The challenges of applying the 2017 OECD guidelines to pre-2017 years

Jari Ahonen and Juan Ignacio de Molina discuss global examples and assess the practical impact of retroactively applying the OECD Transfer Pricing Guidelines.

The OECD Transfer Pricing Guidelines (the guidelines) have evolved significantly in recent years since the publication of the final BEPS report in 2015. A question arises as to which version of the guidelines should be, and can be, applied to interpret the arm's-length principle for a given tax year. In a transfer pricing (TP) audit context, this question involves whether the tax authorities have the right to apply the most recent version of the guidelines retroactively to the detriment of a taxpayer.

This article explores the temporal dimension of the application of the guidelines and discusses certain international case law on the matter.

OECD Guidelines as a source of interpretation

The guidelines provide guidance on the application of the "arm's-length principle" set forth in Article 9 (associated enterprises) of the OECD Model Tax Convention. Thus, the same interpretive principles that guide treaty interpretation also play an important role with respect to the guidelines.

In tax treaty law, there has long been debate on the relevance of changes to OECD commentaries for purposes of interpreting previously concluded tax treaties. In this respect, the main alternatives are a 'static approach' where the tax treaty is interpreted in accordance with the OECD commentaries that existed when the treaty was concluded and an 'ambulatory approach', where the subsequently adopted commentaries (if any) are accepted as the source of interpretation.

With respect to which version of the guidelines should be applied, there are different answers in different countries. Many countries, such as the Netherlands, apply a continuous or ambulatory interpretation and thus refer to the most recent version of the guidelines for all open tax years.

Other countries have a specific rule on the matter. For example, in the UK, HMRC tends to view the 2017 guidelines as a clarification and improvement of the existing guidelines, rather than a new set of rules *per se*. Although the new version is not formally a precedent for interpreting UK TP rules in an earlier period, in practice HMRC audit teams often apply the revised guidelines in tax audits.

In many countries, there are no specific rules regarding the application and these countries typically emphasise the question, to what extent do the revised guidelines merely clarify the existing guidance and to what extent they comprise fundamentally new guidance or change to previous guidance.

Examples of international case law

United States

Retroactive application of OECD commentaries was discussed in US Tax Court case *Taisei Fire and Marine Insurance Co. Ltd. vs. Commissioner* (May 2 1995). In its decision, the court pointed out that it would normally have reservations about interpreting a convention, ratified in 1971, on the basis of a commentary, adopted in 1977, that contradicts the literal language of the commentary in effect at the time of ratification.

However, in light of the extensive analysis by various commentators and the confirmation of such analysis by the court's own research, the court concluded that the criteria in the later commentary reflected the original intent of the commentaries available at the time that the tax treaty was ratified. Based on this, the revision was considered a mere 'clarification' and the approach taken followed the later commentary.

Finland

In Finland, on the other hand, there is a recent Supreme Administrative Court level decision (KHO 2018:173) where the court ruled that the tax authorities should apply in tax audits the version of the guidelines that was available at the time of filing the corporate income tax returns for the year(s) in question.

In the case, the taxpayer had applied traditional transactional methods – such as the comparable uncontrolled price method (CUP method), the cost plus method (CPM) and the resale price method (RPM) – to price its intra-group transactions. The tax authority concluded in a TP audit that since the group's activities were highly integrated and the key value driver of the business was technology that was owned by a Finnish entity, the residual profit split method was the correct approach to set arm's-length prices and imposed TP adjustments accordingly. The court rejected this argument and decided that since it was possible to test the arm's-length profit of the entity with the methods that the taxpayer had actually chosen and applied (and that were primary methods in the 1995 version of the guidelines), there were no legal grounds to reassess the entity's taxable income.

Following the KHO 2018:173 decision, the Finnish tax authority released an official statement where it pointed out that the case should be understood to limit the retroactive application of the 2010 OECD guidelines only in terms of method selection that could be considered as fundamental new guidance. The authority pointed out that in an earlier decision (KHO 2013:36), the court had found it possible to apply the newly introduced Chapter 9 in the 2010 version of the guidelines in a location savings case concerning tax years 2004 and 2005. This was because Chapter 9 was not considered as fundamentally new guidance to the principles included in Chapter 1 existing at the time. Based on this, the tax authority concluded that it would also continue to apply the new versions of the guidelines in future cases where the revision can be considered as a mere clarification.

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Practical impact of the main changes to the OECD Guidelines

The previous section of the article explained how a tax authority, depending on its country, may apply either a static or an ambulatory approach in the use of the different versions of the guidelines. As mentioned above, in many countries the

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key question is whether the new guidance should be understood as mere clarification to the previous guidelines or a fundamental change or as a completely new guidance.

The following section briefly summarises how the main BEPS changes could impact pre-2017 audits from this perspective.

Accurate delineation of the transaction and risk

BEPS made changes to Chapter 1 of the guidelines, involving a significantly more granular functional and risk analysis. From a practical standpoint, taxpayers will have to accurately delineate a transaction by following a five-step process.

In addition, the new guidance provides a six-step process to evaluate and potentially adjust the contractually agreed risk-return allocation between the parties. Both processes provide tax administrations with tools to delineate transactions and risks. The effect on multinational enterprises (MNEs) engaged in activities that allocate routine profits relying on transactional net margin method (TNMM)/CPM, is that they may find that these new rules allocate non-routine returns to those entities.

For pre-2017 years, taxpayers will not have to follow the specific 2017 process to delineate the transaction and/or risk. However, they will most likely have to demonstrate that each entity has the financial capacity to assume and control each specific risk.

Location-specific advantages

Location-specific advantages (LSAs) are market features that provide enhanced financial performance relative to alternative locations, resulting from cost savings or other local market features (for example, product preferences and purchasing power).

LSAs are not defined as an intangible but a factor affecting comparability. In a way, LSAs can be deemed to be an extension of the location savings concept codified in business restructuring Chapter 9 in 2010. However, even the 2017 version of the guidelines does not provide detailed guidance on how to split the savings among jurisdictions, which will leave it up to MNEs and tax authorities to determine such allocation.

Passive association

Passive association and implicit support can be defined as the effect, within a financial transaction, derived by an entity solely from its affiliation with a broader group. This concept has already been discussed in various court cases but only after 2017 was it clearly recognised in the guidelines. From a practical standpoint, the introduction of the passive association concept has resulted in a need for MNEs, to determine, in a nutshell, the borrower's stand-alone rating and determine the gap with the parents rating and, thereafter, quantify the extent to which the rating gap should be reduced through adjustments.

The guidance on passive association and implicit support approaches was further extended in the 2020 Transfer Pricing Guidance on Financial Transactions that also includes, for the first time, technical guidance for evaluating credit ratings of group entities. Applying the newly codified concepts to pre-2017 and pre-2020 periods could be problematic, to the extent that the guidance is considered to be fundamentally new, rather than a clarification of existing concepts.

Intangibles

The most significant change within the guidelines concerns intangibles, to ensure that pricing of intra-group transactions is aligned with value creation. For this purpose, the 2017 guidelines introduce the emphasis on the return for the DEMPE functions (development, enhancement, maintenance, protection and exploitation). This should prevent the use of 'cash boxes' to obtain residual returns.

The new guidance directs the valuation of intangibles to the profit split method and the use of discounted cash-flow techniques. Both the DEMPE analysis and the method preference are new concepts. It may be problematic if tax administrations apply these concepts to test documentation of TP outcomes in pre-2017 years.

When dealing with hard to value intangibles (HTVI), the new guidelines encourage MNEs to include price adjustments or other contingent pricing mechanisms when there is high uncertainty in the value of an intangible. This will for sure be an area of conflict if tax authorities apply these criteria to pre-2017 audits.

Low value-adding services

This is probably the only BEPS report intended to facilitate and simplify TP policies and documentation requirements. However, the adoption of this guidance by tax authorities is still in process in many countries long after 2017. Nevertheless, taxpayers should be allowed to refer to the low value-adding services related guidance in evaluating and documenting the arm's-length nature of service transactions also for pre-2017 periods.

Profit split

The 2018 paper on profit splits is a clear drive towards intended increased use of the method. Tax authorities had applied the guidelines and recommendations on the use of the profit split in pre-2017 audits. The use of the profit split method has as such become more acceptable and common after the 2010 guidelines due to the abolition of hierarchy of methods, including the preference for traditional transaction-based methods over transactional profit methods.

However, application of the new BEPS profit split guidance to pre-2017 periods may be problematic especially in cases where the application is justified through the shared assumption of risk. After all, that concept was introduced in the 2018 profit split paper as the third condition for applying the method, along with the already existing 'unique and valuable contributions" and 'highly integrated operations'.

Conclusion

The application of new TP guidelines to older periods has frequently been an issue of controversy. As indicated above, to date, international case law in the area is scarce, although the topic is complex and widely debated. If we analyse the numerous changes introduced by BEPS within the TP guidelines, the possibility of applying these new guidelines to pre-2017 audits will certainly increase to some extent and MNEs should be prepared to defend their pre-2017 TP policy and documentation.

However, retroactive application of the new guidelines should always be based on detailed analysis of the actual facts and circumstances. Any use of the 2017 guidelines in pre-2017 audits to the detriment of taxpayers will likely be challenged and there will be a need for effective dispute resolution mechanisms. Competent authorities will have to resolve disputes through MAP and arbitration even if they have different approaches to the use of the guidelines.