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The Concept of "Options Realistically Available" under the OECD Transfer Pricing Guidelines

The author evaluates the transfer pricing concept of "options realistically available". The article seeks to understand and analyse the meaning of this concept, identifies various factors that must be analysed to determine the options realistically available and briefly discusses some of the financial management tools and economic theories that can be used to apply this concept in practice.

1. Introduction

The concept of "options realistically available" has found an important mention in Chapter IX – Transfer Pricing Aspects of Business Restructuring since the 2010 update of OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). These Guidelines emphasize that independent enterprises would undertake a transaction only if it does not make them worse off than the next best option available to them, and this behaviour should ideally be reflected in the choice of multinational enterprises (MNEs) when entering into business restructuring. A plain reading of the OECD Guidelines suggests that the concept of options realistically available, which also finds mention in other chapters of the Guidelines, has been used in different contexts. However, the OECD Guidelines do not provide comprehensive guidance on the meaning or practical application of this principle, except for reiterating that independent parties would consider all options realistically available to them.

The main objective of this article is to facilitate an understanding of the meaning of this concept that appears across various chapters of the OECD Guidelines.

1.1. Overview of "options realistically available" in the OECD Guidelines

1.1.1. Background

The concept of options realistically available was first introduced in the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. These guidelines were a revision of the 1979 OECD report on Transfer Pricing and Multinational Enterprises. A review of the historical developments shows that the United States has taken a lead in the development of transfer pricing regulations, and US legislation has played a significant influence in shaping the OECD Transfer Pricing Guidelines.[1] The arm's length standard was initially introduced by the United States in 1968.[2] It was only in 1979 that the OECD, with the publication of its report, Transfer Pricing and Multinational Enterprises, proposed the adoption of the arm's length principle to determine transfer pricing. Further, a review of the literature suggests that the US transfer pricing regulations under section 482 of the Internal Revenue Code, as adopted on 1 July 1994, and its predecessor legislation[3] had a large impact on the OECD Transfer Pricing Guidelines released in 1995. A comparison of both, the US transfer pricing regulations and the 1995 OECD Transfer Pricing Guidelines, shows that they have broad similarities on the issues dealt with and the solutions proposed to the transfer pricing problem, including the adoption of the arm's length principle.[4]

Given the above background, it comes as no surprise that the US transfer pricing regulations were the first to introduce this concept. The US parallel to this concept is the "alternatives available" standard, as found in the US regulations under the Internal Revenue Code.[5] The current US regulations[6] require that transfer pricing must be based on the actual transaction undertaken by the taxpayer. However, the consideration (i.e. the price) may be modified to reflect the alternatives available to the taxpayer. The relevant US regulations read as follows:

> The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the Commissioner may consider the *alternatives available* to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and oper-

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1. H.J. Ault & B.J. Arnold, *Comparative Income Taxation* (Kluwer Law International 2010), at 530.
2. Baker & McKenzie, North American Tax Practice Group, *Transfer Pricing: Managing Intercompany Pricing in the 21st Century* (Baker & McKenzie 2002), at 15.
3. The United States, in a revision of its 1968 transfer pricing regulations, issued a set of proposed regulations in 1992 (the 1992 Proposed Regulations), which were replaced by a set of temporary regulations issued in 1993 (the 1993 Temporary Regulations). This, in turn, led to the culmination of the final US transfer pricing regulations in 1994. *See* Baker & McKenzie, *supra* n. 2, at 13-20.
4. J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Kluwer Law International 2010), at 105-109.
5. A. Bullen, *Arm's Length Transaction Structures. Recognizing and Restructuring Controlled Transactions in Transfer Pricing* (IBFD 2011), at 523-526.
6. US: Treasury Regulations sec. 1.482-1(f)(2)(ii).

> ating under comparable circumstances. In such cases the Commissioner may *adjust the consideration charged* in the controlled transaction *based on the cost or profit of an alternative* as adjusted to account for material differences between the alternative and the controlled transaction, but will not restructure the transaction as if the alternative had been adopted by the taxpayer.[7]

The predecessor of these regulations contained similar language,[8] and a report issued by the OECD Committee on Fiscal Affairs[9] was critical of the proposed language. This report recognized that such an exercise could be arbitrary and could substitute the taxpayer's business judgment with the judgment of the tax authorities, the process of coming up with alternatives was fraught with challenges as to which factors need to be considered, and could potentially lead to double taxation where the tax authorities of the jurisdiction in which the other associated enterprise is resident refuses to accept or agree to such an adjustment.[10]

It is surprising that just two years after the publication of this critical report, the OECD Guidelines introduced a similar concept in 1995 as a factor relevant in analysing the comparability of transactions, and then again its significance was greatly increased in the 2010 revision of the OECD Guidelines. The reasons for the change in thinking, within the OECD – from the scepticism expressed before with regard to the use of this concept to embracing it with open arms – will remain a question to be answered. However, the change in terminology from "alternatives available" to "options realistically available", seems to be an attempt to distinguish from and narrow the scope of this concept as originally introduced in the US transfer pricing regulations. The four main areas within the OECD Guidelines which refer to the concept of options realistically available are:

- comparability analysis,
- pricing of transactions involving intangibles,
- pricing of the compensation due in the event of a business restructuring, and
- recharacterization of a controlled transaction under the commercially irrational transaction exception.

A brief overview of the above four areas is provided below.

1.1.2. Comparability analysis

The concept of options realistically available is prominently mentioned in Chapter I, paragraphs 1.34 and 1.35 of the OECD Guidelines. In this part of the OECD Guidelines, the concept of options realistically available is used for three aspects, namely (i) to support the decision making process followed by independent enterprises, (ii) to demonstrate the effect of options realistically available on the comparability factors and thereby influence the choice of the transfer pricing method used and (iii) the right of tax authorities to adjust transfer prices to reflect the best alternative available to the associated enterprise.

The concept of options realistically available has been used to describe the underlying economic theory of rational decision making which drives decision making for independent enterprises. An independent enterprise is generally motivated to maximize the return on investments and thereby maximize its profits. In doing so, it is rational that it would compare all the alternatives available and choose the most profitable one.

Transfer pricing involves a comparison of the conditions imposed on transactions between associated enterprises and between independent enterprises, and then using this result to revise the transfer price where necessary. This is nothing but the process of comparability which is dealt with in detail in chapter III of the OECD Guidelines and for which the concept of options realistically available is helpful. The OECD Guidelines list five comparability factors[11] that must be taken into account, namely (i) characteristics of property or services, (ii) functional analysis, (iii) contractual terms, (iv) economic circumstances, and (v) business strategies. The OECD Guidelines, in paragraph 1.34, emphasize that for a one-to-one monetary comparison of various alternatives, either all other relevant conditions need to be substantially similar or adjustments need to be made to either the price or the contractual conditions, to account for the differences. Further, the reference to the transfer pricing method used suggests that the options realistically available could be used to independently validate the result of a particular transfer pricing method or as an additional requirement to be satisfied when applying any of the recognized transfer pricing methods.

In the author's view, the concept of options realistically available seeks to refine the available comparables to those which fit best within the alternatives that an associated enterprise would realistically have. It seems that the concept of options realistically available ensures that the unique opportunities and strengths that are available to each transacting party are not disregarded when making a comparison to comparable uncontrolled transactions by independent enterprises which may not have such alternatives available to them. This ensures that the efficiencies and inefficiencies of each party and their individual, unique circumstances are taken into account in the determination of the transfer price and not overlooked in trying to obtain a standard arm's length mark-up for a routine benchmark-able functions.

1.1.3. Pricing adjustment

The concept of options realistically available is also used for the purpose of determining the arm's length price. This is a natural consequence of the above step where the concept of options realistically available has an impact on

7. Id. (emphasis added).
8. OECD, *Intercompany Transfer Pricing Regulations under US Section 482 Temporary and Proposed Regulations* (OECD 1993) ("The district director may consider the *alternatives available* to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. In such cases the district director may *adjust the consideration charged* in the controlled transaction *based on the cost of the alternative*, but will not restructure the transaction as if the alternative has been adopted by the taxpayer" (emphasis added)).
9. OECD, *supra* n. 8.
10. Id.
11. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995-2013)* (OECD 2013), para. 1.36.

the comparability. However, there are two instances which mandate the use of the concept of options realistically available, namely for determining the pricing of transactions involving intangibles and in determining whether compensation is due in the event of a business restructuring.

1.1.3.1. Pricing for transactions involving intangibles

The current chapter VI of the OECD Guidelines – which deals with special considerations for intangible property – requires that the realistic alternatives of both of the transacting parties be taken into account for pricing the transaction. The OECD Guidelines promote the use of a two-sided analysis (as compared to one-sided methods) for purposes of pricing transactions involving intangibles. This is evident from the statement used in the current language of chapter VI which states that the perspective of both of the parties to the transaction is required. It is not difficult to understand the policy rationale behind this choice, as intangibles are usually unique in nature and it is difficult – if not impossible – to find a large number of comparables with features which match those of the controlled transaction under review. Accordingly, a two-sided analysis helps to provide a better framework or a workable range within which independent parties would have transacted.

The OECD is in the process of revising the guidance in chapter VI on intangibles as a part of the base erosion and profit shifting (BEPS) project, and has released updated guidance[12] on the proposed revisions. While one must await the finalization of the new guidance, the report and discussion drafts released to date confirm that any pricing or valuation approach for intangibles requires that due regard be given to the concept of options realistically available and the perspective of both transacting parties.

1.1.3.2. Compensation due in the event of a business restructuring

Business restructurings have become increasingly commonplace over the years.[13] MNEs engage in business restructuring as a means of responding to the constantly changing business environment. Business reasons for undertaking business restructuring vary from lowering costs of production, efficiency in organization of the supply chain, tapping synergies by eliminating duplicate functions, exploiting opportunities presented by the internet and e-commerce, economies of scale and scope, integration of new acquisitions, conforming to regulatory requirements, streamlining or simplifying business processes, and as a response to competitive pressures.[14] The OECD Guidelines define a cross-border business restructuring as the cross-border redeployment by a multinational enterprise of functions, assets and/or risks.[15] There are four main areas which are covered by this chapter, namely (i) special consideration for risks, (ii) arm's length compensation for the restructuring itself, (iii) remuneration of post-restructuring controlled transactions and (iv) recognition of the actual transactions undertaken. The concept of options realistically available plays an important role in parts (ii) and (iv).

Paragraphs 9.59 to 9.64 of the OECD Guidelines comprises of the most comprehensive OECD guidance on the concept of options realistically available. This part of chapter IX deals with the determination of the arm's length compensation for a business restructuring. The OECD Guidelines provide detailed guidance in this regard. The starting point, as with any other controlled transaction, is an examination of the business restructuring transaction. This involves, for example, a review of the restructuring transactions and the functions, assets and risk before and after the restructuring, the business reasons for and the expected benefits from the restructuring, and the options realistically available to the parties. Further, any reallocation of risks and profit potential as a result of a business restructuring, whether any assets of value have been transferred pursuant to the restructuring, and whether there is an indemnification for the termination, cancellation or substantial renegotiation of existing arrangements, must all be taken into account. Thus, the sum total of the above aspects must be taken into account and compared with the next best alternative available to the individual parties to the transaction in order to determine whether any compensation is warranted for agreeing to the restructuring. Further, the OECD Guidelines acknowledge that a loss of profit potential is not something which must be automatically remunerated. This must be evaluated based on the options realistically available for each of the transacting parties. It is also important to bear in mind that the OECD Guidelines reject the argument that a sound commercial rationale at the level of the MNE group suffices as a valid acceptable reason for each of the individual companies which form a part of the MNE group to agree to the business restructuring.

1.1.4. Recharacterization of a transaction

The OECD Guidelines permit, in two exceptional circumstances,[16] tax authorities to recharacterize a transaction differently from how it has been structured by the taxpayer. The first exception is termed as the economic substance exception, while the second exception is the commercially irrational transaction exception.

The economic substance exception can be invoked where the economic substance of the transaction differs from its legal form. In this circumstance, the tax authorities are at liberty to assess the controlled transaction to tax in a manner which befits the economic substance and to impute the pricing to match the economic substance. The

12. OECD, *Guidance on Transfer Pricing Aspects of Intangibles – Action 8: 2014 Deliverable* (OECD 2014).
13. M. Andrew & M. Nixon, *Exit Charges in Asia Pacific: Current trends and Approaches in Asia Pacific Tax Authority Enforcement*, 39 BNA Tax Planning Intl. Rev. 5 (30 May 2012), at 4 (accessed 24 July 2014 at www.bna.com).
14. Andrew & Nixon, *supra* n. 13. *See also* A. Chakravarty & S. Ray, *Is Business Restructuring and Tax Aligned Supply Chain Still Viable?*, 19 Asia-Pac. Tax Bull. 6 (2013), at 415-416, Journals IBFD.
15. OECD, *supra* n. 11, para. 9.1.
16. OECD, *supra* n. 11, para. 1.65.

commercially irrational transaction exception may be invoked where the form and the substance of the transaction are the same, but the transaction – when viewed in totality – differs from that which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax authorities in determining an appropriate transfer price.

In this regard, with respect to the commercially irrational transaction exception, the OECD Guidelines state that the concept of options realistically available should be used as a test to determine whether the transaction is such that independent parties would have entered into it because otherwise it would lack commercial sense. Thus, relying on this standard, where tax authorities determine an alternative option which is more beneficial to the taxpayer but which has not been adopted by the taxpayer and where a pricing adjustment is not possible, this option may be used by the tax authorities to replace the controlled transaction with the realistic alternative identified and attach the tax consequences thereof.

1.1.5. Conclusion

The concept of options realistically available is used for different purposes within the OECD Guidelines. However, in the author's opinion, the fact that it is used for different purposes should not, per se, change the meaning of this standard, as this would seriously undermine the principle of legal certainty which is one of the cornerstones of any tax legislation. In view of this, it is crucial to understand the stand-alone meaning, application and limitations of this concept so as to be able to apply it to any of the situations as required above.

2. Meaning and Application of the Concept

2.1. Meaning of "options realistically available"

2.1.1. In general

Having identified the different areas where the concept of options realistically available is applied, the next step is to understand the meaning of the concept and identify which tools can be used to apply this concept. Paragraph 1.34 of the OECD Guidelines reads, what has been elaborated further in Chapter IX of the OECD Guidelines, as follows:

> Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other *options realistically available* to them, and they will only enter into the transaction if they see no alternative that is *clearly more attractive*.[17]

Thus, the test envisaged can be broken down into two parts. The first step is determining the options realistically available to the transacting party, while the second step is determining whether any of the realistic alternative options are "clearly more attractive" as compared to the controlled transaction. An examination of each of these steps will indicate the potential issues and whether the OECD Guidelines provide any guidance on how to deal with them.

The options realistically available test derives its basis from how independent parties would behave in evaluating a potential transaction. MNEs attempt to behave in a manner that would maximize their shareholder value, i.e. profit maximization forms the basis for rational decision making.[18] Accordingly, the concept of options realistically available attempts to build upon the theory of rational decision making[19] and opportunity cost.[20,21] Bullen aptly opines that, "[there is] […] credence to say that this test reflects a fundamental fact of commercial life".[22] Proceeding on the premise that the concept has a sound economic basis, the pertinent question is to examine the critical factors that taxpayers must consider in determining options realistically available.

An overtly simplistic analysis is provided here to clarify the stand-alone meaning of this concept with the help of an example. Assume that a subsidiary (SubCo) and its parent (ParCo) are members of an MNE group that operates in the fast-moving consumer goods sector. The current business model of the MNE group is structured such that ParCo, which is a taxpayer and resident in country A, is a full-fledged manufacturer engaged in both research and development activities and manufacturing the products for the MNE group, while SubCo, which is a taxpayer and resident in country B, is a full-fledged distributor engaged in developing the marketing strategy of the MNE group, advertising the products and distribution of the products through a network of supermarket chains and retailers which it has built over the years.

Further, assume that because of unfavourable economic conditions, the MNE group expects that the demand for its products will be significantly affected. This in turn is expected to reduce the profitability of the MNE group. The management of the MNE group is concerned that if it does not act and continues with the current business model, there will be adverse consequences for the MNE group and even possible bankruptcy in the long run. Accordingly, the group management decides to restructure the business operations of the group such that ParCo is converted into a principal company which decides to outsource manufacturing to an independent, third-party toll manufacturer, while SubCo is converted into a limited risk distributor with all the marketing functions being centralized at the level of ParCo. The restructuring is projected to achieve significant cost savings because of (i) elimination of func-

17. OECD, *supra* n. 11, para. 1.34 (emphasis added).
18. Bullen, *supra* n. 5, at 545.
19. Rational decision making would require that an enterprise would compare the values of the outcomes available to it and to select the alternative which maximises this value. As long as the value of an outcome is a positive i.e. the decision leads to incremental profits compared to the alternative foregone it is rational behavior. Thus decision making which takes into account the opportunity cost of an alternative is optimum.
20. Oxford Dictionary of Accounting defines opportunity cost as "The economic cost of an action measured in terms of the benefit foregone by not pursuing the best alternative course of action." – accessed online on 24 July 2014 at http://www.oxfordreference.com/view/10.1093/acref/9780199563050.001.0001/acref-9780199563050-e-2416).
21. E. Kamphuis & X. Zhang, Game Theory, *BATNA Insightful when Analysing Options Realistically Available in Business Restructurings*, 18 BNA Transfer Pricing Rep. 13 (19 Nov. 2009), at 758 (accessed 24 July 2014 at www.bna.com).
22. Bullen, *supra* n. 5 at 541.

tions which are cheaper to outsource and (ii) simplification of business processes.

While the restructuring is beneficial for the MNE group as a whole, it will significantly lower the profitability of SubCo, as the risk associated with the marketing and distribution functions has been stripped and shifted to ParCo. This simple example will aid in an analysis of the stand-alone meaning of the term "options realistically available".

2.1.2. *Meaning of "options"*

The word "option" is defined by the Oxford English Dictionary as "something that is or may be chosen; an alternative, a choice".[23] The meaning of the word "option" indicates that it refers to the various alternatives which may be available to a transacting party. The process of identifying the various alternatives while undertaking a decision is a business function that would take into account a variety of factors, such as the situation which is being addressed, the resources available at the disposal of the company, the current business model of the company, the strategy the management has for the future growth of the company, the current and future business prospects of the industry in which the company operates and the external economic environment. To put it very simply, this step can be split into the generation of ideas for investment, quantitative and qualitative screening of all the options, and distilling the list to a set of alternatives that can potentially be considered. Another aspect of the various alternatives which are being considered is that they are generally mutually exclusive, i.e. the company may not be at liberty to adopt different solution of different alternatives for a singular problem, which may be on account of resource constraints or otherwise.

In the present example, if SubCo were an independent enterprise, it could consider the following alternatives:
– agree to the restructuring and act as a limited risk distributor, thereby exchanging the risk of volatility of future profits for stable but lower future profits,
– continue on a stand-alone basis by refusing to agree to the restructuring – in which case it could, for instance, act as an independent, full-fledged distributor for competitors of similar products, or
– continue on a stand-alone basis by refusing to agree to the restructuring – in which case it could, for instance, act as an independent limited risk distributor for competitors of similar products.

Upon identifying the options, it is necessary to determine the value of each option, both quantitatively and qualitatively, so as to rank the options in order of preference. The latter part of this article considers which financial management tools and economic theories can be applied in practice to determine and select an option from the different alternatives available to a taxpayer.

2.1.3. *Meaning of "realistically available"*

The word "available" is defined by the Oxford English Dictionary as something "that may be availed of", or "capable of being employed with advantage or turned to account; hence, capable of being made use of, at one's disposal, within one's reach".[24] Thus, the term "realistically available" refers to two aspects of the options being considered, namely legal availability and whether it is realistic.

In the author's view, the foremost criterion for determining availability refers to the legal possibility of choice. An option that cannot be opted for, because of legal considerations or legal impediments, cannot be said to be available to the associated enterprise. Thus, an option that is illegal either for the associated enterprise under its own domestic law or for the related party to the transaction under that related party's domestic law cannot be regarded as available.[25] This is because neither of the transacting parties can be expected to break civil law or criminal law in evaluating the options available. This can be of particular relevance in regulated sectors such as the financial industry, where there is substantial regulatory oversight.

Further, an alternative may not be available because of contractual obligations or legal impediments for the associated enterprise. In the present example, while being an independent limited risk distributor for an external third-party manufacturer may be an option, what if the existing contract between the MNE group companies stipulates that either party may terminate the contract with a three-month notice period and that there is a one year non-compete clause, or there is a legal prohibition against using the existing dealer and retail network that was acquired as a part of the MNE group for subsequent third-party transactions. Such legal prohibitions can significantly reduce the value of third-party alternatives. It is not uncommon for independent parties to have such covenants in their business dealings. In such a case, even while this option is realistic, it may not be readily available because of the peculiar legal and contractual obligations of SubCo. By default, in such a case the only option is to accept the restructuring transaction.

The second and equally significant aspect of availability involves determining whether the option is "realistically" available. This is a necessary step because, without considering this aspect, the list of options that could be theoretically available to the associated enterprise could be infinite. The word "realistic" is defined by the Oxford English Dictionary as "concerned with, or characterized by, a practical view of life; having or showing a sensible and practical idea of what can be achieved or expected".[26] The "realistic" test, as the definition suggests, is something more than being presented with a list of available options. The option presented cannot be unrealistic when viewed in the context of the business and commercial circumstances

23. OED Online (Oxford University Press 2014) (accessed 23 July 2014 at http://www.oed.com/view/Entry/132082).

24. OED Online (Oxford University Press 2014) (accessed 23 July 2014 at http://www.oed.com/view/Entry/13583?redirectedFrom=available).
25. Bullen, *supra* n. 5, at 554.
26. OED Online (Oxford University Press 2014). (accessed 23 July 2014 at http://www.oed.com/view/Entry/158933?redirectedFrom=realistic).

of the taxpayer. Consider, for example, a company that is a manufacturer of textiles, to make a presumption that – when faced with an economic downturn – it could diversify and enter into manufacturing of chemicals or manufacturing commercial airplanes, is a completely unrealistic option, although it could be a very profitable one if successfully implemented and definitely available from a legal standpoint.

Another example of an unrealistic option is where, instead of being part of a business restructuring, theoretically, the associated enterprise could have the option to undertake an activity on its own, but this might involve huge capital expenditure which might not be realistic, given the present balance sheet size of the company and the amount of funds available at its disposal, or because of the non-availability of a license. Thus, in the author's view, the word "realistic" must be interpreted as an alternative which, if adopted by the company, has a good chance at succeeding, taking into account factors such as the resources and assets available at the disposal of the company, the past and present functional ability of the company, and the capability of its personnel. It must also take into account the fact that an alternative which is completely unrelated to the current business model of the stand-alone entity or the current industry and value chain of the stand-alone entity is an unrealistic option. Thus, "realistic" considerably narrows down the alternatives that must be considered in evaluating the arm's length nature of a controlled transaction.

One can conclude that, when evaluating the options, tax authorities must bear in mind that coming up with business plans or options that do not respect the business of the enterprise or are completely unrelated to the current activities and capabilities (in terms of both financial capabilities and also functional capabilities) of the associated enterprise, is unrealistic, and the OECD Guidelines do not support pricing based on such unrealistic options.

In the present example, while being an independent full-fledged distributor for an external competitor may be an option which is legally available, the company could, upon assessment of the market, conclude that this is an option which is not realistically available, as for various commercial reasons an independent competitor of similar products would be unwilling to engage with a company which is a member of an MNE group to be a full-fledged distributor for its products. There may be concerns over sharing of intellectual property, proprietary customer databases, price lists, lists of preferred dealers, distribution points, incentive strategies for dealers, marketing strategy, and other such sensitive business information. This raises another critical question in applying the separate entity principle when determining the realistic options, namely whether one is expected to consider options that may be unrealistic because the associated enterprise is a part of an MNE group. The OECD Guidelines are silent on this aspect, but it would be a prudent approach to consider all options which – if the associated enterprise were independent – would be able to be pursued, i.e. disregard the MNE group member status. However, in doing this, the business and commercial realities should not be completely ignored in arriving at a list of options realistically available.

2.1.4. Factors to be considered in evaluating "options realistically available"

2.1.4.1. Overview of factors to be considered in evaluating "options realistically available"

Paragraph 9.61 of the OECD Guidelines states that:

> [...] the broad parameters to be taken into consideration while determining the options realistically available, in the context of determining the arm's length nature of a transaction can be summarized as below: At arm's length, there are situations where an entity would have had one or more options realistically available to it that would be clearly more attractive than to accept the conditions of the restructuring (taking into account all the *relevant conditions*, including the *commercial and market conditions going forward*, the *profit potential of the various options* and *any compensation or indemnification* for the restructuring), including possibly the option not to enter into the restructuring transaction. In such cases, an independent party may not have agreed to the conditions of the restructuring.[27]

While this is not an exhaustive list of the factors to be considered when evaluating options realistically available, it is a helpful starting point.

2.1.4.2. Comparability factors as a relevant condition

While the OECD Guidelines state that all the relevant conditions which have an impact on the options need to be considered, they provide no further clarification. In this regard, the comparability factors could be a useful tool to narrow down the options that are "realistically available". The comparability factors are an analytical framework that is used by the OECD Guidelines to achieve comparability between the controlled transaction and comparable uncontrolled transactions. To draw an analogy of the above to the use of the concept of options realistically available, an attempt would be made to determine whether independent enterprises in a similar situation would have agreed to undertake the controlled transaction or if there were other better alternatives available to them.

Toward this exercise, the comparability analysis could be helpful to identify and value the relevant options. Support for such an approach is found in paragraph 1.34 of the OECD Guidelines,[28] which states that the comparability factors can be helpful to identify the economically relevant differences between the various alternatives which need to be considered in the comparison process, and to arrive at a valuation. With this background, the comparability factors can be a useful tool to narrow down the range of options which need to be considered. Jie-A-Joen and Moerer state, in the context of business restructuring, that the comparability factors are a relevant condition for determining options realistically available.[29] This is further elaborated upon below.

27. OECD, *supra* n. 11, para. 9.61.
28. "This point is relevant to the question of comparability, since independent enterprises would generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk or other comparability factors discussed below) when valuing those options". OECD, *supra* n. 11, para. 1.34.
29. C. Jie-A-Joen & O. Moerer, *A Note on Options Realistically Available*, 19 BNA Transfer Pricing Rep. 4 (17 June 2010), at 224, (accessed 24 July 2014 at www.bna.com).

Characteristics of property or services – Paragraph 1.39 of the OECD Guidelines provides guidance that, in achieving comparability between the controlled transaction and comparable transaction, the specific characteristics of the property or services in which the associated enterprise transacts should be taken into account. This guidance should be taken into account when considering the various alternatives available to the associated enterprise. The alternatives which are analysed should share the features of the property or service previously rendered by the enterprise, and it cannot be lightly assumed that an enterprise will venture into a completely unrelated or a different product or service. Thus, the industry and the value chain in which an associated enterprise operates will set the bounds for determining the realistic alternatives of the associated enterprise.

Functional analysis – A functional analysis is generally the starting point of any transfer pricing exercise so as to understand the controlled transaction. Paragraph 1.42 of the OECD Guidelines provides guidance that, between independent enterprises, the amount of compensation will reflect the value of different functions that the parties to the transaction perform taking into accounts the assets used and the risks assumed. This means that a functional analysis of the activities of the associated enterprise is essential to set the boundaries of the alternatives which can be considered realistic. Every organization has capabilities that it has acquired in executing functions which it performs, and has certain assets at its disposal. An evaluation of this helps to identify different alternatives which can be pursued by the associated enterprise. The functional analysis will also shed light on the risk-bearing capacity of the associated enterprise. To word it differently, where alternatives require the associated enterprise to develop functions previously not performed, acquire assets previously not owned or take on risks which are inconsistent with its previous ability to manage those risks, it is questionable whether such an alternative can be regarded as realistic.

Contractual terms – Another significant consideration is the legal and contractual obligations that an enterprise may have. It is well accepted that the starting point of analysis for any controlled transaction is the contractual documents.[30] Paragraph 1.52 of the OECD Guidelines acknowledges that, between independent parties, the contractual terms clearly state the risks, responsibilities and benefits attributable to each of the parties. Thus, an analysis of the contractual terms will determine the existing and proposed contractual risk and reward relationship for the associated enterprise. It will also help to determine whether any indemnification is due upon a business restructuring and what type of external options can be legally explored by the associated enterprise. Accordingly, where the contractual obligations of the enterprise make it economically unviable to not participate in a business restructuring, the same should be taken into consideration in determining the arm's length nature of the controlled transaction.

Business strategies – Business strategies form a part of the commercial circumstances of the associated enterprise. Paragraph 1.59 of the OECD Guidelines acknowledges the important role that different business strategies may have on the conduct of the business operations and thus influence decision making. Accordingly, potential options that are considered should be in line with the existing business strategy of the MNE. For example it will be unrealistic to consider an option of expansion for an associated enterprise of an MNE group which is currently facing financial difficulties and has committed to downsizing its operations so as to concentrate on only core activities. Although this is merely an example, the underlying rationale is that, among other things, the risk-taking ability of the business, future goals and objectives for the business, and any other dominant strategy should not be ignored in outlining the realistic alternatives available at the disposal of the associated enterprise.

2.1.4.3. Commercial and market conditions going forward

Commercial and market conditions refer to the business environment of the associated enterprise. The business environment is comprised of the legal, economic, political, social and technological environment in which the associated enterprise operates. Business cannot be conducted devoid of this commercial reality, and this environment is both internal and external to the business. The OECD Guidelines place emphasis on recognizing the impact of these conditions going forward. Thus, not only the current business scenario, but also how the expected future changes may impact the business of the enterprise must be taken into account in identifying and valuing the potential options.

Commercial conditions for an enterprise must take into account, among other things, the sector and the value chain in which the enterprise operates. The options that are evaluated cannot relate to a totally different line of business or be very different from the current risk profile of the associated enterprise.

Market conditions refer to the external economic and political environment that impacts the evaluation of the alternatives and desired return on capital. Market conditions going forward must be evaluated to determine whether the current levels of profitability could be sustained if the associated enterprise were not to agree to the transaction under review and continue on a stand-alone basis without the assistance of other group members. Market conditions going forward may impact the risk profile of different alternatives and thus the profitability of the different options. An evaluation of the options considered should be based on the future expected profitability of the associated enterprise, and not on the historical profits of the enterprise.

2.1.4.4. Rights and other assets

The rights and any other assets that an enterprise owns have a significant bearing on the options available to the

30. OECD, *supra* n. 11, para. 9.164 ("In the Article 9 context, an examination of the application of the arm's length principle to controlled transactions should start from the transactions actually undertaken by the associated enterprises, and the terms of contracts play a major role".).

enterprise and in turn its bargaining power. Enterprises that have unique functional capabilities or have developed expertise in executing functions which are not easily replicable possess an enduring advantage. The same reasoning applies to the ownership of assets, including intangible assets. Thus, an analysis of all the rights and assets and understanding the opportunities and risks that these assets carry, is a necessary step in the analysis of options realistically available.

2.1.4.5. Compensation or indemnification due upon restructuring

Where an existing contractual relationship is terminated or substantially renegotiated in the context of a business restructuring, the restructured entity might suffer consequences such as restructuring costs (e.g. write-off of assets, termination of employment contracts), reconversion costs (e.g. in order to adapt its existing operation to other customer needs) and/or a loss of profit potential.[31] Independent parties would not voluntarily agree to such a unilateral termination of existing arrangements or change in existing relationships unless it is in the interest of both parties. This means that independent parties dealing at arm's length may demand an indemnification where they are in a position to do so. Indemnification refers to any compensation that is due for the consequences suffered by an associated enterprise which agrees to the transaction under review. The OECD Guidelines recognize that there cannot be a presumption toward the payment of such indemnification[32] and it is critical to evaluate when such compensation needs to be recognized. In this determination, among other factors, the options realistically available to the transacting parties will influence the amount of compensation.

2.1.4.6. Consideration post-restructuring vis-à-vis the profit potential of the other options identified

The entire exercise of determining the realistically available alternatives is to make a comparison with the controlled transaction under review. Independent parties generally seek to maximize their profit and this principle should be taken into account. However profit potential does not exist in isolation and is always accompanied by a risk of loss. It is a well-established economic concept that risk and reward go hand in hand.[33] For instance, when comparing the various alternatives, a mere comparison of the profit potential of various alternatives in isolation, without taking into account the relative risk that each option poses, would be a faulty approach. According to economic theory, for a rational person, higher risk would lead to the expectation[34] of a higher return, and vice versa.[35] Accordingly, where a converted entity decides to trade off its risk for the likelihood of a guaranteed stable profit, albeit lower than other riskier alternatives realistically available to it, the comparison is not straight forward. In this scenario, tax authorities must be careful not to replace the taxpayer's business judgment with that of the tax authorities. This is because the restructuring or de-risking of the entity is similar to purchasing insurance against market volatility in the form of lower but stable guaranteed returns.[36] Accordingly one must take into account not only the transaction of the business restructuring itself but also the post-restructuring transactions and the business rationale therefor. The technique of risk simulation is further described below.

The timing of carrying out the analysis of options realistically available is critical, as the analysis must be undertaken, for and limited to the time, when the actual transaction was undertaken. Tax authorities, when conducting an audit of a business restructuring transaction, often have the benefit of hindsight, but such hindsight should not be used to determine the options that could potentially be available to the associated enterprise.[37]

Another significant factor is that management of an MNE group may have limited time in making decisions. This can force the management to consider very few options or not consider options which may require much due diligence to ascertain their economic viability. This factor needs to be accepted because making a contention that – were the management prepared to wait for a certain period of time – other alternatives might have opened up, is treading into the realm of speculation. Also, there may be a possibility that, while an option is not available for a certain period of time because of contractual obligations (for example a non-compete clause), it could be considered after the expiry of such period, thus potentially resulting in hybrid options. The OECD Guidelines do not provide any guidance on these factors, nor on the number of years for which the forecast of the different options must be considered, nor how the terminal value, if any, of each of the options will affect the analysis. In the author's view, the terminal values of the different options will have a bearing on the attractiveness of the various alternatives, and the forecast should be of a reasonably long period of time that would help an independent business manager to make a decision. In practice, this could be the life of the project or, for example, 10 years for an indefinite project.

2.2. Methods for identifying, valuing and determining the "options realistically available"

2.2.1. Introduction

Financial management is defined by Weston and Brigham as "an area of financial decision making, harmonizing individual motives and enterprise goals".[38] Financial management is concerned with assisting in the decision

31. OECD, *supra* n. 11, para. 9.100.
32. OECD, *supra* n. 11, para. 9.103.
33. P.G. Penelle, *The Economics of Business Restructuring and Exit Charges*, 23 Tax Management Transfer Pricing Report 3 (29 May 2014), 238-246, at 239.
34. The operating word here is "expected", as in real life higher profit may or may not materialize.
35. OECD, *supra* n. 11, para. 1.45.
36. Penelle, *supra* n. 33, at 239.
37. For example, paragraphs 3.74 and 9.56 of the OECD Guidelines caution against the use of hindsight in evaluating a transaction.
38. C. Paramasivan & T. Subramanian, *Financial Management* (New Age International Pvt Ltd Publishers 2008), at 3 (where reference is made to the definition by Weston and Brigham).

making process and has tools that can range from simple ones like capital budgeting and risk simulation, to more complex ones like bargaining power and game theory. These are analysed briefly below.

2.2.2. Capital budgeting

Jie-A-Joen and Moerer[39] suggest that the capital budgeting process is a well known concept that supports and assists in the decision making process in finance management and this could be used to apply the concept of options realistically available. Dayananda defines capital budgeting as a multifaceted activity with the following stages:

- strategic planning,
- identification of investment opportunities,
- preliminary screening of projects,
- financial appraisal of projects,
- qualitative factors in project evaluation,
- the acceptance/rejection of the decision, and
- project implementation and monitoring, and post-implementation audit.[40]

The above process aids in identifying various alternative options that take into account the strategic plan and vision of the company. Investment opportunities take into account the strategic plan and can be proposed by lower-level management of any department or sub-department, as well as by high-level management or even independent parties.[41] The pivotal step in the above process is the quantitative and qualitative evaluation of the project, followed by the decision to accept or reject an option. While there are many alternative financial tools available to quantify the profitability of projects, the net present value method is one of the most common. Some of the other methods commonly used include accounting rate of return, (modified) internal rate of return for discounted cash flow analysis and payback period analysis.[42] In addition to the financial quantification, an option also needs to be subjected to a qualitative appraisal which cannot be evaluated in money's worth – e.g. the impact of the options on the social, economic and political environment, the impact on relationships with employees and the impact on the firm's image.[43]

The entire process of capital budgeting is undertaken so as to either accept or reject the project under consideration. This decision is based on a combined evaluation of the results from the above-mentioned quantitative and qualitative analysis. Common techniques used for decision making include the net-present-value method and the internal rate of return.

Net present value is the present value of the estimated future after-tax cash inflows minus the cash outflow (i.e. the investment required for the project). The discount rate applied to calculate the present value of the cash flows is the required rate of return. This rate should, in theory, fluctuate in direct proportion with the project risk (i.e. the riskier the project, the higher the discount rate so as to earn higher returns), but is generally also the weighted average cost of capital of the firm. Net present value can be calculated using the following formula:

Net present value =t=1nCFt 1 + r t – Outlay

where:
CF_t = after-tax cash flow at time t
r = required rate of return for the investment
Outlay = investment cash flow at time zero

In theory, all projects with a positive net present value are accepted, subject to resource constraints.

2.2.3. Bargaining power theory

The advantage of options realistically available rests in the fact that it is a two-sided analysis. Thus this approach is preferred for determining the arm's length nature of transactions for which it is difficult to find comparables on the market. Bargaining theory can be used to determine whether the transaction is arm's length and also whether any compensation is due pursuant to the business restructuring. The OECD Guidelines make it clear that, when making a decision to transact, specifically in the case of business restructuring and for transactions involving intangibles, none of the parties will agree to a transaction if it leaves that party worse off compared to its next best alternative. This is because it is impossible to reach a negotiated agreement unless both parties are satisfied that the results of the negotiation are at least as good as – if not more beneficial than – their best alternative to a negotiated agreement.[44] In evaluating the alternatives available, the parties to the transaction must recognize that the value of their options depends on the actions of the other party to the transaction. Thus, there is interdependency among the possible actions and the possible outcomes.

Bargaining analysis therefore goes beyond the familiar insight that opportunity cost (i.e. treating the profits foregone as a cost of alternative strategy) is the appropriate basis for evaluating decisions by taking into account interactions.[45] It builds on the premise that it is an essential feature of a bargain freely entered into by two parties that each party should have no option open to it that yields a better result, given the option selected by the other party.[46]

The next step in bargaining theory analysis is thus to determine that set of "combined outcomes" which meets the condition that neither of the parties to the transaction is worse off as compared to an alternative which it may have – and which it can – pursue individually without cooperation of the other transacting party. Only where such a test is satisfied, is the outcome better for all transacting parties than what they can achieve from their next best alterna-

39. Jie-A-Joen & Moerer, *supra* n. 29.
40. D. Dayananda et al., *Capital Budgeting. Financial Appraisal of Investment Projects* (Cambridge University Press 2002), at 5.
41. Jie-A-Joen & Moerer, *supra* n. 29.
42. T.K. Mukherjee & G.V. Henderson, *The Capital Budgeting Process: Theory and Practice*, 17 Interfaces 2 (Mar.-Apr. 1987), at 82.
43. Dayananda, *supra* n. 40, at 7-8.
44. R. Stuckey, *Understanding Casablanca: A Values-Based Approach to Legal Negotiations*, 5 Clinical L.Rev. 1 (1998), at 211 – 213.
45. Ernst & Young, *Business Restructuring: Three Taxation Issues* (June 2007) (accessed 24 July 2014 at https://www2.eycom.ch/publications/items/200706_business_restructuring/200706_ey_business_restructuring.pdf).
46. Ernst & Young, *supra* n. 45.

tive, so that the transaction satisfies the arm's length test – as this reflects how independent parties make decisions. Thus this approach can form the basis for determining how controlled transactions should be priced or whether compensation is due for a business restructuring.

2.2.4. Game theory and best alternative to a negotiated agreement

Kamphuis and Zhang[47] have evaluated how the concepts of game theory, best alternative to a negotiated agreement (BATNA) and reservation values can be a useful means to simulate how, at arm's length, associated enterprises would choose among options realistically available in a business restructuring, and price the business restructuring accordingly.

The capital budgeting process can be used to quantify the value of different alternatives that may be available to an associated enterprise. Rational decision making would require that enterprise compare the values of the outcomes available to it, and to select that with the highest positive net present value. As mentioned, in the case of a business restructuring transaction, the value of the options is interdependent on the choices made by each of the parties to the transaction. Thus, the choice of a party to undertake a transaction is dependent on the choice of the other party. It is because of this interdependency of the parties to the transaction, that the economic concepts of game theory, best alternative to a negotiated agreement and reservation values can be used to determine whether any compensation is due upon a business restructuring. While a simple two-party analysis can be plotted on a scale or solved using the bargaining theory, for more complex situations (i.e. where the number of parties to the transaction is more than two or where one must divide the surplus from the collaboration), game theory and applied mathematics can help to solve the problem.

2.2.5. Risk simulation

Hafkenscheid[48] has evaluated the relationship between risk and return and how risk simulation can be used to confirm the arm's length nature of transactions. According to Hafkenscheid, when comparing different investment alternatives, economic theory uses two criteria for evaluating the economic benefits, namely the expected value of the investment and the variance.[49] The expected value can be defined as the weighted average sum of all the probabilities of the possible outcomes of an investment, while variance measures the deviation of the possible outcomes from the expected value. The greater the deviation, theoretically, greater is the risk of investing in the project. A riskier project will command a higher return to offset this extra risk that an investor must undertake, and vice versa.

Hafkenscheid suggests that using the above and also other techniques (e.g. Monte Carlo simulation), one can compare different scenarios that require different levels of investment and have different risk profiles.[50] This should be used to compare the pre- and post-business restructuring transactions, as when an entity is converted or de-risked, it is trading riskier profiles for guaranteed stable profits, and the lost profit potential must be proportional to the reduction in risk/volatility.[51] A similar line of reasoning is advocated by Penelle.[52]

2.2.6. Conclusion

The above analysis offers an overview of how various financial management tools and economic theories can be used in practice to evaluate the economic benefits of various options. While each of the methods has its own inherent merits and detriments, this approach lacks certainty from a taxpayer's perspective. Thus, the OECD should recommend a single approach for the uniform application of the concept of options realistically available.

2.3. "Clearly more attractive" standard

The "clearly more attractive" requirement is the second step in the analysis of options realistically available. While the first step involves determining the range of options realistically available to the enterprise, a transfer pricing adjustment (whether pricing or structural, i.e. recharacterization) is not warranted unless it is concluded with certainty that the other option realistically available is "clearly more attractive".

The OECD Guidelines do not define what this standard means, nor have they provided any tools or guidance to compare the benefit from the controlled transaction with the benefit of the other options realistically available. Taking a step back, what is being done in this step is assessing the "attractiveness" of the various available alternatives vis-à-vis the controlled transaction. To compare the attractiveness, one looks at the expected economic benefits that will accrue from undertaking the transaction. The OECD Guidelines do not provide any guidance regarding how alternatives with different risk profiles can be quantified in numerical terms, but it will suffice to say here that one must look at a combination of both quantitative financial management tools and qualitative set of criteria.

Where the economic benefit of the controlled transaction is the same or similar to the other realistic options, even then the arm's length principle is satisfied and no further adjustment is required. The question of adjustment arises when one concludes that the economic benefit of other realistic option is "clearly more" when compared to the economic benefit of the controlled transaction. The "clearly more" criterion is a subjective concept. The OECD Guidelines emphasize the fact that MNEs are free to act in their own best commercial and economic interest.[53] Thus, in practice, it may very well occur that different independent enterprises assess the same option to have different

47. Kamphuis & Zhang, *supra* n. 21.
48. R.P.F.M. Hafkenscheid, *De bepaling van een zakelijke risicoallocatie in een business restructuring*, Weekblad voor Fiscaal Recht 2011/660 (12 May 2011), at 660-668.
49. Id.
50. Id.
51. Id.
52. Penelle, *supra* n. 33, at 239.
53. OECD, *supra* n. 11, para. 9.163.

levels of economic benefit flowing from them, and thus have different levels of attractiveness.[54] This subjectivity must be accepted by tax authorities. Accordingly, where there is uncertainty in establishing the "clearly more attractive" comparison, the transaction as structured by the taxpayer must be respected.

3. Conclusion

The concept of "options realistically available", builds on the concept of opportunity cost and rational decision making, and thus has a sound economic basis as long as the perfect competition assumptions are accepted. The chief advantage of this concept is that it helps to accommodate the arm's length principle, even in the absence of comparables. Thus, the success of options realistically available as a tool is dependent upon its resolving the conflict for which it was introduced and – at least in theory – it is a tool that works. Another positive feature of this concept is that, as a two-sided analysis, it is better than one-sided methods that can sometimes distort the results. However, the standard of options realistically available has some major shortcomings.

While the standard of options realistically available is flexible enough to accommodate the perspective of both the parties and their individual strengths and weakness, this has an inherent downside, namely that it is subjective in its approach. The absence of sufficient guidance on the application of this concept, contributes to inherent subjectivity when attempting to apply it. Further, this concept lacks simplicity and could lead to an increase in compliance costs for taxpayers. This is because, in practice, application of the concept relies on the use of financial management tools and economic theories and this may require assistance from experienced professional such as financial analysts, economists and accountants. Further, being a difficult concept to administer, there is a risk that tax authorities may attempt to shift the burden of proof to the taxpayer in order to apply this concept. Without exhaustive guidance on the documentation and procedural aspects that a taxpayer must document when undertaking a transaction, there is a risk that different tax authorities may administer this concept differently. This in turn will jeopardize uniformity in the application of the arm's length principle.

If the above concerns are addressed, it will go a long way toward developing better transfer pricing legislation and provide certainty for the business community. The core areas that the OECD should immediately address are providing guidance on practical implementation (i.e. financial management tools/economic theory to apply this concept), clarifying the extent to which the burden of proof rests with the taxpayer and providing uniform administrative guidelines for tax authorities to administer this concept.

54. Bullen, *supra* n. 5, at 563.