Analysis

Is the arm's length principle dead?

Speed read

The recent OECD pillar one consultation document lays bare the widespread dissatisfaction with the tax outcomes resulting from the arm's length principle (ALP) and current nexus rules evident since the 2013 BEPS work. Within a slowing global economy, would-be 'hold out' countries might have to balance an increasing plethora of taxes aimed at the digital economy (and maybe wider) worldwide against accepting higher levels of local tax than the ALP/nexus principles would mandate. Interested parties should respond to the consultation by 12 November. If agreement is not reached, the clamour for formulary apportionment, or some other way of 'dividing the tax take', might increase. Even if agreement is reached, the number of required simplifications and formulae suggest the arm's length principle might become the arm's length exception. In either scenario, the number of disputes seems unlikely to fall.

Gary Richards
Mishcon de Reya
Gary Richards is a corporate tax partner at Mishcon de Reya. He is a former chair of the Law Society's Tax Law Committee, a member of its VAT & duties sub-committee, and a member of the JVCC, VAT Practitioners Group, and Stamp Taxes Practitioners Group. Email: gary.richards@mishcon.com; tel: 020 3321 6363.

Robert Hartley
Mishcon de Reya
Robert Hartley is a partner in Mishcon de Reya's dispute resolution department and specialises in the resolution of tax disputes. He has been a practising tax lawyer since 1999. Robert's practice is split between direct and indirect tax disputes relating to both corporate and individual clients. Email: robert.hartley@mishcon.com; tel: 020 3321 6499.

At first sight, the OECD's Secretariat proposal for a 'unified approach' under pillar one – set out in its public consultation document (PCD) (see bit.ly/31Idzbm) – might suggest the answer to the question is no. However, a closer reading of the PCD suggests that, in reality, the ALP, or at least its scope, is becoming increasingly circumscribed, either by OECD guidance itself or by the application (or non-application) of the principle.

The ALP

Much ink has been spent describing the principle, let alone on how to apply those principles to transactions into which parties acting at arm's length would be unlikely to enter. Suffice to say for the purposes of this article, the terms of the transaction (including the pricing of the transaction) are correctly understood and consistent with the terms of the bargain that arm's length parties would have entered into had they participated in such an arrangement.

To clarify, that is not a quest for the 'holy grail' of a similar transaction with an unrelated party (for countries hosting extractive industries or farming activities, even a comparable uncontrolled price (CUP) method may deliver an unsatisfactory outcome). There is, though, a view that not only transactional profits methods but even cost plus or re-sale price methods may not appropriately attribute the intended benefits of an integrated group among its component members.

Limits to the ALP

Individual examples alone may not be statistically significant, but when enough examples are provided by tax professionals, it appears that some OECD members have previously ignored OECD guidance.

For example, at a recent conference, an MNC group based in a particular country said that it had given up transferring hard to value intangibles until, perhaps several years later than would have been optimal for development reasons, their value was relatively predictable. This was despite the fact that parties at arm's length transferring such an asset might agree that, for a limited period, the transfer value could be revisited, but eventually for commercial certainty (perhaps after three or four years) the final adjustment would occur. So, depending on the relative bargaining power of the seller and buyer, a more or less good deal for one party might emerge only with the benefit of hindsight.

The tax authorities involved took a particularly inflexible approach by insisting that even after the end of the period during which independent parties would have finalised the terms of the bargain, any additional value that emerged in later years could be taxable on the transferor. In effect, the tax authorities were applying the ex-post outcomes without taking account of the caveat expressed in para 6 of the introduction (in the June 2018 *Guidance for tax administrations on the application of the approach to hard-to-value intangibles*) – namely that 'it would be incorrect to base the revised valuation on the actual income or cash flows without taking account the probability at the time of the transaction, of the income or cash flows being achieved' – and the reference in para 16 (and related guidance in paras 6.185 and 6.192) as to what independent enterprises in comparable situations would have done.

State aid and the ALP

Both the rulings of the General Court, respectively whether the tax rulings on transfer pricing given to Fiat by Luxembourg (see *Fiat Chrysler v Commission* (Case T-759/15)) and to Starbucks by the Netherlands (see *Starbucks and Starbucks Manufacturing EMEA v Commission* (Case T-636/16)) amounted to illegitimate state aid, emphasised that ALP is a general principle of EU law. Consequently, significant departures by the ALP by a member state can be challenged by the European Commission. While the Commission regards itself as not bound by the OECD's Transfer Pricing Guidelines, its attempt to mandate the CUP method over transactional net margin method (TNMM) was not supported by the court, so its freedom of action may be more circumscribed than it believes.

This might suggest that the ALP, or at least the Commission's interpretation of it, is still respected. However, decisions in the CJEU can develop in unexpected ways, and the Commission's repeated attempts to introduce CCCTB suggest a willingness to find an alternative to the outcomes the ALP might otherwise mandate.

© RELX (UK) Limited trading as LexisNexis. Not for external distribution or resale

PCD and likely direction of travel

A recent *Tax Journal* article ('Unify and conquer: the OECD's "unified approach" to pillar one' (Brin Rajathaven and Murray Clayson), 18 November 2019) contained a clear and succinct summary of PCD, so we do not repeat that exercise here. Rather, we focus on the light that the PCD sheds on the future scope of the ALP. First, the fact that it is issued by the Secretariat in an effort to bridge the differences amongst the interested parties suggests a considerable need for compromise, and it implicitly casts doubt out on whether the reallocation of profits – and losses – to market jurisdictions is widely acceptable. Admittedly, the PCD refers in a 'new profit allocation rule going beyond the arm's length principle' (para 15) to 'retain[ing] the current transfer pricing rules based on the arm's length principle but compliment[ing] them with formula based solutions in areas where tensions in the current system are the highest'. However, it is when one examines the detail that the level of disagreement is apparent.

Take this sentence: 'while there *seems* to be adherence amongst Inclusive Framework members to the principle that routine transactions can *normally* be priced at arm's length, there are *increasing doubts that the [ALP] can be relied on* to give appropriate results in all cases' (para 17, emphasis added). The first area where agreement on a threshold would be required is when determining whether the new nexus requirement (of 'sustained and significant involvement in any economy') was met for a particular country (for example, levels of sales to population). The next area of discussion would be on the MNC group's 'deemed residual profit'. This leaves scope for argument over the composition of 'profits' and what level of remuneration should be afforded to 'routine activities' in order to determine what is potentially left to constitute amount A to be shared among market jurisdictions. Incidentally, will countries be prepared to divide amount A by reference to the monetary value of sales or absolute sales numbers, as the former might 'under-reward' countries in which, to build up market share, a price penetration strategy was being followed?

Second, in relation to amount B, countries would need to reach agreement on what level of fixed return should be available to 'baseline' (whatever they amount to) activities, to reduce the number of disputes relating to distribution functions (i.e. the reward thereto). Implicitly, amount C is the amount asserted by the relevant jurisdiction as justifying an additional return to the entities performing distribution functions beyond those allocated under amount B. In other words, where a jurisdiction wishes not to be bound by the amount B outcome, it will need to point to additional functions to justify a claim for additional rewards. This prompts the question of what happens where business models change, and what was additional over time becomes routine or baseline behaviour.

Dispute resolution and double taxation

The PCD is to be commended for its repeated references to 'simplifying conventions' – *if* agreement can be reached on them by all countries – in order to simplify calculations and reduce the scope for disputes, together with its repeated plea for the need for legally binding and effective dispute prevention and dispute resolution mechanisms. So, for example, the PCD contemplates (at para 53) that measures of profit (for amount A) may need to be determined on business line and/or regional and/or market base; and it also contemplates (at para 54) that the level of profits afforded to routine activities might need to vary, with the fixed percentages perhaps varying by industry (which makes sense as some industries are more profitable than others).

Paragraphs 55 and 56 suggest an interesting dichotomy. Paragraph 55 adopts the (z-x)% formula, where x is the percentage of profits referable to routine profits, for the purpose of calculating amount A to be allocated to market jurisdiction. Paragraph 56 states that this would not 'disturb the actual allocation of the remuneration derived from actual routine activities under the current transfer pricing framework'. Yet, if 'actual' is 12% and x is 10% and, per para 25, 'no jurisdiction would be required to give up taxing rights over income generated by the routine business activity', this suggests there would be a higher aggregate level of taxation on an MNC group. That may be an appropriate outcome to the extent that the group's sales benefit from government expenditure in that market (for instance, on education, the rule of law or infrastructure), but it still sounds like additional tax. Admittedly, paras 57–60 seek to ameliorate the mechanical certainty of the calculation by enabling potential amounts A to be reduced by claims on profits attributable to 'innovative algorithms and software'. However, the scope for disputes seems heightened unless fixed percentages can be 'internationally agreed'.

Regardless of whether the proposals technically count as 'double taxation' – insofar as amounts would be allocated to market jurisdictions that wouldn't otherwise be allocated under the conventional transfer pricing analysis (principally because the current nexus requirements could not be met) – the overall impression is that more tax would be payable to more jurisdictions. Clearly, though, there are limits to any one jurisdiction claiming too high a share of an MNC's taxes because an MNC could choose not to market into that country if the 'tax tariff' is too high. Despite the suggestion of simplifying conventions, a lot of 'slicing and dicing' would be needed (although perhaps no more information and analysis than taxpayers faced with transfer pricing disputes will in practice have to provide). Moreover, even if agreement is reached, tax campaigners are likely to monitor the amounts of tax allocated under amount A to countries, and if the allocation is thought 'unfair', they are likely to renew calls for a higher proportion to be allocated to market jurisdictions.

Where does this leave us?

The principal objection to formulary apportionment – apart from the likelihood that it would not give sufficient attribution to intangibles as far as the MNCs that rely on existing transfer pricing guidance are concerned – is that it would require agreement amongst many countries on the relative attributions needed for different factors (such as employees, sales, etc.). Yet on a closer reading of the PCD, the need to agree on the key factors explained above suggests that, if agreement under the PCD cannot be reached, the Rubicon (towards formulary apportionment) may have been crossed. ■

For related reading visit www.taxjournal.com

- Unify and conquer: the OECD's 'unified approach' to pillar one (Brin Rajathurai & Murray Clayson, 18.10.19)
- Cases: *Starbucks and another v Commission* (3.10.19)
- Cases: *Fiat Chrysler v Commission* (3.10.19)

© RELX (UK) Limited trading as LexisNexis. Not for external distribution or resale