Editorial

On a Slippery Slope

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Something out of the ordinary has happened. The OECD, which normally deals only in finished products, has submitted for public discussion a draft of the first part of its new guidelines on international transfer pricing, dealing with principles and methods, although it has already been the subject of numerous hearings and statements by the international business community, and although the second part, dealing with the applications and necessary to evaluate the first, has yet to appear.

It is an open secret that this procedure on the part of the OECD gave way to American pressure. The USA was in a hurry because it wanted to obtain the blessing of the OECD for its own highly problematical regulations on transfer pricing, which were being revised at the same time as the OECD was conducting its deliberations. Thus we already hear from official American sources that the new American regulations have been endorsed by the OECD, and that the latter's guidelines were in line with the regulations of the US. Although this is a considerable exaggeration, if it is the American interpretation of the position, it means that application of the US guidelines would still make it necessary to observe the restrictions established by the OECD guidelines against undue administrative interventions in transfer pricing.

One of the most important bones of contention in the new OECD guidelines is the question whether external profit comparisons and profit splits elevated by the Americans to the status of a method form part of the internationally recognized methods under the arm's length standard. The international tax treaties base these methods on the transactions and the prices agreed for them. Those prices must correspond to the prices which would have been agreed between unrelated third parties for comparable transactions. External profit comparisons as a basis for pricing do not take place between unrelated third parties, any more than do splits of a non-existent joint overall profit. An external profit comparison, then, is not a method under the arm's length standard but merely an internal administrative checking tool for obtaining one hint or the other about the need for further examination. For such an examination, however, the taxpayer cannot be burdened with any obligations regarding either documentation or proof. Nor is a split of the overall profit from a transaction between affiliated companies a method under the arm's length standard: at best, in special exceptional cases and in the absence of other indications, it may be referred to in order to establish an estimate of a transfer price.

Instead of standing by valuations which have always been accepted in the past, the OECD is now declaring these profit approaches to be methods under the arm's length standard, though admittedly with a great many ifs and buts. This is as erroneous as it is dangerous. In taking this approach, the OECD is opening the way to an extremely threatening problematization of international fiscal and economic relations, something which, despite all the changes so far made, is foreshadowed in the American regulations and the rigid sanctions accompanying them. Because the OECD is aware of these dangers, it is endeavoring to minimize the damage with many explanations, distinctions and restrictions. This must be acknowledged. But the dam is breached. We are on a slippery slope, and we will only be able to arrest the slide if a sense of proportion and judgment are preserved, the taxpayer is not left defenseless by exaggerated regulations relating to documentation, evidence and penalties, and the states show international mutual respect. It is now up to the USA to live up to these expectations. Despite its regulations, which impose unacceptable constraints on the taxpayer even when generally accepted methods under the arm's length standard are selected.

Just how seriously the OECD views concerns about wrong turnings in international tax law is demonstrated by its declared intention of having regular reviews of the subsequent course of events, with particular emphasis on the application of so-called 'profit methods'.

The international economic community will have to insist that international tax conventions are not available for retrospective reinterpretation, and that safeguarding international cooperation against arbitrary governmental action is in the states' own interests. The OECD is expected to stay in line with the law.