

Transfer Pricing

The Arm's Length Standard

Views from Canada, US & Australia

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Overview

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- **The OECD Transfer Pricing Guidelines**
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The Arm's Length Standard

- The purpose of transfer pricing is to ensure that the pricing of non-arm's length, cross-border transactions conforms to the pricing that arm's length parties would establish for the same transactions (the "arm's length principle or standard").
- The arm's length standard is the international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes. It is set forth in Article 9 of the OECD Model Tax Convention as follows:
 - Where "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."

The OECD Transfer Pricing Guidelines

- The OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Transfer Pricing Guidelines") were first issued in 1979 and were extensively updated in 1995.
- In July 2010, the OECD Council approved the 2010 version of the OECD Transfer Pricing Guidelines.
- Chapters I-III of the Transfer Pricing Guidelines were substantially revised as a result of the review of comparability and profit methods that was undertaken by the OECD, with input from non OECD economies.
- Building on the experience acquired by tax administrations and taxpayers in applying the OECD Transfer Pricing Guidelines, new guidance was developed.
- In addition, the 2010 version of the OECD Transfer Pricing Guidelines contains a new Chapter IX on the transfer pricing aspects of business restructurings.

The OECD Transfer Pricing Guidelines

Courts have said that the OECD Transfer Pricing Guidelines may inform, but do not dictate, the interpretation and application of domestic legislation.

- **CANADA**

- ***SmithKline Beecham Animal Health Inc. v. The Queen***, 2002 FCA 229

“It appears to be common ground that the OECD Guidelines inform or should inform the interpretation and application ... of the *Income Tax Act*.”
[Paragraph 8]

- ***GlaxoSmithKline Inc. v. The Queen***, 2010 FCA 201 (currently under appeal to the Supreme Court of Canada)

“There does not appear to have been any dispute between the parties before the Tax Court that the methods for determining the price which would have been reasonable in the circumstances, had the parties been dealing at arm’s length, were based on the OECD Commentaries. Nor is there any dispute in that regard between the parties in this appeal.”
[Paragraph 59]

The OECD Transfer Pricing Guidelines

- ***GlaxoSmithKline Inc. v. The Queen***, 2008 TCC 324, overturned on appeal to the Federal Court of Appeal

“The OECD Commentary on Article 9(1) [of the OECD Model Double Taxation Convention on Income and Capital] relies on the arm's length principle to determine the prices that multinational enterprises (“MNEs”) would charge for goods and services sold from one jurisdiction to another. The arm's length principle recognizes that independent enterprises would charge prices according to market forces when dealing with each other. The Commentary recognizes that transfers between MNEs do not necessarily represent the result of free market forces, but may instead have been adopted for the convenience of the MNE. Consequently, prices set by an MNE may differ significantly from the prices agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions.” [Paragraph 60]

The OECD Transfer Pricing Guidelines

- **AUSTRALIA**

- ***SNF (Australia) Pty. Ltd. v. Commissioner***, VID 132 of 2008, Fed. Ct. of Australia, currently under appeal to the Full Federal Court of Australia

“Both the 1979 and the 1995 guidelines have a role in assisting the Court in considering the appropriate methodology and the way in which methodologies are to be applied. I refer to the 1995 guidelines as a convenient reference to the various methods that have been adopted or referred to in determining arm's length consideration. However, the 1995 guidelines do not dictate to the Court any one or more appropriate methods, and are just what they purport to be, guidelines. I treat them effectively as part of the submissions of Counsel as referring to a number of methods by which an arm's length consideration might be calculated.”

Canada Statutory Provisions

For taxation years preceding 1998:

Income Tax Act

Subsection 69(2)

- Where a taxpayer has paid or agreed to pay to a non-resident person with whom he was not dealing at arm's length as price, rental, royalty or other payment for or for the use or reproduction of any property, or as consideration for the carriage of goods or passengers or for other services, an amount greater than the amount (in this subsection referred to as "the reasonable amount") that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, the reasonable amount shall, for the purpose of computing the taxpayer's income under this Part, be deemed to have been the amount that was paid or is payable therefor.

Canada Statutory Provisions

For the 1998 taxation year and following:

Subsection 247(2)

- Where a taxpayer or a partnership and a non-resident person with whom the taxpayer or the partnership, or a member of the partnership, does not deal at arm's length (or a partnership of which the non-resident person is a member) are participants in a transaction or a series of transactions and
 - (a) the terms or conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm's length, or
 - (b) the transaction or series
 - (i) would not have been entered into between persons dealing at arm's length, and
 - (ii) can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit,

Canada Statutory Provisions

[Continued]

any amounts that, but for this section and section 245, would be determined for the purposes of this Act in respect of the taxpayer or the partnership for a taxation year or fiscal period shall be adjusted (in this section referred to as an “adjustment”) to the quantum or nature of the amounts that would have been determined if,

(c) where only paragraph (a) applies, the terms and conditions made or imposed, in respect of the transaction or series, between the participants in the transaction or series had been those that would have been made between persons dealing at arm’s length, or

(d) where paragraph (b) applies, the transaction or series entered into between the participants had been the transaction or series that would have been entered into between persons dealing at arm’s length, under terms and conditions that would have been made between persons dealing at arm’s length.

Canada Jurisprudence

General Electric Capital Canada Inc. v. The Queen, 2009 TCC 563 (currently under appeal to the Federal Court of Appeal)

“... the first step in a transfer pricing dispute is to properly identify the transactions at issue. In the present case, this step involves identifying the parties to the controlled transaction, the functions performed by each party and the risk assumed as part of the transaction.” [Paragraph 232]

“... the concept of ‘dealing at arm's length’ used in the context of the transfer pricing rules to determine a market price for a transaction refers to how independent parties negotiating with each other in the marketplace would behave — the vendor or service provider, for the purpose of achieving the highest price or best terms for his goods or services, and the other party, the purchaser, for the purpose of acquiring the goods or services at the lowest price.” [Paragraph 196]

Canada Jurisprudence

General Electric Capital Canada Inc. continued

“In the final analysis, the “arm's length” principle in the transfer pricing context is tied to modern economic theory, which is based on observations of how parties act in the marketplace. Economic theory assumes that individuals in the marketplace will employ a cost benefit analysis in choosing among the alternatives available for achieving their commercial objectives. The arm's length principle also embodies other features of general human behaviour. Market actors will seek out all relevant information, including information that helps them to understand their counterpart's motivation for entering into a transaction with them. ...” [Paragraph 197]

“The question becomes one of fact or, more precisely, one of identifying the economically relevant characteristics of the transaction that may influence the arm's length parties in their negotiations.” [Paragraph 198]

Canada Jurisprudence

GlaxoSmithKline Inc. v. The Queen, 2010 FCA 201 (currently under appeal to the Supreme Court of Canada)

“In my view, the test set out in [the case law] *requires an inquiry into those circumstances* which an arm’s length purchaser, standing in the shoes of the appellant, would consider relevant.” [Paragraph 73]

“Consequently, it is my view that the [Tax Court] Judge was bound to consider those circumstances which an arm’s length purchaser would necessarily have had to consider. In other words, the test mandated by [the domestic legislation] does not operate regardless of the real business world in which the parties to a transaction participate.” [Paragraph 74]

United States Statutory Provisions

Internal Revenue Code

- Section 482:
 - “In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.”

United States Statutory Provisions

Treasury Regulations

- Regs. §1.482-1(a)(1):
 - “The purpose and scope of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer.”

United States Statutory Provisions

Treasury Regulations

- Regs. §1.482-1(b)(1):
 - “In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances.”

United States Jurisprudence

Xilinx, Inc. v. Commissioner, 598 F.3d 1191 (9th Cir. 2010), aff'g, 125 T.C. 37 (2005)

“Section 1.482-1(b)(1) specifies that the true taxable income of controlled parties is calculated based on how parties operating at arm's length would behave. The language is unequivocal: this arm's length standard is to be applied “in every case.” In the context of cost sharing agreements, this rule would require controlled parties to share only those costs uncontrolled parties would share. By implication, costs that uncontrolled parties would not share need not be shared. In contrast, § 1.482-7(d)(1) specifies that controlled parties in a cost sharing agreement must share all “costs ... related to the intangible development area,” and that phrase is explicitly defined to include virtually all expenses not included in the cost of goods. The plain language does not permit any exceptions, even for costs that unrelated parties would not share. Each provision's plain language mandates a different result. Accordingly, we conclude that when related to each other, the two provisions establish an ambiguous standard for determining which costs must be shared between controlled parties in cost sharing agreements specifically related to intangible product development.”

[Paragraph 2]

United States Jurisprudence

Xilinx, continued

“Given the resultant ambiguity, our choice is to:

1. Apply a rule of thumb: the specific controls the general.
2. Resolve the ambiguity based on the dominant purpose of the regulations.

The first alternative is a simple solution. It is plausible. But it is wrong. It converts a canon of construction into something like a statute.

....

Purpose is paramount. The purpose of the regulations is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions. The regulations are not to be construed to stultify that purpose. If the standard of arm's length is trumped by 7(d)(1), the purpose of the statute is frustrated. If Xilinx cannot deduct all its stock option costs, Xilinx does not have tax parity with an independent taxpayer.” [Paragraphs 3-5]

United States Jurisprudence

Xilinx, continued

Per Fisher J.:

“The parties provide dueling interpretations of the “arm's length standard” as applied to the ESO costs that Xilinx and XI did not share. Xilinx contends that the undisputed fact that there are no comparable transactions in which unrelated parties share ESO costs is dispositive because, under the arm's length standard, controlled parties need share only those costs uncontrolled parties share. By implication, Xilinx argues, costs that uncontrolled parties would not share need not be shared.”

United States Jurisprudence

Xilinx, continued

“On the other hand, the Commissioner argues that the comparable transactions analysis is not always dispositive. The Commissioner reads the arm's length standard as focused on what unrelated parties would do under the same circumstances, and contends that analyzing comparable transactions is unhelpful in situations where related and unrelated parties always occupy materially different circumstances. As applied to sharing ESO costs, the Commissioner argues (consistent with the tax court's findings) that the reason unrelated parties do not, and would not, share ESO costs is that they are unwilling to expose themselves to an obligation that will vary with an unrelated company's stock price. Related companies are less prone to this concern precisely because they are related — i.e., because XI is wholly owned by Xilinx, it is already exposed to variations in Xilinx's overall stock price, at least in some respects. In situations like these, the Commissioner reasons, the arm's length result must be determined by some method other than analyzing what unrelated companies do in their joint development transactions.”

United States Jurisprudence

Xilinx, continued

“Having thoroughly considered not only the plain language of the regulations but also the various interpretive tools the parties and *amici* have brought before us, including the legislative history of § 482, the drafting history of the regulations, persuasive authority from international tax treaties and what appears to have been the understanding of corporate taxpayers in similar circumstances and of others, I conclude that Xilinx's understanding of the regulations is the more reasonable even if the Commissioner's current interpretation may be theoretically plausible.”

United States Jurisprudence

- IRS Response to Xilinx [IRB No. 2010-33, Internal Revenue Service, issued 8-16-2010]

“The Majority ... mistakenly interprets the arm's length standard to limit the behavior of controlled taxpayers, or the transactions into which they may enter, based on the behavior or transactions into which uncontrolled taxpayers may or may not enter. To the contrary, the regulations accept the controlled taxpayers' actual transaction, provided it has economic substance. The regulatory arm's length standard asks what would have been the pricing that uncontrolled taxpayers would have adopted, had they entered into the same transaction in which the controlled taxpayers actually engaged. In other words, the regulations define what is the pricing, as determined under the best method rule, of the actual controlled transaction that produces an ‘arm's length result.’”

Australia Statutory Provisions

Division 13 of the Income Tax Assessment Act 1936

- Section 136AA

- (3) In this Division, unless the contrary intention appears:

...

(d) A reference to the arm's length consideration in respect of the acquisition of property is a reference to the consideration that might reasonably be expected to have been given or agreed to be given in respect of the acquisition if the property had been acquired under an agreement between independent parties dealing at arm's length with each other in relation to the acquisition; and

Australia

Statutory Provisions

136AD

- (3) Where:
 - (a) a taxpayer has acquired property under an international agreement;
 - (b) the Commissioner, having regard to any connection between any 2 or more of the parties to the agreement or to any other relevant circumstances, is satisfied that the parties to the agreement, or any 2 or more of those parties, were not dealing at arm's length with each other in relation to the acquisition;
 - (c) the taxpayer gave or agreed to give consideration in respect of the acquisition and the amount of that consideration exceeded the arm's length consideration in respect of the acquisition; and
 - (d) the Commissioner determines that this subsection should apply in relation to the taxpayer in relation to the acquisition;

Australia Statutory Provisions

[Continued]

then, for all purposes of the application of this Act in relation to the taxpayer, consideration equal to the arm's length consideration in respect of the acquisition shall be deemed to be the consideration given or agreed to be given by the taxpayer in respect of the acquisition.

- (4) For the purposes of this section, where, for any reason (including an insufficiency of information available to the Commissioner), it is not possible or not practicable for the Commissioner to ascertain the arm's length consideration in respect of the supply or acquisition of property, the arm's length consideration in respect of the supply or acquisition shall be deemed to be such amount as the Commissioner determines.

Australia Jurisprudence

Roche Products Pty Ltd v Commissioner of Taxation, [2008] AATA 639 (Taxation Appeals Division of the Australian Administrative Appeals Tribunal)

“The obvious starting point is to look for actual arm's length transactions, preferably for the same goods in the same market. Where there are no arm's length sales of the same goods in the same market it may be possible to find very similar goods or a very similar market. Then, the question is whether the goods or markets are sufficiently comparable and whether any, and if so, what, adjustments can be accurately made to compensate for any differences. This approach is a common one for valuers, particularly real estate valuers, and is described in the multitude of cases following the decision of the High Court of Australia in *Spencer v The Commonwealth* (1907) 5 CLR 418.” [Paragraph 19]

Australia Jurisprudence

Roche Products Pty Ltd, continued

“The relevant tax treaty provisions relied upon before me are based on Article 9 of the OECD Model Tax Convention. Like the tax treaty provisions the Convention refers to "independent enterprises". The Guidelines describe this as "the arm's-length principle" ... They equate arm's-length dealings with the conduct of independent enterprises.” [Paragraph 34]

“The Guidelines describe these methods as the most direct way of establishing an arm's length price. They state that they are preferable to other methods ... The evidence in this case leads me to suggest that, when it is available, the use of comparables might be said to be preferable to the other traditional transaction methods.” [Paragraph 39]

Australia Jurisprudence

SNF (Australia) Pty. Ltd. v. Commissioner, VID 132 of 2008, Fed. Ct. of Australia, currently under appeal to the Full Federal Court of Australia

“I do not accept the Commissioner's submission that the test is to determine what consideration an arm's length party in the position of the taxpayer would have given for the products. The essential task is to determine the arm's length consideration in respect of the acquisition. One way to do this is to find truly comparable transactions involving the acquisition of the same or sufficiently similar products in the same or similar circumstances, where those transactions are undertaken at arm's length, or if not taken at arm's length, where suitable adjustment can be made to determine the arm's length consideration that would have taken place if the acquisition was at arm's length. Just as in a valuation, the focus is not on the subjective or special factors of the parties involved in the transaction (eg whether they were financially sound or not), but is on the transaction itself and the consideration paid. In this sense, the task is not dissimilar to that undertaken in a valuation ...” [Paragraph 44]

Australia Jurisprudence

SNF (Australia) Pty. Ltd., continued

“This is not to say that the relationship between the parties in any comparative transaction chosen is not to be considered. Such is relevant to whether the transaction can assist in arriving at the consideration that might reasonably be expected to have been given in respect of the acquisition of the same or sufficiently similar products between independent parties. If the parties to the comparative transaction are related to each other then such a transaction may be of little or no assistance in determining the arm's length consideration as required by [the domestic legislation].” [Paragraph 45]

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