,
Caixa Postal 24090, 05089 SAO PAULO 10. Tel. 261-1920
Rua Senador Dantas 19 s/205-6, RIO DE JANEIRO GB.
Tel. 232-07. 32

CANADA
Renouf Publishing Company Limited,
2182 St. Catherine Street West,
MONTREAL, Quebec H3H 1M7 Tel. (514) 937-3519

DENMARK – DANEMARK
Munksgaards Boghandel,
Nørregade 6, 1165 KØBENHAVN K. Tel. (01) 12 85 70

FINLAND – FINLANDE
Akateeminen Kirjakauppa
Keskuskatu 1, 00100 HELSINKI 10. Tel. 625.901

FRANCE
Bureau des Publications de l'OCDE,
2 rue André-Pascal, 75775 PARIS CEDEX 16. Tel. (1) 524.81.67
Principal correspondant :
13602 AIX-EN-PROVENCE : Librairie de l'Université.
Tel. 26.18.08

GERMANY – ALLEMAGNE
Alexander Horn,
D - 6200 WIESBADEN, Spiegelgasse 9
Tel. (6121) 37-42-12

GREECE – GRÈCE
Librairie Kauffmann, 28 rue du Stade,
ATHÈNES 132. Tel. 322.21.60

HONG-KONG
Government Information Services,
Sales and Publications Office, Beaconsfield House, 1st floor,
Queen's Road, Central. Tel. 5-233191

ICELAND – ISLANDE
Snaebjörn Jónsson and Co., h.f.,
Hafnarstraeti 4 and 9, P.O.B. 1131, REYKJAVIK.
Tel. 13133/14281/11936

INDIA – INDE
Oxford Book and Stationery Co.:
NEW DELHI, Scindia House. Tel. 45896
CALCUTTA, 17 Park Street. Tel.240832

ITALY – ITALIE
Libreria Commissionaria Sansoni:
Via Lamarmora 45, 50121 FIRENZE. Tel. 579751
Via Bartolini 29, 20155 MILANO. Tel. 365083
Sub-depositari:
Editrice e Libreria Herder,
Piazza Montecitorio 120, 00 186 ROMA. Tel. 674628
Libreria Hoepli, Via Hoepli 5, 20121 MILANO. Tel. 865446
Libreria Lattes, Via Garibaldi 3, 10122 TORINO. Tel. 519274
La diffusione delle edizioni OCSE è inoltre assicurata dalle migliori librerie nelle città più importanti.

JAPAN – JAPON
OECD Publications and Information Center
Akasaka Park Building, 2-3-4 Akasaka, Minato-ku,
TOKYO 107. Tel. 586-2016

KOREA - CORÉE
Pan Korea Book Corporation,
P.O.Box n° 101 Kwangwhamun, SÉOUL. Tel. 72-7369

LEBANON – LIBAN
Documenta Scientifica/Redico,
Edison Building, Bliss Street, P.O.Box 5641, BEIRUT.
Tel. 354429–344425

MALAYSIA – MALAISIE
University of Malaya Co-operative Bookshop Ltd.
P.O. Box 1127, Jalan Pantai Baru
Kuala Lumpur, Malaysia. Tel. 51425, 54058, 54361

MEXICO & CENTRAL AMERICA
Centro de Publicaciones de Organismos Internacionales S.A.,
Alfonso Herrera N° 72, 1er Piso,
Apdo. Postal 42-051, MEXICO 4 D.F.

THE NETHERLANDS – PAYS-BAS
Staatsuitgeverij
Chr. Plantijnstraat
'S-GRAVENHAGE. Tel. 070-814511
Voor bestellingen: Tel. 070-624551

NEW ZEALAND – NOUVELLE-ZÉLANDE
The Publications Manager,
Government Printing Office,
WELLINGTON: Mulgrave Street (Private Bag),
World Trade Centre, Cubacade, Cuba Street,
Rutherford House, Lambton Quay, Tel. 737-320
AUCKLAND: Rutland Street (P.O.Box 5344), Tel. 32.919
CHRISTCHURCH: 130 Oxford Tce (Private Bag), Tel. 50.331
HAMILTON: Barton Street (P.O.Box 857), Tel. 80.103
DUNEDIN: T & G Building, Princes Street (P.O.Box 1104),
Tel. 78.294

NORWAY – NORVÈGE
J.G. Tanum A/S
P.O. Box 1177 Sentrum
Karl Johansgate 43
OSLO 1 Tel (02) 80 12 60

PAKISTAN
Mirza Book Agency, 65 Shahrah Quaid-E-Azam, LAHORE 3.
Tel. 66839

PORTUGAL
Livraria Portugal, Rua do Carmo 70-74,
1117 LISBOA CODEX.
Tel. 360582/3

SPAIN – ESPAGNE
Mundi-Prensa Libros, S.A.
Castelló 37, Apartado 1223, MADRID-1. Tel. 275.46.55
Libreria Bastinos, Pelayo, 52, BARCELONA 1. Tel. 222.06.00

SWEDEN – SUÈDE
AB CE Fritzes Kungl Hovbokhandel,
Box 16 356, S 103 27 STH, Regeringsgatan 12,
DS STOCKHOLM. Tel. 08/23 89 00

SWITZERLAND – SUISSE
Librairie Payot, 6 rue Grenus, 1211 GENÈVE 11. Tel. 022-31.89.50

TAIWAN – FORMOSE
National Book Company,
84-5 Sing Sung Rd., Sec. 3, TAIPEI 107. Tel. 321.0698

THAILAND – THAILANDE
Suksit Siam Co., Ltd.
1715 Rama IV Rd.
Samyan, Bangkok 5
Tel. 2511630

UNITED KINGDOM – ROYAUME-UNI
H.M. Stationery Office, P.O.B. 569,
LONDON SE1 9 NH. Tel. 01-928-6977, Ext. 410 or
49 High Holborn, LONDON WC1V 6 HB (personal callers)
Branches at: EDINBURGH, BIRMINGHAM, BRISTOL,
MANCHESTER, CARDIFF, BELFAST.

UNITED STATES OF AMERICA
OECD Publications and Information Center, Suite 1207,
1750 Pennsylvania Ave., N.W. WASHINGTON, D.C.20006.
Tel. (202)724-1857

VENEZUELA
Libreria del Este, Avda. F. Miranda 52, Edificio Galipán,
CARACAS 106. Tel. 32 23 01/33 26 04/33 24 73

YUGOSLAVIA – YOUGOSLAVIE
Jugoslovenska Knjiga, Terazije 27, P.O.B. 36, BEOGRAD.
Tel. 621-992

Les commandes provenant de pays où l'OCDE n'a pas encore désigné de dépositaire peuvent être adressées à :
OCDE, Bureau des Publications, 2 rue André-Pascal, 75775 PARIS CEDEX 16.
Orders and inquiries from countries where sales agents have not yet been appointed may be sent to:
OECD, Publications Office, 2 rue André-Pascal, 75775 PARIS CEDEX 16.

6-1979

OECD PUBLICATIONS, 2 rue André-Pascal, 75775 Paris Cedex 16 - No. 41 229 1979
PRINTED IN FRANCE
(21 79 01 1) ISBN 92-64-11947-7

PRICE US$9.00 £4.40 F36.00

(21 79 01 1) ISBN 92-64-11947-7