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THE FEASIBILITY OF THE APPLICATION OF THE ARM'S LENGTH PRINCIPLE IN TRANSFER PRICING

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Abstract: *The aim of the research paper is to analyse the feasibility of applying the arm's length principle (ALP) in the international sphere. ALP is a concept introduced by OECD for intra-firm trade especially in cross-border transactions. In the pursuit of profit maximisation, multinational enterprises engage in the process of profit-shifting to low tax-based jurisdictions and this involves the manipulation of prices which they charge to affiliated companies situated in other countries. Therefore, the ALP is being used as a tool to avoid harmful transfer pricing practices. This paper will demonstrate the extent to which a complete harmonization of the ALP across the globe is unattainable. The methodology adopted for the study comprises of the black letter approach for the purpose of illustrating the ALP and the OECD guidelines on the application of the principle. Thereafter, a comparative analysis is carried out to demonstrate the United States (US) divergence to the ALP further to the development of their own transfer pricing rules. This research paper sets out the main reasons behind some countries divergence to the ALP as brought forward by OECD, especially the lack of binding force of law of the OECD guidelines on OECD member countries, the theoretical shortcomings of the ALP and the bias of some governments about multinationals being tax evaders. The paper concludes that a complete harmonisation of transfer pricing rules including the ALP is almost impossible to attain and portrays the US preference for profit-split methods which resembles the formulary apportionment method over traditional transactional methods.*

Keywords: Transfer Pricing, Arm's Length Principle, OECD ALP, United States
Research Area: International Trade
Paper Type: Research Paper

1. INTRODUCTION

Wahl (2005) argues that international taxes are necessary because globalisation leads to an erosion of national tax systems. In the light of the statement, it has been witnessed that investors or multinational enterprises (MNEs) exploit loopholes in the domestic tax system of a particular country to save tax liabilities on their net worldwide income on a large scale. Indeed, MNEs aim to achieve greater efficiency and profit maximisation by establishing subsidiaries in low-tax jurisdictions other than the parent corporation, and thereby allocating income and providing for high deductions to the respective subsidiaries. The practice of re-allocating profits and expenditures is known as the concept of "transfer pricing" which consequently results in income derived by each enterprise being disproportionate to their relative economic contributions and thus impacting on the relevant tax jurisdictions' fair share of tax.

Two main underlying principles of transfer pricing involve the computation of profits of the different units on the basis of separate accounts for entities within the same group structure (the separate entity approach) and the fixing of prices of goods and services for intra-group transactions at arm's length being prices charged among independent persons. The arm's length principle was put forward by Vincent (2005) as a tool to maintain a level playing field with respect to the use of a branch or a subsidiary to carry on business in a given jurisdiction.

While there is no global body to impose taxes on international transactions, countries have to rely on their own systems of domestic taxation to address international elements, and this involves relying on two main sources of international tax law, that is, the domestic tax legislations and the law of treaties concluded with other nations. The Organisation for Economic Co-operation and Development (OECD) has put forward a common approach in respect of the application of the arm's length principle (ALP) which governs the tax treatment of transfer prices. However, differences in the domestic tax system of each country make it difficult to harmonise the application of the ALP approach worldwide. Part I of this research paper provides a brief history behind transfer pricing and the emergence of OECD ALP and aims to provide an overview of the types of acceptable methods to calculate an ALP transfer price. Part II explores the various obstacles encountered with the application of the ALP and the main reasons for the divergence by various countries. Part III and IV portray the approaches to the ALP as adopted by the United States (US) and discuss the feasibility of the ALP in today's world. Part V finally concludes the research by advancing that a complete harmonisation of the ALP approach put forward by OECD is not possible to achieve.

2. HISTORY OF TRANSFER PRICING AND THE ALP

The majority of MNEs are profit-making global entities that share common resources and overheads.[1] While the most obvious objective behind transfer pricing is to reduce MNEs' worldwide taxation as a group, countries across the globe have been engaged in policy formulation and framework for over 70 years to combat transfer pricing issues since such practices impact on the tax base of the other country who is suffering from a loss in tax revenues. Initially, tax treaties and domestic legislations provided for the concept of permanent establishments to the effect that non-residents have to pay their fair share of tax in countries where they carried out business through a fixed basis. Thereafter, some other situations were contemplated such as carrying out business through dependent agents or operating companies without any physical presence.

Back in 1930, the League of Nations established a fiscal committee to investigate the practices and legislations of around 35 countries in relation to the allocation of income to local establishments of foreign entities. Carroll (1933) reported a divergence on the accounting methods of allocating profits to the local establishments with the most common approach being presumptive taxation. This method considers whether the income declared is correct based on an estimation of income of similar enterprises in the respective country.

[1] For instance, according to Daily Records (2018), the top 10 multinational companies in the world consist of: Microsoft, FedEx, Kimberly Clark, Walmart, State Grid, Sinopec Group, China National Petroleum and Toyota.

Another approach which was found by the investigation was the formulary apportionment, whereby income is calculated on the basis of the total income of the group as a whole by applying a formula comprising of assets, turnover, payroll amongst others and allocating the respective profits to a particular tax jurisdiction in which the group has a presence. The fiscal committee of the League of Nations thereafter drafted a multilateral agreement on the allocation of business profits on the basis of the independent enterprise's principle which was synonymous to the ALP approach. In 1956, the OECD took over the work of the League of Nations pursued by the fiscal committee and the OECD issued a report that provided for a draft article on the allocation of profits to permanent establishments and related enterprises. This was later replicated in Articles 7 and 9 respectively of the OECD Model Tax Convention of 1963 (hereinafter referred to as the "Convention"). It is apposite to note that the presumptive taxation method was not included in the Convention at the drafting stage, while the formulary apportionment was incorporated in the draft Convention which was later rejected as a method of profit split by both the OECD Transfer Pricing Report of 1979 and OECD Transfer Pricing Guidelines of 1995, but this has been later incorporated in the OECD Transfer Pricing Guidelines of 2010.[2]

3. THE OECD GUIDELINES

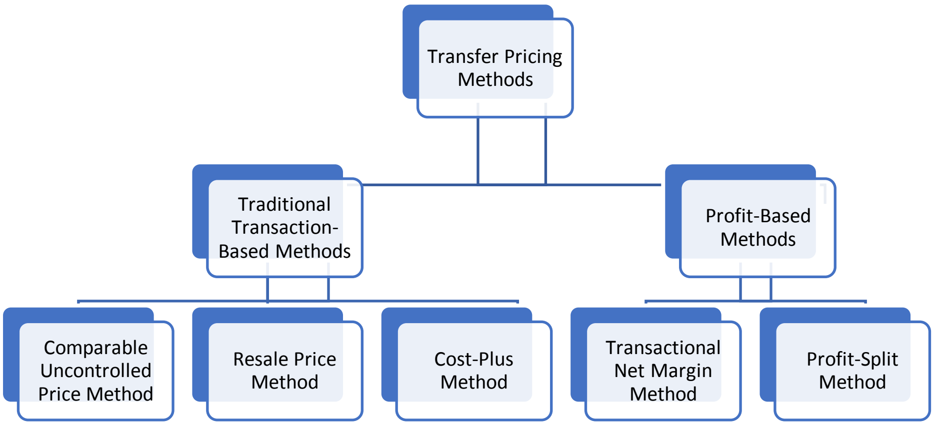
The ALP paved its way to Article 7 which relate to business profits and Article 9 on associated enterprises with respect to the attribution of profits in a separate and independent manner. The OECD has issued transfer pricing guidelines for MNEs and tax administrators in 1979 (hereinafter referred to as the guidelines) which provides extensive and detailed guidance on transfer pricing issues. The guidelines are being continuously updated to address the increasing challenges and threats posed by the globalised economy. The guidelines are also intended to help tax administrators and MNEs to find mutually agreed satisfactory solutions to transfer pricing cases and thereby minimizing conflicts and avoiding costly litigation. The guidelines discuss certain methods and approaches to evaluating ALP and provides an analysis of the practical implementation of such methods. Eden (2000) argues that the OECD guidelines constitute the international transfer pricing regime which forms part of the international tax regime and that both OECD and non-OECD members are adopting the ALP approach through reports, recommendations and principles put forward by the guidelines.

Over the years, the guidelines have been supplemented by numerous reports to facilitate the transfer pricing framework such as the report on the intangible property, on cost contribution agreements, on monitoring procedures, advance pricing agreements amongst others. The guidelines were then updated in 2010 to provide for an additional part on administration approaches to avoiding and resolving transfer pricing disputes and amending the foreword, preface, glossary and annexures. Nevertheless, the ALP was still embedded in the guidelines, but an emphasis was made to avoid the bias opinion that affiliated enterprises

[2] Some countries such as the UK and Australia have incorporated the provisions of the OECD transfer pricing guidelines in their domestic laws. Others have simply referred to these guidelines in their laws such as South Africa. It can be said that the OECD Guidelines play a persuasive role and non-OECD member countries such as Turkey applies these guidelines in international transfer pricing scenarios.

manipulate prices. In addition, the amended guidelines have recommended the selection of the most appropriate transfer pricing method depending on the circumstances of the case rather than relying on the hierarchy of methods practice. In this light, the 2010 OECD guidelines have put forward five methods for evaluating the arm's length price for dealings between related parties, as explained hereunder.

The guidelines have categorised the five methods into the traditional transactional methods and the transactional profit methods as follows:



The traditional transactional method comprises of the comparable uncontrolled price (CUP) method, the resale price method (RPM) and the cost-plus method. The CUP approach compares the price charged to an affiliated enterprise as opposed to an independent party. It takes into consideration the market value in an uncontrolled transaction to establish an internal comparison of prices imposed in the same transaction under similar circumstances. The difficulty with this approach is the problem of identifying comparable transactions, for instance, the products involved may not be similar in nature or quality.

There is also the currency problem which fluctuates over time and thereby manipulating the accuracy of this method. The RPM method determined the market price by the resale price of the products or services to independent parties less distribution costs and a profit rate in order to arrive at the gross margin. This method compares the price at which a product has been bought from an affiliated and that is resold to an unaffiliated party. The gross margin of the controlled transaction is then compared with the gross margin of the uncontrolled transaction to see if the first transaction is covering its selling and operating costs as well as an appropriate profit. The cost-plus method determines the arm's length price by adding an appropriate cost plus mark-up to the purchase price of a product in order to reach an appropriate profit in terms of operating and market conditions and then compare the same price charged in affiliated or controlled transactions.

However, it may be difficult to determine mark-up cost to be added since transactions with independent persons and those amongst affiliated enterprises may differ in terms of the level and types of expenses and the risks exposed to. As a supplement to or as an alternative to the traditional transactional methods, the OECD has provided two additional methods based on the profit model. The profit-split approach determines the arm's length amount of profits by dividing the combined profits of a multilateral group between each associated enterprises within the group, which in turn reflects the enterprise's economic contribution to the group as a whole. The net margin method calculated the arm's length profits using a range of financial ratios such as return on assets, operating income to sales revenue and other net profit measures. The method compares the net profit achieved in a related party transaction against that in a transaction between independent persons. Each of the pricing methods is tailor-made for specific situations, the guidelines make it clear that the method should be applied depending on the facts and circumstances of each case.

4. THE LEGAL EFFECT OF ALP AND OBSTACLES TO THE HARMONISATION OF THE ALP

Calderon (2007) points out that the OECD guidelines are intended to harmonise the application of the ALP by member states. In this respect, it is opposite to reference the two main methods through which countries incorporate the OECD principles in their own domestic legislative framework. One form of integration is by enacting new laws or amending existing laws to shape the domestic legislation to include the ALP on the basis of Article 9 of the OECD Model Tax Convention.

Alternatively, some countries have been concluding tax treaties with other states that follow the ALP approach set out in the same Article 9 of the OECD convention. Gevoian (2013) argues that there is a third way to incorporate the OECD guidelines that is, through the intensive use of administrative and judicial authorities of the OECD by a country as a matter of practice. Countries such as the Netherlands have been able to incorporate the ALP in the national laws in identical terms as provided for in the OECD tax convention. However, although the guidelines are considered to be of an international regulation nature, the way the guidelines have been drafted in a very flexible manner which gives rise to a wider interpretation of the ALP thereby allowing countries to adopt their own national and customized policies when designing an ALP policy framework which in turn create divergences on the application of the ALP.

4.1 The Binding Effect of The OECD ALP

This part of the research analyses the extent to which the ALP is applicable in the absence of incorporation of the OECD principles in a country's domestic laws or inclusion of same in tax treaties, which leads us to the concept of international customary law. D'Amato (1971) sets out the basic principles underlying international customary law, comprising of both quantitative and qualitative aspects. In short, the quantitative requirement provides that practice or norm is considered to be an international custom if it is adopted by a large number of countries, whereas the qualitative approach requires the adoption of a practice arising from a legal obligation to do so instead of social, moral or political obligations. Further to the vast network of bilateral tax treaties concluded worldwide, many scholars tend to argue that the ALP satisfies the quantitative requirement of a customary international law rule ((Avi-Yonah, 2007) and (McLure, 1986)). However, classifying the ALP as a customary international law rule would imply that international transfer pricing rules are also binding on countries even in the absence of treaties which is inconsistent with the idea of concluding bilateral tax treaties between states.

Lepard (1999) argues that by entering into a bilateral tax treaty, a country is demonstrating to the world that it wants to delimit the application of the ALP in transfer pricing by restricting such practice only with states with whom a treaty has been voluntarily negotiated. In other words, if countries were feeling obliged to adopt the OECD ALP, they would have adopted a multilateral approach instead of negotiating with other states on a one to one basis. This argument is further reinforced further to the unwillingness of countries to be bound by a multilateral framework on ALP when the League of Nations first identified transfer pricing issues back in 1930 and when the OECD recommended the adoption of a multilateral agreement in later years. Further to the analysis, it is not clear cut to conclude that the ALP is legally binding as a customary international law rule in the absence of inclusion of the principle in domestic law and in treaties. Nevertheless, Timms (2013) points out that the ALP is a persuasive standard when deciding on the ways to allocate income in cross-border transactions within a group.

4.2 Harmonisation of The ALP

The ALP has often been criticised for failing to consider the economic interdependence between related enterprises, which in other words imply that the ALP fails to consider the economic reality of MNEs as separate entities. The ALP, therefore, distorts the end resulting profits of the group as a whole since factors such as economies of scale and other benefits of integration enjoyed by large organisations are not taken into account.

The shortcoming of the ALP through the use of Comparable Uncontrolled Price method has been demonstrated in the case of *GlaxoSmithKline Inc. v. The Queen 2012 DTC 5147*, whereby the Glaxo subsidiary in Canada purchased a pharmaceutical product called Ranitidine from another Glaxo subsidiary in Switzerland for the purpose of producing pills and marketing the same under the brand name of Zantac owned by the Glaxo parent company. The tax authorities in Canada sued the Canadian subsidiary for paying high prices that were unreasonable as compared to prices charges by other Canadian companies to their non-affiliated suppliers. However, the Supreme Court ruled in favour of the Canadian subsidiary by taking into account several factors that support the reasonableness of transfer pricing. The court advanced that reasonableness is relative and one must compare the amount paid by the entity to its affiliate to that which would have been reasonable had the parties been dealing at arm's length in similar economic circumstances, such as a consideration of the agreements between the parties outside the transaction of the purchase of Ranitidine itself.

Justice Rothstein further stated that an arm's length comparator is only useful if economically-relevant characteristics are sufficiently comparable. In the case, both the Zantac trademark and the patent for the active ingredient were owned by the parent company, and the Canadian subsidiary entered into two contracts, the first one with the parent for granting the right to manufacture and sell products by using Ranitidine and to use the Zantac trademark as well, and the second agreement was a supply contract with the Switzerland subsidiary under which the Canadian subsidiary was given the right to purchase Ranitidine and to fix its price. The Supreme Court concluded that it was because of the licence agreement between Glaxo parent and Glaxo Canada that the latter was purchasing ranitidine from the parent's preferred source being the Switzerland subsidiary. Without the licence, Glaxo Canada would not have been able to manufacture, market or distribute the pills made from the Ranitidine.

It is because of the aforementioned factors that the Supreme Court concluded that the high price charged was reasonable as compared to other generic peers, and pointed out that the objective behind the determination of an arm's length price is to consider everything that the taxpayer would pay for the property and rights and benefits altogether where such rights and benefits are linked to the price paid for the property. The case illustrates that the circumstances in which the company is transacting have an impact over the fixing of prices, and this could as well mean that some other factors such as market power and competitive information advantages of the group as a whole can be considered when determining the arm's length price, a scenario which is different for comparable transactions between unrelated parties. In short, comparable arm's length profits may simply not exist.

In addition, some commentators argue that the ALP put forward by the OECD restrict government's ability to tax MNEs properly. The UK Select Committee on Economic Affairs (2013) advanced that if the principle was a general one, then the system would be a more flexible one through the interpretation of case laws, which would have brought forward the appropriate profit apportionment method. The aforesaid committee has also accused the OECD guidelines to be complex and inappropriate, which can be considered as one of the reasons for countries to diverge from the OECD ALP practice.

Furthermore, another obstacle to harmonisation of the ALP is the desire by governments to combat tax base erosion from profit shifting, and in this attempt, governments engage in bilateral agreements or double taxation avoidance agreements or involve in other kinds of endeavours that provide for a distinct basis of fixing the arm's length price. In order to achieve a fair return from MNEs, governments have continued to apply the OECD guidelines but in a flexible manner, which implies that arm's length results will continue to be arrived at by using methods in ways that diverge from the Guidelines. Consequently, harmonisation of transfer pricing rules across the globe is difficult to attain.

4.3 Divergences to the OECD ALP

The theoretical shortcomings of the ALP and government's desire to avoid losses of tax revenues due to transfer pricing malpractices have prompted countries to diverge from the OECD transfer pricing regime to adopt other methods of profits allocation, and the United States (U.S) has been amongst such countries.

In the US, transfer pricing legislations give authority to the Internal Revenue Service to apply the best method rule rather than a priority of methods as suggested by OECD transfer pricing guidelines. Transfer pricing rules are provided for under Section 482 of the US Internal Revenue Code which gives the Internal Revenue Service a wide adjustment power to distribute, apportion or allocate gross income, deductions, credits or allowances between or among affiliated to unaffiliated organisations, trades or businesses. The Code itself does not provide the methods to determine ALP, but it is rather the US Code of Federal Regulations that set up the general guidelines for the said Section 482 of the US Internal Revenue Code. The regulations provide for a range of methods which are categorised as per the OECD guidelines into traditional transactional methods and the transactional profit based methods, in order to determine whether related parties are operating at arm's length with each other. It is to be noted that the US has been choosing the most appropriate method on the basis of the facts and circumstances of each case that would be able to provide the most reliable arm's length result, that is referred to as the best method rule.

This practice allows for the use of methods that yields the lowest taxable amount. For instance, if a corporation finds that all the five methods are equally reliable, it will be more tempted to use the best method that would bring lower tax liability for itself. It is, therefore, the onus of the Internal Revenue Service to establish the inappropriateness of the chosen method and to select one that results in higher tax liability. The case of *National Semiconductor Corporation and Consolidated Subsidiaries v. Commissioner of Internal Revenue 1994, Tax Court, 67 TC 2849* considered the Revenue Authority's contention that the taxpayer has not chosen the appropriate comparable pricing data in applying the traditional transactional CUP method, and has instead applied profit-split and net margin methods to establish the arm's length consideration. The court, however, ruled in favour of the application of the CUP method by the taxpayer but nevertheless held that the comparable data did not adequately explain why the taxpayer was making a loss, and consequently ordered for an income adjustment between the group companies. The case shows the wide discretion of the Internal Revenue Service to apply traditional profit methods.

4.4 Discussion: The Divergences to the ALP

Schmalbeck (2013) states that the application of the profit-based methods devolves into an analysis that more closely resembles the formulary apportionment of income between related parties. Formulary apportionment splits profits of a multinational group and allocates the profits amongst the subsidiaries in the respective country where they operate on the basis of a predetermined formula. Formulary apportionment differs from the ALP since the former method treats a MNE as a single entity, whereas the ALP treats each subsidiary in the group as separate entities from each other and from the parent corporation. The OECD has acknowledged the use of formulary apportionment as an alternative to ALP in the report covering the revision of chapters of the transfer pricing guidelines, it has nevertheless been critical on the application of this mechanism. Moreover, the OECD distinguished between formulary apportionment and profit-based methods in that the former divide profits on the basis of a predetermined formula whereas profit-based methods compare on a case by case basis the profits of one or more associated enterprises with the profit experience that comparable independent enterprises would have sought to achieve in comparable circumstances. However, the issue is a lack of comparable data that demonstrate the profits which an independent enterprise would have achieved. For instance, the US case of *National Semiconductor Corporation and Consolidated Subsidiaries v. Commissioner of Internal Revenue 1994, Tax Court, 67 TC 2849* could not carry out profit comparison for this reason. As a result, in practice, profit-based methods are applied without comparable data in which case, the mechanism would then be similar to the formulary apportionment method.

5. CONCLUSION

To conclude, it has been seen that a complete harmonisation of the OECD ALP is unattainable, firstly due to the lack of legal binding force of the OECD guidelines in certain countries which in turn leaves countries free to interpret the domestic arm's length provision in ways that diverge from the ALP. Secondly, the theoretical shortcomings in the ALP such as lack of comparable data have compelled states to prefer profit-based methods over traditional transactional methodologies in situations where the OECD recommend to apply the latter as a first priority. Thirdly, the desire to combat transfer pricing malpractices have led countries to be engaged into various forms of endeavours which may not always be consistent with the ALP such as the conclusion of bilateral tax agreements which may provide some other forms of determining the arm's length consideration. Such obstacles have brought about a divergence from the OECD guidelines and countries like the US have been interpreting and applying the arm's length provision of its domestic legislation in a manner not prescribed by the guidelines. One practical recommendation which could be used to look for a complete harmonisation of the OECD ALP is to improve the reliability of comparables and for this purpose, a steering committee comprised of different stakeholders from various parts of the world like tax authorities, tax consultants, transfer pricing experts, governments have to be put in place.

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