Should we twist the arm of the principle?

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In the past couple of years, transfer pricing has been pointed to by media and politicians as being at the heart of international tax avoidance. The arm's length principle has been blamed for being flawed and outdated and for arguably facilitating the concentration of profits in low-tax entities with no or limited substance. The same or other commentators have claimed that the arm's length principle favours residence countries over source countries and that it would not be in the interest of developing or emerging economies to adopt it. A number of academics and non-governmental organizations ("NGOs") have advocated alternatives to the arm's length principle, such as global formulary apportionment or variants of it. The OECD itself considered, as part of its work to counter Base Erosion and Profit Shifting ("BEPS"), possible Special Measures that would deviate from the arm's length principle.

In the course of the 2-year BEPS project, over a hundred pages of proposed amendments to the OECD transfer pricing guidance as well as several thousand pages of public comments thereon were produced. Where does this debate stand ?

The arm's length principle is embedded in Article 9 of the OECD and UN Model Tax Conventions, which state that where conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then tax administrations have the right to tax the profits which were so transferred. A simple literal reading evidences that there is nothing in the arm's length principle that would be designed to allow or favour tax avoidance. To the contrary, the arm's length principle sets out a sound standard whereby multinational enterprises are not allowed to avoid taxation by manipulating the prices of their cross-border intragroup transactions.

The arm's length principle does not set a differing standard depending on the tax regime of the parties to a transaction. It logically follows that it is not a sufficient tool for governments to counter the use of low tax regimes. Governments that want to counter low tax regimes may do so through CFC rules and/or anti-abuse rules such as the ones that restrict the deductibility of certain payments made to low-tax entities under certain circumstances. They may implement administrative measures such as strengthened documentation or disclosure requirements for transactions involving low-tax entities and exchange of information with the jurisdictions concerned. But from the perspective of the arm's length principle alone, the pricing of an intragroup transaction does not depend on the tax rates of the parties to it.
Similarly, there is nothing in the arm's length principle per se that would favour residence over source countries. The arm's length principle's simple and only objective is to establish tax neutrality between intragroup and uncontrolled transactions. It is inherent in the global economy we are living in, rather than in the arm's length principle, that more value is generally allocated to funding, entrepreneurial risk and intangibles than to labour intensive activities. This inevitably creates conflicting interests between capital exporting and capital importing countries. While the conflict may crystalize around transfer pricing disputes, it is not created by the arm's length principle.

Here come into play two important questions: the one of "fairness", which was raised by some developing and emerging economies as well as by some NGOs, and the one of "substance", which was raised by various OECD and non-OECD governments.

The fairness issue is an interesting one in that no one can oppose the notion that fairness is good and should be a shared policy objective. However, it is doubtful that all countries have the same view of what a fair allocation of tax revenues among them should be. From a business perspective, fairness is very much about rule of law and predictability. The substance issue also raises tricky questions. While substance is a long existing concept in international tax, there is no consensus on what substance means, how it should be measured, and what the consequences of failing to demonstrate sufficient substance should be. Does substance necessarily mean that a holding company should have employees or should passive investment be recognized? If employees are needed, what kinds of positions should they hold to provide sufficient substance? What if the key roles are shared among several entities located in several jurisdictions? What if key people are moving from one country to another? What if they hold more than one position within the group? Etc.

The OECD significantly developed its thinking about the role of control functions over investment and risk. While Chapter 9 of the 2010 Transfer Pricing Guidelines already contain detailed guidance on risk allocation and the role of control functions, the new OECD guidance goes one step further, indicating that asset-rich minimally functional entities should not earn more than a risk-free return on their investment: funding alone does not suffice to attract residual profits if the investor does not have the ability to and does not actually exercise control over its investment. In the free market, there are situations where a passive investor gets more than a risk-free return. The OECD is thus introducing into its transfer pricing guidance an anti-avoidance rule which may go beyond the arm's length principle but was considered needed for policy reasons, as the debate over so-called "cash boxes" and stateless income was especially heated.

The OECD specifically examined whether to introduce Special Measures that would diverge from the arm's length principle in case where the principle would not lead to the desired policy outcome. It concluded that such Special Measures were generally not needed, an that the revised transfer pricing guidance could be implemented within the boundaries of the arm's length principle. This is an excellent outcome, although it can raise questions about the prioritization between the new guidance and the over-arching principle in cases where market data would evidence that independent parties do agree to conditions which the OECD guidance would treat as non-arm's length.

The arm's length principle is a means to achieve a sound and specific policy objective. It cannot by itself resolve the whole range of international tax issues and other measures can be designed to address the latter. Governments that have legitimate concerns about transfer pricing abuse should foster a principled enforcement of the arm's length principle. Twisting the arm of the principle, whether by taxpayers or by governments, can only bring increased uncertainty for all, in contradiction with sound fiscal and pro-growth policy.
Should we twist the arm of the principle?