

Beyond and beneath the arm's length principle

Educated pragmatism is the new normal under Pillar 1, and it might not be a bad answer for in-house tax and transfer pricing professionals.

Philippe Paumier, September 2019

Back in what seems now to be the early years in modern transfer pricing, John Neighbour¹ delivered the following message regarding the alternatives to the arm's length principle:

*“the most frequently advocated alternative (to the ALP) is some kind of formulary apportionment [...], **proponents of such alternatives not only have to show that their proposals are theoretically “better” but that they are capable of winning international agreement.**”*

1. A “theoretically better” solution: learnings from BEPS

BEPS TP MATERIALS HAVE DRAMATICALLY CONTRIBUTED TO DELINEATE A “THEORETICALLY BETTER” ARM'S LENGTH PRINCIPLE

It is undeniable that the system needed some serious fixing to cope with increasingly complex business models and value chains and probably with a certain degree of oversimplifications.

From an economic standpoint, it can be considered that most of the OECD publications since Chapter IX on the TP aspects of Business Restructurings have very significantly contributed to technically improve the arm's length principle and have incredibly raised the bar for TP practitioners. The reference to Chapter 9 emanates from the introduction of the Options Realistically Available which is adjacent to a game theory notion well known to economists and encapsulated at the very heart of the arm's length principle where legal entities must transact **as if** they were unrelated.

ARE WE BETTER OFF? THE “TECHNICALLY BETTER” TOOLS MIGHT BE AN OVERKILL FOR A LARGE CATEGORY OF TRANSACTIONS

As such, we have now an **improved referential to solve the critical contention points related to complex transfer pricing operations.**

But are Tax Administrations and tax departments of MNEs better off? Nothing is less certain, as the intrinsic complexity of the new technical arsenal spreads to the analysis of the entire portfolio of transactions carried by MNEs and scrutinized by the Tax Administrations, in a context of limited resources. By nature, this affects the operations of MNEs with

¹ OECD Observer No 230, January 2002

the widest geographical range: distribution, selling and promotion which, while valuable, are not the most complicated transactions in MNEs value chain.

The crux of the issue is that all stakeholders have increasingly dedicated their resources to a very large amount of relatively simple transactions within the value chain of MNEs. Two solutions can be imagined to dissolve such paradox:

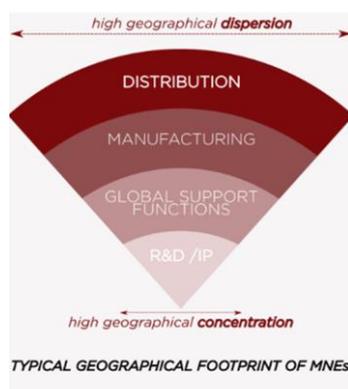
- i. develop a framework where there are no “simple” transactions (and therefore resources are properly allocated)
- ii. develop a resource-conscious solution that achieves a similar result.

The two options are actually not mutually exclusive, and one can imagine the benefits of a combined approach of a full technical arsenal for high value transactions with high profit shifting potential, and a scaled down version of the arm’s length principle codified in a simple economic model for transactions with modest value, but with high volumes.

TO ADDRESS A SIGNIFICANT MASS OF ISSUES AND GAIN RAPID ACCEPTANCE, THE ECONOMIC MODEL CAN ONLY BE SIMPLE AND SHOULD TARGET DOWNSTREAM OPERATIONS OF MNEs

2. International Acceptance: there is momentum

Momentum is composed of two factors: mass and velocity, two factors that have been a constant component in the BEPS initiative. The outspoken proposals of certain taxpayers have contributed to keep, if not enhance, the momentum for international acceptance by bringing the debate to center stage.



To achieve mass, the geographical reach of a simplified model should be maximal and pegged to the activities of MNEs that have the largest footprint, e.g. market based, and therefore Distribution & Promotion is the most suitable candidate. Attempting to address the profit allocation of upstream operations in the value chains of MNEs through an economic model or formula approach would rapidly show serious

A RESOURCE INTENSIVE APPROACH FOR THE MOST DISTINCTIVE OPERATIONS OF MNEs USUALLY EMBEDDING SIGNIFICANT TAXABLE BASIS PER TRANSACTION

limitations, or would require a complex model that would deter any international consensus as both taxpayers and tax administrations would not be able to derive from such model the required visibility in terms of profit allocation, a necessary condition to obtain a policy and political validation.

While economists by nature would advocate for a complex multidimensional model, this author believes that the key is to develop

2 *Lars Peter Hansen, Nobel Prize of Economics, 2013, full quote: "I view the work I've done related to statistics and economics as, roughly speaking, how to do something without having to do everything."*

a simplified model that allows taxpayers and tax administrations to “do something without doing everything”. The full ALP TP based arsenal would then be used to assess the most idiosyncratic transactions of MNEs, the “upstream” transactions.

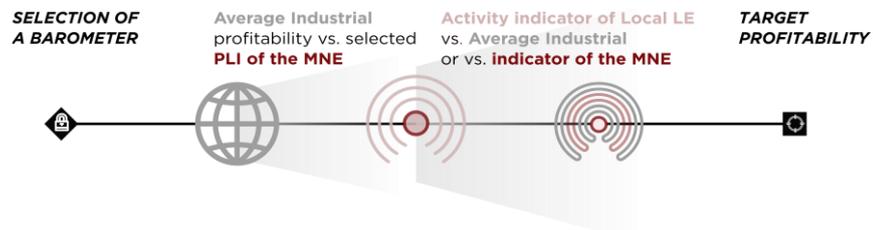
3. Simplified model: a need to be in sync with an intuitive approach but also with the ALP

A simplified economic model in the context of transfer pricing should be defined as an intuitive predictable model that does not deliver results that are fundamentally opposed to the arm’s length principle.

Consensus seems to have been built around the idea of a baseline profitability, some models suggest 2% of sales, others 3%. Subsequently, two main features could prevail in such models:

- **Intuitive factor #1: an above par profitability of an MNE should translate into a higher profitability of the markets.**
- **Intuitive factor #2: a higher contribution of a given market to the profits of the MNE should lead to higher share of profits to the market.**

A BASELINE AND FACTORS TAKING INTO ACCOUNT THE PROFITABILITY OF THE MNE AS A WHOLE AND THE CONTRIBUTION OF THE LOCAL LEGAL ENTITY



Factor #1 could for instance use as a proxy the average system profits of industrial consolidated groups compared to the profitability of the tested MNE, but because marketing and distribution are usually not the main value driver of MNES, only a limited fraction of this gap should gross up local profits. Such fraction acts as a proxy for a residual profit split approach between markets and upstream activities. While some serious questions remain open, the principle seems to have gained significant attention, and even maybe general approval.

Factor #2 might turn out to be slightly more complex. Some of the proposals out there suggest a factor to capture what the IRS codified years ago as “excess marketing spending”, acting as a proxy for marketing intangible, measured through local the marketing intensity (OPEX to sales ratios in the legal entity vs. a “normative” ww rate). The potential distortion linked to the selling prices differential between countries could be overcome if one considers that such distortion is wiped out by the differential of production factors (e.g. labor costs for example). But there is no evidence of such pattern to this author’s knowledge.

It is therefore possible that such approach would end up creating a bias as the OPEX to sales ratio might end up being lower in countries with high selling prices, who generate a significant share of the MNE profits. Should a ratio involving expenses as a numerator be used, this author believes that a better denominator could be gross margin.

One alternative could be to concatenate both factors instead of adding them up (a cumulative approach): factor #1 is weighted by the contribution of the local entity to the MNE system profits (local consolidated profitability ratio vs. MNE's system profits).

The aim of this paper is not to identify all variables possible, but to evidence the fact that a formulaic approach might not be such a disavowment of the arm's length principle, because the construction of this simplified model will require economic inputs derived from the ALP. Time will come (soon), for more technical papers on the formula itself.

4. What's in there for in-house tax and transfer pricing professionals?

Many surveys performed by reputable global firms evidence that risk management and ETR predictability, upskilling/reskilling of workforce and data/digital mastery are of paramount importance for Global Tax departments in their current transformation. Pillar 1 morphing into a formulaic approach for the allocation of profits to Distribution and promotion should allow the first two, and requires the third one, which is anyway an established (though seldom achieved) requirement.

Achieving an unprecedented level of certainty and simplification for such a large number of intercompany transactions should allow in-house tax and TP professionals to dissolve the paradox previously mentioned in resource allocation and focus the most significant and technical transactions, planning and business partnering. Will this come with an ETR cost associated to higher profits to the markets? For groups sourcing market from hubs in low tax countries, there might be little doubt. For the others, the relative global equalization of tax rates (that could be even fostered by pillar 2) should reduce the cost.

Nevertheless, such primary ETR costs need to be put into perspective. Assuming a relatively simple model, two elements should disappear from tax management dashboards: interests on tax basis movements (because of the avoidance/reduction of assessments and resulting MAPs), penalties and reserves for double taxation. To these benefits, one should add an expected reduction of compliance costs (TP documentations should evolve, at the very least), probably leaner teams (either centrally or locally) and, not a negligible factor, a significant reduction of consultancy fees in countries. Moreover, this should also

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limit the exposure on reputational risks by an increased transparency and limit the number (and costs) of sometimes painful and long inquiries by tax administrations and other bodies (Senate, foreign exchange control agencies, etc.)

But it won't come easy, and it won't be for free. A significant investment from MNEs, advisory firms, tax administrations and multilateral bodies will be necessary to deliver such benefits. The road ahead of us is scattered with technical traps, notably:

THERE ARE MANY OPEN ITEMS THAT WILL REQUIRE THE INPUT OF TAX AND TRANSFER PRICING PROFESSIONALS SHOULD THE PROPOSAL GAIN ACCEPTANCE

- A necessary agreement on financial referential to analyze the profit level indicators (US GAAP, IFRS)
- Delineation of the system profits calculation of MNEs that could be used in factor #2
- Economic and statistical analysis to assess the real impact of measures
- More than ever, the consistency of approaches with Customs and Indirect taxes has to be achieved: simplification on one end is not enough.
- Qualification of Distributor: criteria to ensure that entities are not denied access to the simplified application of the ALP
- Unilateral measures that ought to be addressed on a multilateral level (diverted profits for instance)
- Treatment of losses

Conclusion (for the time being)

All persons involved in OECD discussions have witnessed the strong will to get international acceptance on pillar 1, again, with mass and velocity. There are clear threats for MNEs, but there are equally clear benefits. So that the former do not overweight the latter, tax and TP practitioners from all horizons will have to engage in this debate, to ensure that the outcome of this new revolution is sound from a theoretical, but maybe more importantly, from a practical standpoint.

This outcome might not be a “theoretically better” approach, but it might be a better answer. Are we still happily married with the ALP? It's been almost 25 years since the 1995 Guidelines, a good moment to renew the vows, and ensure enough emphasis is put on the essence (full ALP deployment on upstream transactions), while trying to find a mutually acceptable way of dealing with the unavoidable consequences of global cohabitation (market presence). “Mutually acceptable”, as we know, is the key.

Past was imperfect, present is undeniably tense, but future might not necessarily be malign. Certainly not the time to lay down and eat roses³.

³ *Hijacking of Charles Bukowski's "Grammar of life".*