Transfer Pricing Policy: Should the Relief Mechanism Dealing with Corresponding Adjustments Be Reconsidered under Tax Treaties?

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Corresponding adjustments and the MAP process
When the price charged for goods or services sold between related parties is not in accordance with the arm's length principle, Article 9(1) of the OECD Model authorizes the tax authorities of a State to make primary adjustments to the transfer price. This may trigger economic double taxation as the same income may have already been subject to taxation in the hands of the related party in the other State. In order to mitigate economic double taxation, Article 9(2) enables the other State to carry out a corresponding adjustment so that the allocation of profits between the two jurisdictions is consistent. Therefore, effective operation of the corresponding adjustment provision is important for eliminating economic double taxation in the case of a transfer pricing adjustment.

However, neither the OECD Model nor the OECD Commentary or the OECD Transfer Pricing Guidelines (TPG) specify any methodology for carrying out corresponding adjustments. Article 9(2) only provides that the competent authorities shall consult each other if necessary to determine appropriate adjustments. This bilateral consultation, especially for large amounts in dispute, takes place only by way of a mutual agreement procedure (MAP) under Article 25. It may be argued that the use of the words "*if necessary*" in the second sentence of Article 9(2) would suggest that a contracting State may carry out a corresponding adjustment unilaterally as per its domestic law if there is no disagreement on the primary adjustment. However, the OECD Commentary makes it clear that a contracting State is only obliged to make such a corresponding adjustment if it considers that the primary adjustment by the other State is justified both in principle and as regards amount. The correctness of a primary adjustment made by the other State can, in most cases, only be verified by the contracting State by going through the audit carried out by the former which is possible only by way of a bilateral consultation. Hence, in practice, interaction between competent authorities is usually necessary. The OECD commentary to Article 9 also stipulates that the corresponding adjustment should be given through bilateral measures if there is a dispute on the character and amount of the adjustment. The OECD TPG also endorse a similar view. This confirms that a MAP under Article 25 may be used to consider a corresponding adjustment unless a State provides that adjustment by resorting to its domestic law. Therefore, under the present scheme of the OECD Model, the MAP is the only bilateral method available to deal with economic double taxation, especially, in respect of a transfer pricing adjustment. Hence, the effectiveness of the MAP process plays a significant role in eliminating economic double taxation.

This said, the MAP process suffers from several deficiencies even though international policy making organizations (such as the OECD) have recently taken several steps to improve the process. First, the MAP is a complex and a time-consuming exercise. Second, the process does not guarantee conflict resolution in all the situations as a majority of States – signatories to the Multilateral Instrument (MLI) – have not signed up to the mandatory arbitration procedure. Third, the diverse rules and practices of the countries may create unnecessary issues to successfully complete a MAP. For example, countries do not have uniform rules to decide the starting date for calculating the three years period for initiating a MAP. Finally, the interaction of the MAP with domestic legal remedies and the binding nature of a MAP outcome on the taxpayer is extremely critical to the effective operation of a MAP. In some jurisdictions, since the outcome of a MAP is not binding on the domestic courts, the taxpayer could litigate further if the outcome of a MAP is not favourable to it. Thus, the only possibility for an effective MAP outcome is to have absolute international cooperation and coordination which is not easy to achieve. In a nutshell, the post BEPS MAP may not be an effective tool in resolving cross-border tax disputes, especially, in a developing country context.

Comparing the corresponding adjustment process with the process for relieving juridical double taxation

Under the current tax treaty framework, only in cases where the regular relief mechanisms available under Article 23, which deal with providing relief from juridical double taxation, are not applicable then the cases are dealt with under a MAP. Thus, the original intention to introduce the MAP was to provide for an "*additional*" mechanism for resolving double taxation. In other words, the relief mechanism for any taxation that is not in accordance with the treaty including economic double taxation is resolved only under the MAP. Therefore, it could be argued that the MAP process, in economic double taxation scenarios, is not an "*additional*" dispute resolution mechanism. In essence, all cases that are subject to primary/corresponding adjustments have to pass through the MAP (unless the State can provide for a remedy itself) in order to avail relief for double taxation. The disparity in treatment of economic double taxation cases like transfer pricing adjustments as compared to juridical double taxation makes a strong case for revisiting the relief mechanism under tax treaties. In order to arrive at a logical conclusion for suggesting a suitable relief mechanism for cases relating to transfer pricing, it is important to understand various scenarios of transfer pricing adjustments as illustrated below.

With respect to basic facts, assume that Company A located in State A is subject to a primary pricing adjustment (by means of the application of State A's transfer pricing legislation) in relation to a transaction with an associated enterprise, Company B located in State B. State A carries out a primary adjustment by increasing A's profit in order to bring the transaction at par with the arm's length price. In the first scenario, State B may fully agree with the primary adjustment made in the case of A in State A. Consequently, State B would carry out a corresponding adjustment in the case of associated enterprise B equal to the amount of the primary adjustment. The second scenario is that State B may disagree over the primary adjustment, on the amount, or on the principle or on both. In that case, State B will not carry out a corresponding adjustment unless an agreement is reached by way of bilateral consultation. In the third scenario, State B may disagree only on the quantum of the primary adjustment, and compute the allowable corresponding adjustment *suo-moto*.

As per the current scheme of tax treaties, in the case of all scenarios, corresponding adjustments can be made only by invoking the MAP process under Article 25, unless appropriate domestic legal remedies could be resorted towards. Even though the first scenario is straightforward and does not require bilateral consultation, the corresponding adjustment could be delayed. In the case of the third scenario, State B may be willing to partly relieve double taxation, but is compelled to follow the MAP. Therefore, it may be argued that, for cases relating to the first and third scenarios, there is a need for a relief mechanism similar to Article 23, whereas the cases relating to the second scenario may be dealt with only under Article 25. Now coming to the question as to whether Article 23 can provide relief of the corresponding adjustment, it may be mentioned that there is a fundamental difference of tax levied pursuant to a transfer pricing adjustment under Article 9 and tax levied under other distributive rules, for example, under Articles 10, 11 or 12. Article 23 only deals with mitigation of juridical double taxation, which is an imposition of comparable taxes in two or more countries in respect of the same person for an identical period. Therefore, under the current framework, the relief of corresponding adjustments cannot be carried out under Article 23 of the OECD Model.

Conclusion

Even though the OECD Model, under its scope, covers both elimination of juridical and economic double taxation, the granting of relief with respect to juridical double taxation is dealt with more favourably than economic double taxation. To elaborate, juridical double taxation can be relieved under two stages. Firstly, under Article 23, that is, where the tax paid in the source country (withholding taxes on dividend, interest, royalties and so on) is given relief in the State of residence. Only in the case of dispute between the contracting States is relief sought by way of MAP under Article 25.

From a tax policy perspective, there cannot be dissimilar treatment of granting relief with regard to juridical and economic double taxation. The differential relief mechanism not only acts against the neutrality principle of taxation but may result in loss of economic efficiency. Therefore, the authors strongly believe that a two-stage mechanism for granting relief in the case of transfer pricing adjustments should exist, i.e. a mechanism similar to Article 23 (for instance, in scenarios 1 & 3 discussed above) and a MAP under Article 25 as an additional mechanism. This is necessary given the fact that a key area of disputes in the arena of International Corporate Taxation relates to transfer pricing disputes.

It should be noted that the purpose of the contribution was only to throw up ideas. Thus, the authors welcome comments from the international tax community on this blog. The authors would like to thank Mr Johann Muller, Mr Stefaan De Baets, Mr Balthasar Denger and Dr Alessandro Turina for commenting on draft versions of this blog. All views expressed in this blog are those of the authors and are personal.