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## **EU JOINT TRANSFER PRICING FORUM**

### **SECRETARIAT DRAFT DISCUSSION PAPER ON SPECIFIC ISSUES OF APAS**

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**Centre de Conférences Albert Borschette  
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**Working document**

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## ***1. Introduction***

1. The working paper "Key Points for an Efficient APA Procedure" (JTPF/014/2005/EN) outlined various discussion points concerning how an APA procedure could be organised. This paper discusses various areas which feature in many APAs and are often problematic for taxpayers and tax administrations. In Appendix A there is an example illustrating the APA application of a multinational enterprise (MNE).

## ***2. Legal framework***

2. Article 25 (3) of the OECD Model Tax Convention allows Competent Authorities (CAs) to consult together for the elimination of double taxation. The CAs shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation of the relevant tax Convention. It is generally agreed that this permits countries to enter into APAs.
3. However, it is possible that an APA concluded under a tax convention will have to be made binding in domestic law. Some countries may not have a mechanism for doing this. There may be instances where, even if an agreement is made under a tax convention, a taxpayer is not provided with total certainty that domestic law considerations will not result in a transfer pricing related audit. That is, a transfer pricing audit might be carried out even though there is an APA. This might be because the CA does not have the power or authority to commit all parts of the tax administration. Or it might be that only some parts of domestic laws are expressly described as relating to transfer pricing. There may be third countries who do not agree with the above interpretation of Article 25 (3). This seems to place taxpayers in an inequitable position.
4. Therefore, wherever possible, tax administrations should be able to give full, incontrovertible effect to APAs. Taxpayers should be able to enjoy a legally binding assurance that, providing the terms of the APA are in force, transfer pricing will not be subject to an audit. Otherwise, full certainty will not be provided. Tax administrations should be in the position of being able to offer this full legal certainty. If tax administrations are unable to provide this legal certainty without new domestic rules, then they should consider instituting new rules.
5. Taxpayers should be confident that once an APA has been negotiated with a tax administration then the APA is legally binding. This should also apply to both parties. The tax administration should also be confident that the taxpayer is also bound by the agreement. This knowledge will result in more tax administrations and taxpayers feeling more confident that the advantages of APAs can be realised. To achieve this, both tax administrations and taxpayers should accept that they are legally compelled to follow the terms and conditions of an APA.
6. This should not be seen as acting against flexibility. Where it is necessary and possible, flexibility can be built into an APA. For instance, if a critical assumption is not met, it is recommended that taxpayers and tax administrations meet to discuss if the APA can be

modified and do not rescind the APA without doing this. But both tax administrations and tax payers need to accept that an APA must provide certainty of treatment.

**Question 1: Does the Forum accept that APAs should be legally binding for both the tax administration(s) and the taxpayer(s)?**

### **3. Fees**

7. Some tax administrations outside Europe operate a fee system for access to their APA programme. This is charged sometimes as a flat fee to buy into the APA process. Or it can be based on the "out of pocket" expenses the tax administration expects to incur during the negotiations such as travel and accommodation. Or it could be a mixture of both. Staff costs sometimes feature in the calculation.
8. There are undoubted benefits which derive from an APA for both taxpayer and tax administration. It is likely that tax administrations only face increased costs in the short term: over all, a successful APA will result in fewer resources being utilised than in an audit and subsequent MAP and - possibly - arbitration procedure. This will be as true for staff costs as for travel costs. Administrations could keep this in mind when considering whether charges are appropriate.
9. With the advantages of an APA, it is unlikely that charges based on short term administrative costs would act as a major disincentive for MNEs. However, the same might not apply for SMEs. If it was decided that administrative fees were appropriate for MNEs, Member States might like to consider whether fees were equally appropriate for SMEs where they might act as a greater disincentive or whether reduced fees should apply for SMEs.
10. There is also the question of what a taxpayer believes he is receiving in return for his money. The taxpayer's expectations of a "good deal" might be raised in an inappropriate fashion. And what happens to the money if the APA is not finally agreed or perhaps is agreed but later on cancelled. Should the money be returned to the taxpayer? And under what circumstances? At the very least, in return for his fee, the taxpayer should be entitled to a firm commitment to a time-table for the APA.
11. In some instances, however, it may be desirable to have a fee structure where, without fees, a Member State would not otherwise be able to have an APA programme. In this case then the fee actually acts as an incentive for an APA and, whereas without a fee it would be impossible for a Member State to make APAs available, with a fee the existence of APAs could be encouraged.
12. Where tax administrations do charge a fee for the APA, it is incumbent on them to ensure that the process runs smoothly and efficiently.

**Question 2: What is the Forum's view on the issue of fees?**

### *3.1. Other fees for the taxpayer*

13. It should be remembered that a taxpayer can incur considerable professional costs in an APA. These might sometimes act as a disincentive. Member States might like to consider whether they could provide certain functions in return for the APA fee if such a fee were to be charged. For instance, it is possible that some economic analysis (e.g. database searches) could be performed by the tax administration and not the taxpayer or in co-operation with the taxpayer. This is on the basis that the tax administration is likely to have to carry out these searches anyway, particularly during an audit, so it may be unnecessary to compel the taxpayer to perform them as well. The tax administration is being put to no extra expense. This could apply particularly in the case of SMEs where professional costs act as a major disincentive.

### **4. *Participants and non participants, pricing for non participants***

14. To provide maximum certainty, it is ideal for all connected parties to be included in the APA. This would involve the tax administrations where these parties were resident concluding an APA.
15. For example, a MNE group has affiliates in three countries in the EU. All three companies buy from a fourth affiliate resident in Singapore. The MNE group will gain the most advantage from an APA between the tax administrations of all four countries.
16. However, the evaluation and negotiation of an APA by a large number of countries could be a lengthy process, whatever the efficiency of the APA procedures of the countries. Furthermore, it might be the case that one tax administration does not have an APA programme. Or a tax administration takes the view that an APA is not appropriate. Or the taxpayer might feel that the increased advantage of a multi-lateral APA over a bilateral is not commensurate with the extra resources necessary.
17. Under these sorts of circumstances, it will still be possible and desirable to have an APA even though not all tax administrations will be included. The taxpayer and included tax administrations will still enjoy the advantages of certainty.
18. To provide further certainty, unless there are good reasons to the contrary, the transfer pricing methodology in the agreed APA is also used by the affiliates who are not in the APA. These arrangements should be in written agreements, as should all agreements between connected parties covering transfer pricing.
19. This will mean that all affiliates involved in the trading will use the same transfer pricing methodology for the same type of transaction whether or not they are in the APA. This will indicate to tax administrations that one affiliate is not unduly disadvantaged and will help provide tax payers with a partial defence against accusations of non arm's length pricing. Taxpayers will still derive more certainty from having an APA than not having one at all.

20. There will always be a possibility that some affiliates within the MNE group will be in the APA while other affiliates will not. But all affiliates should where possible be governed by the same transfer pricing methodology for comparable transactions
21. For example, six affiliates all perform service activities that are secondary to the main activity of the MNE group. The services are performed for the affiliates; none of the affiliates perform the service for third parties. Having considered the OECD criteria on cost contribution arrangements, the MNE group decides that a cost contribution arrangement represents the best transfer pricing methodology for the service activities. All these service activities of the affiliates are priced according to the cost contribution arrangement. Therefore the transfer pricing methodology applied for these activities is applied to each affiliate.
22. However, the MNE group decides to negotiate an APA with only four tax administrations. There is sufficient uncertainty over the application of the arm's length standard because of the complex nature of the services carried out. The fifth tax administration does not recognise APAs. The MNE group decides that it is not worthwhile negotiating an APA with the sixth tax administration because the resources required exceed the potential benefits. However, the MNE group correctly decides that all six affiliates will be participants in the cost contribution arrangement.
23. There would be total certainty provided if tax administrations five and six could be included. It can be seen from this that it is preferable for all tax administrations to offer APAs and conduct the APA procedure efficiently.
24. It can be envisaged from this scenario that the more affiliates and the more tax administrations which are included in the APA, the greater are the advantages that will arise for all parties. Ideally, if all affiliates and all tax administrations agree to the APA, no tax administration and no taxpayer will be involved in a dispute over the transfer pricing. There is a diminishing return the fewer tax administrations are involved. But there will always be the advantage of certainty for any affiliate included in the APA.
25. Where, for good reasons, an affiliate involved in the connected transactions is to be excluded from the APA, the pricing methodology should be the same as that for the participants in the APA. This should be well documented.

***Question 3: Does the Forum accept that there will sometimes be valid reasons for a taxpayer excluding a particular entity from the APA, for example, when the entity is resident in a country that does not offer APAs?***

***Question 4: Should the taxpayer still put in place a coherent transfer pricing policy for all entities which reflects the transfer pricing policy in the APA?***

## 5. *Unilateral vs bilateral/multilateral*

26. The OECD Transfer Pricing Guidelines strongly recommend that "wherever possible, an APA should be concluded on a bilateral or multilateral basis." (Paragraph 4.163). A bilateral APA is based on a mutual agreement between the CAs of two tax administrations under the relevant tax treaty. A multilateral APA is an agreement between more than two CAs: in practice there will probably be a series of bilateral agreements between the CAs involved. In this section, the terms bilateral and multilateral are interchangeable and for the sake of brevity only the term bilateral is used hereafter.
27. Conversely, a unilateral APA is an agreement between one tax administration and one taxpayer resident in that tax administration's jurisdiction. The CA of the tax administration might or might not be involved. The unilateral APA will dictate the tax treatment of the taxpayer's transfer pricing. Compared to rulings, unilateral APAs always concern transfer pricing and involve a detailed consideration of the future transactions. Rulings can be concerned with tax issues other than transfer pricing.
28. Unilateral APAs have several characteristics which differentiate them from bilateral APAs. These characteristics make unilateral APAs more disadvantageous for taxpayers in many situations than bilateral APAs.
29. Unilateral APAs do not a priori result in the elimination of double taxation. They therefore provide less certainty than a bilateral APA. A risk exists of over-compliance with the arm's length principle. A taxpayer might feel compelled to accept this over-compliance to avoid an expensive audit. This over-compliance for one tax administration will lead to under-compliance in another tax administration and will therefore increase the risk of an audit being carried out by another tax administration. A unilateral APA also carries the risk that some profits might escape being taxed at all by any other tax administration.
30. Thus unilateral APAs do not provide all the certainty of a bilateral APA. A unilateral APA might provide certainty in one tax jurisdiction but increased uncertainty in other tax jurisdictions. A key advantage of a bilateral APA is the elimination of uncertainty over the elimination of double taxation but a unilateral APA leaves considerable doubt over double taxation.
31. A unilateral APA is, by definition, not available under a tax treaty. Therefore the availability of a unilateral APA is determined by a tax administration's domestic rules. It is entirely possible that a tax administration might decide that the disadvantages of unilateral APAs should preclude their availability. A reason for this would be the potential for unilateral APAs to lead to non arm's length taxation in other tax administrations.
32. If a tax administration did decide to make unilateral APAs available, the tax administration would have to have domestic rules in place to allow binding agreement over future treatment of the connected transactions.
33. In all APAs care needs to be taken that the methodology agreed will adhere to the arm's length standard. There will be a natural tendency for this to be the case when negotiations take place between tax administrations. However, this dynamic is different when a single tax administration negotiates with the taxpayer. There is no inherent reason to compel the parties

to agree the arm's length position just as either the tax administration or the taxpayer may feel that an audit has not resulted in the arm's length standard being applied. This guarantee that the arm's length standard has been applied only results from an agreement between CAs.

34. Without the inter-action between CAs, there is more of a possibility that a non arm's length allocation of profit could be agreed in a unilateral APA. For this reason, extra care should be taken that an agreed unilateral APA replicates the arm's length standard.
35. There may be, however, some characteristics of unilateral APAs which might be attractive to taxpayers and tax administrations. A unilateral APA might provide more certainty than no APA at all. Certainty of treatment will be enjoyed by the taxpayer and the one tax administration involved.
36. A second attraction of a unilateral APA might result from the potential for a faster APA process. This time and resource saving might arise from the fact that only one tax administration is involved in the evaluation and only one tax administration and the taxpayer need agree. Inevitably, time savings will arise from this. Tax administrations will not need to negotiate with each other because only one tax administration is involved.
37. However, if APA procedures are organised efficiently then the fact that two tax administrations need to inter-act need only add a marginal amount of time before the APA can be agreed. And it is likely that the extra time necessary in the negotiation between tax administrations will be only incremental to the time necessary to evaluate even a unilateral APA correctly, according to the arm's length principle. Allowing for the fact that a bilateral APA provides much more certainty than a unilateral APA, the extra time and resource necessary to conclude a bilateral APA compared to a unilateral APA will be well spent.
38. The taxpayer may decide, after having taken into account all the advantages and disadvantages of unilateral and bilateral APAs, that a unilateral APA is appropriate. This might be the case if, for instance, the other tax administration potentially involved did not enter into APAs. Or perhaps the extra resource necessary to conclude a bilateral APA was not merited in a particular case.
39. A tax administration cannot force a taxpayer to apply for a bilateral APA. However, a tax administration should take care to ascertain from the taxpayer the reasons for the request for a unilateral APA. The reasoning behind the decision to ask for a unilateral APA should be carefully examined. It might seem to the tax administration that the APA should be bilateral. The tax administration is entitled to come to this conclusion based on the facts of a particular case. One reason for this conclusion might be that a unilateral APA will not provide sufficient certainty for the tax administration. A unilateral APA, even if it avoids the necessity of conducting an audit, might still involve the tax administration in a subsequent MAP. It can be seen from this that unilateral APAs have fewer advantages compared to bilateral APAs for tax administrations as well as taxpayers.
40. Even though a tax administration cannot force a request for a bilateral APA, a tax administration can still turn down a request for a unilateral APA. This refusal might be appropriate if it seems to the tax administration that another tax administration should be involved in the APA. Tax administrations could consider whether they will only enter into APAs if the other tax administrations potentially involved also enter into the APA. But there

would be a legitimate reason for a unilateral APA where, for instance, the other tax administration did not have an APA programme.

41. When a tax administration receives a request for a unilateral APA, it should consider sharing the details of the request with another tax administration. This is good practice. This sharing of information should be done under the usual Exchange of Information Article of the Tax Treaty. With the "Code of Conduct (Business Taxation) – Transfer Pricing" dated 17<sup>th</sup> July 2002, Member States have committed themselves to exchange details of concluded unilateral APAs. Hence it is good practice to exchange details of the taxpayer's initial request for a unilateral APA and also of any agreed unilateral APA.
42. In order to ensure that these exchanges of information take place, it would be necessary for tax administrations to ensure that details of all APA requests as well APA agreements are known to the CA.
43. For tax administrations that organise their APA programme centrally, this will be easy to arrange. Even if the APA unit is separate from the CA it will be easy to share information. If there is no central organisation and taxpayers have to make APA request to local tax offices, then it will be necessary for tax administrations to have administrative arrangements whereby all APA requests are forwarded by local offices to the CA. In any case, this should always be the case for bilateral APAs because the CA should be involved as soon as possible. Even if the CA is not to be involved in a unilateral APA, information about the APA will still need to be exchanged by the CA.

***Question 5: Does the Forum accept that while unilateral APAs may have advantages in specific circumstances, they are not a tool for avoiding cross-border disputes?***

## ***6. Types of transactions to be included***

44. The taxpayer will be responsible for the initial consideration of the transactions which are appropriate for an APA. These will be transactions where there is the necessary amount of uncertainty over the application of the arm's length principle.
45. Taxpayers are free to choose which transactions they require an APA for. It is, however, possible that a tax administration will form different views. If necessary, any difference of opinion should be resolved as early as possible in the APA process and if possible at the pre-filing stage. The taxpayer always has the ability to withdraw from the APA application if unwelcome conditions are imposed. Therefore it makes little sense for tax administrations to arbitrarily include transactions in the APA – or indeed to arbitrarily impose other conditions – without the consent of the taxpayer. The cooperative nature of the process is one of the main advantages of an APA and taxpayers should have the opportunity to argue their case in an open and non-confrontational environment. This should ensure that any differences of opinion are resolved quickly.
46. There will often be a compelling logic for the APA to include all the transactions between connected parties. An APA featuring all of the transactions between the connected parties



will result in the maximum possible amount of certainty. This will equally apply to an APA between all relevant tax administrations which will also provide the maximum possible amount of certainty.

47. For example, a MNE group has affiliates in three countries all of which carry out R&D, manufacturing and distribution. All three buy and sell between themselves and distribute to third parties and other affiliates. An APA which agreed the methodology for all three functions involved between all three connected parties would provide 100% certainty of transfer pricing treatment. If the R&D transactions were very interrelated with the manufacturing, which might well be the case, for example, for high technology businesses, then an approach which included all transactions might be the only way of concluding an effective APA. This would tend to be the case if the industry was one where R&D activity was the primary generator of profit.
48. However, there will be occasions where this approach will not be the best approach for taxpayers. A taxpayer might take the view that the resources necessary to conclude an APA for all connected transactions will outweigh the benefits. In this case, it would be acceptable for only some transactions to be included.
49. For instance, to continue with the above example, if the R&D element was not closely interrelated with the manufacturing then it might be more appropriate for only one set of transactions to be included in the APA. This would be on the grounds that, for example, the manufacturing activity did not generate enough uncertainty over the application of the arm's length principle and the arm's length pricing of this activity was therefore relatively simple. Or perhaps the R&D activity was only incidental to the generation of profit and the distribution activity is seen as more important, in which case the R&D could be outside the APA. This will always depend on the facts of the particular case.
50. Taxpayers should not be excluded from the APA process because only some of their transactions are subject to uncertainty over the application of the arm's length principle. The APA process should be sufficiently flexible to accommodate the circumstances of all taxpayers.
51. To conclude the above example, the MNE group has more affiliates trading in other countries. These affiliates only distribute the goods produced by the R&D/Manufacturing companies. The distribution activity is relatively easily to price according to the arm's length standard – in this case because the distributors have no ownership of any important intangible property. Without significant uncertainty, it is an unnecessary use of resources to include the transactions of the R&D/manufacturing affiliates with these distribution companies in the APA. If, however, it would be easy to do this then it might be appropriate. This would depend on the methodology considered most appropriate by the taxpayer and tax administrations. Even if the transactions with the distribution companies were to be excluded from the APA it would be prudent for the taxpayer to adopt a pricing methodology for those transactions using inter-company agreements which reflected those in the APA.

***Question 6: Does the Forum agree that the taxpayer should not be compelled to include all connected transactions in an APA?***

## **7. Complexity thresholds**

### *7.1. Why do some APA programmes have complexity thresholds?*

52. APAs are expensive in terms of resource commitment for taxpayers and tax administrations. This will remain true whatever best practices are put in place. APAs should however require fewer resources than an audit (this will apply even more so when compared to an audit and MAP). Nevertheless both taxpayers and tax administrations have to choose carefully where resources will be best utilised.
53. Taxpayers in particular will, as part of their transfer pricing risk management, assess the benefits of an APA against the costs of obtaining one. Equally, tax administrations will have in mind the costs of an APA. Tax administrations and taxpayers in particular will be unlikely to want to enter into an APA in cases where the tax at risk would have made an audit unlikely.
54. In general, because of the high costs of an APA (whatever the ultimate cost saving) they are only suitable in cases where the benefit is commensurate with or exceeds these costs. The benefits are most clear where there is significant tax at risk or where the complexity of the transactions creates considerable uncertainty.
55. For both parties, where there is insufficient uncertainty over transfer pricing, then an APA is unlikely to be appropriate. This is because one of the main benefits of an APA is the provision of certainty by an agreement between taxpayer and tax administration. Where there is relative certainty already, then there is little benefit to gain in the quest for agreement.
56. APAs will always be optional for taxpayers but there may be circumstances where a tax administration, in receipt of an application for an APA, would be compelled to conduct an APA procedure in the face of scarce resources or patent unsuitability from its point of view, i.e. the costs to the tax administration far outweigh the expected benefits. It is possible that this compulsion could arise from the need to treat all taxpayers the same. Or perhaps a taxpayer requires an APA because it knows a competitor has negotiated one. It seems wrong if tax administrations, by extending the benefits of an APA programme to taxpayers, are therefore penalised in certain circumstances.
57. For all these reasons, some tax administrations have complexity thresholds which must be passed by taxpayers before an APA procedure will be commenced. These have the advantage for tax administrations of allowing them to assess the benefits of an APA compared to the costs necessary to evaluate and negotiate the APA. For taxpayers, published guidelines on complexity thresholds will allow an informed decision to be made on whether to apply for an APA. In addition, discussion of complexity thresholds at the recommended pre-filing stage will prevent resources being wasted on an abortive application.

### *7.2. What could complexity thresholds consist of?*

58. Complexity is almost always subjective and is by nature difficult to define. This does not mean that complexity thresholds should vary between taxpayers or should be applied

inequitably or inconsistently. But tax administrations will invariably have to consider each case on its own merits and this will make it difficult to develop hard and fast rules. Taxpayers themselves will often have a good idea of whether there is the uncertainty sufficient to require an APA and it will rarely be worth their while to request one where this uncertainty does not exist.

59. Tax administrations should view any complexity thresholds as a tool for including cases in the APA programme where the benefits (for both taxpayer and tax administration) are commensurate with the resources (from both taxpayer and tax administration) necessary to obtain an APA.
60. The level of a complexity threshold used by a tax administration could vary in operation from excluding cases where there is only mild uncertainty to including cases only where there is significant doubt. But it is important that, where there is a complexity threshold, it is operated consistently for all taxpayers. This applies all the more so when the threshold is subjective.
61. It is good practice that tax administrations take into account the likely attitude of other tax administrations which might also have a stake in the application of the arm's length principle. This is because doubts over the elimination of double tax will also create uncertainty as well as arise from uncertainty. For instance, one tax administration might well be unconcerned over the appropriate methodology to be used but might know that another tax administration will have radically different views. This might well create sufficient uncertainty to make an APA appropriate. It might be prudent for CAs to consult on occasions where their views would otherwise be unclear.
62. It is perfectly possible that a taxpayer might require an APA for only a certain type of transaction and does not consider an APA necessary for all the other transactions undertaken where there is no complexity. In this case, the complexity of the transaction for which the APA is requested should be considered and the simplicity of the other transactions should not be a factor in a tax administration's decision to allow an APA to proceed. It is likely that an APA will be more appropriate in an area of key economic activity for the taxpayer.

<p><b><i>Question 7: Does the Forum accept that complexity thresholds can be appropriate in an APA procedure?</i></b></p>
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7.3. *Volume of transactions does not automatically generate uncertainty*

63. On a prudent risk assessment basis in a mature economy, only cases where there is significant amount of tax significantly at risk should be audited. Significant tax is not at risk merely because controlled transactions exist.
64. A large volume of transactions between connected persons does not in itself result in uncertainty over the application of the arm's length principle.
65. For example, consider a distribution company which purchases from a connected supplier and uses only certain basic intangibles. It is likely to be the case that a Transactional Net

Margin Method (TNMM) using comparables will result in the arm's length principle being applied. This will be the case whatever the volume of transactions entered into, providing comparables can be found. A tax administration might decide that, with no real uncertainty, the case is not appropriate for an APA. Another factor in this consideration would be the probable attitude of the tax administration of the country where the connected supplier is resident. Assuming no new facts came to light, this second tax administration could be considered unlikely to take a different view over the application of this TNMM methodology.

66. The only doubt will be over the precise arm's length price of the goods. But consideration of what this price will be in the future is not proper to an APA. An APA must be concerned with choosing the appropriate methodology which will then determine the arm's length price. Any attempt to set the actual arm's length price before events take place in the future will be mere prediction and as such is not proper to an APA.
67. There are occasions where the high volume of transactions is in itself a significant risk factor for taxpayer and tax administration. The high volume of transactions might add complexity where, with fewer transactions, little complexity would be present. This will depend on the facts of the case. But a high volume of transactions between connected persons does not automatically in itself result in complexity and uncertainty over the application of the arm's length principle.
68. There are occasions where the reverse will be true. A transaction might be very complex and give rise to considerable doubt over the application of the arm's length principle. But the volumes transacted might be very small. In this case an APA would probably still not be appropriate. Since it is made clear in the OECD Guidelines that where transactions are small in volume an audit is likely to be inappropriate, an audit would also be unlikely. This factor would act as a disincentive for a taxpayer to apply for an APA in the first place.
69. In circumstances where a comparable uncontrolled price exists, a taxpayer would be unlikely to conclude that an APA is necessary. However, it is equally true that a taxpayer might want the comfort of knowing that the comparable uncontrolled price available would be acceptable to a tax administration in the future.

***Question 8: Does the Forum agree that the volume of connected transactions is not an infallible guide to transfer pricing risk?***

#### **8. Critical assumptions**

70. In any APA, critical assumptions regarding future events must be made. This is to prevent the APA being reliant on uncertain, unreliable prediction. If these critical assumptions no longer apply, then the APA must be reconsidered in some way if it is to still determine how the arm's length principle will apply.
71. Critical assumptions should therefore exist to make prediction of the future events that will be included in the APA more reliable.

72. For example, an APA is required for transactions between two affiliates which carry out R&D, manufacture goods resulting from this R&D and distribute these goods to third parties and each other. The R&D intangibles created are shared. Providing these activities remained constant throughout the period of the APA, then a particular methodology could be agreed. The continued provision of these functions would be critical assumptions for the APA. The methodology might be to give a routine reward using a gross margin method for the functions of manufacturing and distribution but a profit split for the R&D functions. Alternatively, if the R&D was seen as more low level, then a cost plus net margin might be appropriate. This would depend on the facts of the case.
73. A requirement that these functions were to remain the same would need to be featured as a critical assumption. If, for instance, one entity was to stop performing R&D then the profit split methodology would no longer be appropriate because the transactions were no longer so interrelated. In this case the APA would need to be reconsidered.
74. Ideally taxpayers and tax administrations should allow an opportunity to reconsider an APA should a critical assumption fail and not cancel the APA outright. This is to attempt to safeguard the resources used to negotiate the APA in the first place. If the APA is cancelled without further negotiation then these resources are wasted. Of course, it may not be possible to continue with the APA, in which case a new APA could be negotiated for the future. However, it might be possible to modify the existing APA to maintain its relevance into the future.
75. For instance, to continue with the above example, tax administrations might take the view that the methodology already agreed would continue to allocate the arm's length reward between the affiliates. Only now all the residual from the profit split would be allocated to the sole entity which continued to carry out R&D. It is likely that this methodology would not have been chosen in the first place had only one entity performed R&D but the parties might take the view, depending on the facts of the case, that it remains appropriate for the term of the APA. Tax administration and taxpayer would keep in mind the resources already utilised to reach the agreement.
76. To consider further the nature of a critical assumption, consider two manufacturing affiliates. Both affiliates manufacture goods and distribute them to third parties and each other, using one brand. The value of the goods arises from the quality of the goods as well as advertising and marketing. On examining the facts of the case, taxpayers and tax administrations accept that it is the manufacturing activity that generates the main economic profit. This is made a critical assumption. The exploitation of the brand is incidental to this and arises from the manufactured quality of the goods. An APA is agreed with a transfer pricing methodology which reflects this reality.
77. If, during the term of the APA, one affiliate ceased to manufacture then it might not be necessary to terminate the APA since the critical assumption would still remain true. Further consideration might need to be given to how affiliate which now only distributed was to be rewarded but, if the reward for this activity had been agreed in the original APA further work might not be required.

***Question 9: Does the Forum think that it is a good idea that where a critical assumption is not met, then the taxpayer and tax administration should have the opportunity to discuss how the APA could continue and not be cancelled automatically?***

**9. Retrospection/roll-back**

78. Rollback or retrospection is the element of an APA which is carried back into the period prior to the APA to agree the tax treatment of transactions which have already taken place. The agreement in an APA can be applied retrospectively to prior periods for which tax returns have already been made.
79. Rollback may therefore reflect an agreement to change tax returns previously made on a different basis to that in the APA. Or the rollback might be an agreement to accept tax returns for previous periods already made on the basis outlined in the APA application. Or the rollback may be an agreement to accept the APA methodology for the period between the application being made and the agreement.
80. A taxpayer and tax administration might agree to use the methodology in the APA to conclude a transfer pricing audit which is being carried out into earlier periods. The use of rollback can therefore also resolve a transfer pricing audit.
81. There is no doubt that rollback adds to the complexity of an APA. Discussions concerning roll back can often be time consuming. A request for the APA methodology to be applied to previous periods, where transactions have already taken place, does require a tax administration to satisfy itself that by doing this the arm's length principle has been correctly applied.
82. This will require an examination of the facts which existed at the time and the provision of documentation from this period. The tax administration may wish to be sure that the critical assumptions in the APA were also true for this prior period.
83. Any situation involving rollback will be made more complex where rollback affects taxpayers in more than one country. This will often be the case for bilateral or multilateral APAs. Rollback in an APA might require previous tax periods to be reconsidered and this might not be possible in all the countries involved in the APA. This could hinder the negotiations between CAs.
84. So, negotiation about rollback may often extend the time necessary to agree an APA. Taking excessive amounts of time to conclude an APA negotiation is frequently seen as a major disadvantage of APAs and this disadvantage acts a major disincentive for taxpayers when they consider requesting an APA.
85. This is one reason why some tax administrations might exclude all rollback considerations from an APA. The ability to keep the negotiations as simple as possible will result in APAs being concluded more quickly.

86. However, the possibility that an APA can also agree tax treatment for previous years is a major advantage. The advantage may be even greater if the transfer pricing issues in the APA are being audited in previous years. There is significant advantage if an APA can be used to resolve existing enquiries. Taxpayer and tax administration will both receive this advantage. Even if no audit has been started into the previous period, the tax administration is relieved of the task of having to make a full risk assessment and possibly conduct the audit. The taxpayer is relieved of the task of responding to the audit.
87. It is desirable to find a balance between the possibility that negotiations over rollback will require more resources from taxpayer and tax administration by extending the time taken to conclude the APA and the probability that agreeing the tax treatment of years prior to the APA will represent a considerable advantage for all parties.
88. One prerequisite for the inclusion of rollback in an APA could be that the trading conditions between the taxpayers have remained essentially the same for the period of the rollback and are expected to remain the same for the prospective period of the APA. At the very least, it would probably be necessary for critical assumptions to remain the same for the whole period. But it might be possible to have different critical assumptions in each period. This might depend on the methodology chosen to produce the arm's length price.
89. To some extent, the more different the trading relationship between the taxpayers in the rollback period compared to the prospective period, the less suitable it will be to include rollback in the APA. To do so would certainly lengthen the time necessary to conclude the APA because the rollback period would have to be examined more carefully. Where the trading relationship did not change, the more suitable and easier to negotiate the rollback will become.
90. Taxpayers should, wherever possible, provide at the pre-filing meeting a full explanation of their position on rollback. The tax administration should give an indication of whether the rollback will be acceptable in principle as soon as possible after this. If no rollback will be acceptable the taxpayer should be told as soon as possible. This will allow the taxpayer to decide if the APA is still desirable.
91. An APA should mainly be concerned with the future. An APA which is more concerned with the past is to be avoided wherever possible. It is likely that such an APA would more closely resemble an audit. Rollback should always be an incidental part of any APA and should not dominate any negotiations.

***Question 10: Does the Forum agree that there will be advantages to allowing retrospection/rollback in an APA?***

### ***10. APAs for SMEs***

92. Given the resource constraints on SMEs caused by their small size, merely allowing SMEs to access the APA programme in a Member State may not encourage them to apply for APAs.

93. SMEs may be unintentionally excluded from the APA programme because:
- a) The demands of an APA for information, documentation and company time may be too high for an SME; and
  - b) The fees charged by professional advisors may be too high measured against available financial resources and expected benefit.
94. This could amount to de-facto discrimination against SMEs. Member States should therefore consider whether special APA rules are needed for SMEs to encourage more APA applications. These special rules could amount only to a modification of the usual APA process or a wholly separate process tailored to the circumstances of SMEs. This different treatment may be necessary to ensure that SMEs are allowed the same possibilities as larger MNEs.
95. When special rules are considered, they should address those areas where SMEs are in effect put to extra expense because of a lack of internal resource.
96. Traditionally, from the point of view of the tax administration, there is less tax at risk in a SME. Certain procedures or rules can be relaxed or adopted to reflect this.
97. Member States might also like to consider whether even a MNE can access a simplified or modified APA process if the proposed transactions to be covered in an APA are not complex or limited in amount. This would need to be considered in conjunction with any rule on complexity thresholds.

#### *10.1. Possible Suggestions for a best practice APA for SMEs*

98. Applications could be accepted with a functional analysis but without any transfer pricing methodology analysis or even no preferred transfer pricing method. This will be the area where most SMEs lack expertise and hence have to purchase it and incur a high monetary or else develop expertise at a high resource cost. Hence the tax administration can apply its resources and expertise to choose the best methodology to produce the arm's length price.
99. If a fee is to be charged, it should be less than the usual fee. The fee should perhaps compensate the tax administration for any extra work it had to carry out but be less than it would cost the SME to pay outside advisors for the work.
100. Any complexity threshold should be reduced or, within specific circumstances, removed.
101. All questions relating to the pricing of intangible property could be excluded from the scope of an APA for SMEs.
102. All questions relating to the pricing of non routine services and complex financial instruments could also be excluded from the scope of an APA for SMEs. Depending on the type of business, it might further streamline the process if all connected transactions were included in the APA.



103. Given the relative lack of tax risk, the tax administration could adapt its due diligence accordingly. For instance, actual site visits might not be necessary and the taxpayer's own functional analysis could be accepted without exhaustive scrutiny. This would of course be subject to future discoveries arising from none transfer pricing related audits.
104. Any reporting requirements throughout the APA could be limited to an annual statement from the taxpayer that all of the critical assumptions in the APA had been adhered to and that the APA was still relevant.
105. Again to aid simplicity and to remove the possibility of roll back leading to unresolved double taxation, rollback considerations could be excluded from APAs for SMEs.
106. It is possible that APAs for SMEs could be unilateral only, with the proviso that the prospective Treaty partner is informed of the APA application and its outcome.

***Question 11: Does the Forum think that a modified APA procedure should exist for SMEs?***

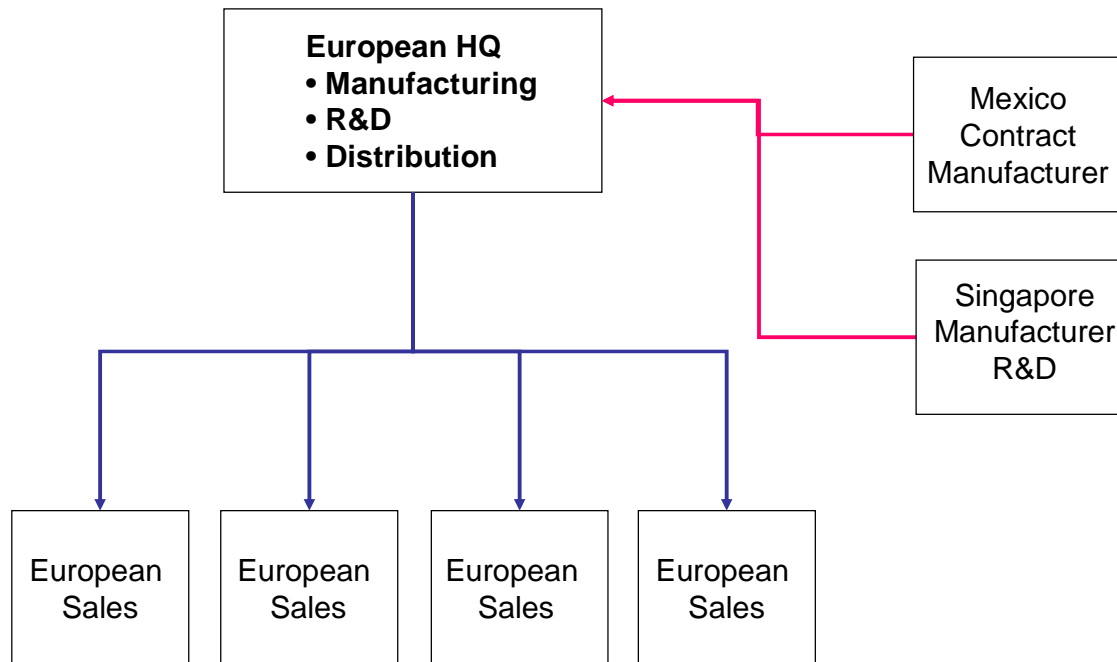
***Question 12: Should a MNE be able to gain access to a modified APA procedure under some circumstances?***

***Question 13: Do Forum Members think that this paper sufficiently covers the issues to be addressed or are there any other issues the Forum wishes to discuss?***

**Appendix A: Example illustrating an APA application**

## Group Structure – Flows of Product

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1. A MNE group has its parent company (EHQ) in one Member State. This company performs the functions of manufacturing and R&D. The manufactured product and products purchased from manufacturing affiliates in Singapore and Mexico are distributed to four European operating affiliates who sell to third parties.
2. The Mexican affiliate does not possess and valuable intangible assets of its own. Any intangibles used or developed through manufacturing processes belong to EHQ.
3. The Singapore affiliate does possess valuable intangibles and utilises these in its manufacturing. It also carries out some R&D to develop intangible assets. The Singapore affiliate also sells to third parties in the Far East. Only product manufactured in Singapore is distributed to these third parties. Due to technological differences product manufactured by EHQ is only sold in Europe.
4. The various activities of EHQ involve different functions and carry different risk. Due to supply-chain delays, EHQ needs to hold significant volumes of stock from Mexico and Singapore. EHQ has to guarantee to purchase significant and regular amounts of stock from the manufacturer in Mexico. Hence the Mexico affiliate functions as a contract manufacturer. Conversely, the Singapore affiliate is a more complex operation than the one in Mexico and

the relationship between the Singapore affiliate and EHQ is more similar to that of fully fledged manufacturer and customer.

5. The taxpayer therefore has to consider the transfer pricing for these transactions:
  - a) EHQ purchasing from the Singapore and Mexico affiliates;
  - b) EHQ selling to the European operating companies;
  - c) The reward for EHQ manufacturing and R&D;
  - d) The reward for the Mexico affiliate – contract manufacturing; and
  - e) The reward for the Singapore affiliate – manufacturing and R&D.
6. Over-all, the inter-play of the connected transactions seems complex. Looked at as a series of transactions in separate areas, this might not be the case. But the inter-action between the affiliates takes place across a range of different functions. The MNE group has to manage a large transfer pricing risk and is subject to considerable uncertainty. It is highly likely that entities will be audited.
7. An APA will help manage this risk and provide certainty. The group has connected transactions in areas administered by seven tax administrations. The group decides that a series of APAs to cover all the entities in all of the jurisdictions will be too time consuming and resource intensive. So, the MNE group considers which transactions could be excluded from the APA.
8. The Mexican affiliate manufactures under contract and carries little risk. The transfer pricing scenario between the Mexican affiliate and EHQ is not complex. The group is confident that a cost plus net margin methodology will replicate the arm's length standard. Even if an audit was to happen in Mexico, there is not sufficient uncertainty about the size of the cost plus net margin to warrant an APA. So, the transactions between the Mexican affiliate and EHQ are excluded from the APA.
9. The question of an arm's length return for the four European operating companies is also not inherently complex. The operating companies sell to third parties and purchase all products from EHQ. The MNE group decides that a resale minus methodology will replicate the arm's length standard. There is the question of the size of the margin that would be enjoyed at arm's length. This is a usual transfer pricing problem which can lead to uncertainty but is not capable of resolution in an APA. The APA, if it is to avoid becoming mere prediction, cannot set the actual, future arm's length return but can only agree a way of calculating this return.
10. However, the four European operating companies source all of their purchases from the EHQ. Therefore, the question of the reward for the operating companies is connected with the complex activities of the EHQ. In the hands of EHQ, the goods come from three sources: manufactured in house, purchased from the affiliate in Mexico or purchased from the affiliate in Singapore. Those goods manufactured in house also involve the inter-play between the R&D and manufacturing activity.

11. It will be necessary for the MNE group to consider EHQ's arm's length reward for the distribution of goods purchased from the affiliates in Mexico and Singapore, the manufacturing of goods within EHQ and the R&D reward. The R&D reward will involve considering the value of the created intangible assets. Hence, the arm's length reward for EHQ is a complex matter and is subject to considerable uncertainty. The MNE group decides that the time and expense necessary to conclude an APA between the tax administration of EHQ and tax administrations of the operating companies is warranted.
12. The Singapore affiliate develops and retains the ownership of valuable intangible assets which it then uses in a manufacturing process. This is a complex matter which generates considerable uncertainty for the MNE group. The arm's length reward for the Singapore affiliate also has an affect on the reward for EHQ since EHQ purchases from the Singapore affiliate. The transactions between the Singapore affiliate and EHQ are also included in the APA application.
13. Therefore, following this line of reasoning, the group decides to request APAs between:
  - a) The Singapore tax administration and the EHQ tax administration (for the transactions between the Singapore affiliate and EHQ); and
  - b) The EHQ tax administration and the four tax administrations of the European operating companies (for the transactions between EHQ and the operating companies);
14. These different APAs are a series of bilateral APAs between the tax administrations involved.
15. However, the MNE group puts in a place a coherent transfer pricing policy between all of the affiliates whether or not the affiliates will be included in an APA. This transfer pricing policy could be:
  - a) A cost plus gross margin method for the Singapore affiliate selling to EHQ. The margin achieved when the Singapore affiliate sells to the third parties in the Far East is used a starting point.
  - b) A resale minus methodology for the European operating companies. The margin is based on the margins enjoyed by comparable companies operating in the European market.
  - c) A cost plus net margin for the Mexican affiliate which consists of a small mark-up on all costs.
  - d) A resale minus methodology for EHQ when it distributes goods purchased from the Singapore affiliate (there is a cross-check with the gross margin method used by the Singapore affiliate).
  - e) A resale minus methodology for EHQ when it distributes goods purchased from the Mexican affiliate (the size of the margin will be different from that in the resale minus methodology used for the Singapore affiliate because of the different ownership of intangible assets).

- f) A cost plus gross margin for EHQ when it manufactures goods for sale to the European operating companies. This will encompass the reward for the R&D.
16. The MNE group also ensures that legally binding agreements exist between the appropriate parties. These will include distribution agreements between the European operating companies and EHQ, a manufacturing agreement between EHQ and the Mexico affiliate (which also agrees the treatment of any intangible assets used or created) and purchase and supply agreements between EHQ and the Singapore affiliate.
17. The MNE group believes that all these methodologies and legal agreements will result in the arm's length reward. Through the APA process, the MNE group will be able to obtain certainty of treatment in those areas included in APAs.
18. Pre-filing meetings with various tax administrations indicate that APA applications will be looked on favourably. However, the tax administrations for two of the European operating companies conclude that, from their point of view, there is not sufficient uncertainty. Therefore, there will not be APAs between the tax administrations of those countries and the tax administration of EHQ. But, to safeguard against any future audit, the MNE group keeps in place the transfer pricing policy chosen and all documentation and evidence already gathered.
19. The APA applications to the various tax administrations include:
- a) Copies of all of the legal agreements;
  - b) A full explanation of why the methodologies have been chosen;
  - c) For each methodology, a set of search criteria for a commercial database that will be used to create the arm's length range of results;
  - d) For each methodology, a rationale for where in the arm's length range the results of the tested party should be;
  - e) A rationale for the Singapore affiliate retaining the ownership of intangible assets;
  - f) A rationale for the Mexico affiliate not owning any intangible assets;
  - g) A functional analysis for all affiliates; and
  - h) Evidence that the chosen methodologies and rationales replicate the arm's length principle.
20. When the various APAs are concluded, the MNE group will be able to enjoy certainty of treatment of a very substantial part of its transfer pricing risk. The tax administrations involved in the APAs will also enjoy this benefit. Those tax administrations not involved can still consider an audit. Even if the MNE group is faced by an audit, the transfer pricing policy in place and concluded APAs will form a defence against any proposed transfer pricing adjustments.