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Contractual Arrangements and the Delineation of a Transaction: A Duo in Crisis Mode

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This article highlights the evolving relationship between contractual arrangements and the delineation of a transaction for transfer pricing purposes since the release of the first edition of the transfer pricing guidelines in 1979. It shows that BEPS-related guidance on the matter has created a serious rift between the delineation of a transaction and the relevance of contractual arrangements. This creates uncertainty and ambiguity for Multinational Enterprises (MNEs) and tax authorities.

1 Introduction

Public discussion draft *BEPS Action 10: Revised Guidance on Profit Splits* was issued on 22 July 2017 by the OECD. One of the key features of the draft relates to the necessity of establishing the nature of the transaction prior to applying the profit split method. Regarding the 'nature of the transaction', paragraph 12 of the draft indicates that the 'accurate delineation of the transaction' must take into account 'the commercial and financial relations between the associated enterprises, including an analysis of what each party to the transaction does, and the context in which the controlled transactions take place'.

Related guidance is found in paragraph 17 of the draft. The OECD suggests that '[w]here each party to the transaction legally owns unique and valuable intangibles that are relevant to the transaction, it will also be necessary to consider whether, under the accurate delineation of the transaction, they each assume the economically significant risks relating to those intangibles, e.g. risks related to development, obsolescence, infringement, product liability and exploitation'.

At the end of paragraph 46 of the draft, we (finally) read: '[a]dditionally, it should be remembered that the starting point in the delineation of any transaction will generally be the written contracts which may reflect the intention of the parties at the time the contract was concluded. See paragraph 1.42 [of the transfer pricing guidelines]'. One must thus go through over two-thirds of the draft before finding an explicit mention regarding the relevance of 'contractual arrangements' for the purpose of the 'delineation of a transaction'. In arm's length settings contractual arrangements are always an obvious and integral part of business dealings. Contractual terms or contractual arrangements have always been one of the five comparability factor of the comparability analysis.

This oversight is not benign. It echoes profound conceptual tensions at the OECD about how one may delineate a transaction without first giving precedence to existing contractual arrangements. This mishap aligns with a new-born over-reliance on some type of 'substance over form' approach which is awkwardly highlighted by paragraphs 1.33–1.41 of the 2017 edition of the *OECD Transfer Pricing Guidelines.*[1]

It could be said that this reliance on some 'substance over form' approach has been present for quite some time in the guidelines. But the efforts centred on BEPS Actions 8–10[2] have indeed given birth to a new breed of this transfer pricing toddler. As will be seen below, a review of the wording found on the matter in previous editions of the guidelines shows that a meaningful threshold has been crossed. Nowadays there is an inclination toward over-reliance on substance over form as far as the delineation of a transaction is concerned. It results in uncertainty and ambiguity for Multinational Enterprises (MNEs) and tax authorities as discussed in this article.

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1 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2017 ed. 2017).

2 *See* OECD, *Aligning Transfer Pricing Outcomes with Value Creation. Actions 8–10: 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing 2015).

2 The origins of related parties' contractual arrangements in transfer pricing

The OECD guidance on the relationship between the 'delineation of a transaction' and 'contractual arrangements' is not new. As early as 1979, paragraph 24 of the first edition of *Transfer Pricing and Multinational Enterprises*[3] indicated that '[a]ssociated enterprises are [...] 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'. MNEs were expected to provide 'legal documents and explanatory material', as they were labelled at the time by the OECD. This included contracts, agreements, arrangements, etc., between related parties who are not dealing at arm's length. Such documents were already meant to delineate the transaction. Terms and conditions of these contractual arrangements were expected to abide by the arm's length principle and therefore meet the standard found in any dealings between arm's length parties.

Otherwise, tax authorities would have had legitimate rights to 'disregard them or substitute other transaction for them'.[4] However, this option was at best seen as a last resort mechanism. Only in unusual or exceptional cases would tax authorities ponder taking these extraordinary actions. Only when the terms and conditions or the transaction itself would not pass the well-known 'smell test' with respect to the general requirements of the arm's length principle would substitution or plain disregard of a transaction be considered.

3 Contractual arrangements in the 1995/1997 guidelines

In 1995, the OECD released a major overhaul which was titled *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.* It was supplemented in 1996 with Chapters VI and VII on intangible property and intragroup services and in 1997 with the first version of the Chapter VIII on cost contribution arrangements.[5] The intent was to revise and compile previously issued material 'addressing transfer pricing and other related tax issues with respect to multinational enterprises'.[6]

Aside from the material found in the 1979 edition, the 1995/1997 edition included content partially found in the 1984 report titled *Transfer Pricing and Multinational Enterprises – Three Taxation Issues* and the 1987 report titled *Thin Capitalization.* It should be pointed out that the 1995/1997 edition of the guidelines also drew 'upon the discussion undertaken by the OECD on the proposed transfer pricing regulations in the United States'.[7]

New Chapter I of the 1995/1997 edition of the guidelines titled 'The Arm's length principle' underlined, among other things, the necessity of reviewing 'contractual terms' in related parties' business dealings for transfer pricing purposes. Paragraph 1.28 indicated that the 'analysis of contractual terms should be a part of the functional analysis'. Moreover, the paragraph added that 'terms of a transaction may also be found in correspondence/communications between the parties other than a written contract'.

Contractual arrangements basically remained at the epicentre of the functional analysis but in the general meaning of the term. This made obvious business sense both from a theoretical and practical standpoint. Parties involved in business dealings would be expected to consign their respective intents and obligations, draw terms and conditions to provide services or goods in exchange for payment, etc., whether through legal contracts or agreements or by way of regular correspondence.

The shift from 'contractual arrangements' to 'contractual terms', although subtle, also allowed a wider-ranging analysis of contractual arrangement for the purpose of the delineation of a transaction. It also introduced the notion of the 'conduct of the parties' in the comparability analysis mix. Regarding the specific 'delineation of a transaction', the 1995/1997 edition reiterated what was found in the 1979 edition regarding the absence of 'normal conflict of interests'. In the 1979 edition, paragraph 24 had indicated that 'tax authorities would have to determine [...] the underlying reality behind an arrangement'. Nothing else what offered in terms of guidance.

From this potential absence of 'divergence of interests' between the parties, as it was now labelled in 1995, paragraph 1.29 of the 1995/1997 edition put forward the necessity of reviewing 'whether the parties' conduct indicates that the contractual terms have not been followed or are a sham'. This guidance, most likely intended for tax authorities, was going a little bit further than what was found in the 1979 edition. It provided greater clarity on the potential transfer pricing audit issues pertaining to the 'underlying reality behind an arrangement'.

From an MNE perspective, the topic of 'parties' conduct' was an open invitation to ensure that contractual arrangements were carefully crafted to ensure that they

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3 OECD, *Transfer Pricing and Multinational Enterprises*, Report of the OECD Committee on Fiscal affairs (1979).

4 *Ibid.*, para. 23.

5 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* (1997).

6 *Ibid.*, para. 13.

7 *Ibid.*, para. 14. The OECD refers back to its 1993 report titled *Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations.*

would include terms and conditions which were either found in existing arm's length settings or which would be properly reflected upon by the parties in their business dealings. Just like the 1979 edition, the 1995/1997 edition of the guidelines acknowledged that '[a]ssociated enterprises are 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'.[8] But the era of the 20, 30, etc. pages 'contract' without any basis in fact or without regard to the actual parties' conduct had come and gone.

From a tax authority perspective, it enabled the opportunity to call into question controlled transactions, whether they may have found their basis in shady 'contractual terms' or with respect to an 'underlying reality' that had nothing to do with the legitimate terms and conditions included in a contractual arrangement. In OECD words, tax authorities could muse over disregarding a transaction either when the 'economic substance of a transaction differs from its form' or when the 'arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner'. [9] In simple terms, commercial reality had to align with the self-imposed fiction brought upon by the requirements of the arm's length principle.

Despite these changes, the guidance in the 1995/1997 edition was still advocated as a last resort mechanism. The OECD indicated that potential 'disregard' for a controlled transaction did not entail that it was appropriate to 'restructure' a transaction.[10] In fact, paragraph 1.36 of the 1995/1997 edition made it very clear that a 'tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them'. For greater certainty, the same paragraph indicated that only in 'exceptional cases' should tax authorities 'disregard actual transactions or substitute other transactions for them'. This is the same expression found in the 1979 edition, as seen above. Paragraph 1.36 went even further adding that '[r]estructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured'.

In short, contractual arrangements did greatly matter. For any tax authority, they were indeed central to the arm's length transfer pricing determination issue, not a simple peripheral feature to cope with and, hopefully, get away from. For MNEs they were a key piece of the documentation process of any transaction between related parties. To start with, the delineation of a transaction was grounded on contractual arrangements. It was then supplemented by the conduct of the parties. Both were expected to match and lead to the determination of arm's length transfer prices.

4 Contractual arrangements in the 2010 guidelines

In 2003, the OECD launched an 'open invitation' to comment on 'comparability issues'.[11] This was followed by another open invitation to comment on the application of transactional profit methods.[12] This then lead the OECD to release a public invitation to comment on a 'series of draft issues notes' on comparability in 2006[13] and a discussion draft on transactional profit methods in 2008.[14] All these efforts resulted in proposed revisions to Chapters I, II and III of the 1995/1997 edition of the *Transfer Pricing Guidelines* issued for public consultation in 2009.[15]

In July 2010, the OECD published what may be considered the third edition of the *Transfer Pricing Guidelines.* With respect to the importance of contractual arrangements, paragraphs 1.52–1.53 of the 2010 edition are a complete reproduction of paragraphs 1.28–1.29 of the 1995/1997 edition. However, the 2010 edition added some clarity on the means and ways of determining comparability with regard to the terms and conditions between related parties. Paragraph 1.54 indicated that 'contractual terms' of intercompany contracts required comparability with 'key contractual terms of uncontrolled' contracts. Although the guidance put forward at the time may have seem restricted to licencing agreements, it is reasonable to infer from this paragraph that the comparability of the contractual terms was becoming more and more 'critical to assessing whether such uncontrolled

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8 *Ibid.*, para. 1.39.

9 *Ibid.*, para. 1.37.

10 *Ibid.*, para. 1.41.

11 OECD, *Open Invitation to Comment on Comparability Issues* (May 2003).

12 OECD, *Open Invitation to Comment on the Application of Transactional Profit Methods* (Feb. 2006).

13 OECD, *Comparability : Public Invitation to Comment on a Series of Draft Issues Notes* (10 May 2006).

14 OECD, *Transactional Profit Methods. Discussion Draft for Public Comment* (25 Jan. 2008).

15 OECD, *Proposed Revision of Chapters I–III of the Transfer Pricing Guidelines*, Public Consultations from 9 Sept. 2009 to 9 Jan. 2010 (2009).

licences [contracts] provide reliable comparables to the controlled transaction'.

Despite this increased awareness about the factual comparability regarding the terms and conditions included in contractual arrangements between related parties, paragraphs 1.64–1.69 of the 2010 edition related to the 'recognition of the actual transactions undertaken' were a carbon copy of paragraphs 1.36–1.41 of the 1995/1997 edition. Disregard for contractual arrangements or restructuring of controlled transaction remained mechanisms of last resort. Delineation of a controlled transaction was still based on the contractual arrangements between the related parties and supplemented by the conduct of the parties as required. Contractual arrangements remained at the heart of the comparability analysis. But from then on, the OECD started its journey toward hardening its guidance on the matter.

5 Contractual arrangements and BEPS

In early 2011, the OECD launched a new initiative on 'transfer pricing and intangibles'.[16] At the time, the intent was to revisit Chapter VI of the *Transfer Pricing Guidelines*, originally issued in 1996, on the basis that '[m]any of the issues addressed in the 2010 revision of the TPG [transfer pricing guidelines] are relevant to intangible transactions'.[17] This led to a meeting with 'business commentators on the valuation of intangibles for transfer purposes' on 21–23 March 2011.[18] After that, there was radio silence. Unlike 2003 and 2006, no 'open invitation' on the matter of intangible property and transfer pricing was handed out by the OECD.

The initiative on transfer pricing and intangibles morphed in early 2013 into the 'Base Erosion and Profit Shifting' initiative, now universally known in international tax circles all across the world as the newest English four-letter word 'BEPS'. The OECD issued a policy paper on the matter in February 2013[19] which was then followed by an 'action plan' in July 2013.[20] This generated numerous public discussion drafts, a first series of 'reports' on 16 September 2014 and a 'final' series of reports on 5 October 2015.[21] These extensive and comprehensive efforts led to the issuance of the fourth edition of the *Transfer Pricing Guidelines* in July 2017. Significant and sometimes surprising changes were made to the means and ways that contractual terms should now be addressed for transfer pricing purposes.

First and foremost, the approach to delineate a transaction made a 180-degree turn. Paragraphs 1.33–1.41 of the 2017 edition of the *OECD Transfer Pricing Guidelines* heavily rely on some type of 'substance over form' approach. This 'substance over form' approach focusses first and foremost on factors such as 'broad-based understanding of the industry sector'[22] found in the Master File and the 'economically relevant characteristics of the commercial or financial relations',[23] prior to the examination of any existing contractual arrangements or contractual terms between the related parties. In the words of the OECD, 'commercial and financial relations' must be 'accurately delineated' prior to performing the 'comparability analysis'.[24] But it was not meant to be that way according to the latest public consultation draft released by the OECD on the matter.

In fact, the new paragraphs 1.33–1.41 of the 2017 edition were initially presented in a totally different form in a public discussion draft released on 19 December 2014 (the 2014 Draft).[25] At the time, there was no demonstrable intent to basically clean the slate and send contractual arrangements and contractual terms to the backbench.

Paragraph 1.34, as it read in paragraph 2 of the 2014 Draft, indicated that the 'process of identifying the commercial or financial relations between associated enterprises follows from examining contractual terms governing those relations together with the conduct of the parties'. Paragraph 9 of the 2014 Draft also indicated that the 'process of identifying the commercial or financial relations and accurately delineating the transaction also starts the process of identifying the economically relevant characteristics of the transaction'. This guidance included in the 2014 Draft was in continuity with the guidance found in the 1995/1997 and 2010 editions of the guidelines. In short, delineation of a controlled transaction through the 'commercial or financial relations between

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16 OECD, *Transfer Pricing and Intangibles: Scope of the OECD Project* (25 Jan. 2011).

17 *Ibid.*, para. 3.

18 *See* the press communiqué on the matter here, http://www.oecd.org/tax/transfer-pricing/oecdmeetswithbusinesscommentatorsonthevaluationofintangiblesfortransferpricingpurposes29march2011.htm.

19 OECD, *Addressing Base Erosion and Profit Shifting*, (OECD Publishing 12 Feb. 2013).

20 OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing 19 July 2013).

21 The detailed bibliography of these drafts and series of reports is outside the scope of this article.

22 *Ibid.*, para. 1.34.

23 *Ibid.*, para. 1.35.

24 *Ibid.*, para. 1.33.

25 OECD, *Public Discussion Draft. BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)*; public consultations from 1 Dec. 2014 to 6 Feb. 2015 (2014).

associated enterprises' was still grounded into the contractual arrangements between the related parties and supplemented by the conduct of the parties.

The 2014 Draft also provided greater clarity and harmonization on the topic in connection with the new three-tier approach on transfer pricing documentation found in Chapter V of the guidelines released a few months before.[26] It was underscored in paragraph 2 of the 2014 Draft that:

> [e]stablishing the conduct of the parties involves examination of all of the facts and circumstances surrounding how those enterprises interact with one another in their economic and commercial context to generate potential commercial value, how that interaction contributes to the rest of the value chain, and what the interaction involves in terms of the precise identification of the functions each party actually performs, the assets each party actually employs, and the risks each party actually assumes and manages.

These basic principles pertaining to the relevance of contractual arrangements already found in the 1995/1997 and 2010 edition of the guidelines were watered down in the final version of Chapter I of the 2017 edition. Rather than providing clarity, the 2017 edition of the guidelines now offers significant uncertainty and ambiguity to MNEs and tax authorities.

On one hand, the delineation of a transaction now starts with the identification of 'commercial or financial relations' based on a 'broad-based understanding of the industry sector', according to paragraph 1.34 of the 2017 edition and the 'economically relevant characteristics of the commercial or financial relations', according to paragraph 1.35. The contractual terms of the transaction may then be considered during the comparability analysis. As seen above, the 'commercial and financial relations' must be 'accurately delineated' prior to performing the 'comparability analysis', according to paragraph 1.33 of the 2017 edition.

But wait! Is it in fact the other way around after all?

On the other hand, paragraph 1.42 of the 2017 edition of the guidelines indicates that '[w]here a transaction has been formalised by the associated enterprises through written contractual agreements, those agreements provide the starting point for delineating the transaction'. Paragraphs 1.43–1.50 then provide greater details on means and ways to combine, within the comparability analysis, the contractual arrangements and the conduct of the parties.[27] It remains to this day that contractual terms or contractual arrangements are one of the five comparability factors. Considered by themselves, these paragraphs seem directly in line with the guidance included in the 1995/1997 and 2010 editions of the guidelines. One may therefore ask: which is which? What should come first: contractual arrangements or identifying the commercial and financial relations?

The apparent ambiguity demonstrated by these statements highlights theoretical and practical tensions between how one may delineate a transaction without first giving substantial precedence to existing contractual arrangements. As seen above, to hopefully untie this transfer pricing knot, the OECD stresses that 'commercial and financial relations' must be 'accurately delineated' prior to performing the 'comparability analysis'.[28]

This statement therefore signals that contractual arrangements come second, that is, after an accurate delineation of the 'commercial and financial relations' has been carried out. Contractual terms of the transaction remain relevant, but only as a factor in the comparability analysis, as indicated in paragraph 1.36 of the 2017 edition of the guidelines.

This subtle distinction is not rhetorical in nature or buried in transfer pricing semantic. It finds its footing in the brand new six-step risk analysis process, which potentially renders ineffective any contractual arrangements between related parties. The six-step risk analysis process opens up the door to tax authorities to disregard the terms and conditions of any controlled transaction. It empowers tax authorities to restructure, as they may see fit, controlled transactions that do not result in the expected contribution to the country's tax base. In other words, this new 'substance over form' approach crosses any red lines that have been drawn in the past by previous editions of the guidelines on the required threshold that should have been met to either disregard a transaction or contemplate restructuring.

Getting back to the big picture, these changes indicate a momentous philosophical shift by the OECD. Instead of providing transfer pricing guidance to MNEs and tax authorities, the new approach enables the use of transfer pricing guidance as an anti-avoidance tool. Some may suggest that this is obviously coherent with the belief that both 'base erosion' and 'profit shifting' indeed exist. But in the end, it creates uncertainty and ambiguity to all parties alike.

6 Contractual Arrangements in the 2017 Guidelines

The 'analysis of risks in commercial or financial relations' is a six-step process pushed forward by the OECD. This

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[26] OECD, *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*, 16 Sept. 2014; updated on 15 Oct. 2015 (2014).

[27] These paragraphs were also found in the 2014 Draft; *see* paras 3–8.

[28] *Ibid.*, para. 1.33.

six-step process aims to 'facilitate' the identification of 'commercial or financial relations' by tax authorities, that is, to delineate the controlled transactions. As good as this may sound and look, it is far from simple. In a nutshell, it boils down to a process which empowers tax authorities, for the better or for the worse, to:

> interpret the information and determine whether the contractual assumption of risk is consistent with the conduct of the associated enterprises and other facts of the case by analysing (i) whether the associated enterprises follow the contractual terms under the principles of Section D.1.1 [contractual terms]; and (ii) whether the party assuming risk, as analysed under (i), exercises control over the risk and has the financial capacity to assume the risk .

In short, this six-step process gives tax authorities the 'appropriate' leeway to potentially disregard or restructure any and every controlled transaction through a highly subjective process. It may be tempting to suggest that this simply indicates that the 'parties' conduct' should now supersede 'contractual arrangements' in the comparability analysis. But such a view goes against the fundamental principle of the rule of law. It goes above and beyond a legitimate transfer pricing examination or audit where an analysis of the contractual terms is supplemented by a review of the conduct of the parties.

Although, a detailed presentation of the six-step process is outside the scope of this article, suffice it to say that the contrived process described in paragraphs 1.71–1.106 of the guidelines is intellectually challenging in its multiple intricacies and possible detours. From a transfer pricing audit perspective, it does not bode well for smaller MNEs that are ill-prepared for lengthy tax litigations or for tax authorities who may not possess experienced transfer pricing personnel. The same rings true from a double taxation perspective. Whether life is a struggle, it is still up for debate. But as far as the six-step process is concerned, the writing is already on the wall.

It is noteworthy that this six-step process was not subjected to public consultations prior to its inclusion in the transfer pricing guidelines. Admittedly, the 2014 Draft does include bits and pieces of the 'guidance' found in the six-step process. However, no clear picture could at the time be seen regarding the fading relevance of contractual arrangements that was soon to be crystalized by the 2017 edition of the guidelines.

And the 2017 edition of the guidelines doubles down on ambiguity. With respect to the 'recognition of the accurately delineated transaction', paragraph 1.120 of the guidelines points out that in 'performing the analysis, the actual transaction between the parties will have been deduced from written contracts and the conduct of the parties. Formal conditions recognised in contracts will have been clarified and supplemented by analysis of the conduct of the parties and the other economically relevant characteristics of the transaction'.

Amazingly, these statements bring back vivid memories of the guidance already found in the 1995/1997 and 2010 editions of the guidelines. Was the six-step process just thrown under the bus? Are contractual terms back in the saddle when comes the time to delineate a transaction?

This completes our journey on the relevance of 'contractual arrangements' in the 'delineation of a transaction' for arm's length transfer pricing purposes. Notwithstanding the deep conceptual tensions which permeate through the 2017 edition of the guidelines on the matter, there may be some hope for the weary after all. Wording included in the 2017 edition of the guidelines may seem to indicate that nothing has changed. Experienced practitioners are aware of the prowess of the OCDE for squaring the circle for transfer pricing purposes. This one may have a genuine right to claim the prize.

However for the transfer pricing realist, this state of affairs illustrates an international tax regime in a deep state of crisis. Piling up more and more guidance on the matter will not lessen the incoherence found in many curves of a road that it is becoming steeper and steeper with time, both for MNEs and tax authorities.