W(h)ither the Arm's-Length Principle?

by Reuven S. Avi-Yonah

Tax Transfer Pricing Under the Arm's Length and Sale Country Principles

By Andrea Musselli, with preface by Reuven S. Avi-Yonah

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Andrea Musselli's outstanding book, *Tax Transfer Pricing Under the Arm's Length and the Sale Country Principles*, is a must-read for any serious student of the topic, including lawyers, accountants, and tax policymakers. (Full disclosure: I wrote the preface.) The OECD transfer pricing guidelines total more than 650 pages, and some of the books on transfer pricing are thousands of pages long. Why, therefore, is there a need for another, much shorter book?

Musselli's novel contribution is his analysis of the arm's-length principle based on the economics of contracts. He focuses on the principle as the internationally accepted standard for transfer pricing analysis. He describes it as embodying a simple market theory allocating (by appropriate contracts) to innovative companies the residual profit (over a normal return subject to competition) of the entire group. The arm's-length principle is a rule that reflects contracts allocating possible ex post residual profits only to group entities that ex ante are going to make innovative investments (and thus may record losses if innovation efforts fail). According to Musselli, that simple rule should be used to verify whether the chosen transfer pricing method is going to lead to appropriate results — that is, those that comply with the arm's-length principle. Musselli gives over 30 examples of how that rule could be applied in practice based on actual cases.

Musselli also criticizes the OECD for adopting in 2015 a transfer pricing model based on value creation, defined as the development, enhancement, maintenance, protection, or exploitation of an intangible by an entity that exercises control over the financial risk from the intangible and whose staff performs important operations in relation to the intangible. He argues that the DEMPE rule is contrary to conditions that independent parties would agree on. Musselli also shows that companies can take advantage of the new formulation simply by relocating the managers of an intangible project to a country with low income tax rates. He then explains how that problem led to the adoption of pillar 1 of the second iteration of the OECD base erosion and profit-shifting project, which partially dispenses with the arm's-length principle.

While Musselli's risk-based analysis is the best possible way of allocating residual profits to constituent parts of a multinational under the arm's-length principle, it will still fail in the absence of comparables (which rarely exist for high-value intangibles). When corporations like Amazon, Apple, or Google allocate the profit from intangibles to their foreign subsidiaries, there is no chance that the subsidiaries' innovations will fail and thus result in losses that are trapped inside the foreign sub and not available to offset U.S. parent income. A new edition of the iPhone, for example, is almost certain to lead to profits and has almost no risk of loss. Under those conditions, the allocation of a theoretical risk of loss is meaningless.

Moreover, as summarized above, Musselli assumes that with the narrow exception of amount A of pillar 1 of BEPS 2.0, the arm's-length

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principle is here to stay. As he states in his introduction:

> [This book] pays attention to the tax treatment of transfer pricing in a single perspective of analysis since the most important principle (the arm's length principle — ALP, i.e. conditions that independent parties would share) is agreed worldwide. It must be applied in the same way even regardless of the economic sector or the specific industry while their regulatory approach should only be taken into account (as it's logical), for example, in the risk analysis: business rules are applied first, then fiscal rules. Even the concurrent principle that partly is going to replace the ALP for the largest multinationals (the sharing of extra profit in the sale country) is internationally agreed. In the author's opinion, a country survey overlooks the most important issue of the fiscal problem, that is, the ability to project a unitary policy in compliance with the ALP (or with the sale country principle) and that should be audited by one sole (only theoretically) existing tax authority. Therefore, the objective of the entire narrative is at setting legal transfer prices while all other aspects are subordinated to that.

Since 1993, I have criticized the arm's-length principle as inconsistent with the reality of contemporary multinationals that operate as a unitary business.[1] Moreover, in most cases, one cannot find comparables to the transactions that form the core of a contemporary multinational's business model — namely, the transfer pricing (however effected) of intellectual property. In the absence of comparables, the arm's-length principle cannot function.

However, by 2009 I came to the same conclusion as Musselli: The arm's-length principle is here to stay, so a compromise is necessary between it and the main alternative. Kimberly Clausing, Michael Durst, and I suggested that the arm's-length principle continue to be applied to a multinational's routine functions but a sales-based formula be applied to residual profits resulting from proprietary, unique intangibles.[2] That is in essence the model applied to a part of amount A in pillar 1, although its application is much narrower because it applies only to the largest, most profitable multinationals and 25 percent of their residual profits.

Pillar 1 seems unlikely to succeed because it requires U.S. participation (the main target is U.S. multinationals) and a multilateral tax convention that the United States is unlikely to ratify. In its absence, countries will continue to apply digital services taxes that so far reach only a small portion of profits.

If pillar 1 fails, will the arm's-length principle survive? In my opinion, the answer is no because it is plausible to assume that countries will adopt formulary apportionment unilaterally. To understand why, it is helpful to briefly survey the history of the arm's-length principle and its main rival, sales-based formulary apportionment.

Origins: The 1923 League of Nations Report

The four economists who met in Geneva in 1923 and drafted the report that formed the basis for the international tax regime recognized that business income should be taxed primarily at source with a credit or exemption provided by the residence country to prevent double taxation. Moreover, they recognized that for that purpose, source included not just origin but also destination countries because profit cannot be earned without sales. As they wrote:

> By *production of wealth* we mean all the stages which are involved up to the point of wealth coming to fruition, that is, all the stages up to the point when the physical production has reached a complete *economic destination* and can be acquired as wealth. The oranges upon the trees in California are not acquired wealth until

[1] Reuven S. Avi-Yonah, "Slicing the Shadow: A Proposal for Updating U.S. International Taxation," *Tax Notes*, Mar. 15, 1993, p. 1511. *See also* Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation," 15 *Va. Tax Rev.* 89 (1995).

[2] Avi-Yonah, "Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation," 2 *World Tax J.* 3 (2010); Avi-Yonah, Clausing, and Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," 9 *Fla. Tax Rev.* 497 (2009).

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> they are picked, and not even at that stage until they are packed, *and not even at that stage until they are transported to the place where demand exists and until they are put where the consumer can use them*. [Emphasis added.]

That excerpt shows that for the four economists, the destination jurisdiction had a right to tax income from the sale of goods, and that this right derived from the benefits provided by the market, which in turn requires legal protections by the destination country's government (which require tax revenue that can be collected from foreign corporations selling into the market).

Of course, neither the permanent establishment concept (which was then included in some 19th-century treaties but not yet widely accepted) nor the arm's-length principle (which had not yet been invented) features in that analysis. The four economists gave the destination country the right to tax business income without specifying any limits on that right.

Limits: PEs and the Arm's-Length Principle

Those limits, however, were necessary because otherwise (a) the destination country could tax a corporation making only occasional sales into its market, and the cost of compliance could exceed the profit from the sales; and (b) origin jurisdictions could tax the same income, and there was no mechanism for allocating profits to prevent source-source double taxation (which would not be solved by an exemption or credit in the residence jurisdiction).

The first problem was solved by the League of Nations technical experts who drafted the original model in 1928. The model acknowledged the right of source (origin and destination) countries to tax business income on a net basis, but it imported from 19th-century treaties the concept of PE, under which a jurisdiction may not tax business income unless the business had a fixed physical presence directly or through a dependent agent in that jurisdiction. That in turn led to the adoption of articles 5 (definition of PE) and 7 (business profits), which are in almost all of the more than 3,000 bilateral tax treaties in force today.

Mitchell Carroll solved the second problem in his report on the allocation of business profits among both PEs and the subsidiaries of a multinational enterprise.[3] Carroll proposed that in dividing income among an MNE's constituent parts, the transactions between related parties be evaluated by comparing them with hypothetical transactions between unrelated parties at arm's length — that is, the arm's-length principle. That suggestion was adopted by the league in its 1933 and later models, and then by the OECD: It is now found in articles 7 (for PEs) and 9 (for related corporations) of most tax treaties.

While adopting the PE standard was reasonable given 19th- and early 20th-century realities, adopting the arm's-length principle was a mistake from the beginning because it was always clear that finding unrelated comparables would be difficult, and because an alternative already existed in the form of formulary apportionment, which Carroll was familiar with and explicitly rejected.

U.S. States Sales-Based Formulas

Since the early 20th century, U.S. states have applied corporate taxes on a unitary basis by disregarding the distinction among the constituent parts of an MNE and dividing the total profit among states by using a formula — that is, formulary apportionment. The original formulas included three factors — tangible assets, payroll, and sales. The MNE's profit was multiplied by the average of in-state assets, payroll, and sales over worldwide assets, payroll, and sales, with the result subject to tax in each state.

The 1964 Willis Commission report said that as of 1929, 10 of the 17 states with corporate income taxes used a sales factor. Thus, it was clear from the beginning that for state tax purposes,

[3] Mitchell B. Carroll, *Taxation of Foreign and National Enterprises, Volume IV: Methods of Allocating Taxable Income* (1936). The arm's-length standard first appears in Article IV of the France-U.S. treaty of 1932 and then in the 1935 regulations under IRC section 45 (the predecessor of section 482, enacted in 1928 with no reference to arm's length), whose stated purpose was to place controlled and uncontrolled taxpayers on a tax parity by determining, according to the uncontrolled taxpayer's standard, "the true net income from the property and business of a controlled taxpayer. . . . The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Both the treaty and regulations were issued when Carroll worked at Treasury.

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profit is earned not just in the origin jurisdiction but also in the destination jurisdiction.

In *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978), the U.S. Supreme Court upheld Iowa's single-factor sales formula as constitutional. The advantage of single-factor sales formulas is that they tax imports and exclude exports, like a destination-based VAT, although the tax is applied only to net profits. As of August, 24 states (plus the District of Columbia) used single-factor sales formulas — the majority of the 44 states with a corporate income tax.

Thus, formulary apportionment based on destination has a long history among U.S. states. Many U.S. states also apply a throwback rule, under which sales into a state that does not have a corporate income tax are thrown back into the profits allocated by the formula to the states that do have corporate income taxes.

Importantly, however, even though the U.S. Supreme Court has upheld the constitutionality of formulary apportionment as applied to the worldwide income of both U.S.- and foreign-based MNEs, political pressure from the federal government has led states to apply formulary apportionment only to the water's edge — that is, within the United States — and follow the arm's-length principle as applied by the IRS to foreign (non-U.S.) income. That has led to significant undertaxation because the arm's-length principle is broken.

Criticism of PEs and the Arm's-Length Principle

Even before the invention of the internet, critics suggested that the PE and arm's-length standards were obsolete in the late 20th century. The PE concept was obsolete because it was possible for MNEs to sell a lot of goods and services into a market jurisdiction without having a PE. The arm's-length principle was unworkable because by the early 1990s it was well established that comparables could not be found for most transfer pricing cases, and in the absence of comparables, it was impossible to decide what unrelated parties would have done at arm's length.

For example, various authors in the 1980s and early 1990s advocated getting rid of PEs and the arm's-length principle.[4] Based on those critiques, in 1993 I proposed getting rid of both PEs and the arm's-length principle and taxing all multinationals using a single-factor sales formula with a numerical threshold to avoid tax on isolated sales.[5]

One important aspect of those critiques of PEs and the arm's-length principle was the response to tax competition by origin countries to attract foreign direct investment. Because of tax competition, those countries frequently would not tax MNEs on their profits, and neither would residence jurisdictions because of competition for headquarters. The only country that was not subject to tax competition was the destination country because the consumer base was not movable, but the PE threshold limited the ability of those countries to tax MNEs on business profits. The combination of tax competition and the PE threshold meant that many MNEs were not subject to significant taxes anywhere even before digitization.

The Digital Economy

The rise of the digital economy exacerbated the PE and arm's-length principle problems by making it easier to earn profits in a destination jurisdiction without a PE and shift those profits to low-tax jurisdictions. The U.S. Treasury Department published a white paper in 1995 that recommended pure residence-based taxation of enterprises engaged in electronic commerce. Because all those MNEs were U.S.-based and the result would be a major shift in revenue to the United States, unsurprisingly, the rest of the world rejected the proposal.

However, there was no consensus on the alternative. Instead, destination countries gradually eroded the PE threshold by, for example, inventing services PEs and treating subsidiaries as dependent agent PEs. The OECD insisted that both PEs and the arm's-length principle must remain international norms, and it

[4] Arvid Skaar, *Permanent Establishment* (1991); Stanley Langbein, "The Unitary Method and the Myth of Arm's Length," *Tax Notes*, Feb. 17, 1986, p. 625; Sol Picciotto, *International Business Taxation* (1992).

[5] Avi-Yonah, "Slicing the Shadow," *supra* note 1.

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amended article 7 of its model treaty to emphasize that the arm's-length principle applied to PEs (the authorized OECD approach). Most countries rejected those changes, so for the first time, actual tax treaties were more similar to the U.N. model (which was more flexible on allocating profits to PEs by formulas) than the OECD model.

BEPS and Pillar 1

The financial crisis of 2008-2010 and the Great Recession that ensued put a lot of pressure on governments to find more revenue. At the same time, hearings in the U.S. Senate and U.K. Parliament revealed how little tax was being paid to destination countries (defined broadly to include the location of both consumers and users) by Big Tech (Apple, Amazon, Facebook, Google, Netflix). Big Tech could earn billions in destination countries without having a PE, and the arm's-length principle and tax competition to attract FDI enabled those companies to shift profits to low- or no-tax jurisdictions.

The immediate result was the unilateral adoption by various destination countries (beginning with the United Kingdom, India, and Australia) of gross-based DSTs (and similar taxes) that were not income taxes and therefore not subject to the PE and arm's-length principle limitations of the treaty network. Moreover, various critics began proposing alternatives, such as the destination-based cash flow tax and the taxation of residual profits in the destination jurisdiction.

The United States reacted to the DSTs by threatening trade sanctions, and the OECD was concerned that it would lose control of the international tax regime. The result was BEPS 1.0 (2013-2015), which was driven primarily by the EU. BEPS 1.0 adopted many useful action steps but refused to abandon either the PE threshold or the arm's-length principle. Further, U.S. opposition meant that no consensus could be reached on action 1 to address the challenges of the digital economy.

The 2017 U.S. tax reform that included significant residence and source-based taxes on U.S.-based multinationals in accordance with BEPS 1.0 broke the impasse. In BEPS 2.0 (2018-present), the OECD finally signaled that it was ready to partially abandon both the PE and arm's-length principle limitations.

Pillar 1 of BEPS 2.0 applies to MNEs with global turnover above €20 billion and profitability above 10 percent (excluding those in the extractive and financial industries). Profits of in-scope MNEs will be determined based on financial accounting income. For in-scope MNEs, 25 percent of amount A (defined as residual profit exceeding 10 percent of revenue) will be allocated to destination countries where the MNE has sales of at least €1 million (€250,000 for countries with GDP below €40 billion). Revenue from sales will be sourced to the end-market jurisdictions where goods or services are used or consumed. Importantly, neither the PE threshold nor the arm's-length principle will apply to amount A.

Other than the limitation to 25 percent of profits and its application only to residual profits, the OECD solution is very similar to U.S. state formulary apportionment. It also builds on previous reform suggestions by, for example, the Oxford-based lawyers and economists that developed the destination-based cash flow tax and a 2009 proposal to tax residuals in destination jurisdictions.[6]

Unilateral Formulary Apportionment?

The prospects of pillar 1 succeeding are not good for three reasons. First, because pillar 1 must eliminate both the PE threshold and the arm's-length principle for amount A, it requires a multilateral tax convention, and that is hard, as many failed efforts from the days of the League of Nations attest.

Second, even if a multilateral tax convention is ratified by enough countries to come into effect, it is highly unlikely to be ratified by the United States, and U.S. participation is essential because most of amount A will be paid by U.S.-based Big Tech MNEs. Third, pillar 1 requires the abolition of all DSTs, but more than 30 countries have them and they are politically popular, so abandoning them will be difficult.

The U.N. has proposed imposing withholding taxes on payments for digital services, but that

[6]Alan Auerbach et al., "Destination-Based Cash Flow Taxation," Oxford University Centre for Business Taxation WP 17/01 (Jan. 2017); and Avi-Yonah, Clausing, and Durst, *supra* note 2.

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idea is inherently limited because like DSTs, withholding taxes are gross-based; would not be includable in U.S. treaties; and would not apply to users of, for example, Facebook or Google because those services are free (and advertisers can be in third countries not subject to the treaty).

A more promising approach is unilateral adoption of pillar 1 (or at least amount A). After all, pillar 1 was already accepted in principle by 141 countries, so unilateral adoption would not violate international norms. That way forward was shown by an Indian proposal (before pillar 1 was agreed to) to tax MNEs operating in India on a portion of their profits derived from sales into India without regard to the PE and arm's-length principle limitations.

India proposed a fractional apportionment method, based on profits derived from India. It differs from formulary apportionment because it limits itself to India-related information; it does not require consolidating profits from all tax jurisdictions. The proposed method relies primarily on information regarding Indian operations and adopts a three-factor formula that gives equal weight to sales, employees (staff and wages), and tangible assets. It suggests a formula for calculating the profits derived from India, which relies on the nonresident's revenue derived from India and its global operational profit margin. The proposal also offers a solution to tax the digital economy: allowing user participation to count as the fourth factor in the fractional apportionment method; the relative weight of the user participation may range from 10 to 20 percent, depending on the user intensity of the business enterprise concerned. The proposal does not rely on either the PE limit or the arm's-length principle.

For countries like the United States, the United Kingdom, and Australia that can override treaties unilaterally, the Indian proposal offers a way to implement pillar 1 without requiring a multilateral tax convention. Those kinds of unilateral actions to allocate profits to destination jurisdictions are an appropriate response to digitization and tax competition. It preserves both openness to FDI and the ability of sovereign countries to impose taxes on MNEs deriving billions of profits from their markets and benefiting from the education, infrastructure, and rule of law those countries provide. For countries that cannot override treaties, it must be hoped that such unilateral adoption would induce them to ratify the OECD multilateral tax convention even without U.S. participation, and that the United States would grant foreign tax credits for the taxes imposed by those countries. After all, as the four economists wrote a century ago, it is hard to deny the justice behind a destination country's claim to some of the tax revenue resulting from selling goods or services to its residents. ■

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